

PREM 19/1666

PART 5

SECRET


Confidential Filing

The Future and Structure of
British Airways.
The Price Waterhouse Report.
CAA Review.

AEROSPACE

Part 1: March 1982

Part 5: February 1986

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
5.2.86		29.7.86					
10.2.86		31.7.86					
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PART 5 ends:-

HMT TO DRN 22.12.86

PART 6 begins:-

TRP TO PS/LPC 6.1.87

WJG



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

Prime Minister 2

David Norgrove Esq
10 Downing Street

DLW

22 December 1986

22/12

Dear David

ROWE & PITMAN REPORT ON BRITISH AIRWAYS

... The Prime Minister recently spoke to the Chancellor about the enclosed press cuttings. I attach a note by Jeremy Colman, which sets out the background. The key point is that the Rowe & Pitman report was killed by Slaughter & May on legal grounds, and not by HMG on policy grounds.

Yours ever,

Tony

A W KUCZYS
Private Secretary

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FROM: J G COLMAN
17 December 1986

CHANCELLOR

Rowe & Pitman Report on BRITISH AIRWAYS

You asked for a note on cuttings from the Sunday Express and the Standard.

2. Both reports are factually accurate but the interpretation placed on the facts by the Sunday Express is quite incorrect. The Standard report is entirely correct as to the reason why the Rowe & Pitman report could not be published.
3. The sequence of events was as follows. When the decision was taken in September to privatise BA early in 1987, Hill Samuel drew up a timetable which envisaged the publication of research reports by three of the four brokers associated with the offer, Wood Mackenzie, Phillips & Drew, and Rowe & Pitman. For obvious reasons the timetable spaced out the publication dates. It put Rowe & Pitman last, just after the publication of BA's interim results.
4. At the time this was done, Slaughter and May expressed doubts about it; they thought that there was a case for verifying to prospectus standards a report by a broker in "the charmed circle" if it appeared in the run up to the offer for sale.
5. It is a matter of judgment how close to the date of a sale a report can be published without verification, and Slaughter and May have a reputation for extreme caution. In the event, it seemed that they did not press the point, and the first two reports were published as planned (not without some grumbling from Slaughter & May).

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6. But when Rowe & Pitman circulated their report in draft, Slaughter & May insisted that it could only be published before the sale if all the material in it had been verified to the standard of the prospectus. Given the length and weight of the report this was clearly impossible in the time. Rowe & Pitman accepted that the report would have to appear after the sale.

7. I think that it is deplorable that a senior analyst in one of the brokers to the offer should talk to the Press about these events, however strongly he personally may have been disappointed by the outcome. After he did so, it is not surprising that a newspaper should put a conspiracy theory interpretation on what they were told. The remark attributed to Hill Samuel's spokesman did not help. The Standard report is helpful in setting the story straight.

J. G. C.

J G COLMAN

THE STANDARD

BA REPORT 'SLAUGHTERED'

SLAUGHTER & May, solicitor to the Government on the sale of British Airways, has advised against the publication of a major report on the airline prepared by its lead brokers Rowe & Pitman, now part of Warburg Securities.

A weekend report which implied that the ban was a result of the opinion expressed in the report was dismissed by the firm as inaccurate.

Rather it appears that the data in the report would have had to be checked to prospectus standards, due to the nearness of the flotation and the connections of the firm with the company. Given that the report took two years to prepare this would have been absurdly costly, and probably impossible in the time available.

Slaughter's advice can be

seen as a further consequence of the internationalisation of markets. It is unlikely that they would have been as strict had the issue been purely domestic.

But the possibility that a large slice of the issue could be sold in America, and the American love of litigation, clearly prompted the solicitors to err on the side of caution.

SUNDAY EXPRESS

23

Eye-of-float rumpus as BA report is grounded

AN astonishing City row has erupted over the banning of an in-depth study of British Airways compiled by Rowe & Pitman, blue-blooded brokers to the Queen.

The study, running to 200 pages and by far the most extensive ever carried out on BA, was to have been circulated to City institutions two weeks ago—shortly after the announcement of the airline's mid-year results which revealed a drop in profits from £201m to £141m.

But suddenly the Government's solicitors Slaughter & May stepped in and told Rowe & Pitman, one of the brokers to next month's share flotation of BA, not to publish the report. Studies of BA by the other two brokers involved in the share offer, Phillips & Drew and Wood Mackenzie, were allowed to be published.

