

PREM 19/1163

THE FUTURE AND STRUCTURE OF BRITISH AIRWAYS
AND ITS SUBSIDIARIES.

AEROSPACE.

THE PRICE WATERHOUSE REPORT

Civil Aviation Authority (CAA)
Review

PE 1: March 82

PE 2: March 84

PART 2

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
12.5.84		11.9.84					
14.5.84		12.9.84					
2.6.84		26.9.84					
8.6.84		27.9.84					
15.6.84							
22.6.84							
10.7.84							
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1.8.84							
5.8.84							
24.8.84							

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Material used by
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PART 2 ends:-

Lord King (British Airways)

to SS/Transport

27.9.84

PART 3 begins:-

C (84) 27

1.10.84

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(A) (84) 44	13.7.84
E(A) (84) 19th Meeting, Minute 3	18.7.84
CC(84) 27th Conclusions, Minute 1	19.7.84
CC(84) 28th Conclusions, Minute 1	26.7.84
C(84) 21	30.7.84
LCA to CC(84) 29th Conclusions, Min. 5	2.8.84
C(84) 22	7.9.84

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 Wayland

Date 23 July 2013

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

Civil Aviation Authority

CAP 500: Airline competition policy

Final report, 16 July 1984

Signed Wayland Date 23 July 2013

PREM Records Team

File

British airways

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

Lord King of Wartnaby
Chairman

27th September, 1984

The Rt. Hon. Nicholas Ridley, MP,
Secretary of State for Transport,
Department of Transport,
2 Marsham Street,
London, S.W.1.

Further to my letter of yesterday and subsequent conversations yesterday evening between your Officials and Colin, we agree to change paragraphs (a), (b) and (c) in Attachment 'A' to the following effect.

British Airways will transfer to British Caledonian its licences to Dhahran and Jeddah upon completion in a manner satisfactory to British Airways of the following actions:-

- (a) British Caledonian surrendering and the CAA transferring to British Airways the licences held by British Caledonian to Atlanta, San Juan and Morocco, and to all points in South America.
- (b) CAA awarding British Airways licences to Tampa and Orlando to be effective from the summer of 1985.
- (c) British Airways obtaining agreement from the Department of Transport to operate from Heathrow its services to Barcelona, Lisbon and Madrid - in exchange for the transfer of an equivalent number of British Airways' Mediterranean services to Gatwick but after taking account of the transfers referred to above.
- (d) British Airways to receive all the necessary authorisations from the appropriate governmental and regulatory authorities in the UK and the affected overseas countries.

Obviously the foregoing will take time. However, if we are both to make a success of privatisation within the present financial year, it seems essential that the necessary procedures be completed by no later than 31st December, 1984.

In addition, British Airways understands that the Department of Transport believe that the ECGD insurance sought in paragraph (d) of Attachment 'A' may not be forthcoming automatically. British Airways therefore is willing to rely on the best efforts and support of the Department of Transport and other relevant departments to obtain such insurance.

We would expect British Caledonian to use its best efforts to take over our own local staff in Saudi and we would give similar consideration to their local staff in the areas they give up, it being understood that each party will be responsible for meeting its own share of any severance/redundancy costs incurred.

I reaffirm our desire for an early decision which will enable me to seek the approval of my Board to the entire proposal.

Subject

1

cc MASTER

10 DOWNING STREET

27 September 1984

*From the Private Secretary**Dear Dinah,*CAA REVIEW

Your Secretary of State came to see the Prime Minister at 0915 hours today to discuss progress in formulating the Government's response to the CAA review. He described the package which had emerged from discussions with Lord King. (This was along the lines of Annex A of the note attached to your letter to me of 26 September). He thought Lord King would agree to the proposals provided they included Atlanta. The effect would be to reduce BA's profits by around £20m which would reduce the sale proceeds by £80-100m. Surrender of the Saudi routes implied a loss of 12 flights a week in return for which BA would get initially 10 a week of which 7 were to Atlanta. The routes gained would require more staff to operate and so would enable Lord King to fulfil the pledges on future employment given to BA staff.

There were two remaining obstacles. First, Sir Adam Thomson would only accept the deal if BCal got Atlanta. Secondly, there was still not an adequate response to the needs of the smaller independent airlines, particularly BMA. Mr. Bishop had accepted that, in practice, it would not be feasible to transfer BA's regional routes to it in the face of strong political opposition at those airports. The Department of Transport were working on an idea which would allow airlines currently operating from Heathrow to retain their existing entitlement to flights but with freedom to switch destinations. This would allow BMA to fly some foreign routes in exchange for some of its domestic routes. The routes would be tradeable between airlines. This idea had emerged only recently and required possibly another 2 to 3 weeks work.

The choice was between putting more pressure on Lord King to surrender Atlanta or putting the existing proposals to BCal on a take it or leave it basis. The Prime Minister

said Lord King had moved a long way from his initial position and the benefits to BCal were substantial. She doubted whether more could or should be extracted from BA.

At 0945 hours Lord King and Mr. Marshall joined the meeting. The Prime Minister said she recognised Lord King's efforts in improving the performance of British Airways and also the distance BA had moved in search of a solution. She was anxious, however, to ensure that the Government responded adequately to the position of the independent airlines.

Your Secretary of State explained that Atlanta remained the only item in dispute. Lord King explained why he could not accept a package without Atlanta. Not only would this further reduce BA's profits but it would leave BA with only 3 services in exchange for the 12 surrendered. This would be bound to mean redundancies. Furthermore Atlanta would fit in well with BA's proposed routes to Orlando and Tampa.

Mr. Marshall said BA had negotiated a number of commercial arrangements which would be helpful to BMA, eg interlining and the provision of back-up services.

Lord King said he hoped BCal would accept. If it did not he would regard it as a demonstration that BCal did not wish BA to join it in the private sector.

The discussion then turned to the Laker cases. Mr. Marshall said that there were two aspects to the criminal charges, price fixing and scheduling. He was hopeful that BA would be cleared on the former and even if convicted of the latter would incur a fine of only \$1m. On the civil case, he said American companies were used to claims of this sort. He was hopeful that the Laker liquidator would eventually agree to a settlement but even if he did not he thought BA would be able to insure against damages above a certain level.

Your Secretary of State said the Government hoped to issue a White Paper shortly setting out its response to the CAA in full. Lord King said that British Airways intended to say nothing publicly until it had seen the Government's proposals.

Sir Adam Thomson subsequently telephoned Robin Butler during the early afternoon and said that he had now heard the revised proposals which Lord King had made. He recognised (when Robin Butler pointed it out) that these appeared to move in his direction, but said that the loss of Atlanta was the sticking point. If Lord King dropped this proposal, Sir Adam said that he would recommend the proposals to his Board: if not, he would call an emergency

meeting of his Board and recommend rejection, but his Board was a lively and democratic one and he could not be sure of the view they would take. Sir Adam asked whether Lord King's proposals had been approved: Robin Butler said that they had been reported to the Prime Minister, but it was not so much a question of approval as what Lord King would be induced to accept. Sir Adam acknowledged this point and agreed that an account of this should be given to your Secretary of State before Sir Adam called on him.

I am copying this letter to David Peretz (HM Treasury) and Callum McCarthy (Department of Trade and Industry).

Yours sincerely

Andrew Turnbull

ANDREW TURNBULL

Miss Dinah Nichols,
Department of Transport.

CONFIDENTIAL



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

CR7

Andrew Turnbull Esq
Private Secretary
10 Downing Street
LONDON SW1

26 September 1984

Prime Minister

Lord King's position
at Annex A and Adam
Thomson's at Annex B

Dear Andrew,

PRIME MINISTER'S MEETING WITH LORD KING
THURSDAY, 27 SEPTEMBER

AT
26/9

I enclose a brief setting out the
bones of a possible response to the CAA's
review of airline competition policy which
the Prime Minister will wish to see before
her meeting with Lord King tomorrow.
My Secretary of State is grateful for the
opportunity of a prior discussion at
9.15 am.

Arranged

Yours,

Dinah

MISS D A NICHOLS
Private Secretary

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Outline of possible Government response to
the Civil Aviation Authority's
review of airline competition policy

Objective

1. Our objective is, without postponing the privatisation of British Airways, to settle the issues raised by the Civil Aviation Authority's report (CAP 500) in such a way as to promote a British airline industry both competitive within itself and strong internationally.

2. The key elements of our policies should be
 - (a) to remove barriers to competition in domestic air services;

 - (b) to seek the designation, wherever possible, of two or more British airlines to operate in competition on international routes ("dual designation");

 - (c) to encourage new services, especially by the smaller independent airlines, between regional airports and overseas (especially continental Europe);

 - (d) to strengthen British Caledonian as a credible competitor and potential substitute for BA on overseas routes both long and short-haul;

 - (e) to ensure adequate safeguards against predatory pricing and other anticompetitive practices by any airline;

 - (f) to avoid the need for legislation or for excessive interference with BA's present operations such as would delay privatisation.

Proposals

(a) Domestic air services

3. Here I propose to endorse the CAA's proposals -

(i) that British airlines be enabled to operate scheduled services between any two points in the United Kingdom, other than Heathrow or Gatwick (excluded for capacity reasons) and any others specifically excluded (eg "lifeline" routes, where isolated communities are dependent on a vulnerable air link); and

(ii) to cease regulating domestic air fares (except insofar as is necessary to prevent predatory pricing).

The CAA can implement both these proposals under their present powers.

(b) Dual designation

4. I propose to welcome the CAA's proposals that "additional competition by British airlines on inter-continental routes should be licensed wherever possible" and that it "will seek to increase the range and market penetration of European scheduled services from Gatwick" (that will be operated largely in competition with British Airways' services out of Heathrow); and I shall use my powers as appellate authority, so far as I properly can, to support the CAA in this. I shall also instruct the traffic rights negotiators in my Department to make every effort to secure the right to dual designation from foreign governments.

(c) International services from regional airports

5. The CAA recommended that "BA's European routes from provincial airports should be taken over by other British airlines". This proposal is contested by regional interests

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and a number of our supporters there. And it would require legislation to make BA give up any of their regional air services, which would delay privatisation. BA have now made a counter proposal for modest assistance to other British airlines ready to operate new services between regional airports and the rest of Europe:

(i) to pay any airline licensed by the CAA up to £450,000 over three years ^{per route} as a contribution to their start-up costs in launching international services from the regions either in competition with themselves or on new routes; and

(ii) to provide them with back-up services (booking, ground-handling, timetabling etc) at the six regional airports BA serve, at cost.

BA's offer would be limited to a maximum of 15 new services, at a total cost of £6½m over three years.

6. This offer is well below the expectations of the airlines concerned, but I believe there would be takers. I understand that Mr Michael Bishop is discussing other arrangements with Lord King. I believe it is the most we could expect BA to do, short of legislation.

(d) British Caledonian

7. I have followed up colleagues' suggestion, at the meeting on 11 September, of a route swap between BA and BCal, instead of the route transfers, to which BA were opposed. It has been extremely hard to persuade either airline to contemplate a satisfactory swap (ie one that gives BCal sufficiently enhanced profits, without disruption to BA's operations, on a scale which would threaten privatisation and be unacceptable to Lord King). With the greatest difficulty I have prevailed upon BA to agree to the offer set out in Annex A, which (on BA's figures) would give BCal about £17m-£18m of extra profit while reducing BA's profit by about £20m in the

short run. BCal have not yet accepted this, and I shall tell Sir Adam Thomson that he must either take it or leave it. If he leaves it, I shall either (i) have to award his new licence to fly to Riyadh to BA, because the Saudis will not accept two UK carriers, and implement minor parts of the CAA's recommendations, or (ii) legislate to impose some route transfers.

8. Such a swap would involve costs to the Exchequer:-

(i) BA's loss of expected profits would mean a reduction in proceeds from the sale (if we sell 100% of the shares) of perhaps £80m-£100m;

(ii) BA would incur about £50m of additional capital expenditure this year on aircraft to operate their new routes; and

(iii) as a result of (ii) BA's debt: equity ratio at the time of privatisation would be worsened; and it would therefore be necessary to allow them to retain a greater part of the proceeds of sale.

I believe this to be a defensible compromise between forcing a larger transfer on BA, which would need legislation and doing nothing to strengthen BCal. But it cannot be effected without agreement of both.

(e) Predatory pricing and anti-competitive practices

9. We must have in place effective means of acting against predatory prices and other forms of uncompetitive behaviour, so as to protect the smaller airlines against BA's dominant position. The CAA accept that they can and must act effectively within their present powers. I propose to reject their request for new legislation, which would create unnecessary uncertainties for a successful privatisation of BA.

Specifically

(a) in the charter market, where anxiety is strongest, now, the CAA would undertake to monitor prices, and act to limit capacity if any airline was growing too fast through predatory competition. If the Secretary of State for Trade and Industry agrees, I propose a new back-up role for the Office of Fair Trading (OFT) here;

(b) even after we have freed scheduled domestic services, the CAA would be able to consider charges of predatory behaviour and could if necessary raise unrealistic fares or cut the schedules of any airline found dumping capacity. The OFT already has a back-up role here;

(c) in international services, the CAA can and does consider charges of predation wherever our international agreements allow.

(f) BA privatisation

10. Time is now short if we are to hit the target of privatisation early in 1985. We need very soon to begin positive action with the City to get investors used to an unfamiliar stock. The present uncertainty must first be dispelled. If colleagues can agree at Cabinet on 4 October, and we can announce decisions in a White Paper immediately thereafter I believe that, unless there are unforeseen developments - and subject to the Laker problem, on which I shall be putting advice to colleagues later - we can still meet the timetable.

CAP

26 September 1984

Proposed route swap between

BA and BCal

BA would give up to BCal its routes to Jeddah and Dhahran in Saudi Arabia (12 services a week)

BCal would give up the following route rights to BA:-

- Atlanta (USA) (7 services a week)
- their south Atlantic route - ie Brazil and, when once more available, Buenos Aires and Santiago de Chile (2 services a week)
- their mid-Atlantic route - ie San Juan (Puerto Rico), Caracas (Venezuela) and Bogotá (Columbia) (one service a week)
- Morocco (not at present operated)

BCal would also undertake not to object to BA's applications to the CAA for licences to serve Orlando and Tampa (Florida).

BA would also be allowed to transfer back to Heathrow from Gatwick its services to Madrid, Barcelona and Lisbon, on condition that it ensured (by transfers of other services from Heathrow to Gatwick, as necessary) that the total package did not bring about any increase of movements at Heathrow.

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MR TURNBULL

26 September 1984

CIVIL AVIATION POLICY

PRIME MINISTER'S MEETING WITH LORD KING ON 27 SEPTEMBER

We have just (3.00 pm) seen a late draft of the recommendations which Nicholas Ridley will deliver later today.

They are without doubt an attractive package. We think the Prime Minister should give credit to BA for the flexibility they have shown in putting it together (the package is very largely their creation) and to Mr Ridley for having got BA to see the political need for compromise.

We strongly support Mr Ridley's proposals (a), (b) and (c) - respectively domestic deregulation, dual designation, and the encouragement of new services between UK regional airports and Europe. These are real benefits to airline passengers.

As to proposal (d) - route swapping between BA and BCal - Mr Ridley is quite right to want to tell BCal to take it or leave it. It is a very good deal, which offers BCal at least £15 million of profit on top of the £14 million they expect to make this year.

Proposal (e) - the prevention of anti-competitive practices in the deregulated sector - is necessary and sensible. It will probably need strengthening in presentational terms, and we would prefer power to devolve to the OFT rather than to the CAA.

The Prime Minister could ask Mr Ridley whether he feels in a position to deliver. (For instance, he does not have direct power to instruct route swaps). How is he going to get the CAA on side in implementing a package which falls some way short of the Authority's recommendations?

R.Y.

ROBERT YOUNG

CONFIDENTIAL



Prime Minister (2) *and*
To note X
AM 27/9

Treasury Chambers, Parliament Street, SW1P 3AG

Miss Dinah Nicholls
PS/Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON SW1P 3EB

26 September 1984

MF

Dear Dinah

The Financial Secretary had meetings with most of the top Wall Street banks and brokers during his recent visit to the United States. His discussions included the topic of the privatisation programme generally. British Airways was singled out on several occasions during the course of the meetings and the Financial Secretary thought the Secretary of State might be interested to hear the views that were expressed - even though they are based only on limited discussions on a subject where his was a listening brief.

There was considerable enthusiasm for BA and the impression given was that there was likely to be considerable demand in the US for BA equity provided there was sufficient education and communication prior to the sale. There was a very general feeling that the Spring of 1985 would be a good time for approaching the US market.

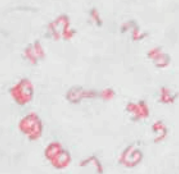
A further point which the Financial Secretary noted was the absence of any reference at any point to the "Laker" anti-trust suits. This issue appears to be having no perceptible impact on the US appetite for BA.

I am copying this letter to Andrew Turnbull, David Peretz (Chancellor of the Exchequer) and Callum McCarthy, (Secretary of State for Trade and Industry).

Yours sincerely
F P Bogan

MISS F P BOGAN
Assistant Private
Secretary

27 SEP 1994



**British
airways**

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

Lord King of Wartnaby
Chairman

26th September, 1984

The Rt. Hon. Michael Alison,
Parliamentary Private Secretary,
10 Downing Street,
London, S.W.1.

Dear Michael

As you know I am seeing the Prime Minister tomorrow morning at 9.45a.m. Obviously the Department of Transport will have kept the Prime Minister fully briefed. Nevertheless I am sending you a copy of my letter of today's date to Nicholas Ridley in case you feel it necessary to show the letter to her.

*Yours sincerely
Peter*

British airways

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

Lord King of Wartnaby
Chairman

CONFIDENTIAL

The Rt Hon Nicholas Ridley MP
Secretary of State for Transport
2 Marsham Street
London SW1

26 September 1984

Dear Nicholas

I think that we have now between us explored all avenues and examined every plan that can be produced to find a satisfactory settlement on the future of Airline Competition Policy.

The objective throughout our discussions has been to find a solution which allows further competition within British Civil Aviation, helps British Caledonian compete with us on more routes, and helps the healthy growth of the smaller British independent airlines. We have been at pains to honour the commitments that were made to our staff and to ensure that the privatisation programme proceeds on time.

BA Position on BCAL

Following the meeting on Monday evening, 24th September between your officials, led by David Holmes, and Colin Marshall and Gordon Dunlop, I am writing to confirm a package of route exchanges which I can recommend to my Board.

This route exchange which is set out on Attachment 'A' should be read in conjunction with this letter and represents the minimum we could accept from BCAL in return for our licences to Saudi Arabia. We would give up 12 departures per week from London and would receive 9 per week in return.

The adverse effects on BA will be to reduce current annualised pre-tax profits by around £20m and the corresponding effect on BCAL, we estimate, is to increase their profits by £17m. We will require to spend about £50m on additional equipment but we estimate BCAL will not require any more equipment.

If my Board agree to this, the benefit to BCAL, whose current pre-tax profits are estimated to be around £10m, will be substantial - at the expense of BA, and therefore its owners.

BA Position on the Rest

We are in the course of reaching a commercial agreement with BMA. We believe your fears about "predatory pricing" in the charter market are unfounded. This was accepted by Thomson/Britannia during a recent discussion with their Chief Executive. We believe there is already adequate machinery in the CAA and in the Office of Fair Trading to regulate such practices; added to which we have no intention of indulging in practices that could be seen to be "predatory" or embarrassing to the Government. As regards the other independents, our previous offer of financial help remains available to enable them to start up new or competing routes to Europe out of any of our UK regional airports at the rate of £450,000 per route spread over the first three years, with an overall maximum of £6.75m.

CONCLUSION

I would appreciate your early decision for two reasons. Firstly, I must obtain the agreement of my Board to these proposals. Secondly, any further delay is now certain to impede the progress that is being made towards an early and successful privatisation.

In Attachment 'B' to this letter I have referred to the more important of the exchanges that have led us to the present proposals, which have, of course, been formulated upon the initiatives of your Department and in response to your desire to resolve the issues raised by CAP 500.

I am sending copies of this letter to Nigel Lawson and Norman Tebbit in view of their personal involvement, which I hope is in order.

John King

John King

ROUTE EXCHANGE

HMG to arrange for:-

- (a) British Airways' existing licences to Dhahran and Jeddah to be exchanged for British Caledonian's licences to Atlanta, San Juan, all points in South America and Morocco, together with all necessary authorisations being obtained.
- (b) BA's existing services from Gatwick to Barcelona, Lisbon and Madrid to be able to be operated from Heathrow in exchange for the transfer of an equivalent number of BA Mediterranean services from Heathrow to Gatwick but after taking account of the transfers referred to in (a) above.
- (c) BA to be granted licences and all necessary authorisations to operate to Orlando and Tampa from Summer 1985.
- (d) Export Credits Guarantee Department to make available to BA insurance against the remittability risk of local funds to the UK, which are generated by BA in countries in South America, as a result of BA serving the points there. BA understand this cover is, in principle, available from ECGD.
- (e) DoT to give the necessary consents to the purchase or lease of the additional equipment which BA will require for certain of these routes.

Other matters:

Other matters which the BA Board believe must be dealt with under these arrangements are as follows:

- (a) DoT will reject recommendations (2) (4) (5) (6) and (9) in the CAP 500 dated July 1984. In the case of recommendation (1) it is necessary to reject the recommendation that "There should be some reduction in the relative size of British Airways so that other airlines have adequate opportunity to develop and prosper including at least one airline fit to replace British Airways on any major intercontinental route should the need arise." BA accepts that "Additional competition by British airlines on intercontinental routes should be licensed wherever possible". In the case of recommendation (3) it is necessary to reject the words under paragraph 56(a) "even at the price of some reduction in the frequency, capacity and market share of British Airways' corresponding services from Heathrow" and to reject all of paragraph 56(b).

l.

Recommendation (8) can be accepted provided the words "...if necessary by reducing British Airways' frequencies" are deleted. Additionally the recommendation under (8) to reduce British Airways' frequencies is inconsistent with recommendation (7) to increase available capacity at Heathrow and Gatwick, which British Airways supports very strongly.

- (b) HMG will recognise that the price of BA, when privatised, is bound to be less than it otherwise would have been, and its debt similarly may be greater. The consequences of these features must be for the account of HMG.
- (c) In view of all the recent publicity given to route transfers, it will be necessary for HMG to give assurances in the prospectus that BA will be given fair treatment by the CAA on future route applications, and that HMG will not increase the powers of the CAA nor change its own policy in relation to route licencing.

K.

BACKGROUND

A. BA's Dual Designation Plan

BA has worked on a wide range of alternative schemes since the CAA recommendations were announced in July. BA put proposals to the DoT 23rd August for BCAL to be dual designated from Gatwick on a number of overseas routes, which BA currently operate out of Heathrow. This proposal was discussed and varied considerably at the request of DoT officials, however BA understand it is not acceptable either to the Secretary of State or to BCAL. This scheme would have increased competition and given consumers greater genuine choice on a number of routes. BA believed BCAL would have been able to earn about £5m in the first year of dual designation and between £10/12m in a mature year. Moreover BA's proposals included providing BCAL with a considerable amount of financial help and support in order to get such operations going.

B. Subsequent main meetings between BA and DoT1. 29 August

DoT stated it wished to limit the adverse effect on BA's profits to £10m per annum as a result of route changes involving BCAL and others.

2. 5 September

DoT tabled 5 alternatives of which 3 were transfers, one was dual designation as proposed by BA, and the last was to do nothing.

3. 18 September

DoT proposed two major exchanges between BA and BCAL, one of which included the transfer of BA's existing Saudi operations to BCAL.

4. 22 September

BA informed DoT of the consequential effects on BA. BA were then told that DoT required an enhanced swop package that would give BCAL an initial benefit in pre tax profits of about £15 million per annum.

5. 24 September

DoT informed BA that it believed BCAL would not be prepared to give up any U.S. points, but after some discussion it was agreed that it was reasonable for BA to have one, namely Atlanta. The package in Attachment 'A' includes only Atlanta and represents the absolute minimum which BA is prepared to accept.

(A)

Lord King's position

Andrew Turnbull

LORD KING'S MEETING WITH THE PRIME MINISTER -
THURSDAY 27TH SEPTEMBER

Cecil Parkinson asked me to relay the following message to the Prime Minister, having spoken himself, privately, to Lord King:-

1. Lord King is coming in as a supporter of the Prime Minister and sorry about any embarrassment he might have caused over stories in the press about his resignation.
2. Cecil Parkinson told him that he could not possibly expect the Cabinet to sacrifice Nicholas Ridley.
3. Lord King is therefore in a constructive frame of mind, prepared to make an offer which is broadly:
for BA to give up its Saudi Arabia operation and to take over from BCal loss-making operations which BA believes it can turn round into profit. Apparently the net profit transfer from BA would be £17-£20 million.

For obvious reasons Cecil Parkinson would not want the Prime Minister to let Lord King know that he has spoken to me about this.

SS

26.9.84

STEPHEN SHERBOURNE

B
Adam Thomson's
position

(B)

PRIME MINISTER

Sir Adam Thomson asked me to go and see him today. His Managing Director was at the same time seeing officials in the Department of Transport.

Sir Adam said that he wanted you to know how unhappy he was with the proposals being put to him by the Secretary of State as the best that were acceptable to Lord King. Sir Adam said that he could not give up some of his North American routes, ^(except St. Louis) since the North American business was inter-dependent. He would be content to give up the mid-Atlantic routes, and also be willing to throw in the South American routes which were more valuable to British Airways than to him; but he understood that Lord King would not accept a deal on this basis. *

* But pl.
see postscript.

Sir Adam said that if Mr. Ridley put this deal to him on a 'take it or leave it' basis, he would leave it. He would put his business into 'survival mode', closing down routes and making redundancies, hoping for a better deal under a future government. He would make an immediate demand for transfer to Heathrow, although he understood that the Secretary of State would not agree to this. While he was not in the business of dealing in threats, he would look for any legal means of protecting his business by delaying BA's privatisation. He handed to me the two attached pieces of paper, about British Caledonian's case, one in technical terms and one in more popular language; ~~but~~ he said that he did not propose to publish the latter immediately but this would be the terms in which British Caledonian would go to the press in due course.

My impression was that, while Sir Adam may mean what he says about rejecting the present deal at the end of the day, his immediate purpose was to apply all the pressure he could in the hope of getting an improvement in what BA could be

induced to accept. The main difference which he was suggesting from the present proposal was that British Caledonian should accept South American destinations in place of those in North America.

F.R.B.

*The latest letter from Lord King shows that he has moved some way further in BCAL's direction and is now asking for one destination in North America - Atlanta - and would accept the South American routes in place of the other destinations in North America. Sir Adam does not yet know this.

26 September, 1984

P.S. Does Adam Thomson want to go down in history as the man who turned down £18 million a year (profit) offered to him as a plate?

AT 26/9

File cc Transport.

AIRLINE COMPETITION REVIEW

A PLAN FOR MONOPOLY?

The Secretary of State for Transport shows every sign that he is submitting to new, monopolistic demands from British Airways.

He is in danger of abdicating his vested responsibility for Britain's aviation industry, as a whole, and betraying his Government's policies for competition and against monopoly.

Nicholas Ridley, who, less than a year ago, promised Parliament a thorough review of airlines in the interests of competition and the industry's sound development, now harbours plans from British Airways to actually increase its monopoly hold.

By accepting these proposals as a bargaining position, the Secretary of State places this Government in the centre of plans which would wreck any reasonable hope of a stable, competitive airline industry and a structured airports policy in the future.

The opportunity for creative, political strategy has apparently been given up.

What might have begun as a responsible consideration of the recommendations of the Civil Aviation Authority has - after three months of prevarication - been dissipated to the ideological values of the auction room.

The CAA recommended adjustments to a few air routes to achieve better balance in the industry and to create the climate and structure for the competitive strength of the industry in the long term.

The key proposal was the transfer of two destinations in Saudi Arabia from British Airways to British Caledonian.

If that is to be accepted by BA, Mr. Ridley says that the airline would require:

- * The take over of three B.CAL destinations in the USA;
- * The take over of three destinations in the Caribbean and South America;
- * B.CAL to give up plans for new services to Florida;
- * The ability to withdraw three of its scheduled services from Gatwick.

There would be no transfer of the route to Harare. There would be no development of proposals for competitive route sharing.

The net effect of this proposal is that British Airways' share of the British airline business would increase from the current 80.5 per cent to 82.2 per cent. B.CAL's share would decrease from 17.3 per cent to 15.6 per cent.

The other independent airlines would have, between them, a share of 2.2 per cent.

British Airways is flexing the muscle of monopoly - and is being allowed to do so - even before the State has relinquished control.

What value the promise of the Conservative Party to "take steps to ensure that these new firms (privatised companies) do not exploit their powerful positions to the detriment of consumers or their competitors?"

The situation mocks the legitimate ambitions of the existing private sector and its supporters.

It is probably too late to hope for any serious re-consideration of the CAA's Airline Competition Policy Report. Time remains, however, to salvage commercial justice, political integrity and plain commonsense.

Reluctantly, B.CAL would be prepared to accept the transfer of just two routes (those to Saudi Arabia) for operation from Gatwick. British Airways was, after all, largely responsible for blocking the introduction of B.CAL's own services to Riyadh. BA admits to the Secretary of State that the re-allocation of these routes would not significantly affect staff or resources though profit from Jeddah and Dhahran would be lost.

B.CAL would in turn, offer to BA five destinations in North, Central and South America.

It would not, under any circumstances, contemplate the carve up of its hard-won US network.

This solution would be short of that which B.CAL and the CAA believes necessary to re-balance the industry and provide a base for rapid development of competition on shared routes.

If nothing is done, it will signify the beginning of a combative survival strategy by B.CAL which could involve a programme of significant cutback and demolish prospects for the development of Gatwick.

B.CAL would immediately:

- * Place formal applications to transfer its scheduled service base from Gatwick to Heathrow, to be able to compete in the prime aviation market place. B.CAL would not be discouraged by talk of capacity 'ceilings,' but would seek every recourse to be allowed lawfully to follow its own free market destiny.
- * Place formal applications to be allowed to compete alongside and share equal capacity with British Airways on a range of scheduled routes emanating from the UK.

B.CAL would pursue these plans through their full regulatory/legal course, taking no account whatever of political requirements to fulfil the British Airways privatisation programme.

In the circumstances, B.CAL would neither be responsible for the effect on Gatwick Airport nor for the possible demands from foreign scheduled airlines to abandon Gatwick in favour of Heathrow.

It would be the Government which had rejected the historic opportunity for planned development of Britain's airlines and airports.

* * * * *

File

AIRLINE COMPETITION REVIEW

British Caledonian Analysis of British Airways Proposal

1. The British Airways Proposal

The Secretary of State for Transport outlined the following package as BA's requirement. For BA agreeing to surrender the right to serve the two Saudi Arabian points of Dhahran and Jeddah, BCAL would vacate:-

- i. Routes to Dallas/Fort Worth, St. Louis and Atlanta.
- ii. The Mid Atlantic route to Caracas, Bogota and San Juan.
- iii. BCAL to forgo the opportunity of service to Orlando and Tampa.
- iv. The return of three Iberian services from Gatwick to Heathrow.

From this list, BCAL has accepted that it would vacate only the Mid Atlantic and St. Louis routes, together with accepting the return of Iberian routes to Heathrow but in exchange for Harare as well as Saudi Arabia.

2. Analysis

i. The Saudi Arabian Benefit

There is no denying the benefit to BCAL of serving Saudi Arabia. Saudi Arabia will produce an important, immediate improvement in BCAL's profitability. An undiluted stream of profits from Saudi Arabia is essential to the development of competitive services by BCAL on both long-haul and short-haul routes.

Loss of Harare would be damaging, particularly for the future of Lusaka but it is not so critical as Saudi Arabia.

ii. Imbalance Increased

The results of a route exchange in the terms envisaged by British Airways will do nothing to reduce concentration in the UK air transport industry. BA's share of scheduled air transport production will rise by 2% to 82% (from 80.5%) BCAL's share of output will decline to 15.6% from its present 17.3%. There would be an overall reduction of 1800 in the annual number of scheduled movements operated at Gatwick and a loss of passenger throughput of about 60,000 passengers per year.

iii. BA in the United States

In the United States BA will acquire substantial additional strength which will be damaging to BCAL at its remaining gateways. BA already serves 12 gateway cities in the US out of 17 available to UK carriers. The addition of St. Louis, Atlanta, Dallas, Orlando, Tampa and Pittsburgh will give BA 19 out of 20 gateways. Of the 19 points served, 15 will be served in competition with only one US competitor or none at all, this sharply increasing the British airline imbalance in the US. (Attachment 1)

iv. BCAL in the United States

Development of BCAL's US network, which has been and remains a key corporate strategy for the airline, will be circumscribed. BCAL's North American routes operate in support of each other; significant volumes of traffic are not tied to a single gateway. Instead of five US gateways, BCAL would now serve only three, two of them in direct competition with BA. Projected results on a New York service would be worsened and, with fewer gateways in support, the viability of starting service in 1985 would be reduced. Deprived of access to traffic flows from Florida, S.E. USA, the Caribbean and northern countries of South America, BCAL would not want designation as a second carrier to Miami.

The reduction in scale and spread of BCAL's North America operation will damage the airline's ability to offset \$-related costs, which are already a net outflow, leaving BCAL exposed to exchange rate movement of the US \$.

The airline's residual US network will not be large enough, compared with other competitive transatlantic airlines, to give BCAL strength in travel retailing and wholesaling in the United States.

For these reasons, the loss of a single major US point would inflict serious damage upon BCAL and its US market. Losing either Atlanta or Dallas to BA would give BA a disproportionate capacity to undermine BCAL's position in the United States

v. Dilution of Benefit

Surrendering points on BCAL's existing network will dilute the benefits expected from Saudi Arabia and reduce the airline's capacity to develop competitive service.

The dilution results from:-

- loss of current and future profits expected on existing routes. (Attachment 2)
- loss of interline earnings. (Attachment 2)
- loss of system synergy, especially on US routes.
- redundancy and other payments.
- increased exposure to BA predation.
- increased expenditure/risks associated with route development.

vi. Impact on BCAL

Awareness, identity and marketing strength in the USA would be seriously impaired and the £30M which has been invested in the Dallas/Fort Worth, Atlanta and St. Louis routes to bring them into profitability would be lost. In the Southern states, BCAL would be forced back to metropolitan Houston.

BCAL will operate in a small way in many markets but, with the exception of West Africa, not be sufficiently strong in any. Saudi Arabia is a self-contained market and, as a result of bilateral restrictions, is not of itself a spring-board to further Middle or Far East expansion for the airline. The reduction of intra-line passenger transfers from long-haul to short-haul services at Gatwick will weaken the airline's efforts to develop a European network.

While the earnings from Saudi Arabia will be of great benefit to BCAL, the price that has to be paid to BA in the form of a truncated network and loss of opportunity in the United States will undermine BCAL's long-term future as a major British intercontinental carrier.

vii. Corporate Risks

BCAL's corporate strategy in developing the United States and Far East routes has been one of matching the political and economic risks of Africa and South America with the competitive risk in facing BA and strong foreign carriers. BCAL accepts competitive risks but exchanging major routes in the United States for Saudi Arabia again increases BCAL's exposure to political and economic risks again. Events of the recent past show how unpredictable and volatile such risks are and why an airline should not carry excessive risks of this kind in its portfolio.

BCAL's portfolio, as a result of this exchange, would be unbalanced in terms of political and economic risk although it would immediately improve BCAL's profitability.

In contrast, BA would be reducing its political and economic risks, already at a significantly lower level than BCAL's. The increase in BA's competitive risk would be marginal since BCAL, as a competitor to BA in the United States, would be diminished.

viii. Acceptability

Staff will regard the loss of hard-won and highly competitive US routes as a defeat for the airline. There will be redundancy of up to 400 staff. Industrial disruption and motivation problems may result.

There will be a loss of confidence in BCAL among the travel trade if the package was accepted. BA would be seen as largely preserving its strength and ubiquity at BCAL's expense. The Press are likely to react unfavourably to such a proposal bearing in mind their general support for CAP 500. This is likely to present problems funding development in the immediate term.

BCAL is required to make a profit for its shareholders. However, while there would be immediate profit gains in acceptance of the BA package, the long-term consequences would be damaging to the airline's profitability and future.

ix. Future BCAL action

If the package were accepted, it is likely that BCAL would not wish to embark upon any substantial development of competitive service for a number of years. The future of the Lusaka route would be in question as would the domestic points which currently make large losses. In short, BCAL would retrench.

x. BA Predation

Although losing profit from Jeddah and Dhahran, British Airways would not be much weakened by the changes. It would be extending its network to important areas and hence its capacity to meet most travel demands. Corporate risk would be reduced. In these circumstances BCAL is more likely to face BA predation on its residual network. While the Saudi profits will better equip the airline to resist predation from BA, the extension of BA's international network and reinforcement of its Heathrow hub will make predation that much more effective.

xi. BA at Gatwick

BA has a poor record of service at Gatwick. It has failed twice in operating US points from the airport. It wants to transfer Iberian services to Heathrow and to operate certain new US points there. While these experiences raise doubts about the benefit to the UK of BA operating long-haul scheduled services from Gatwick, they also indicate an additional risk to BCAL of BA ultimately transferring such points to Heathrow along with the reciprocal US operator. This would damage BCAL's hub at Gatwick as well as its remaining US routes.

xii. Ability to Rebuild BCAL's Network

Because of interline and synergistic benefits BCAL will wish to strengthen its network against the risks and threats outlined above.

However, the demands of British Airways in the United States will deny BCAL opportunities in that market. The US has been the major source of expansion for BCAL because of its liberal and expansionist air transport regime. It was that regime that allowed BCAL to translate its perception of a Southern tier of US gateway points into reality and generate benefits for the UK and Gatwick not identified by BA.

BCAL's expansion opportunities would be constrained by agreement with BA, by very limited bilateral opportunity and by a truncated network.

xiii. Double Designation

The arrangements for double designation opportunities for BCAL so far outlined by the Department do not constitute a sufficiently firm basis, either in terms of profit potential or availability, on which BCAL might build to replace lost routes. S.E. Asia has been ruled

out as has Scandinavia, both key markets in BCAL's strategic thinking for itself and Gatwick. It is only in Europe that some hope exists for securing double designation for a Gatwick operator but constraints on marketing and pricing policy remain.

xiv. UK Air Transport Policy

A route exchange between BA and BCAL would be far removed from the objectives consistently sought by BCAL. The resultant structure of the UK industry would not meet the principles set out by the CAA in its review and subsequent report. The development of Gatwick would not be advanced.

xv. Conclusion

Securing Saudi Arabia is an important objective for BCAL. The BA package, which offers the prospect of Saudi Arabian routes, is therefore attractive. However, the price demanded is excessive and BA grows more dominant in the process. This dilutes the benefits from a Saudi exchange. It will undermine company and public confidence. There are likely to be redundancies among BCAL employees. Above all, the BA requirements expose BCAL to major risks which jeopardise its future survival too severely to enable the package to be accepted. Loss of US gateways in order to secure Saudi Arabia is simply not acceptable to BCAL, and is not in the interest of Gatwick, the industry or the consumer.

25.09.84

CIVIL AVIATION REVIEW

Effect of British Airways Proposals on UK-USA Services

1. Present Position at September 1984

UK Airline Services:-

	Competing with One or Less Direct Carrier	Competing with Two or More Direct Carriers	Total
<u>British Airways</u>			
Anchorage	1		
Baltimore	1		
Boston		1	
Chicago	1		
Detroit	1		
Los Angeles		1	
Miami	1		
New York (Kennedy)		1	
Philadelphia	1		
San Francisco	1		
Seattle	1		
Washington	<u>1</u>		
	<u>9</u>	<u>3</u>	<u>12</u>
<u>British Caledonian Airways</u>			
Atlanta	1		
Dallas/Ft. Worth	1		
Houston	1		
Los Angeles		1	
St. Louis	1		
San Juan	<u>1</u>		
	<u>5</u>	<u>1</u>	<u>6</u>
<u>Virgin Atlantic Airways</u>			
New York (Newark)		1	1
<u>Total Gateways (Unduplicated)</u>	<u>14</u>	<u>3</u>	<u>17</u>

CIVIL AVIATION REVIEW

Effect of British Airways Proposals on UK-USA Services

2. Position After British Airways' Requirements

UK Airline Services:-

	Competing with One or Less Direct Carrier	Competing with Two or More Direct Carriers	Total
<u>British Airways</u>			
Anchorage	1		
Atlanta	1		
Baltimore	1		
Boston		1	
Chicago	1		
Dallas/Ft. Worth	1		
Detroit	1		
Los Angeles		1	
Miami		1	
New York (Kennedy)		1	
Orlando	1		
Philadelphia	1		
Pittsburgh	1		
San Francisco	1		
St. Louis	1		
San Juan	1		
Seattle	1		
Tampa	1		
Washington	1		
	<u>15</u>	<u>4</u>	<u>19</u>
<u>British Caledonian Airways</u>			
Houston	1		
Los Angeles		1	
New York (Kennedy)		1	
	<u>1</u>	<u>2</u>	<u>3</u>
<u>Virgin Atlantic Airways</u>			
New York (Newark)		1	1
<u>Total Gateways (Unduplicated)</u>	<u>16</u>	<u>4</u>	<u>20</u>

BRITISH CALEDONIAN NORTH AMERICAN OPERATIONS

Attachment 2

£ Millions	1979/80	1980/81 Actual	1981/82 Actual	1982/83	1983/84 Estimates	1984/85	1985/86 Forecast	1986/87 Forecast	1987/88
HOUSTON	2.7	5.6	6.0	9.8	14.1	15.8	11.2	15.1	19.6
ATLANTA (with St. Louis)					0.3	1.9	1.6	3.6	6.0
DALLAS (with St. Louis) -	(3.9)	(9.8)	(4.2)	0.9	(0.1)	(0.1)	(0.7)	1.7	4.6
LOS ANGELES			(3.9)	(3.6)	(1.5)	2.3	1.1	3.9	6.2
ALL ROUTES OPERATING PROFIT	(1.2)	(4.2)	(2.1)	7.0	12.9	19.9	13.2	24.3	36.4
FINANCING CHARGES	(3.5)	(5.2)	(5.9)	(7.3)	(7.2)	(7.1)	(6.0)	(4.9)	(3.8)
TRADING PROFIT	(4.7)	(9.4)	(8.0)	(0.3)	5.7	12.8	7.2	19.4	32.6
CUMULATIVE	(4.7)	(14.1)	(22.1)	(22.4)	(16.7)	(3.9)	3.3	22.7	55.3
INTERLINE REVENUES	N/A	N/A	N/A	N/A	12.0	13.2	13.7	15.7	17.7

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FILE

LANAETH

10 DOWNING STREET

From the Principal Private Secretary

26 September, 1984

CAA REVIEW

As you know, Sir Adam Thomson asked to see me this afternoon. (He did not betray any knowledge that Lord King was seeing the Prime Minister tomorrow, and I did not do so either). He handed me two documents - one a technical analysis of what is described as 'British Airways proposal' and the other written in more popular language, which he said that he did not propose to release to the press at this stage but which would act as a basis for what British Caledonian would say to the press in due course. Sir Adam said that he would ask Mr. Pugh to leave copies of these documents with Mr. Holmes.

Sir Adam Thomson's main message was that the Government would be wrong to try to impose the 'British Airways proposal' on British Caledonian. He said that British Caledonian could not accept the loss of some of its North American routes (except for St. Louis) because they were inter-dependent. The freight was also important to British Caledonian. He was willing to give up the mid-Atlantic routes and the South American routes to BA: these would be much more valuable to BA than they were to British Caledonian. But if the present proposals were put to him on a 'take it or leave it' basis, he would leave it. He would have to take his business into 'survival mode', which would involve closing down routes - and he referred particularly to South America - and redundancies. He would make an immediate demand for transfer to Heathrow, although he understood that the Secretary of State for Transport would not agree to this. He would then hope that a subsequent government would give him a better deal. He also said that, while he did not want to deal in threats, British Caledonian would seek any legal means open to them for protecting their business.

I made the point that the Government was seeking honestly to find the best solution which was consistent with a number of conflicting objectives. Sir Adam Thomson said

that he recognised that, but genuinely thought that the 'Nott undertakings' had been given in different circumstances before the implications of privatisation had been properly considered. He also claimed those serious commentators who had looked below the surface of the problem had supported British Caledonian's case, as had the CAA. He added that he believed that the other independents had been offered by BA some 'grace and favour' arrangements by which they would fly to BA destinations out of regional airports, and he understood that the other independents had no enthusiasm for such an arrangement.

I said that I would report his views to the Prime Minister and your Secretary of State.

RB

Miss D. Nicols,
Department of Transport

CONFIDENTIAL



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DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Peretz Esq
Private Secretary to
the Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

26 September 1984

Dear David

CIVIL AVIATION AUTHORITY REVIEW OF AIRLINE COMPETITION POLICY

The Prime Minister is seeing Lord King tomorrow morning at 9.45am to discuss the Government response to the CAA review.

My Secretary of State feels the Chancellor, and the Secretary of State for Trade and Industry, should see the attached paper provided for the Prime Minister as briefing for that meeting.

I am copying this letter with the paper to Callum McCarthy in Mr Tebbit's office and, without the paper, to Andrew Turnbull at No.10.

yours sincerely,

Henry Derwent

H C S DERWENT
Private Secretary

CONFIDENTIAL

26 SEP 1984

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10 DOWNING STREET

file LPOABT
cc John Redwood
cc MASTER SET

From the Private Secretary

CONFIDENTIAL : CMO

12 September 1984

CAA REVIEW

The Prime Minister held a meeting yesterday to discuss issues arising from the CAA's review of air transport policy. Present were the Chancellor of the Exchequer, the Lord Privy Seal, the Secretaries of State for Trade and Industry, Transport, the Chief Whip and the Solicitor General. Also present were Sir Robert Armstrong, Mr. Gregson and Mr. Redwood. The meeting had before it the paper circulated by the Secretary of State for Transport as C(84)22.

The meeting discussed the implications of the various Laker law suits of which the most relevant were those brought by the Laker Liquidator and the class action brought by US lawyers on behalf of individual passengers. It was noted that Hill Samuel had advised that it would be possible for flotation to proceed if BA's directors were able to state, taking into account advice from US Counsel, that the US suits were unfounded and without merit. This was the course which BA hoped to follow. But it was noted that this advice was heavily qualified and it was far from clear whether BA would be in a position to make such a statement.

There were differing views on the extent to which the Laker cases presented an obstacle to privatisation. The damages sought were extremely large but against this it was argued that such claims for damages, with which US

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companies were familiar, were exaggerated. The litigation was likely to be long and drawn out and if the cases were indeed an obstacle they could remain so for a number of years.

It was suggested that Britain should go to arbitration in order to have the issue resolved under the Bermuda Agreement, though earlier advice had been pessimistic on the UK's chances of success. If the cases were lost there could be serious disruption to UK/US air services if British planes were impounded.

Summing up this part of the discussion, the Prime Minister said the Government should continue its efforts to resolve these disputes under the Bermuda Agreement. Consideration should be given to whether there was any way in which UK legislation could protect UK operators from action in the US Courts. It remained unclear how serious an obstacle the Laker suits presented. Meanwhile, the Government should decide what course it wanted to take following the CAA review.

The Prime Minister said the issues raised by the CAA review touched on important elements of the Government's philosophy - its wish to encourage competition and enterprise and to reduce the boundaries of the public sector. Some of these objectives were in conflict with one another. The Chief Whip reported that Government supporters were sharply divided between those opposing any transfer of routes from BA and those who believed it would be wrong to privatise BA without first creating a more competitive

/environment

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environment and a stronger base for the smaller independent air lines. The Prime Minister said the undertakings given by Sir John Nott could not easily be over-ridden.

The Secretary of State for Transport reported BA's proposal that B Cal should be allowed to compete directly with BA by increasing dual designation on a number of routes. While this was superficially attractive it did not, on examination, provide an alternative to route transfers. First, there was only a limited number of routes where dual designation was likely to be possible; secondly, heavy investment would be needed by B Cal to develop their share of the market (particularly given the handicap of using Gatwick) and they could cover the initial losses only if they had additional revenues from the transfers of some profitable routes.

Note was taken of the Foreign and Commonwealth Secretary's minute of 10 September which pointed out that transferring BA's Saudi routes to B Cal (and hence to Gatwick) would strain our relations with the Saudis and could mean a loss of business for the UK.

The Secretary of State for Trade and Industry and the Chancellor of the Exchequer suggested that B Cal could offer the Riyadh route which it had been allocated but which it was unable to use to BA in exchange for some other BA routes, e.g. the Caribbean which would mesh in well with B Cal's routes to Latin America and the Southern United States. This could enable Lord King to say that he had not

/been forced

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- 4 -

been forced to surrender any routes and the Government to say that the Nott undertakings had been honoured. It was agreed that this proposal should be explored with Lord King.

If agreement could not be secured the only other way of meeting with CAA recommendations would be legislation to enforce route transfers. The Lord Privy Seal and the Chief Whip advised that this would be a perilous course which would divide the Government's supporters in both Houses. The Lord Privy Seal was also worried about the propriety of using legislation to transfer revenue earning rights to a private company.

The Prime Minister said the position of the smaller independents and the charter companies should not be overlooked. BA was in a position to use its financial muscle to cross-subsidise its Airtours subsidiary or to use surplus capacity on its scheduled routes to underline these airlines. It was argued that greater safeguards should be established against predatory practices either by strengthening the CAA or giving a greater role for the OFT and MMC.

Summing up the discussion, the Prime Minister said the Group were reluctant to pursue a legislative solution which would be extremely contentious and which would over-rule the Nott undertakings. The Secretary of State for Transport and the Secretary of State for Trade and Industry should contact Lord King in order to secure his agreement to an exchange of routes between BA and B Cal. They should also investigate how policing of predatory behaviour could be

/strengthened.

CONFIDENTIAL : CMO

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strengthened. Work should continue in an effort to clarify the implications of the Laker law suits. To allow time for this work to be completed the issue would not come to Cabinet on Thursday.

I am copying this letter to Len Appleyard (Foreign Office), David Peretz (H.M. Treasury), David Morris (Lord Privy Seal's Office), John Graham (Scottish Office), Callum McCarthy (Department of Trade and Industry), Murdo Maclean (Chief Whip's Office), Henry Steel (Law Officers' Department), and Richard Hatfield and Peter Gregson (Cabinet Office).

ANDREW TURNBULL

Miss Dinah Nichols,
Department of Transport.

File SLHADV



cc Policy Unit

a MASTER SET

10 DOWNING STREET

From the Private Secretary

12 September 1984

CAA REVIEW: BRITISH MIDLAND AIRWAYS

Mr Michael Bishop, Chairman and Managing Director of British Midland Airways came to see the Prime Minister today. Your Secretary of State was also present. I attach a copy of the letter which Mr Bishop had sent to the Prime Minister. Mr Bishop said that British Midland Airways had come into existence as a result of a very large management buy-out in 1978 and it had now grown to a turnover of £110 million. British Midland Airways had the second largest number of movements out of Heathrow and it was the only British airline competing with British Airways there. BMA had been one of the largest private investors in Liverpool following its takeover of the air routes from Speke. It was also the largest UK purchaser of Shorts' aircraft. He felt these points qualified him to speak for the smaller independent airlines.

Mr Bishop said that in the public brawl, which he had sought to stay out of, the fundamental arguments about a better competitive structure for the UK air industry had been submerged by political arguments. He said many of the difficulties arose from industrial relations' problems at British Airways. He acknowledged that BAs performance had been transformed but in the process the management had given undertakings to the staff and the unions that it would not shed routes or declare further redundancies. He believed that many of BAs routes were only marginally profitable, eg. the shuttle to Scotland, and were kept in being by cross-subsidy from profitable international routes. When BA operated under the discipline of shareholders there would be strong commercial pressure to shed these routes but meanwhile BA were hanging on to them to fulfil the undertakings given to the staff and to deny the smaller airlines an opportunity to make a go of them. Eventually, under commercial pressures, these routes might be relinquished but by then the smaller airlines might not be

ECC

in existence to take advantage of them.

His approach differed from that of British Caledonian. He felt the emphasis should be on making BA surrender these marginal routes rather than forcing them to relinquish profitable international routes. Opposition to this had come not just from BA but from the Labour-controlled councils in Birmingham and Manchester who supported BAs wish to hang on to the services to other European cities.

Mr Bishop said the manpower resources of the CAA had been reduced. If it was to tackle seriously the task of enforcing fair competition it would need to be strengthened.

Mr Bishop said BMA was the only UK scheduled airline apart from BA operating from Heathrow but this was solely for domestic routes. BMA should be allowed to operate international routes as well which could be done without bringing a new operator into Heathrow. He argued that domestic deregulation without greater access to international routes would actually be harmful to the smaller companies as BA would be able to undermine them.

Mr Bishop said the uncertainty arising from the CAA review and the privatisation of BA was already beginning to affect the finance available to the smaller airlines. Their banks were becoming worried about their ability to survive if no changes were made to improve the competitive balance of the UK industry.

The Prime Minister thanked Mr Bishop for putting his case so cogently and effectively. She said the Government would bear in mind the points he had made in coming to its decisions.

I am copying this letter to David Peretz (H M Treasury), David Morris (Lord Privy Seal's Office), Callum McCarthy (Department of Trade and Industry), and Murdo McLean (Chief Whip's Office).

Andrew Turnbull

Miss Dinah Nicholls,
Department of Transport

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PRIME MINISTER

THE NOTT UNDERTAKINGS

You asked to see the context of the John Nott undertakings quoted in Lord King's letters to MPs - Flag A. 17.7 84
The first of the undertakings, which is the most difficult, appears in the statement to the House announcing the Government's intention to privatise BA - Flag B. It was subsequently repeated in John Nott's letter of 29 October to the then Chairman of British Airways - Flag C. Much hinges on whether a reallocation following a thorough review of airline policy would be construed as arbitrary.

(Flag D)

The second undertaking quoted by Lord King also appeared in the statement, but it is clear from John Nott's speech on the Civil Aviation Bill that the reference is to ancillary activities such as hotels, travel agencies and tour operations, rather than to routes.

AT

12 September 1984

[Mr. Nott.]
American airlines to fly around the world in a totally de-regulated atmosphere.

Mr. Michael Neubert (Romford): I must declare an interest in matters of air travel. What limitation will be placed on British Airways fringe activities? Although my right hon. Friend said that British Airways is not a monopoly—and that is true in its international operations—within the United Kingdom it certainly has a dominant position in the air travel market. Activities on the margins, such as hotel keeping, running retail travel agencies and tour operating which might be accepted as fair competition from an ordinary commercial company, might be regarded as unfair competition from a company that still has a substantial Government majority holding. I believe that that is why the United States places restrictions on its national airlines, which are privately owned.

Mr. Nott: I do not foresee any directions or other instructions being given to British Airways to divest themselves of these activities. One of the principal purposes of what we intend, namely, allowing other shareholders to have a substantial minority interest in the airline, is that then financial sanctions and the sanctions of the market will apply to British Airways in the same way as they apply to other companies. I believe that British Airways must make a decision within that context as to what they intend to do with these activities. I do not propose that any part of British Airways should be broken up or sold off. I propose that the airline as a whole should be quoted and it will then be for the board of directors to take decisions on how they organise their business.

I was talking about the real meaning of "open skies". It does not just mean freedom on the route between New York and London; it means de-regulation in the sense that we could compete with the United States openly in what is the most profitable and the largest internal market in the world. That is something that we would look at with considerable interest if it were proposed to us. I mention this only to emphasise that in the last resort the decisions of the CAA are dictated by the facts of what my Department is able to negotiate in air service agreements.

I shall outline briefly a few details of the policy. The Civil Aviation Act 1971 which established the CAA, gave it certain statutory functions, but also provided for Ministers to issue guidance to the Authority. The Authority was required to perform its functions in such a manner as it considered would best attain the statutory objectives and give effect to the guidance given to it. This approach was an innovation, but I must say that it has not proved satisfactory. Guidance has been given in 1972 and 1976, but an important part of the 1976 guidance was found, as I have already said, to be ultra vires, in the case of Laker Airways Department of Trade.

When the Under-Secretary of State asked me to consider this area of policy, we concluded that it was wrong to place responsibility for an area of policy on an independent organisation and then so to hamper its freedom that it was hardly able to pursue an independent line. If we wish to hive off certain functions of Government—the CAA provides an excellent example of the way in which independent bodies can undertake this task—we must be ready to take both hands off the wheel or as the Under-Secretary would say, both hands off the joystick.

Clause 10 therefore removes the power for me to give guidance and instead describes those statutory duties within which the CAA must operate. I hope that the House will consider this to be a constitutional improvement. In principle it must be right for the Act to express the will of Parliament—rather than have the Act provide a paving stone for ministerial guidance.

Under the 1971 Act—I am referring to section 3—the CAA had two principal objectives: first, to secure that British airlines provide services which satisfy substantial categories of public demand at the lowest charges consistent with a high standard of safety and an economic return to efficient operators and secondly, securing the sound development of the civil air transport industry in the United Kingdom—it was not notable for grammatical elements; secondly, to secure that at least one major airline other than British Airways has opportunities to participate in providing those services. Subject to those two objectives, the Act was required to encourage the development of the United Kingdom civil air transport industry.

REGISTERED PAPERS

EXTRACT FROM OFFICIAL REPORT (HANSARD)

DATED 20.7.79.....
COL(S) 21.83-98.

BRITISH AIRWAYS (FINANCING)

The Secretary of State for Trade (Mr. John Nott): With permission, Mr. Speaker, I will make a statement on the financing of British Airways.

British Airways has embarked on a major programme of fleet replacement and expansion and I believe that it has excellent growth prospects. As our principal national carrier, it is operating in an increasingly competitive market and, while the world energy situation creates considerable uncertainties, I am none the less confident that the airline will, with the Government's full encouragement, face these challenges successfully.

Clearly there must be some flexibility about the rate of expansion in the face of these uncertainties. Nevertheless, the present appraisal is that British Airways will require a substantial increase in capital investment from both internal and external sources over the next few years in order to meet its objectives. For this reason, I have been looking at its capital structure and financial requirements, and I should like to let the House have my views and proposals.

First, the Government are concerned to give British Airways the most effective form of organisation for carrying out its programme in response to the changing demands of the market rather than on the basis of Government targets and support.

Second, I propose therefore that the framework of the Companies Acts should be used to provide British Airways with a new capital structure and that a substantial minority shareholding in the enterprise should be offered for sale to the public.

Third, the Government will give up control, for example, over British Airways' investment programme and it will in future satisfy its financial requirements from capital markets both at home and overseas.

Fourth, my proposal does not involve a separate disposal of any part of British Airways.

Fifth, special arrangements will be made to enable employees of British Airways to take up shares in the enterprise should they wish to participate in its future and share in its growth.

Sixth, I envisage the fullest possible process of consultation with the airline's management and employees.

Seventh, I will put forward proposals later in the year for the legislation which will be required. The timing of any issue of shares will depend on market and other circumstances.

Eighth, I will also set out the Government's thinking on the licensing provisions administered by the Civil Aviation Authority. I can say now, however, that there will be no arbitrary reallocation of routes.

Mr. John Smith: Is the right hon. Gentleman aware that the decision to make a statement of this gravity and importance on a Friday allocated to Private Members' business is contemptuous of the House? What possible reason is there for not making this statement next week on one of the days allocated to public business? Is it not a further example of how the Leader of the House is allowing the rights of hon. Members to be overridden by those of departmental Ministers?

On the substance of this alarming statement, may I ask whether the right hon. Gentleman is aware that it will be greeted with shock and dismay by all those who wish well to one of our most important public utilities? Will he confirm that there is not a word about such a proposal in the Conservative Party manifesto and that the present Government, who did not have the guts to put these proposals before the electorate—it was obviously a preconceived proposal—have no mandate to sell off a profitable section of a public industry to their private sector friends and to their party contributors?

Is the right hon. Gentleman aware that in the statement he cannot and does not seek to justify this change of ownership—because that is what is involved—in terms of increased efficiency, profitability or industrial relations? Will he say what problems have existed in the past in raising the necessary finance for British Airways? The truth is that such finance can in the future, as in the past, be found from public resources.

What is meant in this Delphic statement by the phrase "a substantial minority shareholding"? Will the legislation—and I want the right hon. Gentleman to give a definite answer on this question—



From the Secretary of State

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 C
 RE/PUSST
 RE/SECRETARY
 MR STEELE
 MR SALMON
 MR WHITAKER
 MR GILDEA
 (ON FILE)

J R Stainton Esq CBE
 Chairman
 British Airways
 PO Box 10
 Heathrow Airport (London)
 Hounslow, TW6 2JA

PA 52/02

27 October 1979

Dear Ross.

Thank you for your letter of 19 October which raised a number of questions relating to the Civil Aviation Bill and the sale of shares in British Airways. I will deal with each point in the order of your letter.

As regards the future financial relationship between the Government and British Airways, I appreciate the need to clarify the position and thus remove any uncertainty in the minds of the board or the financial institutions with which you deal. As you know, the Government's policy is that British Airways should stand entirely on its own feet financially from the time when the running of the airline is vested in the nominated company. Consistent with that policy, the Bill includes no powers for the Government to provide financial assistance or Treasury guarantees after the appointed day although guarantees given before the appointed day will remain valid for the duration of the loans and leases to which they apply. Between now and the appointed day the Government will, in principle, be prepared to issue Treasury guarantees for loans to be drawn down before the appointed day but not afterwards. I believe this strikes a sensible balance between our longer term policy towards the airline and your need to plan ahead in the period before the change of status becomes effective. We hope that the appointed day will be as close as possible to the public flotation of shares and since I shall arrange to consult the Board before setting the appointed day, you will have a period of notice of the date from which no new Treasury guarantees will be issued.



From the Secretary of State

Your letter proposes that Treasury guarantees should be made available to cover finance for the programme of fleet replacement and expansion agreed with the Government before the appointed day. So that you and your Board are in no doubt about the Government's policy, I should make it clear that the arrangements I have outlined above are not intended to cater for all aircraft acquisitions so far approved by the Department. In so far as you require to draw down loans to pay for such aircraft (in whole or in part) before the appointed day then such loan amounts can be covered by guarantee but guarantees will not be available for loans to be drawn down thereafter. I know that you probably have in mind particularly the contract for 19 Boeing 757s which are due to enter service in 1983 and for which the great bulk of progress payments are not due until 1982/85 and later years. However, I would certainly hope that by that time shares will have been sold to the public in which case it would be quite contrary to our policy of allowing BA complete freedom to operate on a fully commercial basis if we were to have given Treasury guarantees in respect of finance to be drawn down by the privatised company. The extent to which future loans will enjoy Treasury guarantee will in practice depend on the timing of the appointed day but I cannot give the general undertaking you seek about finance for the entire fleet programme and I think it is only sensible to make this point quite clear now so that the Board can plan accordingly.

As regards your second point, the provisions of Part II of the Bill are in general quite neutral in their effects as between one airline and another. But as I made clear at our meeting, the size, status and prestige of BA confirm its position as our national flag-carrier. The only particular point is the repeal of section 3(1)(b), which is certainly not harmful to British Airways and this is fully consistent with my own statement that there will be no arbitrary reallocation of routes.



From the Secretary of State

In connection with the timing of an offer of shares to the public, I appreciate the point you make about the deterioration in BA's financial prospects over the past few months and that this may have a bearing on the timing of the flotation. We shall of course keep the situation under close and continuous review and I have no doubt that you and your Board are doing everything possible to reverse the present trend in this year's results and maintain the airline's longer term prospects. I have noted with interest some of the announcements which you have made concerning a number of BA's loss making routes. Naturally I would like to feel that the difficult prospects faced by the world's airlines in the immediate future will lead to a continuing and vigorous search for offsetting economies.

Your letter also referred to the reaction of the airline's employees to the sale of shares and expressed the view that the incentives presently available to encourage employee share participation are very small. You will have gathered from our previous conversations and from my statement to the House on 20 July that I believe it essential to establish as wide a holding of shares by employees as possible when the flotation takes place. I am therefore pleased to note that you are continuing to examine what scheme(s) may be appropriate and my officials will be discussing this with your people in greater detail.

Your last substantial point concerned the BA pension fund and the liability this places on the British Airways Board and which will be inherited by the successor company. I recognise that, because of the generous nature of the benefits, this is a matter which will be weighed in the balance by the investing public. But although the pension arrangements will be rather unique for a private sector company I do not believe that they will preclude a successful sale of shares by the Government. There will not be any form of Government support to underwrite the pension arrangements.



From the Secretary of State

I understand that a number of these points were recently discussed in greater detail between officials and representatives of BA and that such consultation will continue. But I look forward to seeing you this Wednesday to discuss these matters with you personally.

Forus

Shu.

JOHN KOTT

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**DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB**

01-212 3434

Andrew Turnbull Esq
Private Secretary
10 Downing Street
LONDON SW1

11 September 1984

Dear Andrew

PRIME MINISTER'S MEETING WITH MR MICHAEL BISHOP OF BMA:
12 SEPTEMBER

You have a brief for the Prime Minister's meeting tomorrow, which my Secretary of State will also be attending.

The Prime Minister should be aware, as background to the meeting that BMA may be in financial difficulties. The Bank of England had an approach very recently from Mr Anthony Steen MP which referred to difficulties BMA have had in providing financial information to their British bankers because of uncertainties about the Government's decision on the CAA review. The Bank of England understand that Lloyds Bank have been pressing the company either to produce a financial recovery plan or to raise additional capital, or to find other bankers. BMA appear to have done none of these things, and a meeting is taking place today between Lloyds and BMA.

Lloyds are in fact only minor bankers to BMA. Much larger sums have been provided by the US Chemical Bank. Mr Steen has said that the Chemical Bank do not share Lloyds' concern, and will be ready to replace Lloyds facilities. But the Bank of England have no independent corroboration of this view.

The Bank of England have offered to see Lloyds Bank and BMA, if the company would like us talk to them after today's meeting with Lloyds.

*Yours sincerely
Andrew Melville*

ANDREW MELVILLE
Private Secretary

CONFIDENTIAL



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB
01-212 3434

Andrew Turnbull Esq
Private Secretary
10 Downing Street
LONDON
SW1

11 September 1984

Dear Andrew

I enclose, as requested, briefing for the Prime Minister's meeting tomorrow with Michael Bishop of British Midland Airways. As you know, my Secretary of State will also be attending the meeting.

Yours sincerely
Andrew Melville

ANDREW MELVILLE
Private Secretary

CONFIDENTIAL

PRIME MINISTER'S MEETING WITH MR MICHAEL BISHOP, CHAIRMAN AND
MANAGING DIRECTOR, BRITISH MIDLAND AIRWAYS LTD: WED 12 SEPT

In his letter of 29 August (flag A), Mr Bishop requests a meeting with the Prime Minister to discuss the points outlined in it and urges implementation of the CAA's report on airline competition policy.

General background

BMA is the UK's eighth largest airline accounting for 1.25% of UK capacity. It is, however, Heathrow's second largest operator in terms of air transport movements. The airline dates back to 1938 when it was formed as Derby Aviation. It operates scheduled passenger and cargo services to domestic and continental destinations from East Midlands Airport and Heathrow (including the important domestic trunk routes from Heathrow to Glasgow, Edinburgh and Belfast). Other operations include a specialist overseas leasing service using 707s and holiday charter flights to the Mediterranean and North America. In 1982 BMA merged its Isle of Man services and fleet with Air UK's to form Manx Airlines in which it has a controlling interest. In September 1983 it bought 75% of Loganair, the small Scottish airline which runs scheduled services to remote points in the Highlands and Islands. Loganair acts as a feeder airline for BMA's Scotland to London services.

In 1983 BMA made a pre-tax profit of £469,000 on a turnover of £79.6M.

CAP500: CAA Report on Airline Competition Policy

Published on 16 July last, the report makes a number of recommendations, the most contentious of which are that routes to Harare, Jeddah and Dhahran should be transferred to British Caledonian; that BA's scheduled Gatwick services should be taken over by other airlines - principally BCal but not exclusively so - and that BA's European routes from regional airports should also go to other airlines. The CAA also plans to foster competition by licensing a second British carrier, principally BCal, on routes served by British Airways, and has asked for additional powers to deal with anti-competitive behaviour.

In the appendix to his letter, Mr Bishop expresses his concern that a privatised BA will be able to crush opposition by resorting to anti-competitive practices, and he questions whether sufficient thought has been given to controlling this. He regards competition as vital at Heathrow and cites the additional traffic and improved services generated by BMA competition on the Scottish trunk routes. He thinks BA should now be subjected to competition on its international services, by independents already operating at Heathrow (which would rule out BCal who operate from Gatwick); and dismisses the British Airports Authority's claims about congestion at Heathrow, insisting that space could be provided within existing constraints by adopting improved working practices.

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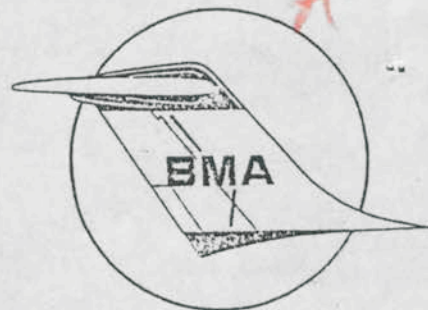
On route transfers, Mr Bishop believes that, far from damaging BA's privatisation prospects, the transfer of domestic routes and European services from regional airports would improve its profitability. He says BA is using excessive profits on its international routes to sustain highly marginal domestic routes; the freezing of all domestic fares for two years, the dumping of excess capacity on the Scottish trunk routes, and the submission to the CAA by BA of pre-emptive licence applications to thwart BMA's plans are, Mr Bishop alleges, further examples of predatory practices. Cabinet will be meeting to discuss the various options suggested by the CAA report, and the Prime Minister should note what Mr Bishop has to say without being drawn into a discussion of his arguments. In anticipation of the Government's decision, BMA has applied for rights to operate from Birmingham to several domestic and European points, and to delete those rights from BA's licence. Also, BMA has appealed against the CAA's decision to license BA on the Manchester to New York route, and to refuse its own application. The applications and appeal are not strictly connected with discussions on the review but should not be debated because that might prejudice the Secretary of State's position in his quasi-judicial role in licensing matters.

Line to take

Ministers have yet to decide the response to the report, so I cannot comment on its merits. But I can assure you that the points you have made will be taken fully into account before we decide what the response should be.

British Midland Airways Ltd

Donington Hall, Castle Donington,
Derby DE7 2SB England
Telephone: Derby (0332) 810741/Telex: 37172



Your Ref:

Our Ref: MDB/RAM

August 29, 1984

Rt. Hon. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W. 1.

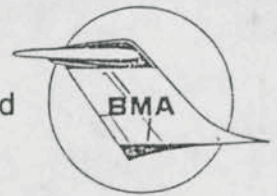
Dear Prime Minister,

I am writing personally to you as the controlling shareholder of the largest privately owned U.K. airline group comprising three airlines; British Midland, Manx Airlines and Loganair. Together they fly from 28 airports in the British Isles, carry 2 million passengers a year, operate 40 aircraft, employ 2,000 staff and generate revenues of more than £100M per annum. British Midland Airways is the second busiest airline operating at Heathrow with more than 500 arrivals and departures each week.

I wish to express how threatened and vulnerable I consider our future prospects if satisfactory decisions are not reached by your Government following receipt of the Civil Aviation Authority's Policy Review.

My partners and I have during the past six years put into practice your philosophy of self sufficiency and enterprise by accepting a total personal financial commitment by acquiring our company through a management buy out in 1978. We did so in the anticipation that a Conservative Government, when elected, would support as a priority those individuals who were prepared to stake all they possessed in order to become owners of their own business.





I feel sure you will agree that this commitment of your Government to private sector investors taking such risks is of far greater long term importance than the short term consideration of satisfying the Board of British Airways whose members have, at the present time, no personal financial stake in their company.

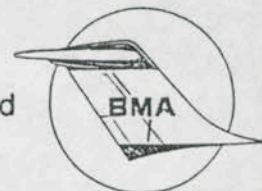
I hope you will feel that since my company has been the pioneer of creating competition to British Airways at Heathrow on U.K. domestic trunk routes, it entitles me to now alert you to vitally important issues which arise from the C.A.A. Report. I ask you to ensure that the need to carry out a financially satisfactory de-nationalisation of British Airways, within the proposed timetable, is not concluded at the expense of endangering the viability of our business and achievements to date.

There is a grave danger that the Government may be forced to accept the arguments advanced by the Board of British Airways, coupled with their supporting media advertising and other lobby pressures, and so take a wrong decision in rejecting, or making substantial amendments, to the recommendations of the C.A.A. Report.

The Appendix to this letter details our specific views which, I believe, are of crucial importance in arriving at the right decisions.

Whilst a failure of the British Airways' arguments to influence the final decision would be a set-back, the consequences for us in failing to convince you of the essential issues at stake will have the most far-reaching effects and lead to a major curtailment of our activities together with a large layoff of staff. More damaging, private airlines may soon be faced with an acute credibility problem with their Bankers and Finance Houses who are likely to adopt an exceptionally cautious approach to airlines whose prospects for growth are so seriously stunted.

We have shown that we are prepared to compete, neither do we seek to merely transfer a route monopoly from the public to the private sector. Whilst we share the view of British Caledonian that the C.A.A. Report perceptively identifies the problem of providing effective airline competition and gives a lucid analysis of difficulties in implementation I must make it clear to you that we have never supported the British Caledonian case to acquire assets from British Airways.



However it may have been overlooked that to achieve the goal of having a competition policy in the airline industry there is initially the need to permit the development of sufficient soundly based airlines. They need satisfactory route networks creating adequate profits so that the scale of financial resources needed to launch new competing air services can be accumulated.

Unless this first stage is supported and the recommendations of the C.A.A. Report, particularly in respect of European air services from provincial airports and our own submission to compete with British Airways from Heathrow on international services, carried out - there is likely to remain a situation where the present dominant single airline style is perpetuated and increased instead of creating effective competing airlines.

My companies are now suffering severe predatory action from British Airways which has nothing to do with achieving improved competition between the airlines but is specifically directed towards our demise.

Furthermore, as a private sector company, our future is being determined, or significantly influenced, by no less than four elements of State patronage - the Civil Aviation Authority, the British Airports Authority, British Airways as a nationalised industry and the Department of Transport.

For a Government determined to create opportunities for individual effort free of excessive state influence, you will understand the real fear that our survival is in jeopardy through failing to get a fair and unbiased hearing of our views.

There is always a temptation for Government to compromise for short term expediencies. Resisting these temptations has been the hallmark of your Administration. However past support and subsidies both in the Railways and Coal Industry which may have appeared attractive at the time have, perhaps, in the final analysis not accelerated the targets which the Government has set itself in achieving lasting improvements of efficiency in these industries. A similar difficulty could develop in the air transport industry if decisive action is not taken now.



This is not a complaining letter neither do I seek any advantage from your Government in our future trading opportunities other than to ensure that British Airways is not sustained in a preferred and privileged position in the U.K. air transport industry.

I believe arrangements are in hand for me to meet you at an early date. I look forward to this as it will enable me to amplify some of the arguments in this letter and its Appendix and explain my approach to an equitable solution.

Yours sincerely
Michael Bishop.

Michael Bishop,
Chairman and Managing Director.

Rt. Hon. Margaret Thatcher, M.P.

APPENDIX
to letter 29.8.84.

1. Competition of British Airways with other Airlines and particularly its role at Heathrow

It is clear to us that the Government must take decisive action to ensure that British Airways in whatever form it is de-nationalised is not in a position to seriously undermine the activities of the gradually developing competing airlines.

The best qualified body to undertake the role of licencing and monitoring an expansion of competition is the Civil Aviation Authority. Rather than relegate its influence and powers - they should be augmented in the short term to ensure a satisfactory transition as new competition policies are implemented.

Whilst we wholeheartedly support the Government plans for bringing as many nationalised industries as possible to the Stock Market, including British Airways, we question whether enough thought and preparation has been given to the problem so familiar in the United States where effective Anti-trust legislation is needed to ensure that large dominant companies do not exercise anti-competitive practices in the market place.

I believe it is important for us to know how the Government proposes to deal with this very urgent problem.

More important, unless British Airways has competition from other British airlines on European and Intercontinental routes at its main base of operations at Heathrow the objectives of the Government in implementing its policies for airline competition cannot be realised.

This is best illustrated when in 1982, after three applications to operate competing services to Glasgow, Edinburgh and Belfast had been refused by the C.A.A., Lord Cockfield, then Secretary of State for Trade and Industry, farsightedly upheld our Appeal. This was the first time ever that another British airline had been permitted to compete with British Airways on any route out of Heathrow.

I outlined some of the problems we were facing, prior to this important decision allowing us to compete, in my last letter to you on April 1, 1982. Since inaugurating these services we have, by general consent, transformed the standards offered

to customers using these routes. We introduced a meal service and reduced fares. More significantly we provided the catalyst for forcing British Airways to improve its own product. Our presence on the routes, combined with the efforts of the new management at British Airways galvanised their staff in understanding the realities of competition. The combination of our new services and the later reaction by British Airways in introducing Super Shuttle resulted in a very substantial increase in total traffic on the routes as we had always forecast. We remain the only British airline providing exactly parallel competition at Heathrow to British Airways.

The Government can act positively to promote real competition by allowing my company and other British airlines currently using Heathrow to operate domestic routes, to now extend their operations to permit competition with British Airways on European and Intercontinental routes.

The Civil Aviation Authority has remained silent in its report on our request to give British Airways the same competition on international routes to complement our pioneering work on domestic route competition.

At the moment British Airways alone is the sole British airline operator of intercontinental and European scheduled services from Heathrow. They carry approximately 40 per cent of the traffic from Heathrow while nearly 60 per cent of the passenger business is carried by overseas airlines. It is quite wrong, in our view, that this situation has been allowed to develop and we criticise the C.A.A. for not acting before now.

It is claimed that British Airways competes with numerous international airlines from Heathrow. This mis-states the position. In the case of many highly profitable services to European capital cities British Airways "collaborates" not "competes" with reciprocal state airlines. They enter into profit sharing pool agreements and other anti-competitive practices which fly in the face of the Government's declared aim to promote competition and reduce fares. These arrangements are among the least attractive features of prevailing airline monopolies within the E.E.C. Indeed the C.A.A. have stated in their report (CAP500 page 5 para. 21) that if they were the sole regulatory authority they would prohibit these agreements as they are anti-competitive and create excessive profits.

It will be said that present Government airport policy does not permit the development of competing British airlines at Heathrow. If that is the case I ask you to change the policy. A minor amendment only is required to permit this essential element of promoting airline competition. There are sufficient existing British airlines now operating

domestic routes from Heathrow to allow competition on international routes to be started. We believe the reaction of overseas airlines to a change in the airport policy, only affecting current operators, would not be as hostile as officials at the C.A.A. and Department of Transport predict. Such a change in policy would not permit for example any major airline now based at Gatwick to transfer its routes to Heathrow but would allow the expansion of British airlines already operating there.

Heathrow is not as congested as the British Airports Authority has indicated. The C.A.A has identified the practicality of creating, subject to environmental considerations, a further 55,000 air transport movements per annum at Heathrow within the capability of existing Air Traffic Control procedures. We have proved from our competition on the domestic trunk routes that space can be provided for additional services through applying improved working practices and greater efficiency in the use of existing resources. In consideration of environmental issues it cannot be stated too clearly that the airline industry has invested hundreds of millions of pounds in greatly reducing aircraft noise. The noise contour for some of our newest aircraft does not extend beyond the perimeter of the airport itself and we believe operators are entitled to a dividend from this investment by being permitted to use airports with such commercial value as Heathrow to the maximum of their capacity.

2. Route Transfers from British Airways to other U.K. Scheduled Airlines

Route transfers are appropriate where it can be demonstrated that another airline can operate low volume or marginally profitable routes more successfully than the incumbent airline. These transfers have two benefits; they relieve British Airways of the need to invest resources at a low rate of return and thus enhance their own profitability. Similarly they offer smaller airlines the prospect of operating these routes profitably because their size and scale including lower unit costs create a more cost effective operation.

We have proved on previous occasions that this process permits improved consumer benefits both in terms of increasing the frequency of flights and lowering fares.

It is argued this process does not advance competition but in many cases there is insufficient traffic for more than one operator. There is a great danger in attempting to deregulate and liberalise air routes from the bottom upwards. The process has to start at the top with the high volume routes where profits can be generated by more than one carrier, as in the example of the U.K domestic trunk routes which are amongst the highest volume services in Europe.

British Airways have co-operated with us frequently in the past and achieved highly successful route transfers which have greatly enhanced their profitability. Their motives for not being prepared to do so on this occasion would appear to have little to do with their present or future financial performance but rather with specific commitments made to their staff to ensure a smooth transition for de-nationalisation.

It has been represented that any reduction in the size and shape of British Airways would have a calamitous effect on the price the Government realised from the sale of the company. This again is a distortion. There can be no doubt that if British Airways did not operate the majority of their domestic routes and the European services from provincial airports the profitability of British Airways as a whole would rise rather than fall.

Two outstanding examples of route transfers within the past six years well illustrate this point. In 1978 we took over all British Airways' routes at Liverpool where we understand they were losing more than £1M a year. Our investment in Merseyside now exceeds £5M. I would be surprised if any other private company in Britain has contributed more, pro-rata to its size, than my company has to Merseyside.

Since assuming the operation of these routes Liverpool has suffered its sharpest ever economic decline and we have had to constantly adapt our operation to remain viable. Yet we have never abandoned the target of making these routes profitable.

In spite of considerable political provocation and uncertainty concerning the future of Speke Airport, we have persevered towards our targets. Recently the airport was closed by Merseyside County Council for a day, with the Airport Committee Chairman posted on the picket line, costing us more than £10,000 in lost revenue. The reason for the airport closure was a protest against the Government's action in trying to restore sanity to the City administration.

We have finally turned the corner into profitability on these routes. In contrast to the performance of the Merseyside County Council, the cost to public funds for our efforts and achievements in Liverpool has been nil.

It is therefore regrettable that British Airways should enlist the active participation of two Metropolitan County Councils with similar political sympathies - Manchester and Birmingham - to block the recommended transfer of routes from those airports. Together they are adopting a tactic of deliberately introducing political issues which have no relevance to the recommendations of the C.A.A. Report but are designed to give the Metropolitan County Councils further ammunition to thwart Government policies when determining future airport ownership policies.

This has taken the form of a liaison between British Airways, its Trades Unions and their affiliated Members of Parliament.

At Birmingham, where we have declared an interest in adopting the C.A.A. recommendations, British Airways is using the liaison described above in an attempt to obtain support for retaining its remaining nine routes. British Airways has already abandoned seven routes from Birmingham during the past six years having failed to make them profitable.

In the case of one particular route, Birmingham/Brussels, this service was pioneered by British Midland in 1972 and was profitable. In 1978 we exchanged the route with British Airways for the Liverpool operations. Within four years the British Airways operation of the Birmingham/Brussels service was losing money heavily and the route abandoned. British Midland then restarted the service a second time and have subsequently restored profitability. This kind of record at Birmingham hardly qualifies British Airways to be retained as a suitable operator of domestic and international services from that and other provincial airports.

It is our firm understanding that, in order to achieve a substantial reduction in staff numbers, specific undertakings have been given to the British Airways Trades Unions guaranteeing no further redundancies or reduction in operations before de-nationalisation regardless of whether or not the routes concerned are really profitable and irrespective of if they have any long-term viability for the airline once it is in the private sector.

The relationship between the Trades Unions and British Airways is not a matter with which we can be concerned. However, it is quite improper that these undertakings, if given, should now be used as a pistol to the head either of the Government or the C.A.A. in an attempt to frame the outcome of the C.A.A. Review in favour of British Airways.

It appears that British Airways is prepared, in order to avoid further network cuts or route transfers to operate its entire domestic network, including the Shuttle, and practically all its European services from Manchester, Birmingham and Gatwick at such wafer thin profit margins that if the results from these activities were to be representative of the financial performance of British Airways as a whole - there would be little prospect for a successful Stock Market flotation.

You will, therefore, understand our great reluctance to be used once again as a back up facility in the event of the routes, after de-nationalisation, failing to produce acceptable returns for the new shareholders of British Airways.

If the existing independent airlines are to have a place in creating airline competition we cannot be expected always to be held waiting in the wings to be used as a stick to prod British Airways into competitive action as in the case of the U.K. domestic trunk routes, or to rescue faltering routes when it is convenient.

It has been said that a commitment was made by Sir John Nott in Parliament on November 19, 1979 that British Airways would be de-nationalised with its present route network intact. Furthermore this alleged commitment has been used as leverage to be dismissive towards the recommendations of the C.A.A. Report in respect of some route transfers and personal criticism has been made of the C.A.A. Chairman for his attempt to explain in public the Authority's judgement.

We believe the truth of the matter to be different. We are sure that Sir John Nott intended in his remarks to indicate that the Board of British Airways had freedom to run and shape their business as they wished and, when ready, whatever size the airline was at that time - it would be brought to the Stock Market as one unit and not be sold off in parts.

3. Predatory Action against us by British Airways

There is already adequate evidence of predatory practices by British Airways against us even before it is de-nationalised. A company, other than a nationalised industry, could never achieve the dominant market situation now enjoyed by British Airways without coming into conflict, during its development to that position, with the Monopolies and Mergers Commission or the provisions of the Competition Act. Every effort is being made by British Airways to sustain this preferred position after de-nationalisation.

The excess profits generated by the British Airways' monopoly of international services from Heathrow in collaboration with foreign airlines are used to sustain the highly marginal U.K. domestic route operation and other low volume services. It is this cushion of profitability which enables British Airways to take severe predatory action against our company.

This predatory action has taken a number of specific forms:

A) Domestic Trunk Routes.

1. Fares have been frozen on all U.K. domestic services for two years. Conversely basic European and Intercontinental fares have risen with inflation.

2. A large increase in route capacity on the trunk services has been operated in an attempt to drive down, though so far unsuccessfully, our market share to a point where it would be uneconomic for us to compete.

The resulting "profit" from British Airways' domestic operations is so miniscule it must be very doubtful if the new shareholders of British Airways would regard such a return adequate for the effort employed.

We assume that after de-nationalisation, and having reached a certain threshold of profitability to secure a successful flotation, the private investors and institutional shareholders will need to see a progressively increasing profit performance from British Airways. It seems to us that the present cross-subsidisation will have to cease and we therefore assume that the present willingness to accept very slim profitability stems from an attempt to curtail our own operations.

B) North Atlantic Scheduled Service Route Applications from Provincial Airports.

We applied to restore the Manchester/Glasgow-New York service, it having lapsed since being abandoned by British Airways in 1981. Although British Airways subsequently stated they had made a decision to re-start part of this route in 1985 their public announcement was delayed until the day before our licence application was heard by the C.A.A. This tactic was both irresponsible and unreasonable and compounds the difficulties for companies like British Midland to make application to restore lapsed routes.