David Freud, the Rowe & Pitman analyst who has spent the last two years on the report, told Iain McKelvie: "I'm very bitter about it—very jaundiced. It was supposed to be the *piece de resistance* on BA. I visited most of BA's overseas locations and interviewed the managers. We have a computer model on all BA's routes which no one else has. My research would have helped would-be investors thoroughly to understand the shares."

Freud's analysis of BA differs from Wood Mackenzie and P & D's in a number of ways.

● His forecast of the profits BA will make in its first year after flotation is some way below theirs—in fact, many millions below Wood Mack's £230m.

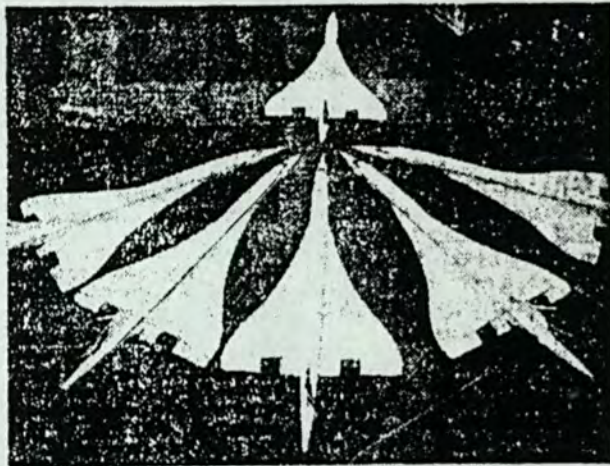
‘I'm feeling very bitter about it—very jaundiced’

● It has pointed to heavy pressure likely on airline fares in Europe next year, which could dent profits.

● It has spotlighted the economics and politics of each of BA's routes including the uncertainties over certain very profitable areas like South Africa. Another high risk it mentions are those services which over-fly the USSR.

Freud says the official reason for the Government gag on his work was that it is "too close to the prospectus and every statement would have to be verified to prospectus standard."

"It's strange they let the other reports go," he says.



BA's Concorde . . . will the flotation be so smooth?

The Government is hoping to float BA for anything up to £1bn—but some experts in the City suggest they will be lucky to get £800m because of the uncertainties over the airline's trading prospects.

Rowe & Pitman and Freud are still optimistic about the flotation and expect it to be a success. The only difference between all three brokers is: How much will it fetch?

So why did the Government really block the R & P study?

The answer is not forthcoming from Hill Samuel, the merchant bankers acting for the Government and, coincidentally, the parent company of Wood Mackenzie. "It was not gagged. It was not banned. It was the view of all concerned that it would be better if it did not come out," said a spokesman.

At Slaughter & May, they said: "We can't say anything, naturally. We can't stop publication—we are simply advisers to the government and we advise in confidence."

At British Airways, where top people are secretly livid that two years close co-operation with Freud should go to waste, they say: "It's nothing to do with us."

What if Rowe & Pitman had gone ahead and published? "Perhaps, it would have hal-

ted the whole issue," says Freud.

There are other factors, too, which could cloud the coming razzmatazz over BA's stock market lift-off. It has emerged that three separate but extremely rancorous disputes are going on between the Government and Spain, Japan and Canada about reciprocal flight arrangements between the respective countries.

With BA's Japan and Far East services being so important to the airline, any lingering argument or action by the Japanese could prove extremely damaging.

3/4





DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 4581

SIR ALAN BAILEY KCB
PERMANENT SECRETARY

Sir Michael Franklin KCB CMG
Ministry of Agriculture
Fisheries and Food
Whitehall Place
LONDON
SW1A 2HH

AN
M.

10 November 1986

Dear Michael,

PRIVATISATION OF BRITISH AIRWAYS -
DISCLOSURE OF PROMOTERS' INTERESTS

I am writing to seek your assistance, and that of a wide range of copy recipients, in identifying and describing any dealings between the Crown and British Airways which we will have to disclose to the Company when shares in British Airways Plc are offered to the public early next year. Similar exercises have taken place before other privatisations, and I understand they worked effectively.