As a result of various licencing manoeuvres, now the subject of an Appeal by us to the Secretary of State for Transport, British Airways have retained a licence to fly from Manchester to New York but have been unwilling to restore the lapsed service from Glasgow. Consequently by denying us the opportunity to operate successfully from Manchester they have denied the prospect of the route being restarted from Glasgow since the combination of the two airports was a vital factor in sustaining the revived route on a year-round basis.

C) Heathrow/Belfast Trunk Route Application.

When the Civil Aviation Authority finally granted us permission to operate this route in July 1983 - British Airways chose to challenge this decision in the High Court. This action hardly squares up with an airline that has made its strongest public statement in dismissing the C.A.A. Report in claiming that it welcomes competition.

Directly as a result of this action the introduction of the route was delayed by some six months with the consequential deferment of consumer benefits on this service and large additional legal costs which we had to meet.

You will understand how damaging this action has been in Northern Ireland for British Midland since we have sustained scheduled air services from the Province throughout the current difficulties. Furthermore we were the first airline whose aircrew agreed to stay overnight in Belfast whilst other

airlines had to ferry their staff back to other parts of Britain for overnight accommodation.

We have further supported the economy of Northern Ireland in a practical way through being the largest U.K. operator of Shorts SD360 prop-jet aircraft which are built in Belfast. Our Group has invested £14million in this type of aircraft and currently operates six units. As in the case of our Liverpool operations we have made no call on Government funds or subsidy in making our commercial decision to support Northern Ireland industry.



Chancellor of the Duchy of Lancaster

PRIME MINISTER

AVIATION POLICY

Although I no longer have any official responsibility for these matters they fell within my remit when I was Secretary of State for Trade and it was during my period of office that the fortunes of British Airways were transformed by John King. You may therefore wish to have a note of my views particularly as the matter is one which also has a significant European dimension.

First we should in my view completely deregulate the domestic market. I had moved significantly in this direction when Trade Secretary: but it does require primary legislation to complete the process. On grounds of competition there is every reason for doing this.

Second to make competition effective it is essential to prohibit cross subsidization - particularly by British Airways. A mere prohibition of "predatory pricing" does not go far enough. The real danger to competition lies in British Airways using profits on its international operations to support domestic services which are uneconomic or to subsidize charter business. In the case of British Telecom cross subsidization between the major parts of the business was specifically prohibited and accounting requirements were imposed to ensure compliance. We need to go at least as far in the case of British Airways.

Third we should wherever practicable press for dual or multiple designation on European and Inter Continental routes. Action within the Community is badly overdue.

Fourth I can see no justifiable case for compulsory transfer of monopoly routes to British Caledonian or to anyone else. This has nothing to do with competition. It is simply replacing one monopolist by another. And it is doing it by transferring a large amount of profit at present accruing to a State owned enterprise to a privately owned enterprise without any consideration. Indeed one could take the view that because the result would be substantially to reduce the proceeds of privatising British Airways and substantially increase the market capitalisation of British Caledonian one was making a present of hundreds of millions of pounds of public money to a privately owned organisation. I accept there is nothing to prevent Parliament doing this by legislation: but it would be a questionable course of action.

Fifth Access to Heathrow is a crucial element in all of this. The fact that for historical reasons British Airways has preferential or in some respects virtually exclusive access to Heathrow puts the independents at a serious competitive disadvantage. I realise the difficulties involved in freer access to Heathrow. The Consultative Document recently issued is too restrictive in its approach. It still clings doggedly to ATM (number of air traffic movements) as the measuring rod. This is based on an outdated approach and this indeed was the view taken by E(DL) Committee when it saw the draft of the Consultative Document. It could well be that the adoption of an alternative measure more closely related to noise pollution would allow more intensive use of Heathrow without adding to environmental damage.

A.C.

A C

11 September 1984


CONFIDENTIAL

P.01381

PRIME MINISTER

Civil Aviation Authority Review

BACKGROUND

The Civil Aviation Authority (CAA) was invited by the Secretary of State for Transport to review the implications of the privatisation of British Airways (BA) for competition and the sound development of the British airline industry. The report of the CAA in response to that invitation was published on 16 July. Among its main recommendations were the following.

(i) Relinquishment by BA of scheduled service routes out of Manchester and Birmingham to a wide variety of destinations in Western Europe; between Glasgow and Paris; between Heathrow and Saudi Arabia and between Heathrow and Harare; and between Gatwick and points in Spain, Portugal, Gibraltar, Italy and Scandinavia. Apart from the Manchester and Birmingham routes, which would pass to smaller airlines, the routes concerned would be likely to be awarded by the CAA to British Caledonian (BCal).

(ii) A number of measures to increase competition in the British airline industry.

(iii) A strengthening of the CAA's own powers, notably to give the CAA a direct statutory duty to secure the sound development of the British airline industry, for example by suitable use of its licensing powers.

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2. Ministers collectively have considered these recommendations on several occasions, both in E(A)(E(A)(84)19th Meeting, Item 3) and in Cabinet (CC(84)27th, 28th and 29th Conclusions). It has been common ground that the recommendations summarised at (ii) above should be accepted and those at (iii) rejected. There has, however, been a sharp difference of view on the recommendations concerning route transfers. At their meeting on 2 August (CC(84)29th Conclusions, Minute 5) the Cabinet invited the Secretary of State for Transport to prepare a further paper discussing the issues. You said that you would arrange for a small group of Ministers under your chairmanship to give preliminary consideration to those issues before the Cabinet resumed their discussion.

3. This preliminary consideration is to take place tomorrow, 11 September, on the basis of a memorandum by the Secretary of State for Transport (C(84)22). This argues that it is necessary to maintain an effective British competitor to BA (in practice, this means BCal) on international scheduled routes; and that both for this reason and because it seems likely that the privatisation of BA will have to be conducted in a way which will be open to criticism as a subvention to BA from public funds, route transfers from BA to BCal are needed. The memorandum is not altogether explicit on which routes should be transferred; but it mentions the following possibilities.

	<u>Effect on BA turnover</u>		<u>Effect on BA operating profit</u>	
	£million	%	£million	%
1. Saudi Arabia	77	3.3	22-25	7.8-8.9
2. Harare plus certain Gatwick services	32	1.4	7	2.5
3. Caribbean	50	2.1	5-10	1.8-3.6

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Mr Ridley also suggests that some of BA's business routes to Europe out of regional airports should be transferred to other independent carriers, with the following effects.

	<u>Effect on BA turnover</u>		<u>Effect on BA operating Profit</u>	
	£million	%	£million	%
4. 50% of capacity on European routes from regional airports.	27	1.1	2	0.7

4. In paragraph 10 of C(84)22 Mr Ridley outlines the latest counter-proposal from BA: that BCal should be designated as second British carrier on a number of routes. However, many of these dual designations would need the agreement of overseas' governments (who would demand difficult concessions in return); and it would not sufficiently strengthen BCal's currently inadequate financial base. Mr Ridley therefore rejects it.

5. It seems clear that Lord King and his Board would strongly oppose route transfers. Mr Ridley discusses a number of ways of overcoming these objections: in view of the risks of legal challenge and challenge on grounds of financial propriety, he concludes in favour of primary legislation early in the next Session of Parliament.

6. Finally, C(84)22 discusses the litigation in train in the United States courts. The relevance of this is that BA (and, for that matter, BCal) faces claims for very large sums, of the order of \$2 billion in damages. In previous discussions some Ministers have suggested that the uncertainties created by these claims could lead to a lengthy deferment of privatisation, so that it would be wrong to let the wish to privatise BA influence decisions on the CAA recommendations. The analysis in C(84)22 suggests that the uncertainties

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are likely to last for a long time; but it does not seem to suggest that they will necessarily be a bar to privatisation.

7. Mr Ridley proposes that he should communicate the Government's decisions to Lord King and then publish them in the form of a well-argued White Paper.

MAIN ISSUES

8. The issues before Ministers are as follows.

- (i) Should routes be transferred from BA to other airlines?
- (ii) If so, which routes?
- (iii) How should any transfers be effected?
- (iv) How should the Government's decisions be announced?

In practice the first three of these issues are likely to be inter-dependent.

Should routes be transferred?

9. The main points which Ministers will wish to consider are as follows.

- (a) The effects on competition. It is unlikely to be disputed that it would be desirable to have two, or more, strong British airlines freely competing on all international routes. Unfortunately, because competition in air transport is so heavily restricted by international agreements, it is not a possibility for the foreseeable future. The argument therefore has to turn on the less direct benefits


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of strengthening BCal's financial position by allowing it to enjoy monopoly-type profits on certain additional routes so that it can compete more effectively on those routes, both domestic and international, where genuine competition is a possibility. It is this argument which is the fundamental reason for Mr Ridley's rejection of the BA counter-proposal reported in paragraph 10 of his memorandum. However, it may not be altogether easy to put across in public discussion. Moreover, there are some other uncomfortable implications not far below the surface of C(84)22: that an efficient BA is dangerous; that a privatised BA might be either predatory (paragraph 4) or tempted to slip back into 'cosy arrangements' with other airlines (paragraph 5(a)); and that financially weak airlines should be shored up by reallocation of routes.

(b) The implications for privatisation. Hill Samuel have advised that if route transfers reduced BA's forecast profits by more than about 10 per cent the risks to privatisation would be unacceptable. It seems inevitable that any package of transfers involving the Saudi Arabian routes will reduce profits by at least that figure. (The minimum estimates in C(84)22, summarised in paragraph 3 above, suggest that even without the transfer of Caribbean routes, the reduction in operating profit would be 11 per cent.) Moreover, there must be a risk that Lord King and his Board would resign if any substantial route transfers were forced through: if they did, there could be no privatisation of BA for a considerable time. Mr Ridley's assessment before the Recess was that the risk of resignation was small. But since then much has happened, including public statements of attitude. His colleagues will wish to ask him for his current view.

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(c) The implications for future policy. C(84)22 discusses the route transfers under consideration explicitly as a one-off operation. But it may well be suggested in public debate that if it is the Government's fundamental policy to maintain at least two British airlines operating international scheduled routes, that could well entail further route transfers at some later date, for example if the finances of the second airline deteriorated. This risk would be increased by the line of reasoning outlined in paragraph 25 of C(84)22 to justify apparent departure from past pledges by Government spokesmen.

Which routes?

10. As noted earlier, C(84)22 is not entirely explicit about which routes should be transferred. The most important question is whether the Saudi routes should be transferred. On the one hand, transfers including them seem very likely to have serious implications for the privatisation timetable; on the other, transfers not including those routes are unlikely to be of enough benefit to BCal's finances to be worthwhile.

11. As for the other routes, there is one general point which Ministers will wish to bear in mind. All decisions on transfers, whether for or against, will be strongly criticised by someone. It would be possible to make a case for the rejection of all the CAA recommendations on the grounds that they would in reality do nothing to promote effective competition. But if Ministers decide that some transfers are justified there will be strong arguments for sticking as closely as possible to the specific transfers recommended by the CAA. Otherwise it would be asked what purpose was served by asking the CAA to conduct the review at all. If this argument is accepted, it creates a presumption:

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(a) against the transfer of Caribbean routes discussed in paragraph 11(c) of C(84)22; and

(b) for the full transfer to the other independent airlines of BA's European services from regional airports, despite the arguments in paragraph 14 of C(84)22 for a transfer of only half the capacity. (It is also relevant that the finances of the other independent airlines are, to say the least, no stronger than those of BCal; and that there will be considerable criticism if the whole exercise appears to be designed to favour BCal rather than to help the independent airlines more generally).

Method of effecting transfer

12. The arguments in favour of effecting any transfer of routes by primary legislation seems strong. Other approaches seem likely to attract legal challenge (which would be embarrassing even if ultimately unsuccessful), or to create objections of Parliamentary propriety. Any such legislation would certainly be opposed strongly by the Labour Party. Ministers will wish to assess the risks of opposition among their own supporters.

Announcements

13. Mr Ridley proposes that the Government's decisions should be announced in a White Paper. Given the public interest that the subject has aroused, and the certainty of objections from interested parties, it is clear that the text of any announcement will need to be very carefully drafted. However, Ministers will wish to consider the possibility that it might look odd to issue a White Paper on a set of specific decisions rather than a general policy. Indeed, the publication of a White Paper could well strengthen suggestions, which are likely to be made in any event, that the Government should declare its

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general attitude to competition among British airlines and whether it might contemplate further route transfers in certain circumstances.

HANDLING

14. You will wish to invite the Secretary of State for Transport to open the discussion. The Chancellor of the Exchequer will have views on the implications for the privatisation programme and for competition. The Secretary of State for Trade and Industry will also have views on competition aspects; and, as you know, he feels strongly that the proposals in C(84)22 would be inconsistent with assurances which have been given to BA and Parliament in the past. The Lord Privy Seal and the Chief Whip can advise on the implications of any legislation for the Parliamentary timetable and the likely attitudes of Government supporters. The Solicitor General can deal with any legal questions.

CONCLUSIONS

15. The conclusions of the meeting must, of course, be subject to the views of the Cabinet on 13 September. However, you will wish to reach as great a measure of agreement as possible on the following.

-
- (i) Whether any routes should be transferred from BA to other independent airlines.
 - (ii) If so, which routes should be transferred?
 - (iii) If there are to be route transfers, should they be effected by legislation?
 - (iv) Announcements.

PLG
P L GREGSON
Cabinet Office.
10 September 1984



FCS/84/243

SECRETARY OF STATE FOR TRANSPORT

1. In view of my absence in Dublin on 11 September, I shall not, unfortunately, be able to attend the Ministerial discussions of the draft Cabinet paper on the CAA Review. I am therefore writing with my comments on those aspects of the paper which have an international dimension.

2. The effectiveness of the proposals dealing with the international routes is, of course, bound to be influenced by the reactions of the other countries involved. We shall need to take the following considerations into account when deciding what action to take on the Review's recommendations:

(a) in the course of the public debate on the CAA Review, it has frequently been argued, particularly by BA, that the best way of advancing competition would be to promote dual designation rather than transfer routes, since the latter merely replaces one UK carrier by another without introducing direct competition between them. This argument ignores the fact that very few countries are prepared to accept dual designation. For instance, strong resistance by the Saudis to dual designation has prevented BCal from operating on the Riyadh route while BA is still operating into Jeddah.

(b) Even where a straight substitution takes place, it is likely that the other government will seek to improve the position of its own airline at the expense of the newcomer. Zimbabwe for example, has indicated that it would not accord BCal the privileged position now enjoyed by BA.

/(c)



- (c) Some countries may also react adversely to being allocated the second airline as opposed to the national flag carrier.
- (d) A change could also reinforce the competitiveness of the other country's national airline if it had access to Heathrow, while the British carrier operated from Gatwick with its poorer network on onward connections. And any suggestion that those flying into Heathrow should change to Gatwick would be firmly resisted.

3. Even so, we must be careful not to allow these tactical arguments to blind us to more important strategic analysis. British Caledonian are currently suffering from a route network heavily dependent on debt-ridden developing countries in South America and Africa. If they are to provide effective competition to British Airways in Europe or, eventually, on the Australian route, they will need a stronger base than their present routes provide. This is at the heart of the CAA case - which is really our own - for an airline industry with some chance of real competition, diversity and choice between operators that are all in private ownership and strong enough to stand on their own feet. I have found it very helpful to read the restatement of that case by John Dent at last month's Financial Times conference.

4. It is on this basis that I approach the conclusions in your paper. I have no difficulty with any of them in principle, but I think we shall have to look carefully at the practical consequences of the various options for route transfers:

- (a) to give BCal all the Saudi routes would be a bold move. It would certainly vastly improve BCal's position. But it would, as our Embassy in Jeddah have already reported, put severe strain on our relations with the Saudis, both government and private companies, and probably lead to a transfer of business to the other airlines which

/would



would affect British earnings on these routes and onward to New York;

- (b) the Zimbabweans will seek to exploit any change to BCal to alter the balance of the Air Services Agreement established at independence, which they believe unduly favoured BA;
- (c) the Caribbean is an area in which we have a number of on-going air service problems resulting from rivalries between the small states involved and their suspicion of the old colonial power.

And in all cases there is the penalty to be paid in the lost revenue from the substitution of Gatwick for Heathrow as the British airline's terminal point.

5. I would have no objection to agreeing now to the transfer of the Harare and Caribbean routes; but if the Saudi routes are also proposed for transfer I think we should first consider very carefully the consequences both for our relations with Saudi Arabia and for privatisation of BA.

6. Of course, as your paper points out, privatisation may in any case be delayed by the Laker dispute. And it is attractive to agree that in that case we can afford to delay our response to the CAA Review, which was after all prompted by the need to consider the effect of an unreconstructed BA on the civil aviation market after privatisation. But the Saudi problem is, as you know, with us anyway. The Riyadh route has only recently been opened to international traffic and the CAA have awarded the route to BCal. You have dismissed BA's appeal against this decision. The Saudis, however, remain adamantly opposed to dual designation ie they will not let BCal on to the Riyadh route while BA retain the Jeddah and Dhahran routes. There is little we can do to budge them. If we cannot



use dual designation, and are not ready to agree that BCal have all the Saudi routes, are we really content that no British airline should, for the present at least, serve the particularly lucrative Riyadh route?

7. The difficulties argue themselves, as you know far better than I. But I am sure you are right **not** to let them stand in the way of your overall strategy.

8. I am sending copies of this minute to ~~our~~ Cabinet colleagues and to Sir Robert Armstrong.

A handwritten signature in dark ink, appearing to be 'G. Howe', written in a cursive style.

GEOFFREY HOWE

Foreign and Commonwealth Office

10 September 1984



10 DOWNING STREET

From the Private Secretary

Prime Minister

Since you saw the papers at the weekend we have received the Cabinet Office brief and comments from Foreign Secretary (who doubts whether there is much scope for the kind of dual designation BA are advocating).

One dimension not covered in the papers is the charter market. The charter firms have two worries

(i) BA can use profits from the Saudi route etc to cross subsidize British Airways, its charter subsidiary

(ii) BA can use sell surplus seats on some scheduled routes eg Venice, to the tourist market.

AT
10/9

Charter



10 DOWNING STREET

From the Private Secretary

Prime Minister ①

These papers will be discussed on Tuesday
and again at Cabinet on Thursday.
A Cabinet Office brief will be available
on Monday.

In my view the Redley's proposals
are more consistent with the Government's
philosophy on competition and enterprise
than the Chancellor / Tebbit view. But
you may feel that the course of legislation
is politically too dangerous.

AT
7/9

B.A. - Riyadh

B. Cal. -

B. Cal.

Lower flights
Health row



10 DOWNING STREET

From the Private Secretary

Prime Minister ①

You are seeing Mr Bishop on Wednesday before the CIAA report is discussed at Cabinet but after the meeting of the smaller Ministerial group on Tuesday. A brief from D/Top will be sent on next week but you might like to see Mr Bishop's arguments before the Tuesday meeting. I also attach a comment by Bob Young.

BT
7/9

PRIME MINISTER

7 September 1984

CIVIL AVIATION POLICY

We see nothing but trouble in Mr Ridley's key recommendations, which are:

- i. to enforce route transfers from BA mainly to BCal by means of limited life legislation;
- ii. to defer the privatisation of a reduced size BA.

The costs - financial and other - of doing this are open-ended, but the benefits very limited. In our view the disadvantages are:

- The transfer of monopoly route rights will benefit a few airlines, not the consumer.
- Like it or not, we will be seen to have pledged a future for the independents in general and for BCal in particular. What happens if the transfer of routes in 1985 does not work?
- BA will have to dispose of surplus physical assets and staff. We do not know the direct cost, but must count on disruption costs too.
- The value of BA on sale will be reduced and the sale itself delayed. None of the so called off-setting benefits will accrue to the taxpayer.
- The general intent, and certainly the Bill which Mr Ridley has in mind, will upset as many of our supporters as it pleases. It is guaranteed to increase media attention to the dilemma facing the government. If there is any gain of political goodwill in Mr Ridley's proposals, it is likely to be very small. Our privatisation programme could look a shambles.

We recommend:

- a. no route transfers;
- b. as complete a form of deregulation as is possible on domestic routes (as the CAA recommend);
- c. either applying a limit to the life of the route licences, so that airlines have to rebid at regular intervals;
or
dual designation of routes on as wide a scale as is feasible;
- d. proceed with the privatisation of BA in Spring 1985 as planned.


ROBERT YOUNG

MR TURNBULL

7 September 1984

c Mr Redwood

PRIME MINISTER'S MEETING WITH MR MICHAEL BISHOP,
BRITISH MIDLAND AIRWAYS

Even with the verbiage stripped away, it is still difficult to see precisely what Mr Bishop wants. The essence of his argument seems to be that:

- i. BMA has competed successfully with BA on domestic routes out of Heathrow. BMA would now like to compete with BA on international routes out of Heathrow, and out of the provincial airports too.
- ii. This would tend to increase the number of Air Traffic Movements at Heathrow, which HMG is committed to limiting to 275,000 per annum. HMG should raise the limit.
- iii. BA is behaving in a predatory fashion by holding down domestic fares and increasing route capacity; by obstructing BMA's applications to fly Manchester/New York and Glasgow/New York; and by having made life difficult for BMA in obtaining a licence to fly Heathrow/Belfast - although BMA did obtain it and is flying the route.

Subsidiary - and I suggest unrelated - points which Mr Bishop makes are:

- iv. he is an entrepreneur in the best Conservative tradition;
- v. he does not wish to associate himself with BCal's stated desire to acquire assets from BA;
- vi. he has supported two difficult areas of the country, Merseyside and Northern Ireland, by respectively running routes out of Liverpool airport and by purchasing Shorts aircraft.

Questions which arise from Mr Bishop's case are:

- a. How does BMA wish to compete with BA on international routes out of Heathrow? Does Mr Bishop have route transfers in mind, or dual designation, or what? And what routes does he wish to compete on?
- b. Can HMG really walk away from its declared limit of 275,000 movements per year at Heathrow? I think

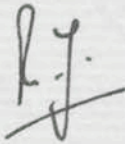
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not, even if the number looks low relative to the passenger capacity which Terminal 4 will provide. The lower noise emissions of current generation aircraft were taken into account when the figure of 275,0000 was arrived at.

- c. Surely price competition on domestic routes is an inevitable consequence of the large measure of deregulation we already have? It is a matter of judgement whether any given level of fare is predatory, and it is open to BMA to demonstrate their belief objectively.

Clearly, the Prime Minister cannot comment on the Manchester/New York and Glasgow/New York routes while they are subject to appeal. But some weeks ago British Airways described another side of each case for me: that voluntary restraints on total North Atlantic capacity have deterred BA from restarting Manchester/New York, and that there is doubt about whether Glasgow airport is suitable for transatlantic traffic. I make no comment on what BA said, but I think it does demonstrate that there is more than one side to most accusations.

All in all, it seems to me that the Prime Minister can and should do no more than politely hear Mr Bishop out.



ROBERT YOUNG

CONFIDENTIAL

British Midland Airways Ltd

Donington Hall, Castle Donington,
Derby DE7 2SB England
Telephone: Derby (0332) 810741/Telex: 37172



Your Ref:

Our Ref: MDB/RAM

August 29, 1984

Rt. Hon. Margaret Thatcher, M.P.,
10 Downing Street,
London, S.W. 1.

Dear Prime Minister,

I am writing personally to you as the controlling shareholder of the largest privately owned U.K. airline group comprising three airlines; British Midland, Manx Airlines and Loganair. Together they fly from 28 airports in the British Isles, carry 2 million passengers a year, operate 40 aircraft, employ 2,000 staff and generate revenues of more than £100M per annum. British Midland Airways is the second busiest airline operating at Heathrow with more than 500 arrivals and departures each week.

I wish to express how threatened and vulnerable I consider our future prospects if satisfactory decisions are not reached by your Government following receipt of the Civil Aviation Authority's Policy Review.

My partners and I have during the past six years put into practice your philosophy of self sufficiency and enterprise by accepting a total personal financial commitment by acquiring our company through a management buy out in 1978. We did so in the anticipation that a Conservative Government, when elected, would support as a priority those individuals who were prepared to stake all they possessed in order to become owners of their own business.





I feel sure you will agree that this commitment of your Government to private sector investors taking such risks is of far greater long term importance than the short term consideration of satisfying the Board of British Airways whose members have, at the present time, no personal financial stake in their company.

I hope you will feel that since my company has been the pioneer of creating competition to British Airways at Heathrow on U.K. domestic trunk routes, it entitles me to now alert you to vitally important issues which arise from the C.A.A. Report. I ask you to ensure that the need to carry out a financially satisfactory de-nationalisation of British Airways, within the proposed timetable, is not concluded at the expense of endangering the viability of our business and achievements to date.

There is a grave danger that the Government may be forced to accept the arguments advanced by the Board of British Airways, coupled with their supporting media advertising and other lobby pressures, and so take a wrong decision in rejecting, or making substantial amendments, to the recommendations of the C.A.A. Report.

The Appendix to this letter details our specific views which, I believe, are of crucial importance in arriving at the right decisions.

Whilst a failure of the British Airways' arguments to influence the final decision would be a set-back, the consequences for us in failing to convince you of the essential issues at stake will have the most far-reaching effects and lead to a major curtailment of our activities together with a large layoff of staff. More damaging, private airlines may soon be faced with an acute credibility problem with their Bankers and Finance Houses who are likely to adopt an exceptionally cautious approach to airlines whose prospects for growth are so seriously stunted.

We have shown that we are prepared to compete, neither do we seek to merely transfer a route monopoly from the public to the private sector. Whilst we share the view of British Caledonian that the C.A.A. Report perceptively identifies the problem of providing effective airline competition and gives a lucid analysis of difficulties in implementation I must make it clear to you that we have never supported the British Caledonian case to acquire assets from British Airways.



However it may have been overlooked that to achieve the goal of having a competition policy in the airline industry there is initially the need to permit the development of sufficient soundly based airlines. They need satisfactory route networks creating adequate profits so that the scale of financial resources needed to launch new competing air services can be accumulated.

Unless this first stage is supported and the recommendations of the C.A.A. Report, particularly in respect of European air services from provincial airports and our own submission to compete with British Airways from Heathrow on international services, carried out - there is likely to remain a situation where the present dominant single airline style is perpetuated and increased instead of creating effective competing airlines.

My companies are now suffering severe predatory action from British Airways which has nothing to do with achieving improved competition between the airlines but is specifically directed towards our demise.

Furthermore, as a private sector company, our future is being determined, or significantly influenced, by no less than four elements of State patronage - the Civil Aviation Authority, the British Airports Authority, British Airways as a nationalised industry and the Department of Transport.

For a Government determined to create opportunities for individual effort free of excessive state influence, you will understand the real fear that our survival is in jeopardy through failing to get a fair and unbiased hearing of our views.

There is always a temptation for Government to compromise for short term expediencies. Resisting these temptations has been the hallmark of your Administration. However past support and subsidies both in the Railways and Coal Industry which may have appeared attractive at the time have, perhaps, in the final analysis not accelerated the targets which the Government has set itself in achieving lasting improvements of efficiency in these industries. A similar difficulty could develop in the air transport industry if decisive action is not taken now.



This is not a complaining letter neither do I seek any advantage from your Government in our future trading opportunities other than to ensure that British Airways is not sustained in a preferred and privileged position in the U.K. air transport industry.

I believe arrangements are in hand for me to meet you at an early date. I look forward to this as it will enable me to amplify some of the arguments in this letter and its Appendix and explain my approach to an equitable solution.

Yours sincerely
Michael Bishop.

Michael Bishop,
Chairman and Managing Director.

Rt. Hon. Margaret Thatcher, M.P.

APPENDIX
to letter 29.8.84.

1. Competition of British Airways with other Airlines and particularly its role at Heathrow

It is clear to us that the Government must take decisive action to ensure that British Airways in whatever form it is de-nationalised is not in a position to seriously undermine the activities of the gradually developing competing airlines.

The best qualified body to undertake the role of licencing and monitoring an expansion of competition is the Civil Aviation Authority. Rather than relegate its influence and powers - they should be augmented in the short term to ensure a satisfactory transition as new competition policies are implemented.

Whilst we wholeheartedly support the Government plans for bringing as many nationalised industries as possible to the Stock Market, including British Airways, we question whether enough thought and preparation has been given to the problem so familiar in the United States where effective Anti-trust legislation is needed to ensure that large dominant companies do not exercise anti-competitive practices in the market place.

I believe it is important for us to know how the Government proposes to deal with this very urgent problem.

More important, unless British Airways has competition from other British airlines on European and Intercontinental routes at its main base of operations at Heathrow the objectives of the Government in implementing its policies for airline competition cannot be realised.

This is best illustrated when in 1982, after three applications to operate competing services to Glasgow, Edinburgh and Belfast had been refused by the C.A.A., Lord Cockfield, then Secretary of State for Trade and Industry, farsightedly upheld our Appeal. This was the first time ever that another British airline had been permitted to compete with British Airways on any route out of Heathrow.

I outlined some of the problems we were facing, prior to this important decision allowing us to compete, in my last letter to you on April 1, 1982. Since inaugurating these services we have, by general consent, transformed the standards offered

to customers using these routes. We introduced a meal service and reduced fares. More significantly we provided the catalyst for forcing British Airways to improve its own product. Our presence on the routes, combined with the efforts of the new management at British Airways galvanised their staff in understanding the realities of competition. The combination of our new services and the later reaction by British Airways in introducing Super Shuttle resulted in a very substantial increase in total traffic on the routes as we had always forecast. We remain the only British airline providing exactly parallel competition at Heathrow to British Airways.

The Government can act positively to promote real competition by allowing my company and other British airlines currently using Heathrow to operate domestic routes, to now extend their operations to permit competition with British Airways on European and Intercontinental routes.

The Civil Aviation Authority has remained silent in its report on our request to give British Airways the same competition on international routes to complement our pioneering work on domestic route competition.

At the moment British Airways alone is the sole British airline operator of intercontinental and European scheduled services from Heathrow. They carry approximately 40 per cent of the traffic from Heathrow while nearly 60 per cent of the passenger business is carried by overseas airlines. It is quite wrong, in our view, that this situation has been allowed to develop and we criticise the C.A.A. for not acting before now.

It is claimed that British Airways competes with numerous international airlines from Heathrow. This mis-states the position. In the case of many highly profitable services to European capital cities British Airways "collaborates" not "competes" with reciprocal state airlines. They enter into profit sharing pool agreements and other anti-competitive practices which fly in the face of the Government's declared aim to promote competition and reduce fares. These arrangements are among the least attractive features of prevailing airline monopolies within the E.E.C. Indeed the C.A.A. have stated in their report (CAP500 page 5 para. 21) that if they were the sole regulatory authority they would prohibit these agreements as they are anti-competitive and create excessive profits.

It will be said that present Government airport policy does not permit the development of competing British airlines at Heathrow. If that is the case I ask you to change the policy. A minor amendment only is required to permit this essential element of promoting airline competition. There are sufficient existing British airlines now operating

domestic routes from Heathrow to allow competition on international routes to be started. We believe the reaction of overseas airlines to a change in the airport policy, only affecting current operators, would not be as hostile as officials at the C.A.A. and Department of Transport predict. Such a change in policy would not permit for example any major airline now based at Gatwick to transfer its routes to Heathrow but would allow the expansion of British airlines already operating there.

Heathrow is not as congested as the British Airports Authority has indicated. The C.A.A has identified the practicality of creating, subject to environmental considerations, a further 55,000 air transport movements per annum at Heathrow within the capability of existing Air Traffic Control procedures. We have proved from our competition on the domestic trunk routes that space can be provided for additional services through applying improved working practices and greater efficiency in the use of existing resources. In consideration of environmental issues it cannot be stated too clearly that the airline industry has invested hundreds of millions of pounds in greatly reducing aircraft noise. The noise contour for some of our newest aircraft does not extend beyond the perimeter of the airport itself and we believe operators are entitled to a dividend from this investment by being permitted to use airports with such commercial value as Heathrow to the maximum of their capacity.

2. Route Transfers from British Airways to other U.K. Scheduled Airlines

Route transfers are appropriate where it can be demonstrated that another airline can operate low volume or marginally profitable routes more successfully than the incumbent airline. These transfers have two benefits; they relieve British Airways of the need to invest resources at a low rate of return and thus enhance their own profitability. Similarly they offer smaller airlines the prospect of operating these routes profitably because their size and scale including lower unit costs create a more cost effective operation.

We have proved on previous occasions that this process permits improved consumer benefits both in terms of increasing the frequency of flights and lowering fares.

It is argued this process does not advance competition but in many cases there is insufficient traffic for more than one operator. There is a great danger in attempting to deregulate and liberalise air routes from the bottom upwards. The process has to start at the top with the high volume routes where profits can be generated by more than one carrier, as in the example of the U.K domestic trunk routes which are amongst the highest volume services in Europe.

British Airways have co-operated with us frequently in the past and achieved highly successful route transfers which have greatly enhanced their profitability. Their motives for not being prepared to do so on this occasion would appear to have little to do with their present or future financial performance but rather with specific commitments made to their staff to ensure a smooth transition for de-nationalisation.

It has been represented that any reduction in the size and shape of British Airways would have a calamitous effect on the price the Government realised from the sale of the company. This again is a distortion. There can be no doubt that if British Airways did not operate the majority of their domestic routes and the European services from provincial airports the profitability of British Airways as a whole would rise rather than fall.

Two outstanding examples of route transfers within the past six years well illustrate this point. In 1978 we took over all British Airways' routes at Liverpool where we understand they were losing more than £1M a year. Our investment in Merseyside now exceeds £5M. I would be surprised if any other private company in Britain has contributed more, pro-rata to its size, than my company has to Merseyside.

Since assuming the operation of these routes Liverpool has suffered its sharpest ever economic decline and we have had to constantly adapt our operation to remain viable. Yet we have never abandoned the target of making these routes profitable.

In spite of considerable political provocation and uncertainty concerning the future of Speke Airport, we have persevered towards our targets. Recently the airport was closed by Merseyside County Council for a day, with the Airport Committee Chairman posted on the picket line, costing us more than £10,000 in lost revenue. The reason for the airport closure was a protest against the Government's action in trying to restore sanity to the City administration.

We have finally turned the corner into profitability on these routes. In contrast to the performance of the Merseyside County Council, the cost to public funds for our efforts and achievements in Liverpool has been nil.

It is therefore regrettable that British Airways should enlist the active participation of two Metropolitan County Councils with similar political sympathies - Manchester and Birmingham - to block the recommended transfer of routes from those airports. Together they are adopting a tactic of deliberately introducing political issues which have no relevance to the recommendations of the C.A.A. Report but are designed to give the Metropolitan County Councils further ammunition to thwart Government policies when determining future airport ownership policies.

This has taken the form of a liaison between British Airways, its Trades Unions and their affiliated Members of Parliament.

At Birmingham, where we have declared an interest in adopting the C.A.A. recommendations, British Airways is using the liaison described above in an attempt to obtain support for retaining its remaining nine routes. British Airways has already abandoned seven routes from Birmingham during the past six years having failed to make them profitable.

In the case of one particular route, Birmingham/Brussels, this service was pioneered by British Midland in 1972 and was profitable. In 1978 we exchanged the route with British Airways for the Liverpool operations. Within four years the British Airways operation of the Birmingham/Brussels service was losing money heavily and the route abandoned. British Midland then restarted the service a second time and have subsequently restored profitability. This kind of record at Birmingham hardly qualifies British Airways to be retained as a suitable operator of domestic and international services from that and other provincial airports.

It is our firm understanding that, in order to achieve a substantial reduction in staff numbers, specific undertakings have been given to the British Airways Trades Unions guaranteeing no further redundancies or reduction in operations before de-nationalisation regardless of whether or not the routes concerned are really profitable and irrespective of if they have any long-term viability for the airline once it is in the private sector.

The relationship between the Trades Unions and British Airways is not a matter with which we can be concerned. However, it is quite improper that these undertakings, if given, should now be used as a pistol to the head either of the Government or the C.A.A. in an attempt to frame the outcome of the C.A.A. Review in favour of British Airways.

It appears that British Airways is prepared, in order to avoid further network cuts or route transfers to operate its entire domestic network, including the Shuttle, and practically all its European services from Manchester, Birmingham and Gatwick at such wafer thin profit margins that if the results from these activities were to be representative of the financial performance of British Airways as a whole - there would be little prospect for a successful Stock Market flotation.

You will, therefore, understand our great reluctance to be used once again as a back up facility in the event of the routes, after de-nationalisation, failing to produce acceptable returns for the new shareholders of British Airways.

If the existing independent airlines are to have a place in creating airline competition we cannot be expected always to be held waiting in the wings to be used as a stick to prod British Airways into competitive action as in the case of the U.K. domestic trunk routes, or to rescue faltering routes when it is convenient.

It has been said that a commitment was made by Sir John Nott in Parliament on November 19, 1979 that British Airways would be de-nationalised with its present route network intact. Furthermore this alleged commitment has been used as leverage to be dismissive towards the recommendations of the C.A.A. Report in respect of some route transfers and personal criticism has been made of the C.A.A. Chairman for his attempt to explain in public the Authority's judgement.

We believe the truth of the matter to be different. We are sure that Sir John Nott intended in his remarks to indicate that the Board of British Airways had freedom to run and shape their business as they wished and, when ready, whatever size the airline was at that time - it would be brought to the Stock Market as one unit and not be sold off in parts.

3. Predatory Action against us by British Airways

There is already adequate evidence of predatory practices by British Airways against us even before it is de-nationalised. A company, other than a nationalised industry, could never achieve the dominant market situation now enjoyed by British Airways without coming into conflict, during its development to that position, with the Monopolies and Mergers Commission or the provisions of the Competition Act. Every effort is being made by British Airways to sustain this preferred position after de-nationalisation.

The excess profits generated by the British Airways' monopoly of international services from Heathrow in collaboration with foreign airlines are used to sustain the highly marginal U.K. domestic route operation and other low volume services. It is this cushion of profitability which enables British Airways to take severe predatory action against our company.

This predatory action has taken a number of specific forms:

A) Domestic Trunk Routes.

1. Fares have been frozen on all U.K. domestic services for two years. Conversely basic European and Intercontinental fares have risen with inflation.

2. A large increase in route capacity on the trunk services has been operated in an attempt to drive down, though so far unsuccessfully, our market share to a point where it would be uneconomic for us to compete.

The resulting "profit" from British Airways' domestic operations is so miniscule it must be very doubtful if the new shareholders of British Airways would regard such a return adequate for the effort employed.

We assume that after de-nationalisation, and having reached a certain threshold of profitability to secure a successful flotation, the private investors and institutional shareholders will need to see a progressively increasing profit performance from British Airways. It seems to us that the present cross-subsidisation will have to cease and we therefore assume that the present willingness to accept very slim profitability stems from an attempt to curtail our own operations.

B) North Atlantic Scheduled Service Route Applications from Provincial Airports.

We applied to restore the Manchester/Glasgow-New York service, it having lapsed since being abandoned by British Airways in 1981. Although British Airways subsequently stated they had made a decision to re-start part of this route in 1985 their public announcement was delayed until the day before our licence application was heard by the C.A.A. This tactic was both irresponsible and unreasonable and compounds the difficulties for companies like British Midland to make application to restore lapsed routes.

As a result of various licencing manoeuvres, now the subject of an Appeal by us to the Secretary of State for Transport, British Airways have retained a licence to fly from Manchester to New York but have been unwilling to restore the lapsed service from Glasgow. Consequently by denying us the opportunity to operate successfully from Manchester they have denied the prospect of the route being restarted from Glasgow since the combination of the two airports was a vital factor in sustaining the revived route on a year-round basis.

C) Heathrow/Belfast Trunk Route Application.

When the Civil Aviation Authority finally granted us permission to operate this route in July 1983 - British Airways chose to challenge this decision in the High Court. This action hardly squares up with an airline that has made its strongest public statement in dismissing the C.A.A. Report in claiming that it welcomes competition.

Directly as a result of this action the introduction of the route was delayed by some six months with the consequential deferment of consumer benefits on this service and large additional legal costs which we had to meet.

You will understand how damaging this action has been in Northern Ireland for British Midland since we have sustained scheduled air services from the Province throughout the current difficulties. Furthermore we were the first airline whose aircrew agreed to stay overnight in Belfast whilst other

airlines had to ferry their staff back to other parts of Britain for overnight accommodation.

We have further supported the economy of Northern Ireland in a practical way through being the largest U.K. operator of Shorts SD360 prop-jet aircraft which are built in Belfast. Our Group has invested £14million in this type of aircraft and currently operates six units. As in the case of our Liverpool operations we have made no call on Government funds or subsidy in making our commercial decision to support Northern Ireland industry.

M. BISHOP



12/9 14/9 (W)
FILE 14/9.
Act 31/8

B/F

For Wednesday meeting

12/9

10 DOWNING STREET

From the Private Secretary

31 August, 1984

I enclose a copy of a letter the Prime Minister has received from Mr. M. Bishop, Chairman and Managing Director of British Midland Airways Limited.

I should be grateful if you could let me have a draft reply for the Prime Minister's signature by Friday, 14 September.

(Timothy Flesher)

A. Melville, Esq.,
Department of Transport.

JK

BRITISH Midland Holdings
Mr. Michael Bishop



6/9

ACE

SA

10 DOWNING STREET

From the Private Secretary

29 August, 1984

Anthony Steen, M.P. has been in touch with this office to propose that, following the Prime Minister's recent meeting with Sir Adam Thomson, she should now meet Mr. Michael Bishop, the Chairman of British Midland Holdings. I should be grateful for your advice on this point. Clearly, it would be impossible for the Prime Minister to meet the Chairman of every independent airline and, in these circumstances, it might be preferable to avoid a meeting of the kind proposed by Mr. Steen or alternatively for the Prime Minister to see a group of Chairmen representing all the independent airlines other than British Caledonian. Perhaps you could let me have your advice as soon as possible.

TIMOTHY FLESHER

Andrew Melville, Esq.,
Department of Transport

55

Caroline

Pse see

FERB comment

Mr. Butler

advice please

CR

Tim Fisher

We need D/Transport's

advice on this. We cannot have
a succession of such meetings. We
need either a good exercise or a
single meeting with a group
representing all the other
independents.

Caroline

British Airways, etc.

FERB

I attach two notes which Stephen
has done for Michael while he (and I)
were away.

28.8.

Anthony Steen telephoned me on Friday,
to press for a meeting between
Michael Bishop (Chairman of British
Midland Holdings) and the Prime Minister.
Further to Stephen's note of 8th August,
AS says that Michael Bishop would
be able to represent the views of
British Midland Airways (obviously)
and also of British Island Airways
which is a subsidiary, I think.

They are very anxious to present "the
other side of the coin" to that of
BCal, and AS feels that as the Prime
Minister has seen Adam Thomson, she
ought to see Michael Bishop.

Is there any chance of a slot before
13th September?

Tess

28/8/84

* We used British Island Airways during
the Election.

DRAFT

CIVIL AVIATION AUTHORITY'S REVIEW OF COMPETITION IN AIR TRANSPORT

1. Cabinet discussed this topic on 2 August (C(84)29th) and asked me to prepare a further paper analysing a number of considerations. In this note I examine the main points; they are addressed in more detail in the Annexes.

Competition

2. Air transport in many areas has for many years been heavily protected from real competition. Our policies since 1979 have been to bring full and fair competition into the airline market, and we will eventually be judged by the extent to which we succeed in securing the benefits of increased competition between British and foreign airlines as well as among British airlines themselves. We want to privatise BA to make competition fair between our airlines, and because in the private sector BA will be more efficient than it has been in the public sector.