We need to take this action because the Crown is, in law, one of the promoters of the Company and has duties to disclose this information formally to the Company. Sufficient and proper disclosure is needed since otherwise it would be open to the Company, and indirectly its shareholders, to bring proceedings which might result in the rescission of contracts with the Government. Such proceedings could even give rise to Government liabilities to the Company. I am aware that this is a time-consuming task - but I fear it is absolutely necessary. I would therefore be grateful if you would provide information about your dealings with British Airways along the lines set out in Annex 1 to this letter. If there are any questions about the details of this letter, I should be grateful if they could be directed to Lucy Watts (212 5850, Room S5/15, 2 Marsham Street), to whom you might also address your replies.

I would be grateful for your initial response by 26 November, 1986, and for notification of any changes as they occur between then and the issue of the prospectus in January, 1987.

I am sending a copy of this letter to the Permanent Secretaries, Directors and heads of all bodies listed in Annex 3 to this letter. I would be grateful if you and copy recipients would

consider whether there is any associated organisation not listed in the Annex which, to your knowledge, should be regarded as a Crown body and if so to copy this letter to that body, informing this Department that you have done so.

Yours,

Alan

ALAN BAILEY

**PRIVATISATION OF BRITISH AIRWAYS:
DISCLOSURE OF PROMOTERS' INTERESTS**

WHAT NEEDS TO BE DISCLOSED IN THIS TRAWL?

1. All dealings or transactions between the Crown and British Airways during the "promotion period" (starting on 1st September, 1979 and expected to end on 31st January, 1987 - see paragraph 5 below), which are not on standard terms and are so significant that knowledge of them is necessary for a potential investor in British Airways to have in order to make an informed assessment of British Airways at the time of issue of the Prospectus, need to be disclosed. A more detailed description of the dealings and transactions concerned is contained in paragraph 6 below and examples are given in Annex 2.

2. Expenditure by the Crown during the last financial year on all passenger, cargo and other services supplied by British Airways, whether under standard or non-standard terms, also needs to be reported.

DEFINITIONS

3. For this purpose, the Crown has a wide definition. It includes all manifestations of the Crown, except Her Majesty in a personal capacity. In essence the Crown includes all Government Departments. It does not, however, include those public bodies which, by reason of their nature or by statute, are not agents or servants of the Crown; it therefore does not include nationalised industries, or commercial companies controlled by the Government such as The Rover Group PLC.

4. Attached as Annex 3 is a list of bodies each of which we believe is or may be a Crown body, and at Annex 4, a letter sent

from the Management and Personnel Office to the Department of Trade and Industry at the time of the sale of British Telecom, which seeks to define what constitutes a Crown body.

The Promotion Period

5. The promotion period commenced on 1st September, 1979 and it will end on the date of issue of the Prospectus, which until further notice should be assumed to be no later than 31st January, 1987. Prior to 1st April, 1984, the date of vesting by the British Airways Board to British Airways Plc, you should consider transactions and dealings with the British Airways Board.

Non-standard and significant

6. Transactions with British Airways arranged on terms which as far as you are aware are the same as those provided generally for other customers need not be disclosed. In the case of fares, those which are not full fares (i.e. they have not been approved by the CAA) are to be treated as non-standard. All other transactions which are known or believed to be preferential to the Crown should be disclosed in this trawl, unless they are of a sufficiently insignificant nature as not to fall within the category of transaction knowledge of which is necessary in order to make an informed assessment of British Airways. Examples of possible non-standard transactions that may exist between the Crown and British Airways are set out in Annex 2. In order to assess what renders a transaction significant for these purposes, it is suggested that transactions falling within either of the following two categories would be significant:-

- (a) transactions which on any test are material, as far as British Airways is concerned, regardless of the time at which they took place during the promotion period (for example, the Concorde arrangements); or

- (b) transactions which have taken place since 1st April, 1984, therefore covering the last two financial years of British Airways and its current financial year.

7. The extent of disclosure for non-standard and significant transactions depends in part on the facts of each case. In general, both the fact that the Crown is interested in the transactions and any "profit" made as a result of the transaction requires to be disclosed. For these purposes "profit" means any net benefit accruing to the Crown as a result of the transaction and not just a cash surplus, so where the Crown has received some other sort of benefit from the transaction that too must be disclosed. Sufficient details of each transaction should be disclosed in order to enable the buyer of shares in the Company or the Directors of the Company to evaluate the transaction. Where non-standard and significant transactions are identified Lucy Watts (212 5850) in the Department of Transport would be happy to advise on the level of detail that needs to be disclosed.