3. Both nationally and internationally we want to ensure that the regulatory regime encourages competition. This is already the case on the North Atlantic, on many long-haul routes and on European charters. Until recently our own domestic services and European scheduled services have been much less open to effective competition. But now, within the United Kingdom, we have authorised UK airlines to compete with British Airways on several routes with a marked effect both on fares and on the quality of service. In Europe I hope that our recent agreement with the Netherlands will be followed by others opening the way to more competing services at keener prices; we have embarked

on bilateral discussions with Belgium, Germany and Italy, as well as multi-lateral negotiations within the European Community. But this will take time: the powerful national airlines which dominate short haul services between the UK and Europe have a strong interest in ensuring that any competition which may be allowed does not seriously threaten their position, especially on the valuable trunk routes to and from London.

4. The independent airlines have survived and grown over the last few years, partly through the CAA pursuing a liberal policy of trying to give them routes in order to increase competition with BA, and partly because of BA's appalling inefficiency until about 1981. Under Lord King BA has become much more efficient, and indeed aggressive, and now seeks to undercut its much weaker competitors. BA has 81% of UK scheduled routes, as well as the dominant position in Heathrow. This leaves too few secure and lucrative routes for the independents, to provide them with a firm enough base from which to continue to compete with BA. BCal and the smaller independents, BMA, Dan-Air, Air UK etc must be given opportunities to carve out networks for themselves, both at Gatwick and in the regions.

5. Competition needs strong competitors. We need independent airlines - rather than just one airline - strong enough to compete on international routes for four reasons: (i) without the stimulus of actual or potential competition from other British airlines, it will be too easy for a single carrier to slip back into the cosy arrangements BA has enjoyed for so long with other national airlines; (ii) the very existence of alternative, viable British airlines ensures competing management styles and philosophies so that, even where direct competition with BA is impossible,

indirectly our airlines set standards of performance for each other higher than might otherwise be obtained; (iii) by ensuring other British airlines can compete with BA, particularly BCal at Gatwick, we also ensure that because of the competitive spur our civil air transport is better placed to take advantage of growing liberalisation in Europe and elsewhere, thereby enhancing the benefits to the consumer; and (iv) total reliance on BA would mean reinforcing the dominant position which Heathrow enjoys in international scheduled services. Unless we allow other carriers to develop their networks at other airports, we will be condemning Gatwick to permanent second class status and the regional airports to being ancillary satellites largely feeding international passengers down to Heathrow.

6. BCal's track record in trying to introduce lower fares into Europe and the fact that it must operate from Gatwick - where it is at an inherent disadvantage - should ensure that it aggressively seizes any openings we can make for it in Europe. But even BCal is at risk unless we are prepared to do what we can in the context of BA's privatisation to reinforce BCal's financial position.

7. The Civil Aviation Authority regard it as axiomatic that we want an air transport industry which comprises a number of airlines, strong and healthy enough to provide a competitive spur to British Airways, and to compete with foreign airlines wherever we can get international agreements to do so. The CAA's recommendations were all aimed at these objectives. In summary they were:-

- (a) on international routes whenever possible to encourage through the licensing system other British airlines to compete with British Airways;
- (b) on domestic routes to liberalise market entry and cease to regulate fares (apart from safeguards against predatory pricing);
- (c) to strengthen by legislation the Authority's powers to promote the sound development of the industry and deal with anti-competitive behaviour;
- (d) to strengthen both British Caledonian and the other independent airlines against being forced out of business and to enhance their ability to compete, by making available to them British Airways' licences for routes to Saudi Arabia and Harare (Zimbabwe) from Heathrow; and to certain European points from Gatwick, Manchester, Birmingham and Glasgow.

8. (a) and (b) can be achieved within the existing statutory framework, by an amendment to the Authority's licensing policy. We have already agreed that they should be encouraged. (c) (powers to promote the sound development of the industry) was strongly opposed in the House of Commons. The CAA already have a good deal of freedom under the statute and there is widespread opposition to widening it so that they would have delegated to them responsibility for deciding the structure of the industry. Moreover, to do so would put great uncertainties in the minds of investors at the time of BA's privatisation. I am sure we all want to prevent anti-competitive behaviour, ^{function} This might fall either to the CAA to monitor and safeguard or alternatively to the Director General of Fair Trading to control, perhaps with extended powers in respect of civil aviation.

(d) the proposals for route transfers, present a more difficult problem. There can be no doubt that they would benefit the other airlines. Annex B gives some figures which try to quantify that benefit and relate it to those airlines'

present financial performance. They are probably essential to ensure the viability of the private sector carriers. This is particularly true of BCal, whose present route structure is insufficiently profitable and too heavily oriented towards countries which are politically unstable or have currency problems or both.

9. Our ability to confer these benefits is constrained by other considerations, which are reviewed at greater length in the Annexes:-

- (i) the means at our disposal to bring them about and the view Parliament would take of such action;
- (ii) the effect they would have on British Airways and on the prospects for privatising them early next year; the latter is also subject to
- (iii) the risks associated with the anti-trust actions in the USA;
- (iv) undertakings given by Ministers in the last Parliament about the integrity of BA's route structure.

British Airways' Solution

10. As an alternative to route transfers BA has proposed that BCal be designated as the second British carrier on a number of routes. BA believe this could add substantially to BCal's revenue and profit. As a quid pro quo, BA would want to move their Lisbon and Madrid services back to Heathrow from Gatwick and estimate that this, together with extra traffic stimulated by the additional competition, would minimise the cost to them. BA have suggested a mix of ~~10~~ 13 short and long haul routes on which BCal could be added as the second British carrier. However, it seems unlikely we could secure BCal's designation with the foreign governments concerned on ^{many} ~~most~~ of these routes. The prospects for dual designation are examined further in Annex C. The proposal does not

in any case give BCal anything they cannot in theory already secure under the present licensing arrangements (except an assurance that BA would not seek to thwart BCal's entry on the routes). Indeed it would require BCal to fund such new route developments from their currently inadequate financial base. I cannot regard BA's proposal as a solution to the problem, although it goes in the right direction and I see no alternative to route transfers of some kind from BA.

Options for route transfers

11. So far as BCal are concerned, the options for transfer might be the routes to:-

- (i) Saudi Arabia: thereby reducing BA's 1984/85 turnover by about £77m or 3.3% and operating profit by about £22-25m or 7.8-8.9%;
- (ii) Harare plus those of BA's Gatwick services appropriate to BCal's operation: reducing BA's turnover by perhaps £32m or 1.4% and operating profit by about £7m or 2.5%;
- (iii) the Caribbean: this was not suggested by the CAA who preferred to recommend the Saudi Arabia routes for transfer since they are more profitable and more easily extractable from BA's network. The Caribbean routes do, however, fit in quite well with BCal's existing operations to South America and Southern USA. Their transfer would reduce BA's turnover by about £50m or 2.1%, depending on which particular routes were transferred, and operating profit by some £5-10m or 1.8-3.6%.



12. BCal are currently licensed to serve Riyadh and were they to do so, BA's operating profit on services to Saudi Arabia would fall from the £22-25m figure above to some £16m. This is because the two airlines would have to share the fixed number of weekly frequencies available to the UK, so that a BCal service to Riyadh would reduce the number of flights BA could mount. At the moment however no British airline serves Riyadh and the Saudis have made it clear they will not accept dual designation. BCal's proposed service is effectively blocked as a result. The choice is therefore between transferring BA's Saudi routes to BCal thereby also allowing them to operate to Riyadh since the Saudis seem willing to accept BCal as the single designated British carrier; or not transferring the existing routes, in which case we would be forced to take Riyadh off BCal and give it to BA. I regard the latter option as singularly unattractive since it would mean not only denying BCal two particularly profitable routes as recommended by the CAA, but it would also mean taking away from BCal the one Saudi route they hope to operate. I therefore favour transferring the Saudi routes to BCal - not only because of their profitability but because it would be a simple and clear cut operation involving relatively few staff.

13. However, transferring the highly profitable Saudi routes may have ~~serious~~ implications for ~~the~~ privatisation, ~~timetable~~, which I deal with later. I have therefore looked at other options less costly to BA and have set out above what seem the two most likely candidates. The second and third options could, of course, be combined.

14. There is also the question of transferring BA's European services from regional airports to other independent airlines, as proposed by the CAA. Representations have been made to me about the proposal on behalf of the airports themselves and also on behalf of the independent carriers. The former see the loss of BA European services from their airports as a threat. They do not believe the independents will provide



a satisfactory alternative, and passengers will increasingly have to travel via Heathrow. The independents deny this: they argue that they will offer better services at regional airports than BA because they wish to carry passengers direct to European destinations, while BA prefers ~~to~~ to channel all their passengers via Heathrow in order to fill up existing services. I am reluctant to deny BA a presence at any airport since this would only diminish competition. At the same time, I should like to encourage the independents to develop regional networks in competition with BA. We might therefore transfer to them some of BA's business routes to Europe leaving BA with, say, half of the routes in terms of capacity and in particular with the sort of European destinations they could eventually develop as points on medium and longer haul routes. This might cost BA around £27m or 1.1% of turnover and £2m or 0.7% of operating profit.

Means of effecting route transfers and attitude of Parliament

15. These are discussed in Annex A. In theory there are three possibilities:-

- (a) BA agreeing to relinquish the routes without compulsion;
- (b) primary legislation giving me the necessary powers;
- (c) use of my powers as sole shareholder of BA plc.

16. Lord King has made it clear that he and his Board will not accept route transfers without legislation and that they would not be prepared to acquiesce in the use of my sole shareholder's powers to effect transfers. Whilst I could insist on using my powers, rather than legislation, I do not rate highly the chances of the Board changing its view in the short time before BA is due to be privatised under the present timetable. I have therefore concluded that route transfers could only realistically be effected through legislation. This has the advantages vis a vis Parliament set out in Annex A and in particular means we may be able to avoid criticism in Parliament:-

(i) that I had gone beyond the intentions of the privatisation legislation (Civil Aviation Act 1980);

(ii) that I had not safeguarded the value of the public assets entrusted to me by Parliament;

17. Legislation also means that we could be certain which airlines received routes vacated by BA. The Bill would be very short but controversial and we could not rely on its being enacted before mid-February 1985. Inevitably this will delay privatisation until later in 1985 than presently planned. BA have also said that a decision to enforce route transfers, by whatever means, could provoke disruption by BA unions designed to frustrate privatisation.

Effect of route transfers on British Airways and its privatisation

18. Annex B sets out in detail the information we have on the impact on BA's finances and staff of possible route transfers. British Airways' estimates of the adverse effect of the CAA's recommendations are higher than the Authority's particularly on the profit contribution. This is partly because the routes bear £22m of central overheads which would have to be absorbed on other services, reducing their profitability at least for a while until offset by growth, or reduced by trimming back costs. Implementation of even the full package of transfers recommended by the CAA would still leave BA with one of the largest networks of international scheduled services in the world.

19. Hill Samuel's present advice is that the risk to privatisation from profit lost to BA because of route transfers would increase significantly up to a level of about 10% of the likely profit forecast in BA's prospectus; and that they judge the risks unacceptable after that. Hill Samuel also advise that any transfers would threaten the privatisation timetable unless it were clear that they were a once-for-all exercise and that the BA Board acquiesced and subsequently cooperated. Legislation for transfers would be drafted to ensure the powers expired immediately after use so making it clear it was a one-off exercise. Nevertheless we have to recognise that the price which could be obtained for the shares might be reduced by more than the proportionate reduction in prospective profits and that a transfer of a package as large as the Saudi routes would create a more uncertain climate for privatisation than the other options considered in this paper.

20. British Airways may need to be able to retain part of the proceeds of the offer for sale if it is to go to the market next year with the prospect of a reasonable balance sheet in the months following privatisation. Although if legislation for route transfers delays privatisation until late in 1985 BA will certainly be able to improve their balance sheet further and may be able to trade their way out of the debt problem altogether obviating the need for them to retain any proceeds from the privatisation. The transfer of routes however does little of itself to affect this question since the financial effect is likely to be broadly neutral in terms of the balance sheet. The benefit of BA of cash from the sale of surplus aircraft is likely to be partly offset by payments to surplus staff made redundant or transferred.

21. However, I doubt if it would be politically acceptable for us to privatise British Airways and allow them to keep a substantial amount of the proceeds (perhaps £100-£200m) and at the same time ignore the main recommendations of the CAA Review, which are designed to protect the rest of the industry from the very real possibility that BA, with their vast market strength and this "further injection of taxpayers' money", will set about eliminating competitors, by cross-subsidy and predatory pricing, (which will always be difficult to prevent).

The "Laker" litigation

22. Our ability to privatise early in 1985 could be threatened by the anti-trust actions in the US Courts or by a serious route with the US Government affecting the continued operation of UK/US air services if we continue to resist US anti trust

jurisdiction. Annex D summarises the present position and prospects. Present and potential suits are of serious concern both as regards BA and BCal. If BA remain exposed to anti-trust actions, successful privatisation would seem to be possible only if they can insure themselves against penalties, or if we and the Board are able to say honestly in the prospectus that the claims are without merit, or if the Government agree to indemnify them against claims. Although this latter possibility is not entirely to be ruled out for BA (and possibly BCal) in the context of an all-out dispute with the US Government, I think all colleagues are agreed that it would be unwise to give such an indemnity simply to achieve BA privatisation; such an indemnity might in any case need legislation. I shall shortly be considering whether, in the aviation context, we should try to live with US anti-trust laws or continue to resist by all appropriate means the unilateral application of their laws to matters bilaterally regulated under our air services agreements. Either way there is a real risk that events on this front will adversely effect the market.

23. A deferment forced upon us on "Laker" grounds would have certain compensations. BA would have another high season's profits to repay debt and improve their equity. We would be able to pursue the CAA review's recommendations in a more orderly manner working through legislation, and we would have more time to examine the advantages and disadvantages of transferring particular routes, and to deal with matters like pricing of assets, and staff redundancy in BA.

24. I have set out above options for route transfers on the assumption that we can sell BA shares with the risk of the "Laker" litigation. Colleagues will recognise however that even if we decide not to delay privatisation by legislating for transfers there is a risk hurried action may prove to have been unnecessary if nearer the time events do force us to conclude that privatisation has to be deferred on "Laker" grounds.

Government undertakings about privatisation

25. Critics of the CAA review in Parliament and outside have quoted statements made by Sir John Nott, when Secretary of State for Trade, and other Ministers that BA would not be broken up and that there would be "no arbitrary reallocation of routes." The latter assurance is particularly called into question by the CAA's proposals. Nevertheless, what was said then should not be allowed to prevent us now taking the right decisions for British civil aviation as a whole. We can argue that assurances given five years ago, when circumstances were much different, should not be allowed to fetter a successor Government in its efforts to promote competition in air transport, a matter to which we now feel we must give precedence. Legislation for transfers would in any case give Parliament a chance to judge for itself on this questions.

Ave transfers
recommended
by CAA
"arbitrary"?

Other considerations

26. As an alternative to route transfers, BCal would be content if we allowed them to operate international services from Heathrow. BA have a further large competitive advantage from their Heathrow base. But I fear we cannot contemplate such a change. It would

be totally against the policy followed by successive Governments for the last six years to reduce congestion at Heathrow. We have managed to impose the policy on foreign carriers because we have adhered to it ourselves resolutely. If we allowed BCal to move to Heathrow, we could not reasonably refuse to allow other British as well as foreign airlines to do the same, and we should have to force a proportion of BA's services to move to Gatwick.

27. An influx of new services would swamp the airport's facilities -particularly the runway, already used to capacity for about seven hours a day. New domestic services which have been permitted have found great difficulty obtaining the landing and take-off "slots" they need. Incoming international airlines would have the same problem on a much larger scale: they too want to operate at the popular times of day, which often need to match convenient departure or landing times at the other end of the route, or restrictions such as night curfews. We should either be forced to abandon the limit on air transport movements, which in turn would have serious implications for the handling of the Stansted Inquiry Report, or move a substantial numbers of BA services out of Heathrow.

Recommendation

28. My conclusions are that:

- (a) if we are to adhere to our plans to privatise British Airways early in 1985 we shall have to devote a considerable amount of the proceeds to strengthening BA's balance sheet; and

(b) we cannot do that and dismiss the recommendations of the CAA's Review; we must take the minimum steps to ensure a multi-airline industry;

(c) in view of BA's attitude, we should legislate to effect route transfers even though this will lead to our delaying privatisation, possibly until November 1985;

(d) such transfers would strengthen the recipient airlines, (although BCal would still be vulnerable to remittance problems or political instability in countries it serves) and give them a more secure future to provide the competition we will increasingly want to see;

(e) there can be no question of relaxing the ban on new international operators at Heathrow.

I invite the Cabinet to endorse these conclusions.

29. I also invite colleagues to consider the options for route transfers which I have set out. Depending on what Cabinet agree, the next step would be for me to inform Lord King of our decisions. I will report the result immediately to colleagues. I think it would be wise to publish our conclusions in the form of a well-argued White Paper.

ANNEX A

TRANSFER OF ROUTES FROM BA AND THE RISK OF CHALLENGE - LEGAL AND PROPRIETY ASPECTS

This annex describes the means by which a transfer of routes from British Airways could be effected, including an assessment of the risk of legal challenge, and considers issues of propriety.

LEGAL ASPECTS

Voluntary action by the Directors

2. If the directors thought that they could reconcile a decision to surrender route licences with the fiduciary duty which they owe to the company and employees it would be possible for the directors themselves to decide that BA should cease to operate certain routes. If they did so no alteration of the Articles would be required although, because of the controversial nature of the proposal, the directors would undoubtedly require a prior authorisation from the shareholders in general meeting consenting to their proposal. It is, however, unlikely that the directors will agree to this course; they will not be persuaded that it is in the interests of the shareholders and the employees for BA to cease to operate routes. Unless they are so convinced, this course cannot be adopted.

Use of the shareholders' powers

3. In order for the Government as shareholder to be able to compel the directors to release any of the route licences held by BA it would first be necessary to amend the Articles of Association. This is because the Articles at present entrust to the directors the management of the company and impose restrictions on the circumstances in which the shareholders may give instructions to the

directors in this respect. Since the Government is the sole shareholder the Articles can be amended quite easily by the passing of a special resolution either at a meeting of the shareholders which may be held at any time once the necessary consents to holding the meeting at short notice have been signed by the shareholders or by all the shareholders signing the resolution in writing. The Articles could be amended so as to require the directors to carry out any instructions given by the shareholders by special resolution. The shareholders could then at any time by resolution instruct the directors to cease operating the routes forthwith or by a specified time. It may also be necessary to instruct the directors not to contest the grant of a licence to any other operator on the routes in question.

4. The shareholders powers, however, can only be used in this way to govern BA's actions; they cannot affect the licensing system for the grant of the licences either relinquished or no longer used by BA (except to the extent that BA is prevented from contesting applications for the grant of licences on the routes it is to cease to operate). This course of action will, therefore, facilitate but not ensure the transfer of routes to BCal. Nor can it guarantee a transfer in the set timescale. BCal will still have to face the usual licensing procedure. Its applications to the CAA will have to be judged on their merit in accordance with the CAA's statutory duties; it is possible that other airlines will contest such applications. Appeal lies to the secretary of State and he will have to maintain impartiality between competing airlines so that his appellate role is not prejudiced.

Risk of challenge to the use of the shareholders powers

5. A transfer of routes is likely to be strongly opposed by both the directors and employees of BA and an attempt to challenge the validity of the action by either of them in the courts cannot be ruled out. However, even if the directors have carried out an improper act it is for the company to commence proceedings to seek a remedy (i.e. in practical terms for the shareholders to initiate the action). It would be completely novel for employees to do so, or for the directors to do so on their own behalf rather than on behalf of the company. Because of this any action brought by the employees or directors might be struck out before it is tried by the courts. However, the Court might be influenced by the highly controversial nature of the shareholders action and the perception that it would be harmful to the company and the employees and might accept an action by the directors for a declaration whether they would be in breach of their fiduciary duty to the company by analogy with similar action by trustees. Nevertheless, in this event the legal action should still not be successful because HMG is sole shareholder, although it would be embarrassing for HMG (the position would be very different and the risk if challenge so great as to make this course totally unfeasible if there were minority shareholders whose interests were affected). Moreover, future shareholders acquiring their shares upon privatisation will not at that time be able to commence proceedings to challenge the action; they will not be able to question past actions of former shareholders of which they had full notice (by disclosure in the prospectus) at the time they purchased their shares.

6. If the directors or employees were able to amount an action, the grounds of challenge would have to be any one of the following, but for the reasons given in relation to each it is not considered that any of those grounds are well-founded (even if it fell to

be determined on its merits).

(1) To comply with the instruction would cause the directors to breach their fiduciary duties, in particular the overriding duty to exercise their powers bona fide in the interests of the company (including present and future shareholders). Where, however, the Articles of Association provide for a division of powers of the management of the company between the directors and shareholders and reserve the powers of decision in certain matters to the shareholders the directors' duty is to comply with instructions vested by the Articles in the general body of shareholders. Whilst, therefore, they will owe a duty to act in the interests of the company in the manner in which they carry out such instructions they cannot refuse to carry one out because they do not consider it to be in the company's interests.

(2) To comply with the instruction would require carrying out an act which was outside the powers of the company (e.g. if the directors were instructed to operate a shipping service which BA is not authorised by its Memorandum to do) or which was in breach of some prohibition of law. The giving up of routes clearly falls into neither of these categories.

(3) The Articles did not authorise the shareholders to give the particular instruction to the directors or that the instruction was not given in accordance with the procedure laid down in the Articles (e.g. the Articles required instructions to be given by special resolution and the shareholders passed only an ordinary

resolution). It is for this reason that the Articles would have to be amended before an instruction could be given and there is no reason why, as sole shareholder, the Government should not comply with the appropriate procedures.

(4) To comply would cause the directors to breach their duty under section 46 of the Companies Act 1980 to have regard to the interests of the employees in performing their functions. Again, however, as in (1) above, if the Articles reserve to the shareholders the power to take decisions in relation to the operation of routes and if that power is exercised, the directors have no function to perform in the taking of that decision. The question of the duty under section 46 will therefore arise only as to the manner in which the directors carry out their function (which is to comply with the instruction).

Legislation to provide for the transfer of routes

7. Route transfers from BA to BCal have been effected twice before in 1971 and 1976 by use of legislative powers. Neither means is directly appropriate as a precedent now - the current legislation is different. In 1971 the Secretary of State used a power of direction over the statutory corporation which is not available for use in relation to the existing public limited company. In 1976, with the assistance of some cooperation from BA, a power to give guidance to the CAA over its licensing decisions was used. Guidance of this sort is no longer possible in view of the present statutory relationship between the CAA and the Government. The precedents, however, provide something of a guide to the provisions which would

be needed. The exact form of the legislation cannot be settled until the details of any transfer are known, but it is envisaged that a relatively short bill would be required, with no more than a handful of clauses, giving the Secretary of State a general power (but a once-and-for-all power) to direct the CAA to revoke or amend route licences specified in the direction or grant licences to an airline so specified. It would be for the direction rather than the statute to identify the airlines involved so as to avoid problems of hybridity.

8. When it was proposed to use existing statutory powers to effect route transfers in 1971 BA threatened to challenge the validity of the exercise of the powers. The circumstances would be quite different now where the new legislation would be tailored to fit the needs of the Government's objectives and could be so drafted so as to make it immune from challenge.

PROPRIETY ASPECTS

9. This section of the annex considers propriety aspects of route licence transfers, with particular reference to the means of effecting route transfers, and the question of compensation.

Means of effecting route transfers

10. If route licence transfers are effected by use of the shareholder's powers, the Secretary of State's position is complicated by the following considerations -

- a. the Secretary of State has a fiduciary duty to safeguard the value of public assets - but compulsory transfer would be likely to reduce net proceeds from British Airways privatisation;
- b. this approach would go well beyond what was intended at the time that legislation enabling British Airways to be converted into a company was before Parliament;
- c. the Secretary of State would be using his power as shareholder, which is essentially a commercial role, to achieve something which is not in the interests of the company but in pursuance of the Government's statutory aviation functions.

In the circumstances transfer of route licences by such means would run the risk of Parliamentary criticism in relation to the way in which the Secretary of State had discharged his several responsibilities. In particular he would be liable to be criticised on the grounds of disregarding his fiduciary duty.

11. In order to resolve strict questions of propriety and regularity which would otherwise arise it will be necessary as a minimum for the Secretary of State to make a complete statement to Parliament on each stage of his proposed course of action with an explanation of the reasons for it and the best estimates that can be made of the financial effects. The alternative approach of legislation to provide for route transfers would have the advantage of divesting the Secretary of State of sole responsibility as shareholder for effecting compulsory route transfers: legislation would in effect

make compulsory transfer the responsibility of Parliament as a whole.

Compensation

12. A further question concerns compensation and the means of settling the value of assets and liabilities to be transferred. There is an important distinction to be drawn here between transfers of route licences and transfers of assets and staff associated with the routes concerned. Route licences in themselves have no inherent value - they provide an operator with the potential to earn revenue: but they are not 'sold' by the CAA and it is not straightforward to put a price on them. But the cost of assets, including staff, associated with the operation of routes can be assessed.

13. Where the airline to which route licences are transferred (the 'transferee') agrees to take on the associated assets (including staff), and on the basis that a fair price for doing so can be established, Parliamentary criticism is likely to concentrate on the reduction in British Airways' revenue earning potential: this could be answered by reference to the primary importance of enhancing competition. But more difficult problems are likely to arise in circumstances where a transferee is unwilling to take on the associated assets. In this case the transferee would increase his revenue earning potential, but British Airways would be left with surplus assets and staff, for the costs of which they might seek compensation from Government or which as a minimum would be likely to depress privatisation proceeds. This would be likely to prompt criticism

not least from the Public Accounts Committee, that the transferee's shareholders were being enriched at the expense of British Airways and ultimately the Exchequer. The question would also arise why a particular operator was being advantaged in this way.

14. Whether route transfers were effected through legislation or use of shareholders' powers, the Government could not be certain of minimising the cost to BA. BCal has, however, said publicly that they would take on BA staff "realistically associated with the routes required". This may not be possible under equal terms and conditions ; the precise arrangements would have to be negotiated. Privately BCal has also indicated its willingness to take over aircraft associated with the routes. Ultimately, the terms of transfer of physical assets would have to be settled by the market. In the event that a transferee was not prepared to provide British Airways with full compensation (however defined) the costs involved would be likely to be reflected in the proceeds of the disposal.

CONCLUSION

15. New legislation is the only watertight and practically effective means of effecting the route transfers. It is the only way by which it could be ensured that licences for routes are given to BCal rather than other airlines and within a set timescale so that there is a smooth and speedy transition. It would also save the Government from the embarrassment of having to contest challenges (albeit almost certainly unsuccessful challenges) to its actions in the courts. On propriety grounds, legislation would also be desirable as a means of divesting the Secretary of State of sole responsibility as shareholder for effecting route transfers.

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ANNEX B

THE EFFECTS OF ROUTE TRANSFERS AND ENHANCED COMPETITION ON THE AIRLINES AND
THE BENEFITS TO COMPETITION AND THE CONSUMER

British Airways

1. The CAA calculates on the basis of 1984/85 estimates that its proposals for route transfers might reduce BA's scheduled service revenue by a maximum of 7.3% or £167 m. There could be a more marked reduction in profit, perhaps a maximum of 9.6% or £27m before contingencies and interest, reflecting the loss of the very profitable Saudi Arabian routes. These account for about 3% of BA's revenue but could at best generate nearly 6% of profit assuming that BCal in any case serves Riyadh - for which it holds the licence - although it is doubtful the Saudis will accept two British carriers to the Kingdom. Harare produces less than 1% of revenue and profit; the Gatwick based services less than 2% (the Iberian services are profitable, those to Italy and Gibraltar break even to Scandinavia lose money); and the routes to Europe from the regions generate some 2% of revenue and 1.4% of profit.
2. In addition BA would, over a period of years, progressively face increased competition if the CAA licences, as it proposes, a second carrier on selected short and long haul routes. The Authority estimates route transfers and this extra competition could together cost BA as much as £271m in revenue in a full year and some £38.5m in profit. BA's estimate of the total combined effect is rather higher: £293m in lost revenue and £58m in operating profit plus a further net loss of £18m in profit because of fixed costs which cannot be eliminated offset by some interest savings. This estimate is based on more pessimistic assumptions than those adopted by the CAA (eg BA suffer more than the CAA think possible from the licensing of a second British Carrier on some BA routes), assumes BA rather than BCal serves Riyadh and ignores the prospect that

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the fixed cost element could in time be absorbed by growth in BA's remaining operations.

3. BA'S viability would be in no way damaged if it lost, for example, only the Saudi routes and some of its European services from the regions (amounting together to perhaps 4.5% of revenue and a maximum 9.6% reduction in operating profit allowing for the loss to BCal of Riyadh as well). It would still remain one of the world's leading international airlines with a massive route network. The other options for route transfers would have an even less marked effect on BA's revenue and profit, although the routes in question might be less easy to disentangle from BA's network than its self-contained Saudi operation. As for competition, the full effects of designating wherever possible a second carrier on BA's routes would not be felt until the end of the decade or later and BA could be expected to adapt over time.

4. If BA is forced to give up routes, the question arises what happens to the aircraft and personnel operating them. It would clearly be desirable for the new operators to take them over in order to minimise any loss in asset value, or the effect of redundancy, on BA. BA estimates the CAA's proposal for route transfers plus enhanced competition would leave 3,600 surplus staff costing £69m in redundancy payments. This seem greatly inflated and ignores, for example, the fact that staff made surplus by the gradual build up of competition ought easily to be absorbed into the general growth of the business. A more realistic assessment of redundancy costs to BA might be a maximum of £28m on the basis of the 1981 severance arrangements (an average of one year's gross pay) and possibly substantially less if staff were in fact being re-employed by other airlines. BCal has already indicated its willingness to take over staff and assets associated with routes it acquires. The position of the other independents is not clear and they could not in any case be compelled to do so. In the event of route transfers, it is therefore envisaged that when announcing

our intentions we would say that so far as possible we would expect airlines receiving routes from BA to buy the associated assets at market value (although some might then choose to sell unsuitable aircraft) and take on BA staff.

British Caledonian

5. BCal's latest results show a group turnover of £428m, operating profit of £18m and a pre-tax profit after interest of only £3.3m. It has substantial remittances of nearly £50m blocked overseas; Nigeria alone accounts for £37.6m increasing at about £6m a month, although payment has been agreed in principle for £11m outstanding from 1983. For the present BCal seems viable on a day to day basis but there must be serious doubts about its ability in the longer term to finance expansion on the basis of its present route network or even to continue to renew its fleet. It remains very vulnerable to cash flow dislocations.

6. Route transfers would undoubtedly improve BCal's position. The transfer of the Saudi routes would add about 20% to its revenues and take it to a level of consistent profitability it has never yet achieved (the Caledonian group as a whole, including its holiday company, hotels, etc, made losses in five of the last twelve years and aggregate net profit came to only £30.6m). The transfer of just some of BA's Gatwick services alone would help. It is uncertain which routes might go to BCal but Madrid, Barcelona and Lisbon, for example (the routes which the CAA is most likely to award it), would be worth some £21m in revenue and about £5m in operating profit.

7. However, even the transfer of all the Gatwick services would be insufficient on their own to guarantee BCal's viability, although clearly this would strengthen the airline. Some profitable intercontinental routes also need to be transferred if BCal is to have some guarantee of survival in the long term, aided as well by

the additional profits it could generate as the CAA progressively licenses airlines to compete with BA on European and intercontinental routes.

Other independent airlines

8. If taken away from BA, it is likely the bulk of its services to Europe from regional airports would be awarded by the CAA to British Midland Airways, Dan-Air and Air UK as the leading second level carriers. Between them the three airlines currently generate an aggregate operating profit of some £7m on revenues of over £300m. Transferring all the regional services would give them another £55m in revenues and £4m in profit. The immediate impact would be substantially reduced if BA retained some of the services; although in the longer term the independents might still be able to build on even a limited transfer if, for example, they successfully developed hub operations at regional airports.

9. The three airlines are in no immediate danger but only Dan-Air has a reasonably healthy balance sheet. Air UK has substantial accumulated losses and historically has survived only with the support of its parent, British and Commonwealth Shipping. British Midland's balance sheet also looks weak and to some extent it operates courtesy of its creditors. None of the three has a particularly strong scheduled network. BA usually holds the licences for the more attractive domestic and European routes, often on an exclusive basis and route transfers could therefore significantly aid their development, although at least Air UK and British Midland might find it difficult to finance extensions to their networks without outside support.

10. Charter airlines might also seek routes as a way of extending into scheduled operations, where at least Britannia and Air Europe have ambitions. Air Europe has recently sought licences for a number of BA's routes out of Gatwick. Whilst it is impossible to quantify what such transfers might be worth to them, it is difficult to see any great benefit when Britannia, for example, generally earns from its charter operations about ten times BCal's profit.

Competition

11. Only the transfer of BA's regional services to Europe would have a direct effect on competition between British airlines; the independents would then be competing from the regions with BA's services to the same European points from Heathrow. The other proposed transfers simply substitute one British carrier for another. Nor would transfers have a major direct effect on the position of UK airlines in relation to foreign competition. BCal from Gatwick might do slightly less well than BA from Heathrow in the Saudi market, offset perhaps by the fact that Saudia is a "dry" airline. Some US cities of importance to the oil trade are also better served from Gatwick. The effect on foreign competition of transferring the Harare and Iberian peninsula services would probably be minimal.

12. It is the indirect effect in Europe which is of greater importance. Until now BCal has treated its European services primarily as feeder services for its long haul routes. Only Paris has been profitable on its own. But it has laid the foundations of a more substantial European network which would be significantly enhanced by addition of the Iberian business routes. BCal has now reviewed its marketing policy and drawn up a plan for much more aggressive competition with a view to creating a substantial and independently viable European network.

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Its new tariff proposals, for example, should generate substantial additional traffic if we can get agreement from at least some of our European partners, as we have done with the Dutch, and on the back of this and other developments BCal sees opportunities for increasing the frequency and range of its services.

13. All this fits in well with our own objectives for increased competition in Europe. If we succeed in opening up increased opportunities in Europe but have no substantial second airline capable of exploiting them, BA and the European national carriers will have no incentive to compete more vigorously for a market which they will be able to share comfortably between themselves, as they have done for so long. Moreover, experience in the United States suggests that a successful airline needs a dominant position at one airport from which it can operate an effective hub and spoke system. BCal has the makings of such a hub at Gatwick and its further development, encouraged by the constraint on growth at Heathrow, could make it a much more powerful competitive force in Europe.

14. The other independents are probably too weak to take head-on competition with foreign carriers on the major routes out of London. Their position would be easier operating from the regions where there is less at stake for foreign carriers.

Consumer benefits

15. Similar considerations apply in respect of consumer benefit. The immediate and direct effects would be small. But the indirect effects could be very great indeed, particularly from a strong competitive BCal seeking to develop its European network in competition with BA and the major foreign carriers at Heathrow. Even the threat of competition has had significant effects.

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BCal's entry into the German market some 18 months ago together with its competitors' reactions has led, through the pressure of empty seats together with cheap fares to the Netherlands, to substantially reduced fares. Alitalia shows signs of reacting in a similar way to BCal's proposal to serve Milan. The benefits to the consumer are already visible and could grow rapidly if BCal is put in a position to sustain and extend its European bridgeheads.

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DUAL DESIGNATION

The attached appendix gives British Airways' estimate of those markets which might be large enough to sustain dual designation, and where in their view such designation should prove negotiable, together with its estimates of the revenue effect for BA and BCal of dual designation. In general it assumes that BCal could obtain 10-15% of the traffic, that BA would retain 30-40%, and that the foreign competition would continue to operate about 50%. It assumes that BCal's entry would stimulate the market by 5-10%, and that they would have to charge lower promotional fares in order to attract traffic to Gatwick in competition with Heathrow. On these assumptions BA predict what revenue might be gained by BCal and what revenue lost by BA. BA's position is that on these assumptions British Caledonian could increase their revenue by about £77 million, balanced by much smaller losses to BA, and that this solution would bring about the greater competition we are seeking.

We are not in a position to question the economic assumptions which underlie BA's projections, though it would not be surprising if they tended to demonstrate a greater potential benefit to BCal than BCal themselves might forecast if they were asked the same question. Moreover no attempt has been made to forecast what profits might accrue to BCal, and we know that breaking into new markets as a junior competitor is likely to be costly. However we have been able to analyse, and to discuss with BA, the international negotiating prospects for achieving this degree of dual designation. BA's estimates take account of that discussion, but it still seems doubtful whether the BA solution would be viable in the light of the negotiating prospects. In particular we have the following comments:

- a. Lisbon, Madrid, Malaga and Barcelona. We agree with BA that if we wanted dual designation, and BA were allowed to take their Iberian services back to Heathrow, we should no longer be able to maintain the limitation on Spanish and Portuguese frequencies at Heathrow which were secured in exchange for BA moving to Gatwick. This would therefore add significantly to our Heathrow ATM problems.

b. Milan and Rome. We shall be attempting to negotiate rights for BCal to serve Milan in competition with BA from Heathrow in the course of the coming autumn and winter. We have given notice that we do not propose to extend beyond 31 March 1985 the existing CMU which provides for single designation on each route and rigid 50:50 capacity sharing, but it is by no means certain that we shall be successful in securing our objectives.

c. Delhi. Our Indian ASA does not provide for multiple designation, and although we would not rule out the possibility that it might be negotiable within the existing British share, we think the Indians would regard this as an opportunity to seek fifth freedom rights on two services a week between London and Montreal which Air India currently have to operate blinded. They might be prepared to grant equivalent rights on two more services beyond India, but these would be of less value than the transatlantic fifths. The additional costs are not included in BA's current calculation.

If the above considerations are taken into account, the scope for dual designation on acceptable terms looks decidedly limited. On long haul routes BCal might be able to put two additional services through Muscat or Abu Dhabi to Delhi, albeit at considerable cost, notably on the North Atlantic. We could certainly get them into Miami, and probably into Toronto and Montreal, but the cost of entering these markets against entrenched opposition would be very high indeed. BCal will have enough trouble financing its proposed re-entry on New York for the next year or two.

The prospects on the long haul routes are therefore rather less attractive or substantial than BA would have us believe. What remains is a collection of European opportunities where BCal would in general be invited to operate one or two services a day from Gatwick in competition with three or four times as many from Heathrow. Historically, with the exception of Paris where capacity into Heathrow has been limited by inter-governmental agreement,

such services have made losses for BCal rather than profits. They might do a little better in circumstances where BA's own operations out of Heathrow were somewhat constrained (an understanding which is implicit in the BA solution) but this would actually inhibit competition between the British airlines on these services. Where the foreign state concerned insisted on limiting the number of services available to UK airlines (the normal practice outside Europe) we would be in a position to impose on BA and BCal whatever market shares we judged equitable and appropriate in the overall interests of UK aviation.

In short, those of BA's proposals where dual designation is feasible could already have been achieved were BCal in a financial position to mount such competition.

ROUTES PROPOSED BY BA FOR DUAL DESIGNATION

	<u>BCal Revenue Gain</u>	<u>BA Revenue Loss</u>
	£M	£M
Abu Dhabi)	8.0	3.4
Muscat)		
Delhi	5.8	4.5
Miami	12.3	4.3
Montreal	6.3	1.7
Toronto	12.2	4.0
Barcelona	2.5	0.4
Lisbon	3.6	2.9
Madrid	7.0	0.8
Malaga	3.9	0.4
Milan	5.9	4.3
Rome	5.1	4.6
Dusseldorf	4.3	4.0
TOTAL REVENUE EFFECT ARISING DIRECTLY FROM DUAL DESIGNATION	<u>£76.9M</u>	<u>£43.3M</u>
Offset to BA through redeploying on other routes surplus aircraft arising from dual desig- nation; and from moving its Iberian services back to Heathrow		£16.2M
TOTAL REVENUE LOSS FOR BA		<u>£27.1M</u>
TOTAL OPERATING PROFIT LOSS TO BA AS A RESULT		£14.9M

CONFIDENTIAL

BA PRIVATISATION: THE IMPACT OF THE LAKER AND OTHER US
ANTI TRUST CASES

1 The US legal proceedings described in para 2 below have been objected to by HMG on the grounds that aviation matters are jointly regulated by the two governments under the Bermuda Air Services Agreement, and are not subject to the unilateral application of the penal US domestic anti trust laws. An acceptable resolution of this dispute, as regards the past and the future, is of major importance to our aviation policy, whether BA is privatised or not.

2 There are several proceedings now pending in the US against BA and others (paras (a)-(c) and others which might emerge - para (d)).

(a) US Government Grand Jury Investigation

The Department of Justice conclusions on this are still awaited but are believed to be imminent. It is now expected that the Department of Justice will shortly inform us that the evidence found by the Grand Jury justifies indictment of BA for participating in inter-airline talks (including with Laker) on fares and in talks with US carriers on frequency scheduling. The Department is not however expected to find that BA acted

CONFIDENTIAL

- 2 -

predatorily towards Laker. The US Department of Justice (DOJ) informally agreed at the outset of their investigation to lay no more than a one count indictment against BA for each violation (maximum fine US\$1 million per count) and to allow BA to plead nollo contendere so as to avoid a trial. This could now happen quite quickly - weeks rather than months and in itself would not materially damage BA financially. The real danger of Grand Jury indictments would be their prejudicial effect upon the existing private suits (see (b) and (c) below) and their real potential to trigger further private actions (para (d) below).

- (b) Private action: Laker liquidator's case
Following the House of Lords decision on 19 July the Laker liquidator is now free, as a matter of English law, to pursue his claim in the US Courts that the collapse of Laker was caused by the predatory and illegal action of BA, BCal and other international airlines. He has called for documents located in the UK which HMG may or may not decide to release under the PTI

CONFIDENTIAL

- 3 -

Act Order and Directions. The case is not expected to come to trial for at least six months and could, allowing for appeals to higher courts, run for up to two years if not settled out of court. The sum claimed (including treble damages) against one or all the defendants is US\$1050 million.

(c) Private "class" actions

These actions (brought by contingency fee lawyers on behalf of the class of individual passengers) claim that airline fares rose because Laker was put out of business. The cases, which were stimulated by and are to some extent dependent upon (b) above, are unlikely to come to trial this year. The damages claimed are not specified but could theoretically amount to as much as US\$1200 million. BA and the other defendants have moved for dismissal of these actions which are legally novel and which must be regarded as speculative at present.

(d) Other possible private "class" actions

These cannot be ruled out and could be

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- 4 -

stimulated by indictments by the Grand Jury in respect of illegal price fixing before Laker's collapse. (Such actions would be serious for BCal too).

3 Immediate concern relates to the Laker private suit ((b) above). Although here the claim amounts to over US\$1000 million it provides little guide as to what in practice a court might award or to the level of an agreed payment in a settlement. Doubtless any/court award would be significantly less than the claim but it is impossible to give even a rough estimate of what the figure might be. The sum would be fixed by a six man jury and would depend on the loss which the liquidator could prove. Moreover US anti trust law provides for joint and several liability with no contribution and it is impossible to predict how, in the event of recovery, the liquidator would enforce any award. BA's possible "share" of an award can only be a matter for speculation; theoretically they might be forced to pay all of it. All that can be said at this stage is that BA face a risk of a very large award against them and that an informed guess at the sort of amount and of the estimated risk is not possible at this stage. The legal costs (which are not recoverable) of the defence against these suits is estimated to be of the order of US\$3-5 million.

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4 Because of the risks and costs involved (however good the defence) the vast majority of anti trust cases are settled out of court. Thus far, however, it appears that the Laker liquidator is pursuing this claim with missionary zeal and is only likely to settle for a very large sum (figures being mentioned by the US legal community after the House of Lords decision began at US\$100 million). What BA's share of any settlement might be is again pure guesswork; certainly it would be very substantial. (BCal could afford only a very modest contribution). Possible settlement figures for the other private actions (and any new ones) cannot be estimated.

5 Options for BA privatisation to attempt to offset the effects of US suits and meet the planned timescale include the following:

- (a) flotation with the liability. Anti trust liabilities are not regarded as an insuperable obstacle to company flotations in the United States, and there is growing familiarity with the problem in the UK. At the end of the day this is for the market to judge but advice from the merchant bankers is that flotation should not be jeopardised if in the prospectus the Directors can state, taking into account advice from US Counsel, that the US suits are unfounded

CONFIDENTIAL

- 6 -

or without merit and that they will be vigorously defended. This is the course that BA hope to pursue but which they are still considering, doubtless in the light of US developments.

- (b) the airlines might reach an acceptable out of court settlement, but the timing of this is unpredictable.
- (c) BA may be able to insure their interest. However they are reluctant to probe too deeply into this unless and until necessary for fear of spreading alarm. In principle they appear to be satisfied that insurance cover for any liability in excess of a given figure appears to be a viable option.
- (d) the Government have guaranteed BA's creditors against a BA default before privatisation. The Government could decide, at the time when the prospectus is finalised, to continue after privatisation a guarantee limited to damages in the Laker suits or to the excess over a predetermined sum (though this might possibly require legislation).

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- 7 -

6 In considering these options it is important that nothing be done which would undercut the position of HMG in its dispute with the US Government. This affects options (a) and (d) above. So far as option (a) is concerned the ability to float successfully with the liability may be dependent upon BA's unhampered ability to defend themselves in the US courts. However HMG objects strenuously to the US court proceedings and has invoked the PTI Act to prohibit disclosure of UK located documents, commercial information etc. This issue is currently under consideration. So far as option (d) is concerned it is difficult to see how HMG could stand guarantor to meet awards arising from proceedings to which it has so strenuously objected, simply to pursue BA privatisation. However this is a possible, though unattractive, option as one of the measures to maintain the UK position in the wider dispute.

7 This paper does not attempt fully to analyse or present options for dealing with the hydra-headed complexities of the "Laker" dispute. In broad terms the position is that if BA (and BCal) remain exposed to current and anticipated US suits the financial consequences are potentially very serious; equally, if HMG decides to pursue the dispute vigorously there could be a crisis in UK/US aviation relations which could give rise to alarm about BA's services to the USA. Either way a spill-over on to BA privatisation seems an unavoidable possibility.

24 August, 1984.

Thank you so much for your letter of 14 August which reached me while I was staying with Lady Glover. It was very good of you to write.

I am sure we both realise that whatever decision is ultimately taken, it is going to be extremely difficult for some people. It is therefore very important that every aspect should be thoroughly thought through among colleagues so that we are satisfied that we have reached the best possible solution.

The Lord McAlpine of Moffat

blind copies to:

00
Prime Minister
Secretary of State for Transport



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

24 August 1984

Lord King of Wartnaby
Chairman
British Airways
PO Box 10
Heathrow Airport
Hounslow TW6 2JA

*N
28/8*

Dear Lord King

Many thanks for your letter of 21 August.

I would gladly respond to your suggestion of a dialogue, were it not for the fact that I shall be out of the country for the next two weeks. I have therefore suggested to Nicholas Ridley that in my absence, he might contact you to set up a meeting without delay. I shall, of course, be very happy to join your discussions myself, if they are still taking place when I return in the second week of September.

Yours sincerely,

Margaret O'Hara

NIGEL LAWSON

*(Approved by the Chancellor
and signed in his absence)*

**British
airways**

British Airways Head Office

PO Box 10
Heathrow Airport (London)
Hounslow TW6 2JA
Telephone: 01-759 5511
Telex No. 8813983

Chairman:
Lord King of Wartnaby

21 August 1984

22 AUG 1984

MR R H WILSON

MR MONICA UK

MR BARKER UK

The Rt. Hon. Nigel Lawson, MP,
Chancellor of the Exchequer,
The Treasury,
Parliament Street,
London SW1P 3AG.

Nigel Lawson

I am apprehensive that in early September the protagonists in the Debate over the future of our airline industry will, by force majeure, get locked in further unrewarding and repetitive argument. In this atmosphere and with time being short some of the principles at issue may become obscure and compromises, that benefit none of the parties involved, may be imposed. This outcome would be the worst of all worlds and I am most anxious to do all that I can to help in preventing such a situation occurring.

On coming to power the aims of the Government, as far as British Airways is concerned, were twofold:-

- (a) to provide the circumstances and the freedom of management that would allow the airline to develop by its own resources to a commercial standard of profitability, and
- (b) to sell the Government owned shares to the public as soon as it was reasonably possible to do so.

The first has been achieved satisfactorily, the second is now possible but is threatened by some of the CAA recommendations.

Complementary to these aims is the Government's strong support of competition and the operation of market forces. It is under this guise that the Independent Airlines, particularly British Caledonian have mounted their campaign for route transfers which, in effect, are subsidies at the expense of British Airways. It does not seem to matter how often we say it but we cannot seem to get across that "transfer" is not "competition" between airlines. Competition in the true sense, where airlines compete one with the other, on a given route, is very much in the context of the Government's wishes and market forces then decide the future.

/continued.....

The Rt. Hon. Nigel Lawson, MP

21 August 1984

During the past months the Independents and the CAA Report have accused British Airways of many things - "Monopoly", "Dominance", "cross-subsidy" from one route to another, "overwhelming power" and etc. All of these comments are answerable but, in the end, from a commercial standpoint it is route transfers from British Airways which would frustrate the Government's aim of privatisation. At the same time they would damage the Airline's financial performance and its capabilities as a world leader. All for no benefit to the consumer.

It is because we cannot see any commercial logic in route transfers for the Government or British Airways that I accept the necessity of a political solution to the issue.

In fact, the only hindrance to a solution that would satisfy both the privatisation and "competition" aims of the Government would seem to be the provision of sufficient opportunity for the Independents to expand. Not by subsidy, because that is against Government policy, but by organic growth.

To this end we have advocated already the de-regulation of domestic services and are not opposing licence applications by British Caledonian or the other Independents on international routes where we are already operating. No doubt our experts could investigate further opportunities for competition, meanwhile we have in progress a detailed study to show the likely benefits to the Independents should they take up the route access now available to them.

However, in accepting that a political solution has to be found I have to say where my Board and I are inflexible for political as well as practical reasons.

We cannot condone or agree to route transfers from British Airways. Firstly, there were the Ministerial undertakings to the contrary given by word and letter to Chairmen and Union Leaders; secondly, the consequent undertakings that were given by Management to workforce and, lastly, the very adverse effect route transfers would have on commercial objectives including privatisation.

Apart from the industrial troubles that undoubtedly would occur in the event of transfers, any breach of faith on this front would be seen as a precedent by the national union leadership and might well be used in efforts to frustrate the whole privatisation programme.

/continued.....

The Rt.Hon. Nigel Lawson, MP

21 August 1984

You will agree that it is my, and my Board's, absolute duty to safeguard the affairs of the Company for the best interests of the Shareholder. Therefore, as Chairman of a State-owned Corporation, and a staunch Conservative, the last thing I want is to find myself in a situation where I am compelled to oppose Government proposals publicly. It is because time is so pressing if the Government's stated aims for British Airways are to be fulfilled on time that I write to you in the hope that you can use your good offices to initiate some form of dialogue before all sides become even further entrenched.

Lawson
DL

28 AUG 1954

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7

File

MR. ALISON

cc. Mr. Turnbull
Mr. Redwood

British Airways, B Cal and Independents

James Moorhouse, MEP rang on this subject making the following points:

1. We need to preserve the authority of the CAA.
2. He believes that the independents including B Cal will be at risk if British Airways retains its present huge slice of the scheduled flights.
3. He is not optimistic about liberalising European air routes.

Mr. Moorhouse has a professional as well as a political interest in civil aviation and I am writing ^{simply} to record his views.

S.

STEPHEN SHERBOURNE

21.8.84

1) Mrs Ryder: please invite x

2) MR. TURNBULL - On return

CAA Review

We have provisionally arranged a small meeting of Ministers to discuss the CAA Review on Tuesday 11 September, prior to the Cabinet meeting that week. There are, however, some problems over attendance to which you will wish to give thought.

First, the Foreign Office have put in a bid. The Foreign Secretary is away, and if the Prime Minister agrees that they should be represented, Mr. Whitney would come. Could you please let Colin Budd know.

Secondly, Mr. Tebbit is unavailable and will be represented by Mr. Fletcher.

Thirdly, I see from the LCA that the initial discussion paper is to be circulated to the Attorney General. He will be in the US on 11 September, but I have provisionally arranged for the Solicitor General to attend the meeting.

So the line-up is:

Chancellor of the Exchequer

Lord Privy Seal

Secretary of State for Transport

Chief Whip

~~Mr. Fletcher~~ S/Trade

Solicitor General

?Mr. Whitney, and

~~Cabinet Office.~~ Peter Gregson a possible RTA.

End
20 August 1984

CAROLINE RYDER (on return)

Civil Aviation Policy

The Cabinet will be returning to the subject of Civil Aviation policy on 13 September. Before then, we need a meeting of a smaller group of ministers, as follows:

Chancellor of the Exchequer

Lord Privy Seal

Secretary of State for Trade and Industry

Secretary of State for Transport

Chief Whip

Mr Gregson or Mr Buckley

The only opportunities I can see in the diary are Monday 3 September or Tuesday 4 September. Could you please press the appropriate offices hard for a meeting on one of these days, to last about one hour.

DBS

David Barclay

16 August 1984

From
Lord M. Spence of Maffat
Telephone: 01-837 3377

40, Bernard Street,
London, WC1N 1LG

14th August 1984

My dear Prime Minister

Perhaps I should offer you my apologies for raising the question of British Airways on a somewhat unsuitable occasion, but the sincerity of Lord King's distress impressed me so much when he spoke to me on the telephone on Sunday morning that I really felt it would be wrong for everyone concerned if I did not seize the opportunity when I had a few minutes of your time unaccompanied.

My last phrase I think was a somewhat unfortunate one, when I said "You must forget Sir Adam Thomson". What I intended to convey was that his priority could not be compared with that of the unhappy position which the Government would find itself in if Lord King was unable to implement the promises which he gave to his employees at B.A. which had been supported by the Government. Both he and I have a very great respect for the work which Adam Thomson has done. Lord King's problem is that he cannot afford to have any of his air routes removed, but he would welcome Adam Thomson's competition on many of them, because it would have the effect of sharpening up his staff, and the increased competition of both companies could well result in a greatly increased amount of business.

Of course, Sir Adam is in a difficult situation because until Lord King's appointment he was competing with a somewhat flabby and unenthusiastic Nationalised Industry, whereas under Lord King's leadership he has to compete with a thoroughly efficient and splendid organisation, which, of course, you will appreciate is quite a different matter. When Lord King was first

Contd.

appointed I anticipated this situation and invited them both to lunch to meet one another, in the hope that I might have been able to create an entente, but British Caledonian do not seem to have responded. I genuinely think that they are sufficiently financially strong to be able to weather the storm until you achieve your ultimate object of privatisation.

I am most sorry to burden you with this while on your well deserved holiday. I do most sincerely hope that you and Denis will have an enjoyable and restful holiday and that the Swiss weather will be kind to you.

*Yours truly
P. Min*

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

From
Lord McAlpine of Moffat
Telephone: 01-837 3377

40, Bernard Street,
London, WC1N 1LG

14th August 1984

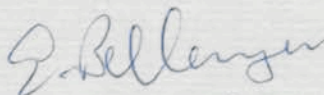
Dear Lady Glover,

Lord McAlpine has rang me from the country and asked if I could send you this letter for the Prime Minister.

He had hoped to send it to her by Ian Gow but there has been a misunderstanding over his dates.

Lord Edwin says he would appreciate very much if you could let the Prime Minister have the enclosed letter, and he sends you his love.

Yours sincerely



for Mrs D M Thomas

Private Secretary

Lady Glover
Schloss Freudenberg
Rotkreuz 6343
Kanton Zug
Switzerland

MR. ALISON

Anthony Steen, MP telephoned me to say that you had given him an assurance that the Prime Minister would meet in early September (before any decision ^{on the CAA Report} was taken) the Chairmen of the independent airlines: he feels they have a case quite separate from B Cal. Moreover he feels she ought to see them as she has already seen Adam Thomson (of B. Cal)

The Private Office are not keen for the Prime Minister to see these people. Indeed, Nick Ridley has already seen them.

However, Steen was very pressing and as I was not clear about how much of an assurance you gave him I had to leave it by saying you would contact him on your return from holiday. He has various telephone numbers as follows:-

01-219 5670	(his number in the HOC)
01-219 5045	(his secretary)
01-219 3778	(messages)
0804 32530	(his home in the country)
0803 866069	(his Conservative Association)

Steve

STEPHEN SHERBOURNE

8.8.84



British Caledonian

Prime Minister (2)

To note *BT* *3/8*

3 August 1984

British Caledonian Airways Limited
Caledonian House Crawley
West Sussex RH10 2XA England

Telephone: Gatwick (0293) 27890
Cables: Scotair Gatwick
Telex: 87161 BCAL G.
Prestel Number: 282

Mr F E R Butler
Principal Private Secretary to the
Prime Minister
Prime Minister's Office
10 Downing Street
London SW1

Dear Mr. Butler,

I understand that when the Prime Minister met our Chairman, Sir Adam Thomson, on Wednesday of this week, reference was made to a recent letter dated 24 July which Sir Adam had written to all Members of Parliament on the question of British Caledonian finances and the Civil Aviation Authority's news release on the subject.

I now have pleasure in enclosing the text of the letter referred to for your records.

Yours sincerely,

J M Ritchie
External Affairs Director

enc:



Registered in England No 233961
Registered office Caledonian House
Crawley West Sussex RH10 2XA

TEXT OF LETTER SENT FROM SIR ADAM THOMSON, CHAIRMAN OF
BRITISH CALEDONIAN AIRWAYS, TO ALL MEMBERS OF PARLIAMENT,
SELECTED PEERS AND LEADERS OF COMMERCE AND INDUSTRY ON
24 JULY 1984

"Since the publication of the CAA Report on Airline Competition on 16 July, British Caledonian has been most concerned at the number of groundless, critical and derogatory remarks that have been made about our ability to finance the route transfers that the CAA recommended.

British Caledonian has never had any doubt about its ability to raise the £75 m. of new equity that would be required to finance the additional BCAL routes proposed by the CAA. In fact, we and our advisers were confident that we could cover the higher amount that would have been required had our full proposal to the CAA been accepted.

We can advise you that the CAA has today issued a new release stating that it is satisfied that BCAL can raise the additional finance.

The text of the CAA's news release reads:-

'In its report on airline competition policy the Authority stated that, before making a firm recommendation for the transfer to BCAL of the routes to Harare, Dhahran and Jeddah, it would need to be satisfied that BCAL could raise the necessary additional resources.

Following discussions with BCAL and its financial advisers, the Authority is now satisfied as to the prospect that BCAL will be able to raise the necessary finance to take over their routes and compete on inter-continental as well as European routes. The Authority therefore confirms its recommendations to the Secretary of State.'

This means that the debate can now be entirely about the merits of a competitive airline policy."

AEROSPACE

Future of BA

AN

Marked up copy for Mr. Turnbull.

PRIME MINISTER

BRITISH CALEDONIAN

I had an hour with Sir Adam Thompson, at his request, earlier this evening. He was particularly anxious to follow through the balance sheet queries you directed at him this morning.

We tackled first the three specific points you raised:

- (i) Blocked overseas balances.
The £67 million shown in BCal's latest accounts have now been almost completely cleared. Since BCal had borrowed against the balances, the remittances have been applied to reduce borrowings rather than to increase liquidity.
- (ii) Dollar borrowings.
As we thought, BCal do feel uncomfortable.
- (iii) Gearing.
Yes, it is high and will not come down much, even in the medium term. But gearing of over 200% is commonplace in airlines, and BCal gave me a table for Europe and the USA to confirm the point.

Annex 1

BCal's comments should make us feel a little easier about its short term future; but they admitted that they would have to strengthen their balance sheet soon, regardless of Government's response to the CAA's recommendation.

As background to improving the balance sheet, Adam Thompson took me through BCal's recent earnings - and its projected earnings on the assumption (unwarranted in his

view) that BA would not behave in predatory fashion once privatized. The figures are in Annex A. They exhibit great volatility in the past and great growth in the future. Adam Thompson was very confident of earnings of £14 million this year (versus £3.3 million last).

If we were to believe these figures, there would be no case for Government support to BCal.

BCal's plan (they said) was to raise new equity of £30 million late this year, mainly from existing shareholders. But the prospect of BA's being privatized, intact with its routes, kills off that possibility. So the only way forward for BCal is to press for the reallocation of profitable routes from BA and to raise much larger sums to service them. BCal's own proposals for route transfers would have required a further £150 million of equity capital and £250 million of loans. The CAA's smaller package of proposals requires some £75 million of equity and £120 million of loans. Even that is a large addition to their present £69 million of shareholders' funds and £160 million loans.

Annex 2.

BCal have given me copy letters of comfort from their financial advisers that they could raise the funds to finance BCal's own proposed route transfers. The CAA are satisfied that BCal can raise the necessary to service Saudi Arabia and Harare. We do not have evidence that the CAA package in full can be financed. BCal mentioned that they would want "a close look" at the Gatwick/Iberian routes before taking them on.

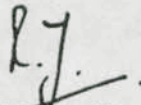
So long as route transfers could be phased, BCal do not see the likelihood of service interruptions on handover. They would offer to take on BA's dispossessed staff in the UK and overseas, but would not necessarily want the aircraft which BA might declare surplus. They do not feel that the reallocation of routes from BA to BCal poses serious

difficulties for the construction of a BA prospectus: why is it harder for BA to forecast the reductions than for BCal to forecast the gains?

We discussed other minor matters, and I was given a *Annex 3.* copy of their Five Year Plan for background information.

My conclusions are:

- (i) if BCal's £14 million profit prediction for this year is accurate, the company is not about to go bust;
- (ii) BCal's plans to expand its capital base seem to me immodest. If you believe that route transfers to BCal are, de facto, the start of Government's underwriting the future of BCal, beware the scale of ambition to be underwritten;
- (iii) the competition issues do not look different by virtue of Sir Adam Thompson's presentation to you or his discussion with me;
- (iv) the behaviour of BA post privatization is important. You could ask Mr. Ridley to explore further what restraints can be applied. He could respond to the CAA's recommendations in principle (accepting domestic deregulation and competition but rejecting the immediate transfer of routes) while announcing his intent to investigate and head off the possible abuse of dominance.


~~Robert Young~~
Policy Unit
1 August 1984

*BCal accounts also
attached as Annex 4.*

ANNEX A

BCal's Profit Record and Forecasts

	<u>Turnover</u>	<u>Profit before Tax</u>
	<u>(£m)</u>	<u>(£m)</u>
1973/74	77	(5.7)
1974/75	86	(0.3)
1975/76	117	5.6
1976/77	159	7.9
1977/78	177	12.2
1978/79	200	6.6
1979/80	252	9.7
1980/81	323	(6.2)
1981/82	401	1.5
1982/83	428	3.3

1983/84 Estimate	495	14.0

1984/85 Forecasts*	c.590	31.0
1985/86	c.640	28.0
1986/87	c.720	55.0
1987/88	c.800	81.0

* excluding route transfers



10 DOWNING STREET

Annex 1.

AIRLINE STATISTICS

£'M

(LOCAL CURRENCY TRANSLATED @ JULY 1984 BCAL COMPANY RATE)

EUROPEAN AIRLINES

<u>Airline</u>	<u>Accounts Date</u>	<u>Fixed Assets</u>	<u>Working Capital</u>	<u>Debt</u>	<u>Equity</u>	<u>Debt:Equity Ratio</u>
Aer Lingus	31. 3.83	121.9	33.1	121.0	40.0	3.0
Air France	31.12.82	1,148.4	(33.6)	960.3	154.9	6.2
Alitalia	31.12.82	647.4	20.0	508.7	158.8	3.2
Austrian	31.12.82	137.0	9.9	63.5	83.4	0.8
Finnair	31. 3.82	239.9	(25.8)	187.4	26.7	7.0
Iberia	31.10.82	648.2	2.7	483.6	167.3	2.9
KLM	31. 3.83	623.1	92.8	341.8	248.5	1.4
Lufthansa	31.12.82	709.1	22.4	384.1	347.7	1.1
SAS	30. 9.83	310.1	118.3	287.6	129.3	2.2
Swissair	31.12.83	672.1	77.4	412.8	263.8	1.6

Av. airline rate 2.9

AMERICAN AIRLINES

American	31.12.83			1,812.3	941.6	1.9
Delta	31.12.83			687.4	680.0	1.0
Eastern	31.12.83			1,798.1	230.9	7.8
Northwest	31.12.83			72.6	620.3	0.1
Pan Am	31.12.83			1,119.8	315.2	3.6
PSA	31.12.83			333.6	129.6	2.6
Piedmont	31.12.82			267.9	184.7	1.4
People Express	31.12.83			179.4	74.1	2.4
Southwest	31.12.83			120.0	228.5	0.5
Trans World	31.12.83			873.3	374.2	2.3
United	31.12.83			1,047.1	1,001.8	1.0
US Air	31.12.83			254.1	444.2	0.6
Western	31.12.83			336.2	63.2	5.3

Av. airline rate 2.35



10 DOWNING STREET

Annex 2



T.E. Boud Esq
Group Financial Director
The Caledonian Aviation Group PLC
Caledonian House
Crawley
West Sussex

July 3, 1984

Dear Trevor,

As you know, Barry Firmin visited the Bank today to discuss the latest developments in your submission to the Civil Aviation Authority for its Competition Review and in particular The Caledonian Aviation Group PLC's Business Plan dated June 1984. We have discussed previous submissions and we have given you our thoughts on those plans and specifically on the feasibility of arranging finance.

With regard to some of the recent press reports which either directly or by implication have questioned the Group's ability to:

- i) finance existing capital commitments,
- ii) finance the purchase of additional aircraft and equipment to serve additional routes transferred from British Airways, and
- iii) service the levels of debt, incorporated in the above plans,

we would say that we and other banks had already considered these points in the light of information provided by the Group earlier this year and subsequently, Bank of America, together with National Westminster, were able to arrange successfully a \$107 million facility for your two Airbus A310-200 aircraft, and a further facility for £19.6 million. Consequently I can assure you that our views on the Group's ability to raise equity and term debt to finance its BA route and aircraft acquisition plans remain unchanged; i.e. given the Group's ability to raise £150 million in equity of which you are confident, we believe you should be capable of raising £250 million in other capital markets, provided there are no adverse movements in the airline industry or in the financial markets, and that sufficient time and attention of senior management is devoted to executing this part of the plan.

We have formed the above conclusions on the following grounds:

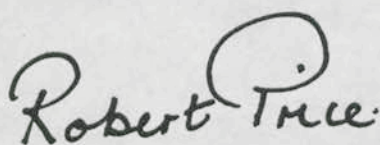
- i) The Group's plan incorporating the BA routes and its financial forecasts indicate an ability to service the debt partly as a result of improving profitability and partly due to improved leverage. Given the Group's record versus previous plans, this will enhance its credit standing.

T.E. BOUD ESQ
July 3, 1984

- ii) We believe the 85% financing for the specified aircraft over the tenors indicated in the plan will be attractive.
- iii) The effect of the Nigerian remittance situation (which, as we have discussed, has improved dramatically in the last three months) will be considerably diluted under the plan to the benefit of the Group.
- iv) We believe that the Group has the management expertise to turn the plans and financial forecasts into reality.

Given the long standing relationship between the Group and the Bank which started in the mid 1970's, you may wish us to discuss our views with others. Peter Wainwright and I would be delighted to do so.

Yours sincerely,

A handwritten signature in cursive script that reads "Robert Price". The signature is written in dark ink and is positioned above a horizontal line.

Robert N. Price
Vice President

4th July 1984

Civil Aviation Authority
Civil Aviation House
45 Kingsway
London WC2

For the attention of J. Dent Esq.

Dear Sirs,

We write to confirm that we are prepared to advise British Caledonian in raising £150 million of equity and consider that this can be achieved. This view is shared by Hoare Govett Limited as is evidenced by the signature of its Chairman, Mr. Westmacott, to this letter. The raising of this equity money must obviously be subject to certain conditions and those we have in mind are as follows:-

1. A suitable package of routes being available to British Caledonian. We have seen the package set out in the submission made to yourselves by British Caledonian dated 18th June 1984. We understand from our clients that there is no possibility of their Hong Kong route proposal being accepted but that they would be awarded another route which would have a compensating financial benefit. We understand that you have informally indicated that you consider that the revenue and traffic assumptions made by British Caledonian in their submission are fair and reasonable.
2. That the financial projections, and in particular the figures set out in section 2.3 of British Caledonian's submission, are realisable. It would be necessary in due course to have a satisfactory accountant's report, as is required in the case of all such issues, vouching inter alia for the integrity of these projections.

DIRECTORS

M J HAWKES (CHAIRMAN)

M W ACOMB THE EARL OF LIMERICK K B E (VICE-CHAIRMAN)

T G BARKER S R BARROW D H BENSON R J BODEN R A BROOKS D R O C CAMERON C G H CLARK D C CLEMENTI C W L CROOK J G DAVIS
M DEFRIEND J L E G DELVAUX P H P DEPELET M C DEVAS M C P J G ELWES C A A P EUGSTER R T FOX M J B GREEN P GUY T H HOLLAND-BOSWORTH
J D HOWLAND JACKSON C R M KEMBALL E C MACADAM P MACARTHUR B W J MANNING R M MAYS-SMITH J F NELSON R A B NICOLLE P J PARSONS D A E R PEAKE
G R PINTO P R RICKWOOD S M ROBERTSON THE LORD ROCKLEY J A SPALL J F H TROTT S J URWIN D C WAKE-WALKER W H N WILKINSON J H WILSON R N YOUNG

3. Satisfactory market conditions at the time of the fund raising; the timing of the flotation of British Airways has some relevance in this context.
4. A commitment by bankers to finance the purchase of aircraft and equipment to accommodate the routes to be transferred, which we anticipate would be conditional upon the raising of some £150 million of equity finance.

We should be glad to meet you either with or without your financial advisers at any time to discuss the matter further.

Yours faithfully,
for Kleinwort, Benson Limited

T. H. Hollands-Bosworth

Director

Yours faithfully,
for Hoare Govett Limited

A. J. G. G. G.

Chairman

CLARK D C CLE
FOX
SMITH
UNWIN

Citibank N.A.
P.O. Box 78
336 Strand
London WC2R 1HB
Telephone: 01-438 1121

M. Christopher S. Leslie
Vice President

5 July 1984

Mr. T. Boud,
Group Finance Director,
Caldeonian Aviation Group PLC,
Caledonian House,
Crawley
WEST SUSSEX RH10 2XA

Dear Mr. Boud,

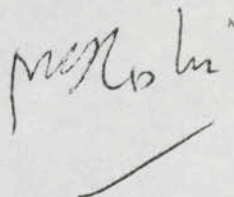
Following Barry Firmin's visit yesterday, I am writing to outline what we think is achievable in terms of loan finance for Caledonian Aviation Group ("CAG") as a result of the possible acquisition of a package of routes from British Airways. The requirement is based on the cost of acquiring aircraft, spares, and other support assets, together with various launch costs.

We believe that term finance of up to £250 million is capable of being raised, from a variety of international sources, based on the following minimum conditions -

- (i) the raising beforehand of £150 million of equity capital
- (ii) the package of routes acquired being no worse than those set out in the June 1984 presentation
- (iii) the acquisition costs of the assets being in line with free market values (the aircraft, in particular, being in line with the estimates set out in the presentation)
- (iv) the loan finance being secured by, and not exceeding, 85% of the basic hull acquisition cost of the aircraft, such aircraft to be of the type set out in the presentation
- (v) there being no material worsening of the general outlook for civil aviation, and CAG's operation in particular

If a requirement of this kind were to materialise, then, subject to the negotiation of mutually satisfactory terms, Citibank would be prepared to try to arrange a loan package of this size, in conjunction with your other major lenders. This willingness is based not only on the financial aspects of the transaction, but also on our perception of CAG management's ability and determination, which has been built up in the many years of involvement between our respective organisations.

Yours sincerely,



Hoare Govett Ltd

Heron House, 219/225 High Holborn
London WC1V 7PB and at
27 Throgmorton Street, London EC2N 2AN & Stock Exchange
Telephone 01-404 0344
Telex 885474 and 885773
Telegraphic Address Auresco, London WC1
Facsimile No. 01-404 0342 (Group 3)

11th July 1984

For the attention of J. Dent, Esq.

Civil Aviation Authority,
Civil Aviation House,
45 Kingsway,
London, W.C.2.

Dear Sirs,

The Caledonian Aviation Group plc

We are writing further to our letter of the 4th July 1984 written to you jointly by Kleinwort Benson and ourselves.

You are aware that, with Mr. D. Reed of County Bank, we visited three leading London institutional investors last week to seek their preliminary views and support for the proposed financing of Caledonian.

Over the past two days we have visited nine further leading investment institutions in both London and Edinburgh; the latter in conjunction with Sir Adam Thomson and Mr. Trevor Boud of Caledonian for the same purpose. These institutions represented a cross section of the institutional investment market comprising insurance companies, pension funds and investment trust managers.

The response from eight out of the nine institutions was positive and we are confident that they will support the proposed financing - in several cases with units of investment well above their normal percentage.

Equally important, the response from this significant cross section of the investment community encourages us to confirm to you our belief that £150m of equity finance can be raised for the Group.

/ Contd.

Directors: R.K. Westmacott, R. West, R.J.P. Jenks, F.C.A., J.B. Brooks, R.C. Livesey, F.I.A., P.R. Meinertzhagen

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The single institution which did not give a positive response has particular restrictions on investment in unquoted companies but, nonetheless, did not rule out participation.

We would be happy to attend a meeting at your office together with Caledonian and Kleinwort Benson if it would be of help.

Yours faithfully,
for and on behalf of Hoare Govett Ltd.

R. K. Westmacott

R.K. Westmacott

Mr. Trevor E. Boud, F.C.A.,
Group Finance Director,
The Caledonian Aviation Group plc,
Caledonian House,
Crawley,
West Sussex RH10 2XA
England

July 10, 1984

Dear Sir,

I am writing on behalf of E.F. Hutton & Company Inc. ("Hutton"), of which E.F. Hutton International Inc. is a wholly-owned subsidiary, regarding the reception that could be expected for the United States portion of a public equity offering during late 1984 or early 1985 on behalf of The Caledonian Aviation Group plc ("Caledonian"). We have been made aware of Caledonian's proposal to the Civil Aviation Authority regarding the potential transfer of route authority to Caledonian, and the related £400 million in financing requirements that would ensue should Caledonian's proposal be approved in full, of which approximately £150 million would be the expected equity financing requirement. We have therefore examined the prospects for the United States portion of a public equity offering for which the proceeds would be applied to these financing needs, and assuming that Caledonian's proposal had been approved by all requisite United Kingdom governmental authorities.

It is Hutton's opinion that the United States portion of a public equity offering on behalf of Caledonian in late 1984 or early 1985 could be successfully consummated in a size ranging from approximately \$100 million to \$150 million. This opinion assumes no material adverse change in the financial condition of Caledonian or in present United States public equity market conditions.

In reaching this opinion we have considered, among other items, Caledonian's October 31, 1983 published financial statements, Caledonian's proposals to the Civil Aviation Authority regarding the transfer of route authority to Caledonian, together with Caledonian's projection of the financial results and position that would ensue should their proposal be approved in full, and Caledonian's expected financial results and position for the fiscal year ended October 31, 1984.

Cont'd...

Mr. Trevor E. Boud, F.C.A.

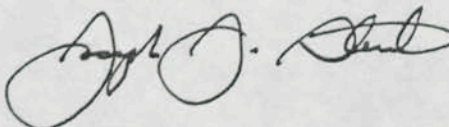
July 10, 1984

- 2 -

During 1983 Hutton managed or co-managed public financing on behalf of United States airlines aggregating approximately \$1.2 billion, more than any other investment banking firm, and approximately half of the \$2.5 billion in airline public financing consummated in 1983. The substantial portion of such public offerings was equity or equity-related (i.e. convertible debt) financings, and was made on behalf of such international airline clients as Trans World Airlines, Pan American World Airways and American Airlines.

We would be pleased to answer any questions you may have regarding our opinion, and you may feel free to show this opinion to such financial or governmental institutions as you require.

Sincerely,



Joseph J. Steuert
Senior Vice President,
Head of Transportation Group,
Corporate Finance Department



10 DOWNING STREET

Annex 3.

THE CALEDONIAN AVIATION GROUP PLC

FIVE YEAR PLAN

18th July, 1984

THE CALEDONIAN AVIATION GROUP PLC

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THE CALEDONIAN AVIATION GROUP PLC

FLEET COMPOSITION

	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>	<u>1986/87</u>	<u>1987/88</u>
DC 10-30	8	10	10	10	10
Boeing 747-200	1	3	3	3	3
BAC 1-11 (500)	13	10	10	10	10
Airbus A310	3*	3	3	3	3
Airbus A320	-	-	-	-	3*

*Introduced to service during year.

THE CALEDONIAN AVIATION GROUP PLC

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1

ACCOUNTING POLICIES

ROUTE TRANSFER PLAN

1. Initial Advertising and Promotion Costs of £5.0 million have been amortised over three years.

2. — Deferred taxation has been provided for at 35% on total profits.

No account taken of prior years deferred taxation or accumulated ACT.

SUMMARY AIRLINE PROFIT AND LOSS PROJECTION

	1983-4	1984-5	1985-6	1986-7	1987-8
Airline Baseplan Trading Profit	10,291	30,939	27,958	55,184	81,481
Add: Profits arising from New Routes/ Activities	-	14,100	36,500	44,000	52,500
	10,291	45,039	64,458	99,184	133,981
Less: Additional Finance Costs re New Routes/Activities	-	(4,517)	(6,873)	(6,067)	(5,223)
	10,291	40,522	57,585	93,117	128,758
Less: Initial Promotion & Advertising	-	(972)	(1,667)	(1,667)	(694)
	10,291	39,550	55,918	91,450	128,064
Add: Extra Interline Benefits	-	2,900	7,800	8,400	9,200
	10,291	42,450	63,718	99,850	137,264

THE CALEDONIAN AVIATION GROUP PLC

PROFIT AND LOSS ACCOUNT

YEARS ENDING 31ST OCTOBER

<u>£'000</u>	1983	1984	1985	1986	1987	1988
Turnover	428,484	495,064	641,972	751,598	841,731	945,249
Airline Trading Profit	6,394	10,291	42,450	63,718	99,850	137,264
Profit on Sale of Aircraft	1,851	8,790	-	-	-	350
Unknown Competition Factor and Provision for Exceptional Items	(5,044)	(6,200)	(10,500)	(16,000)	(25,000)	(35,000)
	3,201	12,881	31,950	47,718	74,850	102,614
Other Group Activities						
Jetsave	-	71	207	600	1,086	1,202
Helicopters	(1,478)	(1,004)	-	-	-	-
Engine Overhaul	368	38	612	376	761	854
Inclusive Tour Holidays	26	429	1,242	1,334	1,460	1,596
Hotel Operations	1,138	1,510	2,394	3,337	4,617	6,001
Holding Company Income	82	833	1,000	2,200	4,200	8,600
	3,337	14,758	37,405	55,565	86,974	120,867
Employee Profit Share	-	(738)	(1,870)	(2,778)	(4,349)	(6,043)
Profit before Taxation	3,337	14,020	35,535	52,787	82,625	114,824
Taxation	(1,211)	(4,837)	(12,437)	(18,475)	(28,919)	(40,188)
Profit after Taxation	2,126	9,183	23,098	34,312	53,706	74,636
Dividend (Gross) (4 times cover)	-	(2,296)	(5,774)	(8,578)	(13,427)	(18,659)
Net Retained Earnings	2,126	6,887	17,324	25,734	40,279	55,977

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THE CALEDONIAN AVIATION GROUP PLC

ADDITIONAL AIRCRAFT REQUIREMENT

1984-85

<u>ROUTE TRANSFER PLAN</u>				
	<u>No. of Units</u>	<u>Estimated Unit Cost</u>	<u>Average Age</u>	<u>Remaining Depreciable Life</u>
Boeing 747-200	2	\$35.0 M	7 years	9 years
Douglas DC10-30	2	\$30.0 M	5 years	11 years
Airbus A310	1	\$48.0 M	New	16 years

THE CALEDONIAN AVIATION GROUP PLC

FINANCING ASSUMPTIONS

<u>ROUTE TRANSFER PLAN</u>	<u>PERIOD OF FINANCING</u>	<u>REMAINING DEPRECIABLE LIFE</u>	<u>% OF HULL VALUE FINANCED</u>	
Boeing 747-200	8 years.	9 years.	85%)
)
)
Douglas DC10-30	8 years.	11 years.	85%)
)
)
Airbus A310	10 years.	16 years.	85%)
)

Equal repayment mortgage loans

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THE CALEDONIAN AVIATION GROUP

SUMMARY OF CAPITAL EXPENDITURE

	1983-84	1984-85	1985-86	1986-87	1987-88	Total
<u>BRITISH CALEDONIAN AIRWAYS</u>						
Airbus A310 - Aircraft (3 Units)	66,600	31,530				98,130
Spares	4,900	3,320	3,618			11,838
Airbus A320 - Aircraft (3 Units)	700		450	600	72,765	74,515
Spares					7,000	7,000
Boeing 747 - Aircraft (3 Units)		46,053		13,978		60,031
Spares		9,011				9,011
BAC 1-11 - Aircraft & Refurbishment	4,164	8,450			1,645	14,259
Douglas - Aircraft (2 Units)		39,474				39,474
DC 10-30						
Spares		1,974				1,974
General	11,620	15,000	18,500	19,500	20,500	85,120
	87,984	154,812	22,568	34,078	101,910	401,352
<u>BRITISH CALEDONIAN HELICOPTERS</u>						
	8,003	150	150	200	200	8,703
<u>CALEDONIAN AIRMOTIVE</u>						
	1,245	3,360	831	672	600	6,708
<u>CALEDONIAN HOTEL HOLDINGS</u>						
	4,214	6,793	4,923	4,988	2,782	23,700
Others	706	788	538	854	520	3,406
	102,152	165,903	29,010	40,792	106,012	443,869

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THE CALEDONIAN AVIATION GROUP PLC

SOURCE AND APPLICATION OF FUNDS

£'000	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
<u>SOURCE OF FUNDS</u>						
Profit after Tax before Dividend	2,126	9,183	23,098	34,312	53,706	74,636
Exchange Adjustment	7	-	-	-	-	-
Items charged not requiring cash:						
Deferred Taxation	-	2,214	9,768	15,738	26,079	37,215
Regional Development Grant	(74)	(90)	(108)	(129)	(138)	(151)
Depreciation	19,120	25,359	36,408	42,833	45,934	50,283
Amortisation of Forward Costs	933	620	1,717	2,579	2,126	1,320
Amortisation of Goodwill	-	58	58	58	58	58
	22,112	37,344	70,941	95,391	127,765	163,361
Share Issue	-	-	75,000	-	-	-
Loans Received	62,732	91,489	118,555	9,594	23,186	69,681
Sale of Fixed Assets	2,409	644	-	-	-	308
Regional Development Grant	122	196	420	104	84	76
	87,375	129,673	264,916	105,089	151,035	233,426
<u>APPLICATION OF FUNDS</u>						
Purchase of Fixed Assets	14,733	102,152	165,903	29,010	40,792	106,012
Increase in Investments	2,635	-	-	-	-	-
Forward Costs Incurred	120	750	6,000	1,000	1,000	2,200
Loans Repaid	61,105	24,659	63,653	45,415	47,875	55,360
Dividend (Gross)	-	2,296	5,774	8,578	13,427	18,659
Mainstream Corporation Tax	-	-	-	-	6,495	32,960
	78,593	129,857	241,330	84,003	109,589	215,191
Increase/(Decrease) in Working Capital	8,782	(184)	23,586	21,086	41,446	18,235
	87,375	129,673	264,916	105,089	151,035	233,426

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THE CALEDONIAN AVIATION GROUP PLC

GROUP BALANCE SHEET

AS AT 31ST OCTOBER

<u>£'000</u>	1982	1983	1984	1985	1986	1987	1988
Fixed Assets	227,948	242,782	317,915	447,410	433,587	428,445	483,866
Capitalised Goodwill	-	-	1,092	1,034	976	918	860
Investments	453	3,088	1,704	1,704	1,704	1,704	1,704
Deferred Expenditure	2,674	1,861	1,991	6,274	4,695	3,569	4,449
Net Current Assets	8,986	17,768	17,584	41,170	62,256	103,702	121,937
	240,061	265,499	340,286	497,592	503,218	538,338	612,816
Share Capital and Reserves	55,425	69,233	76,120	168,444	194,178	234,457	290,434
Regional Development Grant	1,585	1,633	1,739	2,051	2,026	1,972	1,897
Deferred Taxation	-	-	2,214	11,982	27,720	47,304	51,559
Loans and Term Finance	183,051	194,633	260,213	315,115	279,294	254,605	268,926
	240,061	265,499	340,286	497,592	503,218	538,338	612,816

THE CALEDONIAN AVIATION GROUP

FINANCIAL COVENANTS

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
<u>Tangible Net Worth</u>						
Share Capital and Reserves	69,233	76,120	168,444	194,178	234,457	290,434
Less: Capitalised Goodwill	-	(1,092)	(1,034)	(976)	(918)	(860)
Deferred Expenditure	(1,861)	(1,991)	(6,274)	(4,695)	(3,569)	(4,449)
	67,372	73,037	161,136	188,507	229,970	285,125
<u>Debt:Equity</u>						
Consolidated Debt	194,633	260,213	315,115	279,294	254,605	268,926
Tangible Net Worth	67,372	73,037	161,136	188,507	229,970	285,125
Debt:Equity Ratio	2.9 : 1	3.6 : 1	2.0 : 1	1.5 : 1	1.1 : 1	0.9 : 1
<u>Net Current Assets</u>						
Balances at 31st October	17,768	17,584	41,170	62,256	103,702	121,937
<u>Debt Service Coverage</u>						
Debt Service Capability:						
Profit before Taxation	3,337	14,020	35,535	52,787	82,625	114,824
Add: Employee Profit Share	-	738	1,870	2,778	4,349	6,043
Finance Charges	16,350	22,730	29,530	29,618	26,094	25,520
Dépreciation & Amortisation	19,979	25,947	38,075	45,341	47,980	51,510
	39,666	63,435	105,010	130,524	161,048	197,897
Debt Service Requirements:						
Finance Charges	16,350	22,730	29,530	29,618	26,094	25,520
Loan Repayments	61,105	24,659	63,653	45,415	47,875	55,360
	77,455	47,389	93,183	75,033	73,969	80,880
Coverage	-	1.3	1.1	1.7	2.2	2.4

THE CALEDONIAN AVIATION GROUP PLC

FINANCIAL ANALYSIS

	1983-84	1984-85	1985-86	1986-87	1987-88
<u>(1) RETURN ON ASSETS EMPLOYED</u>					
Profit before Taxation	14,020	35,535	52,787	82,625	114,824
Add back: Finance Charges	22,730	29,530	29,618	26,094	25,520
	<u>36,750</u>	<u>65,065</u>	<u>82,405</u>	<u>108,719</u>	<u>140,344</u>
Assets employed at beginning of year	265,499	430,593*	497,592	503,218	538,338
Return (Baseplan in brackets)	14% (14%)	15% (12%)	17% (7%)	22% (12%)	26% (18%)
* Factored for additional assets purchased from BA mid year.					
<u>(2) RETURN ON CAPITAL EMPLOYED</u>					
Profit before Taxation	14,020	35,535	52,787	82,625	114,824
Capital employed at beginning of year	69,233	119,870*	168,444	194,178	234,457
Return (Baseplan in brackets)	20% (20%)	30% (19%)	31% (4%)	43% (21%)	49% (34%)
* Factored for equity issue made mid year.					

12.

THE CALEDONIAN AVIATION GROUP PLC

LOANS OUTSTANDING AT 31ST OCTOBER

	31.10.83		31.10.84		31.10.85		31.10.86		31.10.87		31.10.88	
	£'000	\$'000	£'000	\$'000	£'000	\$'000	£'000	\$'000	£'000	\$'000	£'000	\$'000
Caledonian Aviation Group	4,785	-	4,372	-	3,546	-	2,720	-	1,894	-	1,068	-
British Caledonian Airways	98,718	115,261	164,480	104,969	226,908	87,506	204,753	69,492	194,704	51,106	227,281	32,314
Caledonian Hotel Management	2,888	-	4,666	-	6,139	-	7,041	-	7,671	-	5,606	-
British Caledonian Helicopters	3,567	-	9,840	-	8,393	-	6,835	-	5,157	-	4,107	-
British Caledonian Travel Holdings	138	-	73	-	17	-	-	-	-	-	-	-
Caledonian Airmotive	7,019	667	7,723	-	12,542	-	12,227	-	11,557	-	9,605	-
	117,115	115,928	191,154	104,969	257,545	87,506	233,576	69,492	220,983	51,106	247,667	32,314
Exchange Rate	77,518	@ 1.4955	69,059	@ 1.52	57,570	@ 1.52	45,718	@ 1.52	33,622	@ 1.52	21,259	@ 1.52
	194,633		260,213		315,115		279,294		254,605		268,926	

BA ROUTE TRANSFERTRADING PROFIT

£'M

	1983/84	1984/85	1985/86	1986/87	1987/88
BCAL Trading Profit	10.3	20.9	7.0	32.2	55.5
Add back BA Predation Factor	-	10.0	21.0	23.0	26.0
	10.3	30.9	28.0	55.2	81.5
Additional Routes P/(L)					
New York	-	(3.0)	(1.6)	0.7	2.0
Harare	-	4.2	8.1	6.9	6.4
Saudi Arabia	-	12.9	30.0	36.4	44.1
	10.3	45.0	64.5	99.2	134.0

14

BA ROUTE TRANSFER

£'M

Annual Net Turnover of BA Route Package and BCAL Route Development

	1984/85	1985/86	1986/87	1987/88
New York	20.1	36.3	41.8	46.5
Harare	14.9	25.8	27.7	30.0
Saudi Arabia	43.0	83.7	94.7	107.0
	78.0	145.8	164.2	183.5

15

BA ROUTE TRANSFER

£'M

Incremental Interline Revenue

	1984/85	1985/86	1986/87	1987/88
New York	1.7	5.8	6.3	6.8
Harare	0.2	0.4	0.4	0.5
Saudi Arabia	1.0	1.6	1.7	1.9
	2.9	7.8	8.4	9.2

Note: Figures discounted by 12% to allow for commissions and passenger DOCs.

CIVIL AVIATION AUTHORITY AIRLINE COMPETITION REVIEW

16

ROUTE EVALUATION ANALYSIS

ROUTE: NEW YORK

ANALYSIS		<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Annual Round Trips		217	365	365	365
Annual Aircraft Hours		3,110	5,216	5,216	5,216
BCAL Forecast Passengers	000s	78.8	127.1	136.8	141.9
BCAL Forecast PLF	%	43	41	44	46
Total Net Revenue	£'M	20.1	36.3	41.8	46.5
Total Cost	£'M	23.1	37.9	41.1	44.5
Profit/Loss	£'M	(3.0)	(1.6)	0.7	2.0
Less Results of Current Operation	£'M				
Improvement of Company Result	£'M				
Operating Ratio		87	96	102	104

ASSMPTIONS

Aircraft Type & Configuration		B.747/424 F/J/Y			
Initial Direct Competition		*See Commentary Below			
New Route Discount (IGF)	%	0.7	0.82	0.88	0.91
Effect of LGW Transfer Traffic	%				
Effect of LGW Transfer Yield					
Aircraft Units Employed		1.2	1.2	1.2	1.2
Route Capital Investment	£'M	39.3	39.3	39.3	39.3
Route Start-Up Expenditure	£'M	4.0	-	-	-
Additional Interline Traffic	£'M	1.7	5.8	6.3	6.8

Licensing/Designation BCAL compete with all incumbent 3rd/4th freedom carriers and a range of 5th freedom carriers.

COMMENTARY

Despite high volume route and high cost efficient operation, results do not achieve an adequate operating ratio. This may be offset by substantial interline benefit.

* BA 21 x 747; 14 x SSC pw
 TW 21 x 747 pw
 PA 21 x 747 pw
 PE/VIRGIN 14 x 747 pw
 Others 11 x 747 pw

CIVIL AVIATION AUTHORITY AIRLINE COMPETITION REVIEW

17

ROUTE EVALUATION ANALYSIS

ROUTE: LGW-LUN-HRE (SOLUS)

ANALYSIS		<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Annual Round Trips		60	104	104	104
Annual Aircraft Hours		1,290	2,236	2,236	2,236
BCAL Forecast Passengers	000s	34.0	55.4	55.4	55.4
BCAL Forecast PLF	%	71	66	66	66
Total Net Revenue	£'M	14.9	25.8	27.7	30.0
Total Cost	£'M	10.7	18.3	20.3	21.8
Profit/Loss	£'M	4.2	7.5	7.4	8.2
Less Results of Current Operation	£'M		(0.6)	0.5	1.8
Improvement of Company Result	£'M		8.1	6.9	6.4
Operating Ratio		139	141	136	138

ASSMPTIONS

Aircraft Type & Configuration		B.747/400 F/J/Y			
Initial Direct Competition		LUN: 3 x QZ DC10, HRE: 3 x RH 707 pw			
New Route Discount (IGF)	%	5	5/0	0	0
Effect of LGW Transfer Traffic	%	0	0	0	0
Effect of LGW Transfer Yield		0	0	0	0
Aircraft Units Employed		0.5	0.5	0.5	0.5
Route Capital Investment	£'M	16.5	16.5	16.5	16.5
Route Start-Up Expenditure	£'M	0.5	-	-	-
Additional Interline Traffic	£'M	0.2	0.4	0.4	0.4

Licensing/Designation BCAL transfers BA HRE services to LGW and operates end sector from LUN, cutting out DLA/LBV en-route stop. RH continues at LGW.

COMMENTARY

A most valuable opportunity to turn around the fortunes of Central Africa route, but high risk attached to HRE as well as LUN, requiring an OR of this magnitude. BCAL would regard HRE as prime destination on the route, with LUN as secondary, en-route stop.

CIVIL AVIATION AUTHORITY AIRLINE COMPETITION REVIEW

18.

ROUTE EVALUATION ANALYSIS

ROUTE: SAUDI ARABIA (SOLUS)

ANALYSIS		1985	1986	1987	1988
Annual Round Trips		390	676	676	676
Annual Aircraft Hours		4,993	8,655	8,655	8,655
BCAL Forecast Passengers	000s	113.1	207.5	220.4	232.9
BCAL Forecast PLF	%	40	42	45	48
Total Net Revenue	£'M	43.0	83.7	94.7	107.7
Total Cost	£'M	30.1	53.7	58.3	62.9
Profit/Loss	£'M	12.9	30.0	36.4	44.1
Less Results of Current Operation	£'M				
Improvement of Company Result	£'M				
Operating Ratio		143	156	162	170

ASSMPTIONS

Aircraft Type & Configuration		DC10/235 F/J/Y + B747/400 F/J/Y			
Initial Direct Competition		11 x SV L10 pw			
New Route Discount (IGF)	%	5	5/0	0	0
Effect of LGW Transfer Traffic	%	11.5	11.5	11.5	11.5
Effect of LGW Transfer Yield		0	0	0	0
Aircraft Units Employed		1.8	1.8	1.8	1.8
Route Capital Investment	£'M	51.8	51.8	51.8	51.8
Route Start-Up Expenditure	£'M	1.0	-	-	-
Additional Interline Traffic	£'M	1.0	1.6	1.7	1.9

Licensing/Designation BCAL take over BA routes and transfer to LGW, becoming solus UK carrier to the Kingdom. SV continue at LHR.

COMMENTARY

Extremely attractive package for BCAL and LGW, offering high level of profitability and good network synergy. But very high element of risk demands a counter-balancing network elsewhere.

Doubt that high return can be sustained to end decade and results might worsen.



10 DOWNING STREET

Annex 4.

The Caledonian Aviation Group

Caledonian House
Crawley West Sussex
RH10 2XA England

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

Prime Minister

*Sir Adam has responded to
your criticisms of the B Cal
balance sheet. Bob Young has
discussed this with him - see attached note.*

From the Chairman's office

1st August, 1984

The Rt. Hon. Margaret Thatcher, M.P., *ATi/8*
Prime Minister,
10, Downing Street,
London, SW1

Dear Prime Minister,

Following our discussion earlier today I am writing to address some of the concerns you expressed regarding our Group's financial condition.

Firstly, I would mention that our record for the past eight years has shown Group profits on seven occasions and only one year of loss. Of those profits the Airline produced just over two-thirds. This has been an extremely creditable performance through a period when the world airline industry generally has experienced very poor results, of which British Airways is a prime example. Not only has British Caledonian, in common with other airlines, been affected by the world recession but in recent years has suffered deterioration of its profits as a result of factors outside the Airline's control including losses which were largely peculiar to its licensed area of operations. Such factors have included the grounding of DC 10 aircraft by the F.A.A. of the United States, exceptional devaluations of foreign currency balances and the Falklands War which alone cost us £9 million.

In the interests of creating future stability we applied for and commenced operation of several new routings, including Hong Kong, Houston, Dallas, Atlanta, Los Angeles and others, which incurred substantial development costs - without these costs our profitability would have been much greater.

Cont'd...

DIRECTORS: Sir Adam Thomson, C.B.E., LL.D., F.R.Ae.S., F.C.I.T. (Chairman and Chief Executive),
Sir Peter Masfield, M.A., C.Eng., F.R.Ae.S., F.C.I.T., Hon.F.A.I.A.A. (Deputy Chairman), T. E. Boud, F.C.A. (Group Finance Director), L. N. Bechick (U.S.A.),
D. A. Beety, R. M. Gibson, V.R.D., M.A., F.C.I.L., J. McWilliam, A. T. Pugh, F.R.Ae.S., Sir Iain M. Stewart, LL.D., B.Sc., L. V. D. Tindale, C.B.E., C.A.,
M. Vidockler, C.T.C. (U.S.A.), D. H. Walter, M.S.L.A.E.T., S. Young, F.C.A.

For the current financial year we are confidently forecasting a profit of £14-15 million, even after the adverse effects of political events concerning both Libya and Nigeria. Absent the privatisation of British Airways, which would have a serious adverse impact on our forward predictions, we are forecasting considerably improving results for the years ahead which would stem mainly from the maturing of our current route network.

You referred to the Group's level of gearing which stood at a ratio of debt to equity of 2.9 : 1 in our latest annual report. With the acquisition of new Airbus A310 aircraft that ratio will increase to over 3.0 : 1 by the end of our current financial year. This ratio is comfortably within the constraints imposed by the Group's lenders, who comprise major international banks and the Export-Import Bank of the U.S.A. Indeed, the Group has never been in default of such financial covenants and enjoys considerable respect within financial communities, with the consequence that the funding of capital acquisitions and working capital requirements has been obtained without difficulty.

The airline industry has traditionally operated on debt:equity ratios higher than those considered normal to other industries. Comparison with the major European airlines (excluding British Airways) shows that our last reported gearing ratio approximates to the average of that group. Our recent survey of United States carriers has shown an average airline gearing as at end December 1983 of 2.35 : 1.

On the basis of the CAA's recommendations for route transfers we, together with our Merchant Bankers - Kleinwort Benson - and Stockbrokers - Hoare Govette, have determined that a debt equity ratio in the range of 1.5 to 2.0 : 1 will be satisfactory to ensure success for the proposed private placement of new shares. The actual level within that range will depend upon the length and type of commitment entered into to secure the acquisition of the additional fleet and equipment requirements.

You referred to the overseas remittance problems which we have experienced. I have in the past written on this subject to both the Secretaries of State for Foreign and Commonwealth Affairs, and Transport. Whilst we have to be continually concerned with this problem because so many of British Caledonian's routes have since formation been associated with developing countries, the position is not as bad as may be assumed by reference to the figure of £67.4 million shown to be held overseas by our last annual report. Of that amount, only

Cont'd...

The Rt. Hon. Margaret Thatcher, M.P.

1st August, 1984

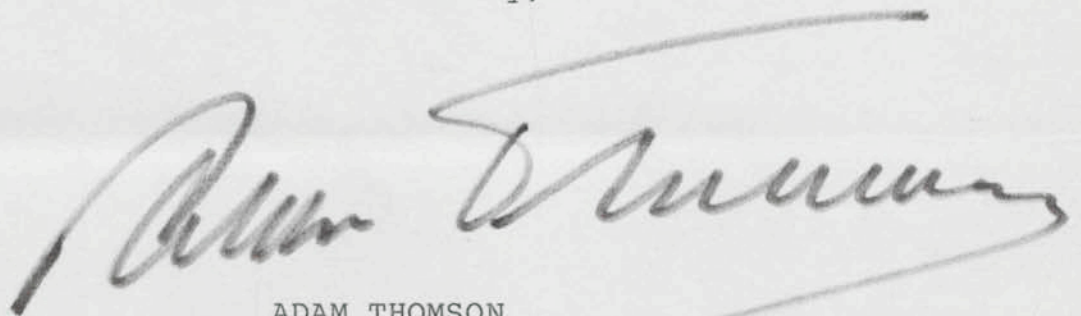
- 3 -

15% remains to be received and indications are that the majority of the remainder will be received within two months. The Group's cash resources are not impaired to the full extent of balances held overseas due to the availability of U.K. bank credit facilities which are partly secured thereon.


Before making its recommendations the CAA carried out searching investigations into our Group's ability to finance and absorb the increased level of business which would result. They requested evidence of our ability to raise the necessary equity and loan finance. Their basic requirement was satisfied by a joint letter from Kleinwort Benson and Hoare Govett, who confirmed following discussions with financial institutions that the raising of £150 million could be achieved. Our ability to raise the necessary loan finance was confirmed by letters from National Westminster Bank, Bank of America and Citibank. In addition further letters were supplied by E.F. Hutton & Company Inc. and Merrill Lynch Capital Markets confirming their ability, if required, to raise substantial equity capital in the United States market. We further indicated to the CAA our confidence that other sources were also available to us.

Copies of information supplied to the CAA, or to support matters referred to in this letter, are of course available and we would be happy to provide them to whoever you may nominate.

Yours sincerely,

A large, fluid handwritten signature in dark ink, appearing to read 'Adam Thomson', is written over a horizontal line. The signature is cursive and extends across most of the width of the page.

ADAM THOMSON


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P.01367

PRIME MINISTER

Civil Aviation Authority Review

(C(84)21)

BACKGROUND

The Civil Aviation Authority (CAA) was invited by the Secretary of State for Transport to review the implications of the privatisation of British Airways (BA) for competition and the sound development of the British airline industry. The report of the CAA in response to that invitation was published on 16 July. Its main recommendations were as follows.

- i. Relinquishment by BA of scheduled service routes out of Manchester and Birmingham to a wide variety of destinations in Western Europe; between Glasgow and Paris; between Heathrow and Saudi Arabia and between Heathrow and Harare; and between Gatwick and points in Spain, Portugal, Gibraltar, Italy and Scandinavia. Apart from the Manchester and Birmingham routes which would pass to the smaller airlines, the routes concerned would be likely to be awarded by the CAA to British Caledonian (B.Cal).
- ii. A number of measures to increase competition in the British airline industry.
- iii. A strengthening of the CAA's own powers, notably to give the CAA a direct statutory duty to secure the sound development of the British airline industry, for example by suitable use of its licensing powers.
- iv. Relief of capacity constraints at Heathrow and Gatwick.

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2. The Ministerial Sub-Committee on Economic Affairs (E(A)) has already approved the recommendations at (ii) and agreed that the recommendation at (iv) should be rejected because the Government already has a clear policy regarding air traffic movements at Heathrow and Gatwick (and is about to issue a consultative document on the subject). E(A) expressed some scepticism about the recommendation at (iii) (E(A)(84)19th Meeting, Item 3).

Flag A

3. The most difficult recommendations are the proposed route transfers covered by (i). A majority of E(A) favoured rejecting the recommendations. However, when the conclusions of E(A) were reported to them on 19 July the Cabinet agreed that the best solution would be a compromise which would provide for an agreed transfer of routes from BA to B.Cal; the Secretary of State for Transport and the Chancellor of the Exchequer were invited to discuss a compromise, which would not require primary legislation, with the Chairmen of the two airlines (CC(84)27th Conclusions, Minute 1). On 26 July the Secretary of State for Transport reported that he and the Chancellor, after discussions with the two Chairmen, had concluded that no compromise transfer could be agreed. The Cabinet invited him to circulate a memorandum setting out the issues for decision (CC(84)28th Conclusions, Minute 1).

B

C

4. The memorandum by the Secretary of State for Transport (C(84)21) answers this invitation. It puts forward (paragraphs 15 and 16) two options for consideration:

D

(i) rejection of the route transfers suggested by the CAA; or

(ii) insistence on the transfer of sufficient routes to strengthen B.Cal's position: a possible package would be BA's most profitable routes out of Gatwick (to Madrid, Lisbon, Barcelona and Bilbao), plus the Harare route from Heathrow.



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Mr Ridley also recommends endorsement of the CAA's proposals for increased competition, but rejection of the proposal that the CAA should be given extended powers to reallocate routes (see paragraphs 1(ii) and (iii) above). The Government's decisions should be announced without delay in order to resolve uncertainty in the industry.

MAIN ISSUES

5. The main issues before the Cabinet are as follows.
 - i. What should be done about the route transfers recommended by the CAA?
 - ii. What should be the Government's response to the CAA's other recommendations?
 - iii. When should the Government's decisions be announced?

Route transfers

6. There are three issues:
 - a. should there be any route transfers at all?
 - b. if there are, what routes should be transferred?
 - c. how is it to be done - by legislation, by the Government's powers as sole shareholder, or by persuasion?
7. On a., the Cabinet are already familiar with the main arguments. We do not want to harm the prospects of privatising BA. Equally we want a viable B.Cal. Although it is unlikely that B.Cal could ever be a major contender in the world airline market like BA, it is useful to have more than one UK airline on those routes profitable enough to support two UK carriers. For B.Cal to compete effectively



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it needs to be the sole UK carrier on some profitable routes. It must be admitted that B.Cal's existing international routes are not intrinsically very profitable, especially bearing in mind the problems now being encountered in Nigeria. Collapse of B.Cal would be embarrassing, especially since it is the only UK operator of the Airbus A 310 and is a launch customer for the new A320. If we can strengthen B.Cal without seriously harming BA and the prospects for privatisation, it would be helpful both on political grounds and in the interests of UK civil aviation.

8. Mr Ridley suggests that a more modest transfer of routes than that proposed by the CAA might meet this requirement. BA would keep the Heathrow to Saudi Arabia routes (worth £30 million a year) and the Manchester and Birmingham services. It would lose some profitable Iberian routes from Gatwick (worth £3 million a year) and the Heathrow-Harare route (worth £7 million a year). BA's annual profits would be reduced from £280 million to £270 million; B.Cal's would be increased from £18 million to £28 million. This ought not to harm BA significantly or to prejudice a successful privatisation. But is it good enough, both politically and in substance, for B.Cal?

9. On the method of effecting such a transfer, Mr Ridley is not entirely clear. His soundings have established that Lord King is resolutely opposed to a voluntary transfer but in paragraph 16 he talks of persuading the two parties BA and B.Cal to accept the compromise. If persuasion is not possible, should the Government nevertheless go ahead with a limited transfer? Since the Cabinet on 26 July were not disposed to favour legislation (which would undoubtedly delay privatisation), this leaves the Government's use of its powers as sole shareholder. What would be the attitude of Lord King and the BA Board to such action? Is there a legal problem (see letter of 1 August from the Law Officers' Department)? The Attorney General is being invited for this item to give his views on this point.

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Other CAA recommendations

10. It is not strictly necessary for the Cabinet to go over matters already decided by E(A). However, it seems unlikely that the Cabinet will disagree with the proposal to approve the CAA's recommendations to increase competition and to reject their proposals for additional powers for themselves.

Announcements

11. There are strong arguments in favour of an early announcement of the Government's decisions. You will no doubt wish to invite the Secretary of State for Transport to circulate a draft.

HANDLING

12. You will wish to invite the Secretary of State for Transport to open the discussion. The Chancellor of the Exchequer will wish to comment, both because of his responsibility for the privatisation programme and because he has been associated with the discussions with the Chairmen of BA and B.Cal. The Secretary of State for Trade and Industry will wish to comment because of his responsibilities for competition policy and from his previous experience. The Secretary of State for Scotland has an interest because of B.Cal's Scottish connections.

CONCLUSIONS

13. You will wish the Cabinet to reach conclusions on the following:
- i. Should the Government seek to arrange route transfers from BA to B.Cal?
 - ii. If so:
 - a. what routes should be transferred?
(ie the CAA proposals or the smaller package in C(84)21)



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b. how should the transfer be achieved?
(ie only if it can be done by persuasion?
or should it be imposed on BA and, if so,
how?)

iii. Should the Government reject the CAA's suggestion that
it should be given greater powers to transfer routes in the
interests of the structure of the British ariline industry?

iii. How should the Government's decisions be announced?

PLG

P L GREGSON

1 August 1984

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10 DOWNING STREET

bc By

cc MASIER
SET

From the Private Secretary

1 August 1984

CAA REVIEW: BRITISH CALEDONIAN

Sir Adam Thomson came to see the Prime Minister today to put B Cal's case on the CAA Review. He was accompanied by his deputy chairman, Sir Peter Masefield. Your Secretary of State was also present.

Sir Adam said he had four major points to make. First, B Cal did not seek to undermine British Airways or to obstruct privatisation. If the CAA recommendations were implemented, BA would still have 70 per cent of the market. He did not believe implementation of the recommendations need delay privatisation by 3-4 years as claimed, nor need it reduce the sale proceeds as B Cal would be prepared to buy equipment from BA to service the routes transferred. Secondly, BA was at present effectively a public sector monopoly which it would be wrong to turn into a private sector monopoly. Thirdly, B Cal strongly supported the thrust of the review in favour of greater freedom and competition. Finally, it was essential to establish a better balance within the private sector.

Sir Adam said that BA and B Cal had always operated within a framework set by the Government; indeed B Cal had come into existence as a result of the Government's wish to see a strong second force. While BA operated effectively under Government supervision there was a limit to any predatory behaviour, but as a private company it would have

a duty to its shareholders to compete as hard as it could. It had a number of major advantages, eg some very profitable routes and a better airport to operate from. In areas where BA and B Cal competed head to head, a tiny diversion of BAs turnover, eg into travel agents' commissions, could rob B Cal of its markets.

Sir Adam said B Cal had originally recommended to the CAA that BAs market share be reduced from 80 per cent to 60 per cent, B Cal's share increased from 15 per cent to 30 per cent and the independent share be increased from 2 per cent to 10 per cent. The CAA was recommending a smaller adjustment which would reduce BAs share to 70 per cent. This would leave B Cal as a strong viable airline and was therefore acceptable to it. The recommendations would increase from 10 per cent to 30 per cent the areas of the market where BA and B Cal competed head to head, giving an extra 70 million passengers a choice. There would be no need for any redundancies as B Cal would be prepared to take on staff on similar terms and conditions. BA would be prepared to buy aircraft worth \$165 million which would be useful to BA in reducing its debt.

The Prime Minister commented that B Cal's balance sheet was weak, being very highly geared. In addition very large sums were owed from abroad, for which there were difficulties in securing remittance. She asked Sir Adam how B Cal would manage if the status quo were maintained. Sir Adam said this would present no problem for B Cal. It had firm plans to raise an additional £30 million capital. If the CAA recommendations were not acted upon, it would be difficult to raise even this amount as B Cal would be under attack from BAs aggressive marketing. If, however, the CAA recommendations were acted upon, it would be possible to raise even larger sums. He would seek an additional £75 million of capital plus additional loans for the

purchase of aircraft. This extra capital, in conjunction with the improvement in route structure and profits would allow B Cal to reduce its gearing from its present 211 which though very high was not unusual for airlines.

The Prime Minister asked what B Cal would do if the CAA recommendations were not accepted. Sir Adam said that competition from BA would probably force B Cal into a period of retrenchment; far from improving competition in the industry it would weaken it. B Cal would apply to operate from Heathrow which could improve its profits by £30 million. (Your Secretary of State said there was no realistic prospect of this). The final option, which was not one he recommended, was for BA and B Cal to merge. This would leave the UK with one very large airline, representing a reversal of the policy towards more competition.

Sir Adam acknowledged that in the recent Debate in the House B Cal had been outgunned by the lobbying of BA. It was also unfortunate that not many B Cal supporters had been called to speak. He remained confident because there was substantial backbench support and he had now sent a letter to all MPs setting out B Cal's position.

Summing up, Sir Adam said the industry was at a crossroads. Either the industry would move towards total domination by one airline or the opportunity would be taken to achieve a better balance, with two major well-based airlines.

The Prime Minister thanked Sir Adam for presenting his case with such care. She asked him to ensure that she received a copy of the letter B Cal had sent to all MPs.

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I am copying this letter to David Peretz (H M Treasury), Callum McCarthy (Department of Trade and Industry), David Morris (Lord Privy Seal's Office) and Murdo McLean (Chief Whip's Office).

ANDREW TURNBULL

Miss D N Nichols,
Department of Transport

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PRIME MINISTER

CAA REVIEW

In the discussions on the CAA review it is argued, e.g. by the Treasury and the Policy Unit, that route transfers do not increase competition. In my view, this over-simplifies the argument. Clearly, transfers of routes on which there is single designation of the UK carrier does nothing in itself to increase competition but the issue is more complex than this. There is a significant sector of the market, which will be increased by the CAA's recommendations where BA and B Cal compete, e.g. routes like Paris, Brussels and Hong Kong and, from May next year, New York, plus the charter market.

The issue is whether there can be true competition in this area while BA has a war-chest financed from routes like that to Saudi Arabia and from its advantage in operating from Heathrow. I believe the answer to that is no and that B Cal are right. In my view also, transfer of routes to B Cal would be welcomed by other independent airlines because it would reduce the extent to which they are vulnerable to predatory competition from the giant in the market.

We are left with two choices:

- (i) Reject the CAA recommendations on route transfers; or
- (ii) transfer routes, by legislation if necessary, while accepting some delay in privatisation.

I would go for (ii). But if Cabinet decide to go for (i) they should not do so believing that they have the logic

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-2-

of competition on their side - it would be because they
prefer to maintain the momentum of privatisation.

AT

ANDREW TURNBULL

1 August, 1984

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01-405 7641 Ext.

3040

Communications on this subject should
be addressed to

THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

CABINET OFFICE	
A	5985
1 AUG 1984	
FILING INSTRUCTIONS	
FILE No.	

~~cc - Mr. Gregson
Mr. Buckley~~

Miss D Nichols
Private Secretary to the Secretary
of State for Transport
2 Marsham Street
London SW1

1 August 1984

Dear Miss Nichols,

CIVIL AVIATION AUTHORITY REVIEW

1. I refer to ~~the~~ C(84)21 which may be considered tomorrow at Cabinet. There is a point which I think I should raise without being able to give any firm view on it.
2. Paragraph 14 of the Memorandum indicates that one way of effecting transfers of routes would be for the Government to use its powers as sole shareholder to instruct BA's Directors to release the route licences.
3. There may be a risk that such an instruction could conflict with the obligations of the Directors, particularly, for example, those owed to future shareholders and employees. The Directors might, therefore, be legally impeded from complying with the instruction if they could not in good faith conclude that to do so would be in compliance with their fiduciary duties. There might be grounds for a Director or employee to seek a declaration from the courts that the instructions were not proper.
4. I have not been able to make contact with the Department of Transport lawyers advising on this. Not knowing in detail what consideration has been given to this aspect of the matter, I have not consulted the Attorney General but would suggest that appropriate steps be taken to ensure that this point is not overlooked.
5. I am copying this to McCarthy (PS/Secretary of State DTI) and to Hatfield (PS/Sir Robert Armstrong).

Yours sincerely,

R K Gardiner

R K GARDINER

CONFIDENTIAL

PRIME MINISTER

BRITISH CALEDONIAN

I had an hour with Sir Adam Thompson, at his request, earlier this evening. He was particularly anxious to follow through the balance sheet queries you directed at him this morning.

We tackled first the three specific points you raised:

- (i) Blocked overseas balances.
The £67 million shown in BCal's latest accounts have now been almost completely cleared. Since BCal had borrowed against the balances, the remittances have been applied to reduce borrowings rather than to increase liquidity.
- (ii) Dollar borrowings.
As we thought, BCal do feel uncomfortable.
- (iii) Gearing.
Yes, it is high and will not come down much, even in the medium term. But gearing of over 200% is commonplace in airlines, and BCal gave me a table for Europe and the USA to confirm the point.

BCal's comments should make us feel a little easier about its short term future; but they admitted that they would have to strengthen their balance sheet soon, regardless of Government's response to the CAA's recommendation.

As background to improving the balance sheet, Adam Thompson took me through BCal's recent earnings - and its projected earnings on the assumption (unwarranted in his

view) that BA would not behave in predatory fashion once privatized. The figures are in Annex A. They exhibit great volatility in the past and great growth in the future. Adam Thompson was very confident of earnings of £14 million this year (versus £3.3 million last).

If we were to believe these figures, there would be no case for Government support to BCal.

BCal's plan (they said) was to raise new equity of £30 million late this year, mainly from existing shareholders. But the prospect of BA's being privatized, intact with its routes, kills off that possibility. So the only way forward for BCal is to press for the reallocation of profitable routes from BA and to raise much larger sums to service them. BCal's own proposals for route transfers would have required a further £150 million of equity capital and £250 million of loans. The CAA's smaller package of proposals requires some £75 million of equity and £120 million of loans. Even that is a large addition to their present £69 million of shareholders' funds and £160 million loans.

BCal have given me copy letters of comfort from their financial advisers that they could raise the funds to finance BCal's own proposed route transfers. The CAA are satisfied that BCal can raise the necessary to service Saudi Arabia and Harare. We do not have evidence that the CAA package in full can be financed. BCal mentioned that they would want "a close look" at the Gatwick/Iberian routes before taking them on.

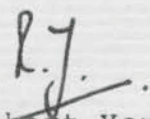
So long as route transfers could be phased, BCal do not see the likelihood of service interruptions on handover. They would offer to take on BA's dispossessed staff in the UK and overseas, but would not necessarily want the aircraft which BA might declare surplus. They do not feel that the reallocation of routes from BA to BCal poses serious

difficulties for the construction of a BA prospectus: why is it harder for BA to forecast the reductions than for BCal to forecast the gains?

We discussed other minor matters, and I was given a copy of their Five Year Plan for background information.

My conclusions are:

- (i) if BCal's £14 million profit prediction for this year is accurate, the company is not about to go bust;
- (ii) BCal's plans to expand its capital base seem to me immodest. If you believe that route transfers to BCal are, de facto, the start of Government's underwriting the future of BCal, beware the scale of ambition to be underwritten;
- (iii) the competition issues do not look different by virtue of Sir Adam Thompson's presentation to you or his discussion with me;
- (iv) the behaviour of BA post privatization is important. You could ask Mr. Ridley to explore further what restraints can be applied. He could respond to the CAA's recommendations in principle (accepting domestic deregulation and competition but rejecting the immediate transfer of routes) while announcing his intent to investigate and head off the possible abuse of dominance.


Robert Young
Policy Unit
1 August 1984

ANNEX A

BCal's Profit Record and Forecasts

	<u>Turnover</u>	<u>Profit before Tax</u>
	<u>(£m)</u>	<u>(£m)</u>
1973/74	77	(5.7)
1974/75	86	(0.3)
1975/76	117	5.6
1976/77	159	7.9
1977/78	177	12.2
1978/79	200	6.6
1979/80	252	9.7
1980/81	323	(6.2)
1981/82	401	1.5
1982/83	428	3.3

1983/84 Estimate	495	14.0

1984/85 Forecasts*	c.590	31.0
1985/86	c.640	28.0
1986/87	c.720	55.0
1987/88	c.800	81.0

* excluding route transfers

BRIEF FOR PRIME MINISTER'S MEETING WITH SIR ADAM THOMSONBackground to the CAA review of airline competition policy

1. British Caledonian Airways (BCal) have been lobbying the Government for some years to transfer some routes to them from British Airways. They wrote to the Prime Minister and the Secretary of State for Trade in August 1981, who in reply repudiated the idea. A year later Sir Adam Thomson again wrote to the Prime Minister about BA privatisation and towards the end of a long letter returned to the idea of a transfer of routes. The Prime Minister replied encouraging him to agree a voluntary transfer with British Airways. (Copies of this earlier correspondence are attached.) Sir Adam achieved no success in negotiating a voluntary transfer with British Airways, and in September 1983 he sent the then Secretary of State for Transport (Mr King) a further letter on the subject, accompanied by a lengthy supporting paper entitled "A Strategy for British Civil Air Transport in Private Ownership", which has come to be known as "BCal's Blue Book".
2. BCal argued that a privatised British Airways - dominating the UK industry with modern aircraft, a large marketing organisation, much reduced interest burden and freed from Government controls - would present unfair competition. It therefore recommended a transfer by the Government of a number of routes from BA to BCal to go some way to redress this uneven balance of market power. BCal were prepared to take over the aircraft and staff needed to operate the routes, and to pay BA for them. The routes and assets to be transferred would, BCal recommended, be identified by a DTp/CAA Working Party assisted as necessary by the airlines concerned, but in the appendix to their Blue Book, they indicated which ones they were interested in.
3. The Department of Transport prepared an assessment of the BCal's proposals, and it was clear that while such a transfer of routes, if it could be carried out, would benefit BCal, and help

the establishment of Gatwick as an alternative scheduled service hub to Heathrow. That was a desirable objective to try to reduce pressure on Heathrow's capacity, and on the working of the limit which will be imposed for environmental reasons next year. But it was also clear that removing routes on the scale suggested from British Airways would be prejudicial to the privatisation of the airline.

4. Towards the end of last year Mr Ridley sought the CAA's advice about this problem, and accepted their suggestion that they should undertake a formal review of the implications of BA's impending privatisation for competition in the UK airline industry, and for a policy on air transport licensing. Mr Ridley announced this review during the course of a Parliamentary statement in which he also announced the Government's plans to privatise British Airways early in 1985.

The review proposals

5. The CAA review has made a number of recommendations aimed at reducing the dominance of British Airways in the UK industry, strengthening BCal's operations so that it is better equipped to compete with BA, and potentially to replace it on major routes, and to reinforce the development of Gatwick as a second centre for London of a network of international scheduled services.

6. The proposals of particular interest to BCal are that British Airways' routes from Heathrow to Saudi Arabia and Zimbabwe should be transferred to BCal; while BA's routes from Gatwick to Spain Portugal and a few other European destinations should also be transferred to BCal and/or other independent carriers who were interested in them. BCal are most likely to be interested in four of the Iberian "business" destinations, rather than the more leisure-related places. This group of routes represents the CAA's judgment, after consulting BCal during the course of its review, of a

less ambitious package of routes than BCal originally asked for, which would nevertheless achieve the desired effect while keeping to a minimum the effect on BA's total operations.

Present Government position

7. The Government's response to the CAA recommendations has been discussed at the last two meetings of Cabinet, and the Secretary of State for Transport has circulated a further paper for discussion at Cabinet this week. That paper explains that Lord King, when he met the Chancellor of the Exchequer and Mr Ridley last week, showed no disposition to cooperate in a transfer of routes on any scale, even something less than the total CAA proposal. Cabinet will need to consider whether further pressure should be exerted on British Airways, in one way or another, to try to change their attitude.

Suggested line to take

8. Until the Cabinet have decided what further action, if any, they intend to take on the CAA proposals, the Prime Minister will not be able to say anything positive or encouraging to Sir Adam. It is suggested therefore that she should use her meeting with him mainly in order to listen to what he says, and to explain that the Government are still considering the CAA's recommendations. They raise complex issues, and he will understand that they merit careful consideration and not hasty decisions. But it is only fair to point out that they do raise a number of formidable problems, and since the transfer of routes from one carrier to another does not of itself enhance competition, the Government has to weigh the benefits which that would yield to British Caledonian (and other independent airlines who might benefit as well) against the consequences for British Airways' profitability, the prospects of privatisation, and the commitment of its employees - which now seems to be very strong - to that objective. There have been debates in the last week in both Houses of Parliament, at which

there was a considerable amount of support for British Airways, and opposition to the Authority's proposals, and the Government have received a number of other representations from various quarters since they were published. All these comments, and of course Sir Adam's at this meeting, will be taken carefully into account, but at this stage no promises can be made.

9. The Prime Minister might also try to draw Sir Adam out on the minimum level of route transfer which would be of value to BCal (see para 7 of 'C(84) 21.ry of Staff's paper'). So far he has asserted that nothing less than the CAA proposals would do, but if he shows a willingness to lower his sights, that would be useful to know before Cabinet meet.

SUMMARY OF MAIN CONCLUSIONS AND RECOMMENDATIONS

- (1) There should be some reduction in the relative size of British Airways so that other airlines have adequate opportunity to develop and prosper including at least one airline fit to replace British Airways on any major intercontinental route should the need arise. Additional competition by British airlines on intercontinental routes should be licensed wherever possible (paragraphs 4-14, 25 and 46).
- (2) Specified intercontinental routes should be transferred from British Airways at Heathrow to British Caledonian at Gatwick (paragraph 49).
- (3) The Authority, acting within existing policies and powers, will seek to increase the range and market penetration of European scheduled services from Gatwick (paragraphs 56-57).
- (4) British Airways' scheduled service routes from Gatwick should be taken over by other British airlines (paragraphs 56-58).
- (5) British Airways' European routes from provincial airports should be taken over by other British airlines (paragraph 63).
- (6) The Government should take specific powers to give effect to the reallocation of routes in recommendations (2), (4) and (5) above. These powers should then lapse (paragraph 90).
- (7) The Government should look again at the possibility of increasing available capacity at Heathrow and Gatwick (paragraphs 26-38).
- (8) Provision should be made for access to Heathrow for competing services on those of British Airways' domestic trunk routes where direct competition does not already exist, if necessary by reducing British Airways' frequencies (paragraph 66).
- (9) The Authority would favour a strengthening of its air transport licensing powers in order to promote the sound development of a competitive British airline industry and deal with anti-competitive behaviour (paragraph 88).
- (10) The Authority does not propose any immediate restriction on British Airways' or British Airtours' charter operations but, given a strengthening of its powers, will not hesitate to set a quantitative limit to their penetration of the holiday charter market if it is shown there is abuse of a dominant position (paragraphs 77-78).
- (11) The Authority proposes to introduce, on a two-year experimental basis, an area facility allowing airlines to serve any domestic route other than those specifically excluded (paragraph 93).
- (12) The Authority proposes to cease regulating domestic air fares but will still require fares to be filed with it so that it can intervene to prevent predatory or monopoly pricing. It will consult the Channel Islands and Isle of Man before extending the new arrangements to them (paragraphs 94-95).
- (13) The Authority has decided at least for the present not to amend the general exemption so as to allow the carriage of separate fare traffic on aircraft with ten or fewer seats on any route covered by the area facility (paragraph 96).
- (14) The Authority has updated its Statement of Policies so as to reflect those changes of emphasis that are within the scope of its present statutory powers and duties (paragraph 102).



RECEIVED

10 SEP 1982

SECRETARY

10 DOWNING STREET LONDON

THE PRIME MINISTER

10 September 1982

Richard Thompson

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

don't 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.

Very good wish.

Yours sincerely

Raymond Delisle

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

British Caledonian

Caledonian House
Crawley West Sussex
RH10 2XA England

Telephone Crawley (0293) 27890
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From the Chairman's office

27th 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.

1980 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 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.

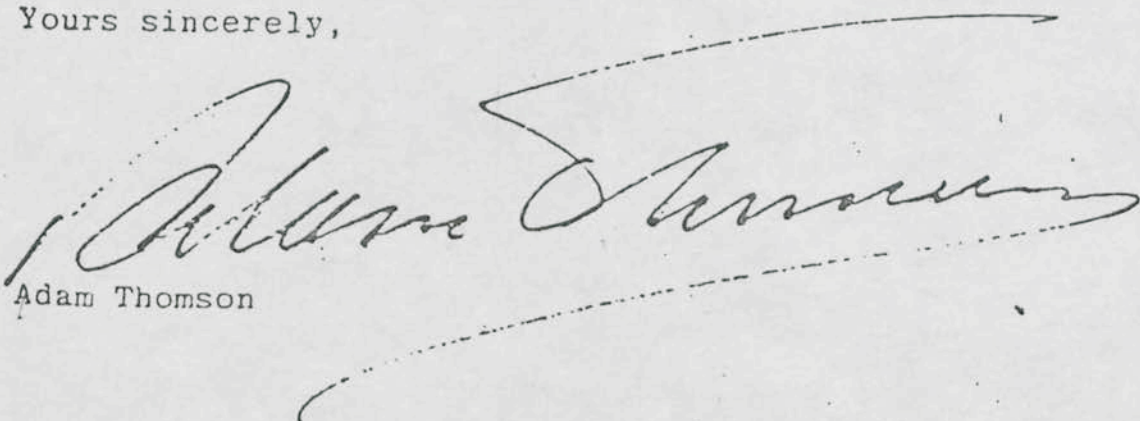
There are a number of actions that can be taken between British Airways and British Caledonian that could result in improvements for both. In the past we have been rebuffed by the British Airways' management when we have put these forward. I have recently put such proposals to Iain Sproat and John King 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

534-379

DEPARTMENT OF TRADE

1 VICTORIA STREET LONDON SW1H 0ET

Telephone 01-215 7877



SECRETARY
MR. KENNEDY
MR. BEAUMONT
MR. ROBERTS
MR. TAYLOR
(ON FILE)

From the Secretary of State

Adam Thomson Esq CBE
Chairman
British Caledonian Airways Ltd
Caledonian House
Crawley
West Sussex
RH10 2XA

30. September 1981

Dear Mr. Thomson,

You kindly sent me a copy of a letter you had written to the Prime Minister about the reorganisation of the British airline industry. As you say, your letter raised a number of the issues which you put to me during our interesting luncheon on 26 July.

After our discussion I gave considerable thought to the views that you had expressed but at the end of the day I decided that it would be wrong to embark on such a radical reorganisation of our air transport industry. You are no doubt familiar with the Civil Aviation Authority's interim policy statement which they published in November 1979 and with their April 1981 "Statement of Policies". I would agree with the Authority that while there may be scope for what might be called "natural evolution" it would be wrong to set out to build up one airline relative to another as a deliberate act of policy. Arbitrary route transfers in order to achieve structural changes in our aviation industry are not really appropriate.

You may say, of course, that the present position of British Airways is such that some sort of drastic solution involving a major re-distribution of routes is necessary. I would not agree with this point of view. I confidently expect that British Airways efforts to put their house in order will succeed and, while it is always open to other airlines to apply for their routes, I think it would be wrong to force British Airways off any of their routes and give them to other operators.



From the Secretary of State

Leaving aside my basic policy objections to what you propose, there are also a number of more detailed difficulties. For example, we would need to give a great deal of thought to the specific routes to be transferred. You say that one airline would be formed around British Caledonian with new routes: but these could only be profitable routes which British Airways would not like to give up, or unprofitable ones - and I doubt whether you would welcome a portfolio made up of unprofitable routes transferred as part of a package deal. It would also be very difficult to transfer assets as a temporary Government investment as you suggest. We would also run into difficulties over our international Air Services Agreements and so on. All in all, although I found your proposals very interesting I do not think it would be a sensible use of our time - or yours - to set up a working group to take the ideas further. I do not think that a major reorganisation of the nation's air transport industry is necessary.

Yours sincerely

John Biffen

JOHN BIFFEN

RECEIVED IN
- 3 SEP 1981
SECRETARY OF STATE FOR
TRADE'S OFFICE



*Mr. Hodgson
for case files &
also to general file
SIC*

10 DOWNING STREET

THE PRIME MINISTER

2 September 1981

Mr. Clavin

Mr. Tymon
CAP
Mr. Blanks CAP
Mr. Roberts CAP
S. & P. see case

Dear Mr. Thomson.

Thank you for your letter of 14 August, giving me your interesting ideas for a major reorganisation of the United Kingdom air transport industry.

As you acknowledge yourself, what you are suggesting is a very significant shift in policy. While I recognise that the industry, worldwide, is facing a difficult operating environment, I am not at all sure that such a fundamental restructuring of the United Kingdom industry is necessary. However, I am asking the Secretary of State for Trade to make a detailed examination of your proposals and let you have a full reply.

*Yours sincerely
Margaret Thatcher*

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

British Caledonian

Caledonian House
Crawley West Sussex
RH10 2XA England

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

From the Chairman's office

14th August, 1981.

RIS

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

Dear Prime Minister,

I write to express the concern of all of us in the British air transport industry, at the present situation and to express a view on what might be done with some urgency to place it upon a sound basis for the future.

There is no doubt that 1980 was, financially, the worst year in the history of air transport - and 1981 does not promise much better. British Caledonian is not immune to the crisis within the industry, and unlike last year, we do not expect to make a profit in the current year. Our problems are, however, of a short term nature and we expect recovery in 1982. British Airways' difficulties appear to us to be much more intractable because they are rooted in structural definitions. While fundamental changes appear warranted, they also present opportunities which - wisely promoted - could achieve an industry structure which would substantially improve its economic results and its effectiveness in world markets.

In spite of the report of the Edwards Committee in February 1969, which led to the formation of British Caledonian Airways Ltd in 1970, the industry has been dominated by nationalised airlines - for forty years. - Today, British Airways, with its 100% State ownership, is seven times the size of British Caledonian, the British private enterprise airline which operates the most extensive network of scheduled services in the Private Sector. Altering this ratio has presented problems, as any British Caledonian proposed expansion impinges on the very extensive British Airways' route network.

As we see things, the paramount requirements are, undoubtedly, first, the elimination of the internal circumstances which have led to British Airways' substantial losses and secondly, the setting up of a structure for the industry which will both ensure its sound and profitable development in the future and create a climate for the ready injection of private capital to replace State funds. Such a policy must, I suggest, start from a re-balancing of the route networks - with their profitable and not-so-profitable elements - at present so predominantly apportioned to British Airways which, for the requirements of efficient management is too big (and over manned), whereas the rest of the industry is too small and constricted.

One promising approach might be for British air routes to be re-allocated so as to form strong British airlines. One would be British Airways, restructured into manageable and viable operating units based on a nucleus of its present worthwhile routes. Another would be formed around British Caledonian with new routes, increased private capital and making use of surplus assets transferred from British Airways as a temporary Government investment. Between them these two airlines already fly the majority of British flag routes but in addition there would be specialist operators such as those involved in domestic services or inclusive tours or, as in the case of Laker, mainly low-fare services over dense North Atlantic routes.

There are a number of ways in which such an approach could be developed. To achieve this we would like to propose that you should consider setting up a rapid and effective working group to assess the potentials which, with the right people allocated to the job, could be completed in - say - three months from the start - two for studying the various options and one for assessing their merits and reaching a conclusion.

We in British Caledonian, with our track record of profitable operations in highly competitive international markets, are ready to participate and to produce a detailed memorandum on this subject, should you wish. We shall, of course, be glad to submit it to the Secretary of State for Trade, Mr. John Biffen - to whom I am sending a copy of this letter.

Our whole objective is to see a strong and healthy British air transport industry formed out of the present unsatisfactory situation in which one, loss-making nationalised component, dominates the scene. This can be seen as an opportunity to be achieved by:

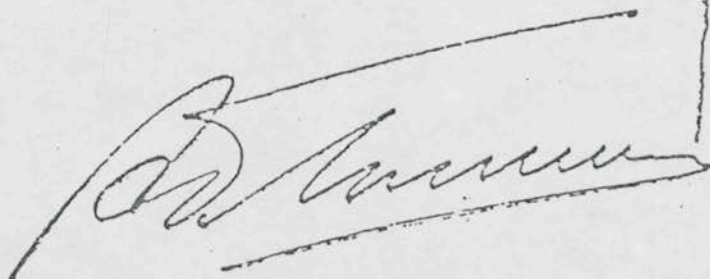
- a) Urgently restructuring British Airways into leaner and more efficient units which would be attractive to private investment.
- b) Adjusting routes as part of the process of restructure.

c) Diminishing HMG's investment in British Airways through a transfer of surplus assets which would constitute a minority and temporary shareholding in British Caledonian until private capital could take over the investment.

The opportunities are great. The rewards for Britain and British overseas trade, substantial. The knowledge and experience exists and a great deal of private capital will be ready to invest in a soundly structured solution.

If you will take the initiative we propose, I am sure that, though the situation is complex, a solution can be found which will place the industry in a commanding position for years to come.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'Adam Thomson', is written over a horizontal line. The signature is fluid and cursive.

Adam Thomson

CONFIDENTIAL

PRIME MINISTER

31 July 1984

BA, BCal AND THE CAA

① The Annex is specifically related to your meeting with Sir Adam Thomson. Mr Ridley is coming five minutes early to report on his meeting with Sir Adam.

The issues are simple, well aired and nicely summarised in Mr Ridley's paper C(84) 21.

We fully support Mr Ridley in wanting to adopt the CAA's proposals to promote domestic competition (his paragraph 2) and to reject the CAA's desire to acquire even more power to restructure the airline industry (his paragraph 3).

The key issue is whether or not to transfer routes from BA to BCal. We have advised you strenuously against this hitherto, and we still do so now.

The key considerations seem to us as follows:

1. Route transfers do nothing for competition in the sense that the consumer gains. They simply re-allocate monopoly rights from one beneficiary to another.
2. Route transfers to BCal will be seen as a Government attempt to underwrite BCal's future. Government should not attempt that, because it is the start of a long slippery slope.
3. The BA Board (not just Lord King) will fight route transfers all the way, and compel Government to enact primary legislation. There will be a deplorable spectacle all round. It will delay and damage the privatisation of BA. It will antagonise BA employees who (unlike many nationalised industry employees) actually want privatisation. There could be fall-out damage to the rest of the privatisation programme.
4. Whatever you do, you will gain the approval of some MPs and Lords and the censure of others. There is no way of having everybody on your side, and not much certainty about the numbers. As Mr Ridley points out, BA have been late in getting back-benchers on their side, but have apparently been successful in balancing up what was supposed to be a pro-BCal lobby.
5. BCal's case for route transfers is weak. It began as an apparently altruistic harangue in favour of 'competitive balance' as between big BA and the little independents (although notably the little

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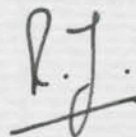
independents other than BCal did not join in the campaign). By last week, Sir Adam Thompson of BCal was quite openly saying to Mr Ridley that he needed some monopoly profits in order to stay in the air. This is an astonishing shift. We believe the truth is that BCal are already in serious difficulty and that Sir Adam is desperate for help - not for competition.

Since you are seeing Sir Adam Thompson on Wednesday, we have annexed a note on BCal for your meeting.

6. The general theory behind route transfers is to create a sizeable second force UK airline. The nearest we have been to this is with the old BEA and BOAC, but they did not compete directly with each other anyway. BCal is not a reincarnation of either.

Conclusion

The costs of embarking on enforced route transfers are open ended and of very dubious benefit. We recommend you to reject route transfers outright. If you feel (and we do not) that a gesture should be made to BCal, you could pursue BA's suggestion to give BCal dual designation (out of Gatwick) on routes which BA serve from Heathrow. BCal will almost certainly turn it down, but you will have called BCal's bluff on competition.



ROBERT YOUNG

BRITISH CALEDONIAN
(based on Company Accounts to October 1983)

The company has sales of £428 million, a (historic) profit before tax of £3.3 million, and a balance sheet value of £69 million. It employs just under 8,000 people and has a fleet of 25 aircraft and 7 helicopters.

BCal's main scheduled routes are to the USA (Los Angeles, Dallas, Houston, Atlanta); to Brazil, Venezuela and Colombia; to Nigeria, Zambia and the West African coast; to Hong Kong; to Libya and Tunisia; and, within Europe, to Paris, Brussels, Geneva, Frankfurt and Genoa.

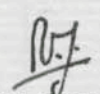
Its headquarters and route structure are based at Gatwick.

BCal's balance sheet is, on any objective assessment, weak. The key features are:

- i. Of £69 million cash reserves, £67 million are held overseas. No provision has been made for non-remittance.
- ii. It has £93 million of dollar borrowings, which at present exchange rates must feel uncomfortable.
- iii. At 31.10.83, it had total borrowings of £160 million against shareholders funds of £69 million - a dreadful gearing.
- iv. At 31.10.83 the company had entered into future commitments valued at £216 million.

For your meeting with Sir Adam Thompson, we suggest it would be prudent to listen to his case rather than to present one of your own. But you could ask:

- i. How solid BCal now feels its own balance sheet to be.
- ii. How BCal would fund any expansion, with gearing at over 200%.
- iii. Whether BCal is seeking competition, or help over the short term.
- iv. What the benefits of a merger with any other airline (not just BA) might be.
- v. Do the subsidiary businesses of BCal (holidays, hotels, aircraft engine overhaul and helicopters) offer good development opportunities? Hotels made a pretax profit of £1 million on a turnover of £8 million compared with profits of £3.2 million on £363 million of airline turnover. Helicopters lost £1½ million - why stay in?


ROBERT YOUNG

FROM: THE RT HON. JULIAN AMERY, M.P.



112, EATON SQUARE,
SW1W 9AA

TEL: 01-235 1543
01-235 7409

*NAPM
J.*

27th July, 1984.

Dear John,

We had a word in the division last night about the handling of the CAA report. Much of the report is I think acceptable to most people concerned but there are important sections (route transfers from BA to BCal, charter rights and airport interests) which are highly controversial.

I myself am strongly opposed to the main recommendations but write to you as Leader of the House not on the merits of the matter but on the procedural implications.


As I understand it, giving effect to the main recommendations of the report would require legislation. It looks as though the opposition parties would oppose this, so would a very substantial element of our party. The report thus looks like a potential banana skin of some size.

What is the best way of avoiding a nasty slip on it?

It seems to me that the easiest way out would be for Nick Ridley to make a statement either just before the House rises or in the recess endorsing those parts of the report which are not contested but explaining that he cannot consider giving effect to the rest of it for two reasons. First, that it would require legislation for which there is no room in the programme; second, that legislation, even if room could be found for it, would delay the privatisation of BA and prejudice the opportunity for the public, who at present own the airline, getting the best price for it.

I am copying this to Nick Ridley, the Chief Whip and Number 10.

Yours ever,


Julian Amery

The Rt.Hon. John Biffen, MP

28 JUL 1984

11 12 1
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8 3
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6 5

done
DMS
3/17
OK
put in diary.

ROBIN

Sir Adam Thomson is seeing the Prime Minister at 9.30 tomorrow morning. His Secretary telephoned to ask if it would be in order for him to bring Sir Peter Masefield, Deputy Chairman of the Caledonian Aviation Group.

I said someone would be in touch with her -
930-5746

Angela
4.40 pm



10 DOWNING STREET

Prime Minister

Mr Ridley is seeing Sir
Adam Thomas this
afternoon. We should
therefore get this letter off
as soon as possible. Otherwise
a substantive reply will be
needed.

AT

26/7



10 DOWNING STREET

THE PRIME MINISTER

26 July 1984

CR
cc D Evans
HMT

Dear Sir Adam,

Thank you for your letter of 19 July. I think that in the first instance you should discuss the issues raised by the CAA review with the Secretary of State for Transport. Since you wrote, I have learnt that you are seeing Nicholas Ridley and I have asked him to report the outcome of your discussions to me.

Yours sincerely

Margaret Thatcher

Sir Adam Thomson, C.B.E.

6



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

Andrew Turnbull Esq
Private Secretary
10 Downing Street
LONDON SW1

26 July 1984

Dear Andrew,

CAA REVIEW - BRITISH CALEDONIAN

Thank you for your letter of 20 July about Sir Adam Thomson's request for a meeting. If the Prime Minister were to see Sir Adam Thomson at this stage, she would need to be advised to do no more than listen. In fact Sir Adam Thomson has asked to see my Secretary of State and a meeting has been fixed for Thursday afternoon. Mr Ridley therefore suggests that the Prime Minister should not see Sir Adam Thomson, at least for the time being.

I am copying this letter to David Peretz (HM Treasury).

Yours,

Dunich

MISS D A NICHOLS
Private Secretary

AEROSPACE &

CAA Review &

R-2

DEPARTMENT OF TRANSPORT
111 CANAL STREET, SINGAPORE 04



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10 DOWNING STREET

From the Private Secretary

20 July, 1984

CAA REVIEW - BRITISH CALEDONIAN

BF
Sir Adam Thomson has written to the Prime Minister requesting a meeting. I would be grateful for early advice on whether she should agree to this, in the light of the decision of Cabinet that your Secretary of State and the Chancellor should try to secure agreement on a limited transfer of routes between British Airways and British Caledonian.

I am copying this letter to David Peretz (HM Treasury).

(A. Turnbull)

Miss D.A. Nichols,
Department of Transport

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NR



NB 1/17

AT 20/7

FCS/84/213SECRETARY OF STATE FOR TRANSPORTCivil Aviation Authority Review

1. I have seen the Note you have circulated to the Economic Affairs Sub-Committee of the Ministerial Steering Committee on Economic Strategy, (ECA)(84)44), on the report sent to you by the Civil Aviation Authority (CAA) following its review of airline competition policy.
2. You will be relieved to know that I see no foreign policy complications in the course you propose nor, so far as I can see, in any compromise that may emerge as a result of yesterday's discussion in Cabinet. You will no doubt keep me informed of any progress in that direction.
3. I am copying this minute to our colleagues on E(A) and to Sir Robert Armstrong.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
20 July 1984

Aerospace BA Pt 2

20 JUL 1984

11 12 1 2 3
4 5 6 7 8 9
10

me

GENO

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

Ack'd 20/7

19th July, 1984.

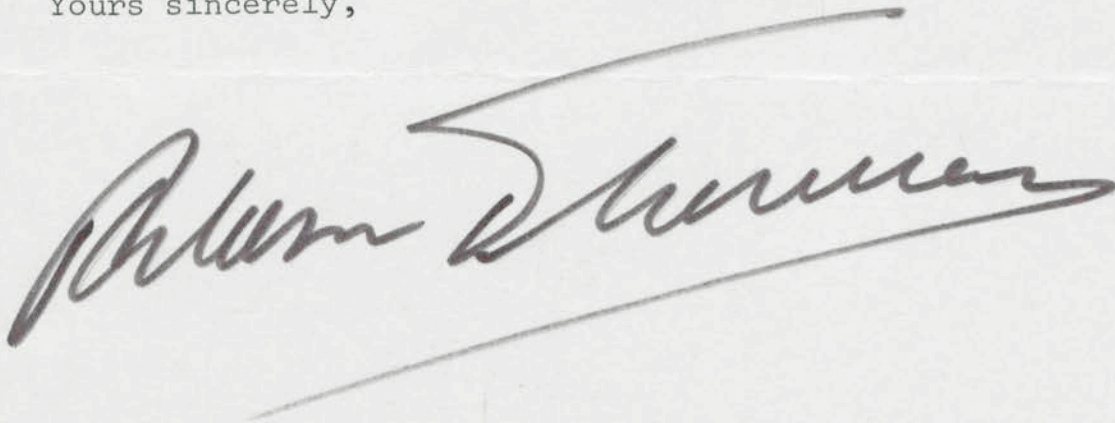
The Rt. Hon. Margaret Thatcher, MP,
Prime Minister,
10 Downing Street,
London SW1.

Dear Prime Minister,

The Civil Aviation Authority has reported to the Secretary of State for Transport following the Authority's investigation into the implications of privatising British Airways for competition and the sound development of the British Airline Industry. In this report there are many far reaching consequences for British Air Transport and certainly the final outcome, whatever that may be, will have significant implications for British Caledonian Airways.

I do believe that this matter is sufficiently important for me to respectfully request a meeting with you. Discussing British Caledonian's position in isolation inevitably will lead to the effect the CAA's proposals will have on the British Air Transport Industry as a whole.

Yours sincerely,



A

**British
airways**

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

Pine Ministu
Lord King's circular sets out
the Nott undertakings very
clearly

AT 1817

Lord King of Wartnaby
Chairman

pa
20/7

Mr Turnbull

To see.

Agree no reply? Yes AT

20/7
18/7

To: All Members of Parliament
House of Commons
London SW1A 0AA

17 July 1984

R18

mt

FUTURE OF THE BRITISH AIRLINE INDUSTRY

I regret that this impersonal approach to you is necessary in view of the urgency required to convey my reactions to the recommendations of the Civil Aviation Authority.

Substitution of one airline for another by transfer of routes does not increase competition nor does it do anything to benefit the consumer. Furthermore it is likely to lead to an immediate diminution in business by British airlines for the benefit of foreign carriers.

If the Government were to accept these recommendations this would amount to a breach of faith to the airline and its staff. In a letter to my immediate predecessor from the then Secretary of State, Mr John Nott, dated 29th October 1979, it was said that;

"The size, status and prestige of British Airways confirms its position as our national flag carrier and that there will be no arbitrary reallocation of routes".

On 19 November 1979 in the House of Commons during a debate on the 1980 Civil Aviation Act Mr Nott stated;

"I do not propose that any part of British Airways should be broken up or sold off. I propose that the airline as a whole should be quoted and it will then be for the board of directors to take decisions on how they organise their business".

/2....

On taking office I, and my Board, were given a similar understanding and with this assurance we restructured the airline.

If adopted, these recommendations would lead to the loss of many jobs at considerable cost to the airline.

Furthermore the reduction in profits would be substantial. This country would lose its position in the forefront of the world's airlines - the beneficiaries possibly being the few shareholders in certain other British airlines as well as the foreigners who would take great pleasure in seeing one of their largest international competitors reduced in stature.

I am urging the Secretary of State for Transport to keep British Airways intact and to introduce more competition on our routes as soon as his officials are able to negotiate dual or multiple designation with their foreign counterparts. Some already exist with a number of countries, not many of which have been fully taken up by other British carriers.

By this means we would avoid lost jobs, and ensuing costly, painful and damaging redundancies. Such avoidance would ensure the continued progress of one of this nation's greatest successes.

Kings

Ref. A084/2067

PRIME MINISTER

Parliamentary Affairs: Civil Aviation
Authority Review

You had it in mind to ask the Secretary of State for Transport to report to the Cabinet on today's discussion by the Ministerial Sub-Committee on Economic Affairs of the Civil Aviation Authority (CAA) Review (E(A)(84) 19th Meeting, Item 3).

2. The main points, as you will recall, are as follows:

i. The CAA has made various proposals to increase competition with British Airways (BA) on suitable international routes and on domestic routes; these can be accepted.

ii. The CAA has, however, also proposed to transfer routes from BA to other British airlines which would cost BA about 7 per cent of its revenue and profits of £30 million a year at 1984 levels. The objections to this are:

a. It would require controversial legislation thus deferring the privatisation of BA.

b. It would reduce the receipts from privatisation and make BA a more uncertain prospect for investors (although this latter point is contested).

c. It could be held to be inconsistent with Ministerial undertakings about privatising BA as it stands; these were given in Parliament during the passage of the Civil Aviation Act 1980 which provided the powers for privatising BA.

d. Transferring profitable routes would seem a poor reward to the management and employees of BA for their efforts in improving the airline's performance.

iii. Refusal to accept the route transfer proposals will however be strenuously opposed by British Caledonian, and

the Government may be accused of merely substituting a private monopoly for a public monopoly rather than promoting competition.

iv. The majority view in E(A) was that the route transfer proposals should be rejected. It was however agreed that much care would be needed to get the presentation right (in particular to avoid the charge that the decision was taken wholly in the interests of privatisation). Some members of the Sub-Committee thought that the decision should not be announced before the House rose for the Summer Recess. Both the Secretary of State for Transport and the Chancellor of the Exchequer consider it vital to clear up uncertainty as quickly as possible.

Conclusions

3. You will wish:

- i. to confirm that the majority view of E(A) to reject the route transfer proposals is endorsed by the Cabinet;
- ii. to seek the Cabinet's views on whether the decision should be announced before the House rises for the Summer Recess.

R
Approved by
ROBERT ARMSTRONG
and signed in his absence.

18 July 1984


CONFIDENTIAL

P.01343

PRIME MINISTER

Civil Aviation Authority Review

(E(A)(84)44)

BACKGROUND

The Civil Aviation Authority (CAA) published on 16 July a review of the implications of the privatisation of British Airways (BA) for competition and the sound development of the British airline industry. This review concluded with, among other things, recommendations for the transfer of certain routes now operated by BA to British competitor airlines.

2. At a meeting under your chairmanship on 11 July it was agreed that it would be desirable for the Government's response to the review to be made known before the Recess. The Secretary of State for Transport was asked to prepare a paper suggesting that the Government should be prepared to accept a number of recommendations which would increase competition, but not to accept major route transfers.

FLAG A 3. In his note E(A)(84)44 the Secretary of State for Transport summarises the CAA's recommendations. They are as follows.

(i) Transfer to other British airlines of all BA's international scheduled services out of Gatwick, Birmingham, Manchester and Glasgow, and those out of Heathrow to Harare and Saudi Arabia (paragraph 2(a)).

(ii) Measures to increase competition through the provision of new services by British airlines (especially British Caledonian (B.Cal)); more competition out of

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Heathrow; no debarring of BA from the charter market, but improved safeguards against predatory pricing; and a strengthening of the CAA's powers (paragraph 2(b) to (e)).

(iii) Relief of capacity constraints at Heathrow and Gatwick (paragraph 2(f)).

4. Mr Ridley proposes that the recommendations summarised at paragraph 3(i) above should be rejected; that those summarised at 3(ii) should be accepted, subject to further exploration with the CAA of the suggestion that the Authority should be given new statutory powers. Capacity constraints at Heathrow were the subject of Ministerial discussion earlier this year, in connection with the privatisation of airports, in the Ministerial Sub-Committee on Disposal of Public Sector Assets (E(DL)(84)1st Meeting, Item 1). At that discussion it was agreed that Mr Ridley should issue a consultative document. This is at an advanced stage of preparation. It will not advocate raising the ceiling on air traffic movements at Heathrow, since this would provoke powerful opposition from local residents and risk reopening the Stansted Inquiry. Mr Ridley proposes to stand firm on this.

FLAG-B

MAIN ISSUES

5. The main issues before the Sub-Committee are as follows.

- (i) What should be the Government's response to the CAA's recommendations on route transfers?
- (ii) What should be the Government's response to the CAA's other recommendations?
- (iii) When should the Government's decisions be announced?

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Route transfers

6. The argument is often advanced - and it has now been effectively accepted by the CAA - that BA has an over-dominant position among UK airlines, and that there should be a better balance. B.Cal. has mounted a considerable press campaign based on this argument and can be expected to claim that the CAA has vindicated it. It is likely to attract a good deal of support among the Government's supporters.

7. Route transfers on the scale proposed by the CAA would defer the privatisation of BA, both because the necessary legislation would be controversial and because it would be harder for investors to assess BA's past profits and future prospects. This argument weighed heavily with the Ministers present at the meeting on 11 July. However, it may not be easy to put across in public: the reply might be either that fostering competition is more important than privatisation or that the Government's privatisation programme should not take priority over doing justice to BA's competitors.

8. The Sub-Committee may therefore wish to consider whether the following additional arguments would be sufficient to carry the Government's case in public.

(a) Competition is mainly between British and overseas airlines, not between different British airlines.

(b) BA has shown that it can be made more efficient in response to that competition. Privatisation will take the process further.

(c) The effect of transferring routes from BA could be to create two weak British airlines rather than one strong one against overseas competition. (The Secretary of State for Trade and Industry attaches much importance to this point).


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Other recommendations

9. The Sub-Committee seem likely in general to endorse the other recommendations of the CAA (apart from those relating to air traffic movements at Heathrow and Gatwick, on which E(DL) has already reached conclusions). But they may wish to consider the following.

a. The Authority already has power to take a route away from one operator and give it to another but cannot use these powers solely to modify the competitive structure of the industry. If the CAA's powers were to be extended in this way difficult issues would arise, particularly when, following the privatisation of BA, all UK airlines will be in the private sector. Valuable rights would pass from one private sector company to another by administrative action based on the CAA's view of what the right competitive structure of the industry should be. The Secretary of State for Transport might be asked how he thinks such difficulties might be overcome and to raise these issues in the exploratory discussion which he already envisages with the CAA (paragraph 4(e) of E(A)(84)44).

b. It is not clear from the memorandum whether Mr Ridley intends to accept the suggestion in CAA recommendation 8 (Annex to E(A)(84)44) that the frequency of BA services at Heathrow might be reduced. We understand from his

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officials that Mr Ridley does not intend to reach any decision on this matter until he has seen the response to the consultative document on air traffic movements at Heathrow which he hopes to issue shortly.

Announcements

10. The Sub-Committee are likely to agree that the Government's decisions should be announced quickly. You will probably wish to invite the Secretary of State for Transport to circulate a draft of the announcement to the Sub-Committee. The discussion on the substance will probably have provided guidance on how the Government's decisions, in particular on proposals for route transfers, should be presented.

HANDLING

11. You will wish to invite the Secretary of State for Transport to open the discussion. The Chancellor of the Exchequer will wish to comment from the standpoint of the privatisation and competition programme. The Secretary of State for Trade and Industry will also wish to comment from the standpoint of competition policy as well as from his experience of the airline business. The Lord Privy Seal will have views on the implications for the legislative timetable of any suggestion that the CAA should be given power to transfer routes between airlines.

CONCLUSIONS

12. You will wish the Sub-Committee to reach conclusions on the following.

(i) The Government's response to the recommendations in the CAA review regarding:

(a) route transfers between British Airways and other airlines;

(b) capacity at Heathrow and Gatwick;



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(c) other matters.

(ii) How the Government's decisions should be announced.

PLG

P L GREGSON
Cabinet Office
17 July 1984

CONQUEROR
LONDON



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

Richard Hatfield Esq
Private Secretary
Sir Robert Armstrong GCB CVO
Secretary of the Cabinet
Cabinet Office
70 Whitehall
LONDON SW1A 2AS

16 July 1984

Dear Mr Hatfield

CAA REVIEW: AIRLINE COMPETITION POLICY

My Secretary of State's paper E(A)(84)44, due to be discussed at the meeting of E(A) on the morning of Wednesday 18 July, sets out the recommendations contained in the Civil Aviation Authority Review.

I enclose for your information, and the information of members of E(A), a copy of the CAA report published today.

Yours sincerely

Andrew Whittham

for

H C S DERWENT
Private Secretary

Subject as marked



*File ✓
cc Bob Young*

10 DOWNING STREET

From the Private Secretary

11 July 1984

CIVIL AVIATION REVIEW

The Prime Minister held a meeting today at the House of Commons to discuss your Secretary of State's minute of 3 July reporting on the Civil Aviation Review. Present were your Secretary of State, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, the Lord Privy Seal and the Chief Whip.

Your Secretary of State said the CAA would shortly be publishing the outcome of its review. The Government was likely to be able to accept a number of its recommendations but some created acutely difficult choices. In particular, the CAA were arguing that it would be desirable to transfer some routes from British Airways to other airlines, especially B.Cal, in order to strengthen the "second force" in British aviation and make it capable of competing with BA. He himself was attracted to this proposal but recognised the difficulties it created.

The Chancellor of the Exchequer was concerned at the prospect of major route transfers. He did not accept CAA's logic that this would increase competition. For the most part British Airways was in competition with foreign airlines, not with other domestic airlines. (The Secretary of State for Trade and Industry pointed out that his recent statement on competition policy had stressed that competitive conditions had to be judged in the light of competition from abroad as well as from home.) The Chancellor was also concerned at the impact on the privatisation of BA. This had been the first case identified by the Government for privatisation. It had taken a long time to prepare BA for the market but the prospects for a successful privatisation in 1985 were excellent. This could be jeopardised by acceptance of the CAA's recommendations.

The Secretary of State for Trade and Industry said BA had shed 40 per cent of its staff in the process of improving its efficiency. There would be a major outcry if it were required to sell assets and lay off still more employees. He doubted whether B.Cal had the resources to buy the assets needed to service the routes suggested for transfer. He preferred to see one strong national airline rather than two weaker ones.

The Lord Privy Seal and Chief Whip were concerned at the prospect of extending the long title of the bill on aircraft movements to widen CAA's charter in a way which would permit it to make route transfers. Even if this involved only a few clauses it would turn an uncontroversial bill into a very controversial one, enabling amendments to be put down bringing the whole BA/B.Cal dispute into the bill.

The Secretary of State for Transport said many of CAA's recommendations could be accepted without adverse consequences for the legislative programme or for the privatisation of BA. Items A, B and D, listed in his minute could be accepted (CAA itself did not propose to adopt Item C).

Summing up, the Prime Minister said that CAA's thesis that route transfers would increase competition was disputed. The Secretary of State for Transport should prepare a paper on the Government's response to the review, indicating that the Government would accept a number of recommendations which would increase competition but would not be prepared to accept major route transfers. It was desirable for such a paper to be put to colleagues as soon as possible so that the Government's position could be made known before the recess. The Secretary of State for Transport could indicate to the CAA the direction in which the Government was likely to respond. He should also request them to delay publication of the report beyond next Monday in order to reduce the gap between its publication and the Government's response.

I am copying this letter to David Peretz (HM Treasury), Callum McCarthy (Department of Trade and Industry), David Morris (Lord Privy Seal's Office), Murdo Maclean (Chief Whip's Office) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

Miss Dinah Nichols
Department of Transport

PRIME MINISTER

Your meeting with the Chancellor, Mr. Tebbit and Mr. Ridley is in two parts.

(i) CAA Review

In view of the political sensitivities and the possible need for legislation, the Lord Privy Seal and Chief Whip have been invited for this item. The Policy Unit come down strongly in favour of BA. So too, I think, do the Chancellor and Mr. Tebbit who are worried that Mr. Ridley is egging CAA on towards route transfers without considering the politics adequately. The Chief Whip could be asked to advise on the relative size on the Government backbenches of the King faction and the Thomson faction.

(ii) Sealink

Only one decent bid has been received - this is likely to become known. Is it good enough to proceed with? There is much to be said for getting Sealink into the private sector as soon as possible, to leave the new owners to sort it out. But Government cannot afford another highly controversial sale just now. The Policy Unit favour pressing on. What do the others think?

AT

10 July, 1984

PRIME MINISTER10 July 1984

c Mr Redwood

CIVIL AVIATION POLICY REVIEW

1. Whether we like it or not, as we run up to the sale of British Airways, the world at large will see our response to the CAA review as symbolic of our real intentions towards privatisation. Are we genuinely concerned to bring about competition, or just auctioning BA off for the highest short-run proceeds?

2. There may be a case for Government to accept the CAA's findings whole, because the Authority was asked to act as Government's independent expert adviser. The CAA will be seen as pro-competitive, and the Government would be given a reasonable ride if it agreed. Yet, if Mr Ridley is correctly forecasting what the CAA is going to say, the recommendations seem to us flawed in parts.

We fully support the Authority's wish to ease entry to the domestic route market (paragraph a) and to deregulate domestic fares (paragraph b). Allowing BA to stay in the charter market (paragraph c) also looks sensible, although it may provoke surprise among the independents.

3. Where we find fault with the CAA's logic is in the enforced transfer of domestic routes from BA to others (paragraph d) and of international routes from BA to BCal (paragraph e). We see the following points as fundamental:

- i. What does route stripping do for competition? There is no greater freedom of choice for the traveller if BCal is designated the single British carrier on a given route. If BA and BCal share the UK's 50% portion of a pooled route, that seems to us to weaken the prospects of both British carriers against foreign competitors.
- ii. Chipping pieces off BA is bound to delay privatisation. It will generate redundancies at BA; will require asset valuation, negotiation and sale; will involve the independents in large-scale recruitment of people and the funding of new assets; will require the re-negotiation of Government to Government treaties overseas; and will make BA's prospectus harder to write. It will delay exposing BA to the rigours of the market. It will make Government look hesitant when it need not and should not. The costs seem to us large and open-ended, the benefits small and uncertain.

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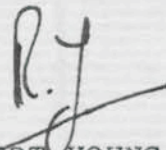
iii. At the end of April, the CAA saw no "competitive balance" argument in favour of stripping BA of some of its route rights. The Authority is now shifting its ground to concern about BCal's survival. The CAA cannot underwrite BCal's survival, and should not even attempt it. If an initial allocation of routes to BCal did not work, what next? More routes? Given their weak balance sheet, what will BCal use for money if surplus BA assets are to be sold to them at fair prices? Why indeed confine the help to BCal? Aid to the independent airlines, however disguised, seems to us a very slippery slope for Government.

4. Either solution presents a political problem. Back the CAA and you lose some of Lord King's achievement and enthusiasm, BA will mount anti-Government publicity, and you will have delay. You may do better on competition grounds. Back BA and you will then have the BCal backbench lobby against you, and the press will construe the decision as anti-competitive.

We recommend that the best bet is to go confidently for an early sale, (this is also the Treasury view) and to try to deflate the anti-competitive argument by:

- i. reaffirming Nicholas Ridley's desire for national and international deregulation of routes;
- ii. explaining that, at bottom, BCal want extra monopoly routes, not more competition;
- iii. emphasising that 'giving' routes to BCal leaves open the rights and ambitions of other smaller but equally worthy airlines.

5. Economically, all the arguments are on BA's side. If there is any case for making a non-economic gesture, in order to head off opinion which champions BCal as David taking on BA's Goliath, it should be a small gesture on domestic routes only. David did not win by making out a case for having Goliath's sword.


ROBERT YOUNG



PRIME MINISTER

CIVIL AVIATION REVIEW

I understand that we are to meet on Wednesday 11 July to discuss Nick Ridley's minute to you of 3 July. I very much hope I shall be able to be present for the whole meeting, but I have to chair the Committee of Privileges at 4.30 pm and I may therefore be slightly late. If so, I apologise in advance.

In the circumstances, it may be useful if I outline briefly my own reactions to the Parliamentary aspects of the situation, so that you can have them in mind when discussing the matter.

Nick suggests that the CAA seem likely to recommend route transfers to British Caledonian on a scale which, together with the other route changes they are likely to recommend, might reduce British Airways' revenue by about 10 per cent and their profits by rather more. Such changes would require legislation to effect the route transfers and he suggests that, in order to fit in with the privatisation programme, the legislation would have to be through Parliament by the new year. In addition, he thinks that if the CAA's report is published on or about 16 July there may be pressure for a debate before the House rises. I get the impression that this would be welcome to him.

Rt Hon Margaret Thatcher MP
Prime Minister

./...



I have to say that legislation in next Session on the timescale which he outlines is virtually out of the question. This matter was not put before QL or the Cabinet in their consideration of next Session's legislative programme and, as you know, the programme is already extremely tight. This is clearly a very controversial subject, and I do not think that we can accept that it can be slotted in to the programme without taking out some other measures. Nor, I have to say, do I think there is time for a debate on this subject before the House rises.

I am sorry to be so discouraging in an area which I recognise is of some importance to the Government's privatisation programme, but I do find it difficult to understand why the issue has suddenly assumed its present prominence in legislative terms at this point in time.

May I suggest that, if you think it appropriate, the Chief Whip should be invited to this meeting.

I am copying this to the Chancellor of the Exchequer, the Secretaries of State for Trade and Industry and Transport and the Chief Whip.

WJB

J.B.

9 July 1984

-2-



B/P for Wednesday
meeting

10 DOWNING STREET

Prime Minister.

We had arranged for you to see Mr Ridley on Monday to discuss the choices posed by CAA Review. He now wants a word with you today as he is meeting the CAA this afternoon. If Govt. is to steer CAA off its ideas for major route transfers he feels he should start today. He therefore wants your reaction

This is difficult as neither you nor other colleagues have had a chance to consider the issues. Treasury, at official level, are sceptical about major restructuring of the industry and about "second force" thinking.

- I suggest you tell Mr Ridley that Ministers need time to consider
- (i) ~~whether~~ what they think of CAA ideas?
 - (ii) whether they prefer to let CAA publish or want to influence the outcome?

CAA should publish until Ministers have met.
AT 5/7

B/P for a July meeting
AT 3/7

C/NO

Prime Minister (2)

PRIME MINISTER

No decisions are being
sought at this stage.Mr Ridley seeks a preliminary
meeting before he circulates a
paper to E(DL)

AT 3/7

CIVIL AVIATION REVIEW

The Civil Aviation Authority (CAA) are due to report in the middle of July on the review which I asked them to undertake, of the implications of privatising British Airways (BA) for competition and the sound development of the British airline industry. In this minute I summarise the general lines on which they seem likely to report.

The Authority, in a consultation with the aviation industry and its users, have been considering the issues under five broad heads -

- (a) Domestic routes: route entry. The CAA proposed to introduce a kind of open general licence, allowing easy market entry for airlines using smaller aircraft, to domestic routes not involving Heathrow (because of the congestion there) and not involving vulnerable lifeline services (eg some Scottish island routes);
- (b) Domestic routes: fares deregulation. The CAA proposed the removal of their positive control over domestic tariffs, but with the retention of some reserve power to intervene in cases challenged as involving predatory pricing.
- (c) The charter (non-scheduled) services market: proposals by independent airlines that British Airways should be debarred from competing in this market and should dispose of their charter subsidiary.



- (d) British Airways' international scheduled services from Manchester and Birmingham, and their domestic services: proposals by the independent airlines generally that such routes should be taken away from BA or thrown open to greater competition.
- (e) British Airways' international routes from London: British Caledonian's (BCal) proposals that a number of such routes should be transferred from British Airways to them.

The CAA seem likely to go ahead with (a) and (b); decisions on both are a matter for them, under the Civil Aviation Act. I make no further comment on them.

As regards (c), the indications are that the CAA think it would be retrograde to debar British Airways from competing in the charter market.

On (d), the CAA seem likely to recommend to me that the international services from Manchester and Birmingham should be taken away from BA and made available to the smaller independent airlines; but that no special regulatory intervention is required in BA's domestic services, which already face competition, and would be open to greater competition in future.

The most controversial part of the CAA's emerging views is on the proposals for transfer of international routes from BA to BCal. The CAA's interim consultation document at the end of April implied that they were not persuaded of the case for straight transfers of international routes from British Airways to BCal, on the ground that whatever this might do for "balance" within the industry, it would add nothing to competition. Instead they seemed inclined to recommend that the opportunities for BCal (beyond their present routes) should be -



- (a) where they are or can be licensed to compete directly with British Airways. The market realities and attitudes of other countries are likely to limit these, as at present, to some United States and European points and Hong Kong, but some further points might be added over the next decade);
- (b) the development of a concept of "indirect competition" in which another airline - usually in practice BCal - would be licensed to serve a second point in some of the bigger markets which BA serves at present. The CAA made a start on this recently by licensing BCal to serve Riyadh in Saudi Arabia and they envisaged other possibilities such as Canada, Australia and South Africa.

BCal's reaction to this was that without a substantial part of the route transfers they sought, they would not have the financial strength to compete effectively with BA in these ways, nor would they have the clear prospects which would enable them to raise substantial further capital to gain that strength. The CAA now seem to be coming to accept this: and to be taking the view that without route transfers there is a risk that BCal would gradually decline, perhaps leaving no substantial British alternative to British Airways (as distinct from the much smaller scale scheduled airlines such as Dan Air, or the new entrant Virgin Atlantic). Even though the direct competition for British Airways on most international routes comes from foreign airlines, the CAA judge that the threat of substitution by a credible British alternative is desirable to avoid British Airways becoming complacent, especially on routes where foreign competition is weak or muted.



So the CAA now seem likely to recommend route transfers to BCal, on a scale less than BCal's opening bid but which, together with the other route changes they are likely to recommend, might reduce British Airways' revenue by around 10% and their profits by rather more.

72 - £30m.

Recommendations on these lines would face us with difficult decisions, partly because they are highly contentious and partly because of the effects on the timing of privatising British Airways. Legislation would be needed to effect such route transfers and it would have to be through Parliament by the New Year. There would need to be negotiations over the sale of associated assets and any transfers of staff. The effect on BA's prospects would need to be assessed to provide the basis for the sale prospectus. We would have to move swiftly to maintain the possibility of privatising BA by early 1985. On the other hand it is important, before we privatise so large a part of this industry, to establish a sound basis for competition in the industry. There is also a strong point in favour of accepting the CAA's recommendations in toto if we can - that it gives us "expert" cover for what will be highly controversial decisions in a field where there is great public interest.

The CAA's report on their review is expected to be completed and published on or about 16 July. I shall wish to make a holding statement saying simply that we shall be considering it and will announce our conclusions as soon as possible. There may be pressure for a debate before the House rises; to accept this would make it easier to announce our conclusions during the Recess, which will be desirable to resolve uncertainty and maintain momentum on the privatisation of BA.



I shall, of course, bring the substantive issues to colleagues in E(DL) as soon as the CAA's report has been made and assessed. This is early warning of what is likely to happen, and it might be helpful if we could have a brief early discussion on the immediate political and handling implications.

Copies of this minute go to the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Lord Privy Seal. I ask that they will strictly limit any further circulation of it in their Departments.

NICHOLAS RIDLEY

3 July 1984

AJ

CIVIL AVIATION
22nd June 1984

Dr. Ellis

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JEREMY MOODY

CIVIL AVIATION

Summary

On its election in 1979 the Government inherited an inefficient state owned airline with a poor reputation working within a highly regulated and protectionist market. All the evidence was that service was poorer, fares higher and the opportunities for initiative and enterprise fewer than they should be - all to the detriment of the traveller. The Government has worked hard on several fronts and its progress shows that continuing present policies will yield further benefits.

British Airways is now one of Europe's most efficient airlines and is in the process of privatisation. Government intervention in the domestic aviation market is much reduced, the liberal licensing policy of the Civil Aviation Authority (CAA) makes entry for new airlines relatively easy. In concert with other measures, there is now a genuinely competitive market for domestic public transport between air, train and coach.

There is wider competition on the transatlantic and Hong Kong routes, while the Government is actively working in Western Europe (both bilaterally and through the EEC) for broader competition, cheaper fares and a better route structure. The Government has reached the stage where it has asked the CAA to hold a review of competition policy.

The Government is also tackling the conflict between the rapidly growing passenger demand and the limited supply of airport space in the south east. An Inquiry has been held into the applications for a third London airport at Stansted and a fifth terminal at Heathrow. and a review initiated into the airport problems of lowland Scotland. Meanwhile, the fourth terminal at Heathrow is nearly complete and the improved West Midlands airport opened. Proposals for a Stolport in London's Royal Docks have been heard at public inquiry.

International Framework

Many countries regard their national airline as much as an object of national prestige as a commercial enterprise and will readily use protection and subsidy to hide any weaknesses. International aviation is conventionally regulated by bi-lateral agreements between Governments under which the rights to fly particular routes are divided between two national carriers and the fares fixed, so minimising competition. At present the only competition faced by many major national carriers is from surface transport which will normally only stand comparison over relatively short distances. This protection is commonly compounded by pooling agreements whereby the chosen airlines divide the revenue from a route between them by the seats flown allowing an airline to earn money while flying a poor service and protecting higher fares.

The disparity between European and American air fares has been one of the roots of British concern about aviation policy for some years. As the attached table shows, few European fares are below 22 pence per mile and few American fares above 16 pence. The International Chamber of Commerce, observing that European air fares are twice those in the USA, could see "No real competition in the price sense". (The Times, 25th April 1984). British Airways' Chief Executive, Colin Marshall, has said "There is no doubt that some fares on some routes are too high" (The Sunday Times, 6th May 1984) while Donald Barr of People Express has argued that the London-Paris fare should be \$25 and London-Geneva \$38.

The airlines argue that smaller aircraft are flown over shorter distances for less hours per day in Europe, specific costs for navigation and landing charges are four to five times higher, costs are rising twice as fast and the routes are uneconomical for historical and defence reasons: the Zurich-Brussels route is 40% longer than the direct distance.

European airlines, however, have a poor productivity record in general and are vastly over-manned by American standards. British Airways having shed 40% of its staff now heads the European efficiency league now with Lufthansa, Swissair, KLM and British Caledonian but an American airline such as Delta is estimated to be 25% better still. The pace is now set by People Express which has taken a well publicised and radical approach to establishing a low cost, low fare structure.

The USA has deregulated its domestic market and Canada, while retaining route licences, is currently decontrolling its fares and promising sympathetic consideration to low cost proposals.

Government Policy

British aviation is an important and growing part of our service sector with air travel growing even faster than motoring and with a volume one twelfth that of rail in 1981. Our airlines carry more international passengers than any country outside the USA while London's airports offer more international scheduled services to more destinations than any other city in the world.

In aviation as in other areas of transport the Government regards the user rather than the provider as paramount and has sought to reduce the framework of regulation where this hampers initiative and enterprise. Mr Ridley has clearly set out the objectives of the Government's civil aviation policy: 'to further the interests of users of air transport services by seeing that British airlines provide services that satisfy all substantial categories of public demand at the lowest charges consistent with a high standard of safety, an economic return to efficient operators, and the sound development of the civil air transport industry of the United Kingdom'. (Hansard 18th November 1983, WA col 584)

Domestic Services

The 1980 Civil Aviation Act abolished the Government's powers of guidance and required the CAA to give greater emphasis to competition between British airlines and to give users' interests equal footing with those of carriers. This policy has been strengthened by the Government support at appeal of licences for several new air services offering travellers a wider choice. There are at present some 20 regular passenger airlines and the Government policy is enabling relatively easy entry to the airline market for competent and financially sound enterprises.

The major development in domestic services was the licensing in 1982 of competing services from Heathrow to Glasgow and Edinburgh where British Midland Airways challenged British Airways' monopoly and won almost a third of the market. This competition has increased passenger traffic on the shuttle services at lower fares - a direct benefit to the public. In August 1983 Genair was licensed to fly between Blackpool and Heathrow, in October 1983 Loganair took over an unprofitable British Airways Edinburgh - Manchester service, in January 1984 Air Ecosse was allowed the Manchester Aberdeen route and Dan Air the Gatwick-Aldergrove route. British Midland Airways now also competes with the British Airways Heathrow-Belfast Shuttle. British Airways has started two Scotland-Jersey routes and has just announced a £69 Heathrow-Aberdeen return to match the shuttles

and compete with British Rail.

EEC Countries

Internal EEC flights are still regulated bilaterally whatever the apparent implications of the Treaty of Rome. Within this structure the United Kingdom has been restricting fares increases on UK - EEC routes to encourage airlines to tailor their costs to the market rather than demanding fares to pay for protected inefficiency. Earlier this year the Government withdrew from the 1967 Civil Aviation Tariff Agreement which demanded Government consent for fare changes.

Negotiations are continuing with Holland both within and about the existing Anglo-Dutch bilateral agreement. Under the present arrangements four airlines have proposed an off-peak £49 London-Amsterdam return fare from 1st July (the cheapest British Airways rate is an Apex return at £87). The British Airways-KLM package would require the ticket to be reserved the day before travelling and may only be used if surplus space is available. If there is no room, the ticket holder must wait for a later flight. There will be a maximum seven-days stay condition. British Caledonian and Air UK are proposing a more liberal scheme under which no advanced booking is required and seats might be reserved.

While the Dutch argued that the independents would have an unfair advantage and should accept the conditions agreed by the state airlines, the Government has just obtained an agreement allowing both sets of schemes. It will enable any airline designated by either Government to fly on any route between Britain and Holland, deciding for themselves the frequency and capacity of their services. Fares will only need the approval of the country where the ticket is sold.

Virgin Atlantic have applied to operate a £20 single fare service from Gatwick to Maastricht.

Once a substantial breakthrough to cheaper fares is made on this front it should serve to encourage other European countries to follow suit rather than deny their citizens the opportunity of cheaper travel. British Caledonian have this week filed applications for cheap fare services to a number of European destinations.

Within the EEC the Commission has drafted Memorandum 2 containing proposals to reduce the level of regulation and pooling. Examining the need for the vast array of rules governing air transport in the EEC, it argues that Governments should only intervene when their national carriers' share of a particular route falls below 25%. Both Governments would have to approve air fares which should be related to costs with a limited (15%) flexibility in the event of disagreement. Pooling agreements should only allow for a revenue transfer of 1% of a route's earnings.

David Mitchell commenting on these proposals said, 'It is clear that they are very modest. Indeed I can already say that they do not go any where near far enough to meet our aspirations to introduce the degree of competition which we believe is desirable if airlines are to provide the varied services which their customers want at prices they can afford.... we shall seek to persuade our partners to adopt a more worthwhile series of measures which will introduce significant liberalisation into European air transport'. (Hansard, 11th April 1984, WA col 213)

As a result at the May Council of Ministers a high level working party was established to prepare proposals for more liberalisation.

British commuter airlines are developing continental services; recent developments include the Venture Airways Coventry Paris service, London European Airways flights from London to Amsterdam and a Connectair service from Gatwick to Antwerp.

Within the EEC, the 1979 initiative of the Conservative Government led to the Regional Air Services Directive being adopted in July 1983. This reduces Government control over scheduled flights by aircraft with not more than seventy seats between regional airports (in the UK this means all airports save Heathrow, Gatwick, Stansted and Luton) although governments will be able to decide which national airlines will be able to fly, they will be unable to refuse another country's service except in certain clearly defined circumstances.

International Services

Following deregulation in the USA a more flexible North Atlantic market has developed with a Memorandum of Understanding allowing operations within bands of fares and short notice changes. Recent developments include the entry of People Express on the Newark - Gatwick route, of Air National on the New York - Belfast - Athens route and the application by Virgin Atlantic to operate a £99 single trans-atlantic service while British Caledonian plans to revive its New York - Gatwick flights in 1985.

British Caledonian and Cathay Pacific are now competing with British Airways on the London-Hong Kong route.

Air routes

The European Air Navigation Group has made proposals for improvements in route alignments which are currently being considered by the International Civil Aviation Organisation. The UK has taken action in advance and last month introduced two week-end routes from Land's End to France and Spain and a new daily route from the Midhurst radio beacon to Dublin.

The CAA Review

Nicholas Ridley announced in December 1983 that he was asking the CAA to conduct a review of competition and licencing policy in civil aviation. The CAA is aiming to present its conclusions by mid July and as part of its extensive consultation published an interim report for discussion in mid April. This report argued the merits of competition as greater innovation, better service, alternative styles management and greater effectiveness in competing with foreign airlines and discusses the difficulties of balancing airports as well as airlines. It suggested that imbalances in the British Airline industry need to be moderated to allow more competition and that there is a case for licensing domestic services more freely still and de-controlling domestic air fares. It discusses British Airways dominant position due to its size and its monopoly of the UK flown international scheduled passenger services from Heathrow and seeks to balance the strength this gives Britain in the international market with the restrictions on opportunities for other British airlines. It suggests that rather than route transfers there be more dual designation of British carriers on international routes with the available capacity such as those to New York, Miami, Toronto and Australia. The dangers of a simple transfer of route monopolies between airlines is that the passenger would receive little benefit while shifting routes to Gatwick could harm Britain's large interlining trade.

The CAA is also conducting a review of its policy on discriminatory fares - reduced fares not available to the general public and only applying to particular groups or individuals. Since 1972 it has generally tried to block new schemes and see old ones withdrawn on the ground that the public which does not benefit has to pay through higher fares.

British Airways

Recognising that there are many airlines, including some of the larger ones, that are privately owned the Government can see no justification for state-ownership of British Airways. Indeed, as Nicholas Ridley has argued: "The best way to make the competition more fair is to have BA in the private sector. We know how much it was able to lose in the public sector, which could have been an anti-competitive measure - although it did not do it for that reason. Privatising BA will bring the same market disciplines to bear on both BA and its competitors" (Hansard, 12th December 1983 col. 690).

Accordingly, the Civil Aviation Act 1980 provided for the sale of shares in British Airways when market conditions allowed. The airline had a poor efficiency record even among European airlines and the effects of the recession on airline travel made an early sale impractical.

Lord King, Chairman since February 1981 has overseen the airline's dramatic increase in efficiency. In 1981-82 British Airways lost £544 million after extraordinary items. Staffing has fallen from 56,000 to 36,000, some 80 ageing or surplus aircraft have been retired or sold, some overseas stations closed, some routes cut and unwanted assets sold. It returned to profit in 1982-83 and in 1983-84 made £268 million before interest and tax. Between March and December 1983 it repaid over £100 million of its £1 billion debt guaranteed by the Government and hopes to pay off another £150 million this coming year. On 1st April 1984 it had a net worth of £126 million having returned to technical solvency. In 1983-84 productivity rose by 9% in available tonne kilometres per employee and freight and mail tonnage rose by 15%.

On 12th December 1983, Nicholas Ridley announced that British Airways would be established as a limited company in early 1984, becoming the successor to the British Airways Board on 1st April 1984 as a Companies Act company and so no longer bound by the British Airways Board Act 1977. The Government will continue to stand behind British Airways debts until flotation which is hoped to be in early 1985, the timing depending on BA PLC's performance, its general prospects and the state of the market.

Both Neil Kinnock in his recent speech to the POEU and John Prescott, Labour's Transport spokesman, have indicated that they would renationalise British Airways. There can be little rational justification for spending the taxpayer's money to buy a commercial enterprise like this while the prospect of state-ownership with the political arguments for doing it can only damage the proper working of the firm.

The Government has said that shares will be available to employees and earlier this month British Airways announced a scheme whereby the profit shares announced last November could be put in trust for share purchase on flotation under the rules for employee shareholdings.

Airports

There are some 50 airports in the United Kingdom which handle regular passenger flights - the British Airports Authority owns seven and most of the remainder are owned by local authorities or the Civil Aviation Authority.

The Government's general policy on airports was set out in 1981: 'To meet the growth and demand for air transport, first, by encouraging the fullest use of regional airports and, secondly, by providing additional airport capacity, as the traffic develops, based on the existing airports in the south east, particularly Heathrow, Gatwick and Stansted. The Government support the provision of air services which enable passengers in the regions to fly from their local airport but reject a policy of seeking to divert passengers with origins and destinations in the south east of England to other parts of the country.' (Hansard, 13th May 1981, WA col 273)

Heathrow handles 16% of the nation's trade and is used by 70 airlines flying direct scheduled services to over 200 destinations. Its capacity will rise next year to 38 million passengers per annum following the opening of the £200 million Terminal Four. While the environmental impact of Heathrow has been reduced in recent years the Government has indicated that on the opening of Terminal Four there will be a ceiling of 275,000 air traffic movements. The present level is already around 260,000 and rising rapidly.

Gatwick has grown from $\frac{1}{2}$ million passengers in 1960/1 to 11 million in 1981/2. Its capacity will be increased once the North terminal is opened but further expansion is precluded by an agreement between the BAA and West Sussex County Council that another runway will not be built in the next forty years. The new half hour rail shuttle from Victoria has made Gatwick more accessible to London.

Stansted which presently handles some 300,000 passengers a year has been selected by the BAA as the most appropriate site to develop the necessary extra airport capacity in the south east. A planning Inquiry has heard evidence on the BAA's plans for an airport handling 15 million passengers a year and linked to London by rail and on the neighbouring district councils' counter-application for a fifth terminal at Heathrow on the Thames Water Authority's Perry Oaks sewage treatment plant.

In Scotland, Aberdeen is one of Europe's fastest growing airports and, due to the North Sea oil trade, the world's busiest heliport. In the lowlands, Prestwick is the designated international airport while Glasgow and Edinburgh are expected to handle shorter haul traffic. Following the Secretary of State's upholding of an appeal against a British Midland Airways route licence from Glasgow to New York a review has been announced of Scottish lowland airport policy, in particular, whether it continues to offer the best means of meeting the area's civil aviation requirements with an assessment of the financial, environmental and social consequences of any changes.

In the docklands area of London an application to build a short take-off and

landing airport (Stolport) to take 50 seater Dash 7 commuter aircraft has gone to public inquiry. The proposal, causing negligible environmental impact, involves building a runway on a pier in the Royal Docks within 6 miles of the City of London. The CAA operates a number of airports in the highlands and islands of Scotland as vital links for these communities with the outside world. All except Sumburgh with its oil trade are loss making: the 1982-83 loss of £3.6 million was recouped from the Scottish Office.

In addition to the Government's 1979 approvals of the new terminals at Heathrow and Gatwick and of expansion of the West Midlands airport, substantial investment has been approved in regional airports. Expenditure of £32.5 million has been allowed for twelve airports in 1984-85.

British Airports Authority

The BAA which runs the airports of Heathrow, Gatwick, Stansted, Edinburgh, Glasgow, Aberdeen and Prestwick handles 75% of air passenger traffic and 85% of air cargo. It is a nationalised industry which has a consistent record of profits and in 1982/3 earned a current cost trading profit of £30.3 million. Employing some 7000 staff it derives half its income from aircraft landing and parking charges and the other half from commercial activities including duty free, catering, car parking and a wide range of concessions. It has financed almost all its considerable programme of capital investment from internal sources.

It is due for privatisation and the Government is currently resolving the best means to do this. In the south east the dominance and attractiveness of Heathrow is so strong (its traffic income is twice that of all the other UK airports and five times that of Gatwick) that on its own it would need severe regulation. Nicholas Ridley has said to the Select Committee on Transport that it is likely that the south eastern airports will be privatised as a block.

JM/SM

INTERNATIONAL AIR FARES 1984:

Economy Single Fares

<u>WORLD</u>				<u>EUROPE</u>			
<u>Route</u>	<u>Distance</u> <u>(miles)</u>	<u>£ per</u> <u>mile</u>		<u>Route</u>	<u>Distance</u> <u>(miles)</u>	<u>£ per</u> <u>mile</u>	
<u>200 miles</u>							
New York - Boston	191	14.6p		London - Brussels	203	40	p
- Washington	203	13.8p		- Paris	209	32	p
Denpasar - Surabaya (Indonesia)	200	16	p				
Sydney - Wagga-Wagga	227	22	p				
<u>300 miles</u>							
New York - Buffalo	292	19.8p		London - Dusseldorf	307	27.3p	
London - Glasgow	349	16.6p					
<u>600 miles</u>							
Pittsburgh - St. Louis	566	21	p	London - Milan	585	28.6p	
Jakarta - Singapore	564	20	p	London - Copenhagen	611	26	p
Brisbane - Canberra	591	18	p				
<u>900-1200 miles</u>							
Brisbane - Hobart	1109	11	p	London - Rome	892	22.8p	
Los Angeles - Oklahoma	1183	7	p	Amsterdam - Bucharest	1108	24	p
Hong Kong - Peking	1212	11	p				
Newark - Houston (People Express)	1415	5	p				

Sources:

Financial Times 12/5/84
 Sunday Times 29/4/84



NBM

19/6

CCPO

Treasury Chambers, Parliament Street, SW1P 3AG

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

15 June 1984

Ree N. d. d. d.

BRITISH AIRWAYS - EMPLOYEE SHARE SCHEMES

Thank you for your letter of 7 June.

I have carefully considered your proposals for free and matching offers of shares to BA employees but am bound to say they are too expensive both in absolute terms and also by comparison with the levels of inducements offered in other privatisations. I am afraid I cannot accept them.

I attach for comparison a table showing some of the relevant figures. You will see that your proposal involves a maximum matching offer over twice the size of anything offered before; that its total cost is likely to be substantially higher as a proportion of proceeds; that the maximum incentive is again over double the size of any previous maximum and the estimated cost per employee (based on the assumptions about take-up in your letter) is £650 by comparison with about £200 for the BT offer.

I recognise you feel constrained by what John Nott said in the House in July 1980. But the following considerations are relevant to how far, after such a long interval, those commitments should be updated:

- John Nott had in mind a sale of only 49 per cent of BA; moreover it has been general practice not to offer further employee share incentives for secondary sales such as those of Cable and Wireless and BP;
- John Nott estimated the total cost of his proposals in 1980 at £6 million;
- British Airways has since that time gone heavily into the red and has had to completely reorganise itself, we are now talking about a quite different sale;

- BA has introduced a generous profit sharing scheme (about which Nigel Lawson expressed reservations from the point of view of its likely impact on privatisation proceeds); under this scheme employees get 10 per cent of pre-tax profits above £150 million, which in 1984-85 should give them some £20 million (worth perhaps £80 million in share proceeds);
- all the pattern of precedents for actual privatisations since 1980 point to much lower incentives; to concede incentives as large as you propose now would undermine the offer being made on BT which has been reasonably well received by the BT unions, and considerably add to the cost of future sales after that.

For these reasons I believe that we must keep the estimated total cost and the cost per employee down to levels, which, in the light of the bonus scheme ought to be below those of previous sales. A total cost figure of the order of that envisaged by John Nott, ie £6 million, would be as much as I would feel was reasonable.

You will have your own views about the appropriate balance to be struck between the free and matching offers. One possibility would be to have only a matching offer on the grounds that the profit bonus scheme replaces the free offer. Allocations under the matching offer might too be limited to a maximum amount (say, £6 million) as they were for British Aerospace. Thus there would be scaling down of any applications by employees in excess of this amount. This would enable the matching offer to be more generous than otherwise while limiting the total cost. (Even so however I doubt whether it would be feasible to make an offer with a maximum as high as £1000).

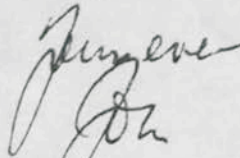
Turning, finally, to your other proposals. I have little difficulty with any of them. Specifically:

Preferential Allotment. I agree with the line you propose to take both on the 10 per cent Stock Exchange limit and on preference for pensioners;

Option Schemes. I agree that BA's proposal to encourage their employees to use their profit bonus to invest in BA shares is attractive. I strongly agree that it would be right for the company to wait until they have private shareholders before introducing their other proposed option schemes. This is very much the line taken on similar proposals in other privatisation. The prospectus can of course reflect the intention subject to shareholders' views.

I am sorry that this letter will not enable you immediately to conclude arrangements with Lord King and let him get ahead with the necessary changes to the profit sharing scheme. The main problem however stems from the statements made in 1980. I do not think we either can or should be bound by these. I hope therefore that you can reconsider your initial views on this matter.

I am sending a copy of this letter to the Prime Minister.

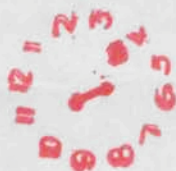


JOHN MOORE

Aerospace Pt 2

future of BA

18 JUN 1984



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	Free Offer	Maximum Matching Offer	Total Cost	Max Incentive P/employee	Actual Cost P/employee
Britoil	£58.5	£400 (1:1)	£0.49m	£458	£247
B. Aerospace	£49.5	£450 (1:1)	£6.54m	£499 (limit of £3.3m)	£ 99
ABP	£59.33	£252 (1:1)	£1.12m	£311	£126
B. Tel	£70	£200 (2:1)	£45m (est)	£470	£196 (est)
EA proposal	£50	£1000 (1:1)	£22.75m (est)	£1050	£650 (est)

CONFIDENTIAL

NBPM
85
13/6

MR TURNBULL

8 June 1984

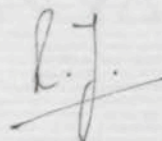
BRITISH AIRWAYS - EMPLOYEE SHARE SCHEMES

CF
By hand → We like Mr Ridley's proposals. (Contrast his crisp approach with that of DTI on Jaguar!)

We think it entirely right to support Mr Ridley's intention to reject the easing of restrictions which BA proposed for Schemes A, B and C. It is difficult to see what benefits BA's intended generosity would procure for the airline, but easy to see that costs would mount and arguments open up.

We strongly approve the idea that the Options Schemes should be put to the new shareholders for ratification.

One point which Mr Ridley does not deal with is whether we want to compel employees who take up free shares (Scheme B) to keep them for a minimum period. The free offer is not a large one per capita, but there could be some embarrassment if employees are seen to profit from the giveaway by selling their shares shortly after receiving them.



ROBERT YOUNG

JMGAAC



BF with Treasury
response ref 7/10

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
Parliament Street
LONDON SW1P 3AG

7 June 1984

Dear Nigel

BRITISH AIRWAYS - EMPLOYEE SHARE SCHEMES

When I made my statement in the House last December about the privatisation of British Airways I confirmed that in line with other privatisations there would be a share scheme for employees. The intention to encourage BA employees to acquire shares had been announced on behalf of the Government in July 1980 by John Nott; I attach the relevant Hansard extract. British Airways are anxious to agree details of their employee share schemes and have submitted proposals to me (details of which are already with your officials); I would like to give BA a prompt response.

GENERAL CONSIDERATIONS

Several of the proposals will involve the Government sacrificing some of the proceeds of the sale. We have therefore to weigh the likely cost of the various items (which cannot be estimated precisely because it depends

on how fully the offers are taken up by employees) against the benefits of employee involvement - which are primarily to give employees a greater incentive to work for the company's long-term future, to reassure other investors by a sizeable employee shareholding, and to establish a body of employees who, with a financial interest in the company, would be less likely to support renationalization if the prospect ever arose. Of course, the more money employees are willing to invest the less we shall have to raise from elsewhere. We also have to honour the commitments made in 1980.

THE PROPOSALS

BA's proposals contain the following elements:-

- A. An offer of free shares to match those purchased by employees.
- B. An unconditional offer of free shares to each employee.
- C. An allotment of shares for the purchase of which employees' applications would take precedence over those from other members of the public ("preferential allocation").
- D. Certain share option schemes.

Our main concern is with A and B above, as these are the elements that will cost the Government money; for C and D our interest is simply that of vendors of the company, in ensuring that what is proposed will not impair the success or the issue or our expectation of proceeds.

I set out below under the above headings how I think we should proceed:

A. The Matching Offer

BA propose that employees be offered one free share for each one they buy, up to a limit of £1,000, so that an employee can buy £2,000 worth of shares for an outlay of £1,000 without being taxed on the free ones; they also propose that any free shares not taken up by eligible employees should be available to other employees up to a further £1,000 each.

From the experience of similar matching offers made in other privatisations, it seems prudent to assume that about 60% of BA's workforce might qualify for up to £1,000 worth of shares. If they all drew the maximum entitlement (which I think is inherently unlikely) that would cost about £21m. At the limit, if every employee bought £1,000 worth, the cost of matching would be £35m but it would be unrealistic to expect that degree of demand. The £1,000 maximum is higher than in other privatisations hitherto. It was however included without qualification in John Nott's announcement in 1980, and I do not think we could offer something less generous now, when the proceeds of the sale are expected to be substantially higher and the number of employees in BA is substantially reduced. That would be seen by BA, its staff, and the public at large as a breach of faith. At the level of takeup which now seems likely it would represent less than 3% of likely gross proceeds - a smaller percentage of proceeds than the 1980 offer was expected to use up

when the announcement was made. However, since the £1,000 is generous compared with other privatisations, I am not disposed to extend the limit in the way that BA suggest by allowing the transfer of unused allocations to other employees.

B. The Free Offer

BA propose that each employee should be offered (without preconditions as to purchase etc) £100 worth of free shares - an offer that, if taken up by all eligible employees, would cost about £3½m. In 1980 John Nott in his announcement promised an offer of "about £50 worth" of shares to each employee. More recently Associated British Ports' employees were offered £60 of free shares each; and BT employees are to be offered £70. There is no precedent for an offer of as much as £100.

Although a case could be made out for offering BA employees the same as employees at ABP or even BT, I am not myself persuaded that we need increase the £50 offer John Nott announced in 1980 (costing about £1¾m).

C. Preferential Allotment

A Stock Exchange rule restricts the number of shares allotted by priority to employees to 10% of the total number of shares offered for sale. BA propose seeking a dispensation from this restriction.

In 1980 John Nott announced that employees would have priority in the allocation of shares during the offer for sale, and I am sure that this is right. Such an arrangement is quite normal in offers for sale generally, and it would cause great surprise if one were not included for BA. However, I am not persuaded of the case for a waiver of the Stock Exchange's 10% limit; my merchant bank advisers, Hill Samuel, are examining the case for this, and I propose to await their advice before deciding whether to support BA here.

I am also being asked whether I would agree to extend the preferential allotment to BA pensioners. My present inclination is to resist this: the main reasons for a preferential allotment apply to present employees rather than pensioners; and though I hope many BA pensioners will invest in BA shares, I cannot see any justification for treating them differently from other members of the public.

D. The Option Schemes

BA have proposed three option schemes: a profit sharing scheme, a Save As You Earn scheme, and an executive option scheme.

For the profit sharing scheme BA want to change their two-year cash profit sharing scheme, announced last November, so that employees can take their bonus tax-free in shares rather than in cash subject to tax. The first bonus due next month would, for those who chose, be paid into a trust and earn interest until

it was used to buy shares in the offer for sale. The shares would then have to be held in trust for them in accordance with the Finance Act provisions. There would be no cost to Government, as the shares would be paid for. For my part I see no reason to object to this proposal. It is of course subject to Inland Revenue approval, and this is already being sought.

Similarly the other two proposed option schemes would be subject to Inland Revenue rules, and apart from that I regard them as primarily a matter for the company. However, I believe that it would be desirable to defer their introduction until the detailed proposals can be approved by the shareholders after privatisation. The intention to introduce them would, of course, have to be explained in the prospectus.

RESPONSE TO BA

I am therefore minded to respond to BA proposals in the following way:-

A. The Government adheres to the £1,000 matching offer for BA employees which it announced in July 1980, but rejects the proposal to extend the offer to allow the transfer of rights from one employee to another.

B. We reject BA's proposal for a £100 free share handout to each employee and stick to the £50 announced in 1980.

C. We approve the proposal for preferential allotment to BA employees (but not to pensioners); but we do not commit ourselves to support BA in seeking a relaxation of the Stock Exchange's 10% limit pending Hill Samuel's advice.

D. We support the modification of the current profit sharing scheme to allow employees to elect to invest their bonuses tax-free in BA shares when available. We also approve in principle the BA scheme for Save As You Earn and executive options, but ask BA to submit them first to their shareholders for ratification after privatisation.

Lord King is pressing me for an early restatement of the Government's position, particularly on A above - the matching shares - because he wants to encourage employees to commit their 1983/84 bonus money, due to be paid later this month, to the purchase of shares rather than take it in cash. This is an aim that I am sure we should support, and I therefore hope that you will be able to give your early agreement to the response to BA that I have proposed above. We have in fact just heard from BA that they must have a decision by 15 June in order to make the necessary arrangements for BA staff to take their bonus in shares.

I am sending a copy of this letter to the Prime Minister.

Tomson
Nicholas

NICHOLAS RIDLEY

[Mr. Nott.]

Although part I of the Bill contains the legislative framework for the change of status to a company on an appointed day, we intend to retain complete flexibility about the timing of the sale of shares.

The international civil aviation market is at present going through a difficult time, due largely to the rapid increase in fuel prices over the last year or so, together with some falling off in demand for air travel. British Airways has not escaped these problems, and the results for 1979-80, which will be announced shortly, will fall considerably below what the board had earlier expected. British Airways continues to face problems in the current year and, as the House will know, the board has developed a plan of action to maximise profits and maintain its competitive position.

The industry faced similar problems before in the mid-1970s, and British Airways showed its ability to recover then. In the past few years, airline traffic has grown at an average of 8 per cent. per annum, and I do not believe that the present difficulties will be long-lived. I am confident that when the market does recover British Airways has the right plans and the right policies to continue to operate profitably and to achieve a successful flotation. The earliest possible date for such a flotation would be the summer of 1981. However, I emphasise again that it is too early to take any decisions. We have no commitment to any particular date, and we shall continue to preserve flexibility on this issue.

Throughout the debates on the Bill, my hon. Friends and the official Opposition have rightly raised many points about the interests of the employees, and in particular about employee shareholding. In my statement on 20 July last year I said:

"special arrangements will be made to enable employees of British Airways to take up shares in the enterprise should they wish to participate in its future and share in its growth."
—[Official Report, 20 July 1979; Vol. 970, c. 2183.]

That is our intention. We believe that the employees should be given the opportunity to acquire a more tangible stake in the company and should be able to do so on favourable terms. We are working out four ways of making employees into shareholders. The principal

offer that we would like to make to the employees of British Airways is to make "two shares for the price of one" available on the same lines as the recent BF offer. The idea is that for every share that an employee is willing to buy at the ordinary offer price, another share will be given to him free, provided the both shares are held by trustees. The value of the free share will then not be subject to income tax. Under the new concessions in clause 46 of the Finance Bill the shares need be held by the trustees only for a minimum period of two years instead of five years under the Finance Act 1978. If the employee decides to withdraw his shares from the trustees and sell them during the next five years, the tax concession is wholly or partially withdrawn.

The Finance Bill also raises the maximum value of shares which can be given to an employee in any one year from £500 to £1,000. I hope that a large number of British Airways employees with more than a qualifying period of service will take advantage of the bargain offer—which could entitle them to a substantial investment of up to £2,000 at about half the offer price to outside shareholders, and with considerable tax advantages in train.

Mr. John Smith (Lanarkshire, North): Perhaps the Secretary of State will be good enough to explain why this announcement, which appears to me to be quite a new matter, was not announced earlier by the Government so that it could have been considered in detail and with care by hon. Members, sitting both as a House and in Committee. It is extremely odd that the Government should produce a new statement at the last gasp of consideration in the House of Commons. I submit that this is not a proper way to treat Parliament.

Mr. Nott: I do not think that that is correct. When the proposals for British Airways employee shareholding were discussed in Committee my hon. Friend the Under-Secretary of State said that the development of our ideas must wait until we saw what my right hon. learned Friend the Chancellor presented in his Budget. We now know that he made two valuable tax concessions available in the Budget to encourage growth of employee shareholdings in general. I thought that it was appropriate to

notice now of this to be help sure why the rig consider it unb news to the Ho slightly lost.

Mr. Smith: obviously does am driving at, responsibility c what the Gove fleeing appear of the various s bon. Gentleman we have spent t sing the matter ounced. In a Secretary of Sta to answer a wr be likes. The this forward at tion in the Ho respect, I believ

Mr. Nott: I c any obligation of what the s might be in th merely thought to the House i right hon. Gen ment on Repc trying to help by giving notice earliest can co the summer of think that he about.

Secondly, the visions for sav schemes in clau are working or advantage of th

Thirdly, we system of prior shares as any scribe for at t would caution too great a p to any one in

Finally, we v a free offer of ployees, whethe eracy or not, of shares per figures and det be worked out pectus, when w

notice now of our intentions. I intended this to be helpful, and I am not quite sure why the right hon. Gentleman should consider it unhelpful to give favourable news to the House. I am sorry, but I am slightly lost.

Mr. Smith: The right hon. Gentleman obviously does not understand what I am driving at, which is that it is the responsibility of Parliament to consider what the Government say. Despite his fleeting appearances during discussion of the various stages of this Bill, the right hon. Gentleman knows perfectly well that we have spent two days on Report discussing the matter since the Budget was announced. In addition, it is open to the Secretary of State to make a statement, or to answer a written question, at any time he likes. The truth is that he has put this forward at the last gasp of consideration in the House of Commons. With respect, I believe that to be wrong.

Mr. Nott: I do not think that there was any obligation to put forward the details of what the share offers to employees might be in the event of a flotation. I merely thought that it would be helpful to the House if I did so now. Had the right hon. Gentleman tabled an amendment on Report—[*Interruption.*] I am trying to help the right hon. Gentleman by giving notice of something which at the earliest can conceivably happen only in the summer of 1981. Therefore, I do not think that he has anything to complain about.

Secondly, the Finance Bill contains provisions for savings-related share option schemes in clause 47 and schedule 10. We are working on an offer which will take advantage of these provisions.

Thirdly, we would intend to have a system of priority allotment for as many shares as any employees care to subscribe for at the full price, although we would caution employees not to commit too great a proportion of their savings to any one investment.

Finally, we would propose also to make a free offer of shares to all eligible employees, whether they subscribe their own money or not, of up to about £50 worth of shares per employee. Naturally, the figures and details for all these offers can be worked out precisely only in the prospectus, when we know the price at which

the shares will be sold and the full financial facts.

All these proposals are within the responsibility of the Government, as the seller of the shares initially, but I am glad to inform the House that British Airways itself intends to work out an employee share ownership and profit sharing scheme for the successor company. This will mean that employees with 10, 20 or more years' service will build up quite a large shareholding in the company.

I hope that the House will feel that I have given enough detail at this stage to make it quite clear that we mean business, and that we intend to play our part in helping the employees of British Airways to identify themselves with the airline's fortunes. After all, British Airways is nothing if it is not about those who work in the airline, from the chairman to the youngest stewardess or most junior clerk.

There are still details to be settled, such as the qualifying period of service and whether there should be an upper ceiling on the total percentage of the shares which might be in the hands of employees, on which we are still happy to receive the views of the staff representatives. I would also be happy, as I have been throughout the progress of the Bill, to discuss this or any other matter with the British Airways trade unions. If they wish to change their position and offer their advice, we shall be glad to receive it and consider it.

~~**Mr. Clinton Davis (Hackney, Central):**~~

~~From the discussions that he has had with the interested parties, has the right hon. Gentleman been able to form an approximate judgment—I cannot ask for more than that—as to the proportion of the shares that are likely to be acquired by or on behalf of the employees?~~

~~**Mr. Nott:** It is impossible to judge that at this stage. We do not know what the profits of British Airways will be at the time. At present, we do not know the timing of the share issue. As I said, we want to keep this flexible. We do not yet know what the price may be. Those are all factors which would be relevant to a decision by the employees as to whether they might wish to put a small proportion of their savings into the airline. I cannot answer the hon. Gentleman's question at this stage. It is simply not~~

File

Prime Minister

LORD KING

Lord King telephoned this morning to let you know that he takes issue strongly with today's Leader in the Daily Mail (copy attached).

The Leader alleges that Lord King has threatened to resign if British Caledonian get a slice of BA's action. Lord King said that they completely distorted what he had said and that this was not true.

MICHAEL ALISON
14.5.84

cc. Andrew Turnbull

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FILE

cc: MR. YOUNG. (6)

10 DOWNING STREET

From the Private Secretary

12 March, 1984

BRITISH AIRWAYS PRIVATISATION

The Prime Minister has seen your letter to me of 5 March and she was grateful for this full report on the CAA review and its likely outcome. She has commented that there is a difficult trade-off to be achieved between privatising British Airways as smoothly and quickly as possible; responding to British Caledonian's pressure; recognising backbench opinion; and respecting the CAA's quasi-independent methods of working. She has noted that a massive publicity campaign by BA could hinder rather than help resolution of these difficult issues.

(Andrew Turnbull)

Miss Dinah Nichols,
Department of Transport

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10 DOWNING STREET

From the Private Secretary

Prime Minister ⁽²⁾

Following your meeting with Lord King, I asked Dept of Transport to comment on Lord King's view that CAA could produce a report which would damage BA and make privatisation much more difficult. The Department's reply is relatively reassuring.

As BA's balance sheet improves under its own efforts, to less hold the Government has on BA to encourage it to shed routes and assets. But equally if BA is privatized without a debt write off / injection of Government funds, the weaker the B Cal case becomes.

Content with this report?

Yes - Thankyou
ms AT 8/3

7 March 1984
Policy Unit

MR TURNBULL

c Mr Redwood

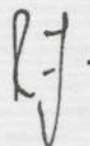
BRITISH AIRWAYS PRIVATISATION

There is undoubtedly a difficult trade-off to be achieved between:

- (i) privatising BA as smoothly and quickly as possible;
- (ii) responding to British Caledonian's clamour;
- (iii) recognising backbench feeling and
- (iv) respecting the CAA's quasi-independent methods of working.

We judge that Nicholas Ridley's tactics for stepping through this minefield are absolutely right (Dinah Nichols' letter to you of 5 March).

Only in one respect would we offer a counter-view. That is that BA should not remain silent in the face of continuing allegations, mainly by BCal, that it enjoys a dominant position which ought to be dismantled before BA is privatised. Certainly BA should avoid being crass - perhaps Lord King's use of the term 'massive publicity campaign' worries Nicholas Ridley. The key points which we think have to come out are that BA is not being privatised with a huge State handout and that its real competitors are not the British independents but a swarm of subsidised State airlines overseas.



ROBERT YOUNG

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a/NO



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

Andrew Turnbull Esq
Private Secretary
10 Downing Street
LONDON SW1

5 March 1984

Dear Andrew,

BRITISH AIRWAYS PRIVATISATION

In your letter of 22 February, recording Lord King's conversation with the Prime Minister you mention certain matters on which the Prime Minister requests information.

The proposal for route transfers from British Airways was made by Sir Adam Thomson, Chairman of British Caledonian Airways, last autumn. He argued that the privatisation of British Airways would confirm a situation of gross imbalance in the UK airline industry; and that if (as he speculated) the Government gave substantial financial help to the restructuring of British Airways' balance sheet, this would unfairly favour British Airways as compared with the existing private sector in the industry.

When Ministers discussed BA privatisation in E(DL), doubts were expressed about the case for route transfers. They noted that the Government had no power to require British Airways to divest themselves of routes - route licensing being a matter for the Civil Aviation Authority. Nonetheless, they noted that there was much sympathy among Government supporters in the House for the points made by the independent private sector airlines about "unfair competition", and, if routes were transferred, the sale of the associated assets might contribute towards the reduction of British Airways' debt. Ministers thought that the possibilities of route transfers should be explored with British Airways, though it should not be suggested that such transfers were a condition of privatisation. The Prime Minister endorsed the conclusions of E(DL) and agreed that my Secretary of State should hold further talks with Lord King on the question of route transfers (your letter of 30 November 1983 to John Kerr). Mr Ridley accordingly asked Lord King

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to consider strengthening British Airways' balance sheet by the sale of assets, including the possibility of voluntary route transfers to British Caledonian (or other independent airlines). In fact it now looks as if BA's balance sheet might conceivably be strong enough through its own efforts - by making profits and by revaluing its assets.

Mr Ridley has also had in mind the wider concern expressed in the House about whether privatisation of British Airways would in itself produce unfair competitive conditions in the airline industry. He believes that if any significant changes in the structure of the airline industry or in the licensing and competition regime within which it operates are to be made, they should be made before BA's privatisation. He therefore asked the Civil Aviation Authority to consider the implications of the privatisation of BA for competition and the sound development of the British airline industry. When Mr Ridley announced this Review in the House in December it was well received. The CAA are now well into the Review and they have promised their report by the second half of July.

Turning to the Prime Minister's first question: the CAA's Review is a formal consultation with the airline industry and users of its services. Insofar as the questions raised involve a review of the Authority's licensing policy, and the Authority conclude that changes are called for which are possible within the statutory framework in the Civil Aviation Act 1982, they will effect these by issuing a revised statement of licensing policy. If they conclude that legislative or other action is called for that falls to the Government rather than to the Authority they will make recommendations to my Secretary of State.

It is at this stage uncertain what recommendations the CAA may make. They will probably not recommend an immediate transfer of routes from British Airways, but rather some change in the criteria for awarding licences (which might or might not require new legislation). If so, the effect of their recommendations would emerge progressively through the operation of the new licensing criteria as applications are received and considered. We do not consider that this would inhibit the sale of BA's shares, so long as the policy and its likely effects are known.

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The Prime Minister asks whether, if the CAA recommended a major reallocation of routes, we should be in the difficult position of either rejecting this recommendation or, by accepting it, of putting the privatisation timetable at risk. If the CAA were to recommend this, or a fundamental change in licensing policy, and the recommendation were accepted, there could be some delay in privatisation; particularly if there were a need for new legislation. Such an outcome is unlikely. It is more likely that the CAA will have regard both to the Government's timetable for flotation and for the need to remove uncertainty about future licensing policy as soon as possible. A more marginal change in the operation of the licensing system in favour of the independent airlines of the kind mentioned above, while being of some help to British Caledonian and the other independents, would be unlikely to call into question the integrity of British Airways' central route structure and their basic profitability. We have to take that risk in order to respond to the Parliamentary concerns. Mr Ridley is keeping closely in touch with the way in which the CAA's thinking develops, and will let you know if things look like going wrong.

Finally, the Prime Minister asks about Lord King's argument that a reallocation of routes between BA and other UK carriers will not affect competition in the industry. The real point is not so much about competition: it is about the imbalance of size between BA and the independents. BA has 83% of the scheduled service output of British airlines. The CAA does what it can to enable scheduled service routes, international as well as domestic, to be operated by more than one British airline in competition, where this can be done profitably and without damage to the UK's share of total traffic on the route. British airlines now compete with one another on the main domestic routes and between London and Hong Kong, between London and Los Angeles, and between London and a number of points in the rest of Europe. But most international scheduled service routes cannot be operated by two British carriers in competition, either because there is insufficient traffic, or because the country at the other end of the route refuses to accept more than one British airline. British Airways' scheduled services could be said to be in competition with foreign airlines on these routes - but it is real competition. If British Caledonian's proposals were accepted they would not be competing directly with British Airways on any more international routes: but they would have a stronger base from which to compete on domestic routes, and in respect of charters. The real question is whether the financial strength of British Airways might be used to crush the independents on domestic routes and charters. The CAA are considering these questions in their review.

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Mr Ridley considers both the substantive issues and the political aspects of this require careful handling. As regards the latter he considers that the arguments about competition are best set out by an independent report by the CAA. The criticism about financial help to British Airways can probably be met by reducing the need for such help to zero. Lord King seems to accept the need for further self-help by the airline. In this it is helpful if during the next few months Lord King is kept guessing about route transfers. Lord King now feels he must seek Parliamentary support against route transfers by a massive publicity campaign. Mr Ridley feels this may well prove counter-productive. The right policy is to await the CAA review, which will give us the authority to take action if action is necessary.

Yours sincerely,

Dinah Nichols

MISS D A NICHOLS
Private Secretary

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BELOSKAUS
Future of B.A.
March 82

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PART

PE 1

ends:-

Lord King to PM 23/2.

PART

PE 2

begins:-

Transport to AT 5/3/84.