ACTION REQUIRED

8. (a) Non-standard and significant transactions For such transactions, including any in the categories identified in Annex 2, we need to know essential details. To help simplify the task, I would be grateful if replies could follow the following pro-forma:-

- (1) A statement along the following lines:

"We confirm that, having made due enquiry, this Department [Crown body etc] has had no relationship with British Airways in the promotion period other than:

- (i) the supply of passenger, cargo or other services by, or any other transactions with, British Airways either:-

(a) on standard terms; or

(b) where such services or transactions are not significant;

(ii) the supply of passenger, cargo or other services by, or any other transactions with, British Airways, where such services or transactions are significant, on terms known or believed to be preferential to the Crown, details of which are set out below."

(2) For each item in (ii) above the following information:-

- A Name of Crown body.
- B Name of any other Crown body involved in or associated with this contract or transaction.
- C Relevant date(s) of contracts or transactions - and the date on which the Crown obtain its interest.
- D Description of nature of transaction or contract, including terms which you know or believe to be preferential to the Crown.
- E Any "profit" (see paragraph 7 above) arising from the transaction.
- F Any further details considered relevant.
- G Name, address and phone number of a contact who could supply further details if necessary.

(b) Provision of passenger, cargo and other services whether standard or non-standard significant or insignificant For all

passenger and cargo services and other services (including engineering services) provided to you by British Airways (irrespective of whether or not the terms are special or the transaction is significant), you should complete the following statement:

"We understand that, for the purpose of writing the Prospectus, a reasonably accurate estimate of the revenue received by British Airways from the Crown over the year ended 31st March, 1986 is required. After taking all due care to check on our expenses, we estimate the total expenditure on passenger, cargo and other services provided by British Airways during that year for this department [body, etc] to be £, * ".

POSSIBLE NON-STANDARD TRANSACTIONS BETWEEN
THE CROWN AND BRITISH AIRWAYS

1. Examples include:

- (a) dealings involving the supply of passenger, cargo and other services by British Airways to the Crown on non-standard terms (e.g. not full fares) which are known or believed to be preferential;
- (b) dealings involving the supply of non-airline goods or services by British Airways to the Crown on non-standard terms which are known or believed to be preferential;
- (c) dealings involving the supply of special goods or services to the Crown by British Airways;
- (d) dealings under which the Crown supplies for payment goods or services to British Airways;
- (e) dealings between the Crown and British Airways involving land and/or buildings: this would cover either sale or leases of land and/or buildings.

2. Dealings to be disclosed should include the entering into a contract within the relevant period even though no action may occur under the contract until after the period has expired. It is not necessary to disclose transactions which, although they occur in the promotion period, are in implementation of a contract entered into before that period began.

3. Transactions which merely represent the application of general fiscal or other similar regimes need not be disclosed, eg. the payment of taxes or national insurance contributions.

4. The duty of disclosure arises in respect of any transaction and whether the Crown is, broadly speaking, the supplier or the customer. It is necessary to make disclosure in respect of both sides of any dealing (for example, both payment for goods and services supplied and details of the services supplied) and whether goods and services are supplied to the Crown for its own use or for resale.

CROWN BODIES

ADVISORY, CONCILIATION AND ARBITRATION SERVICE
AGRICULTURE, FISHERIES AND FOOD, MINISTRY OF
AGRICULTURE FOR NORTHERN IRELAND, DEPARTMENT OF
AGRICULTURE AND FISHERIES FOR SCOTLAND, DEPARTMENT OF
ARTS AND LIBRARIES, OFFICE OF
CABINET OFFICE
CENTRAL OFFICE OF INFORMATION
CHARITY COMMISSION
COUNCIL OF TERRITORIAL, AUXILIARY AND VOLUNTEER RESERVE
ASSOCIATION
CROWN ESTATE COMMISSIONERS
CROWN OFFICE, SCOTLAND
CUSTOMS AND EXCISE, HER MAJESTY'S
DEFENCE, MINISTRY OF
DIRECTOR OF PUBLIC PROSECUTIONS, DEPARTMENT OF
DUCHY OF CORNWALL
DUCHY OF LANCASTER
ECONOMIC DEVELOPMENT DEPARTMENT, NORTHERN IRELAND
EDUCATION AND SCIENCE, DEPARTMENT OF
EDUCATION FOR NORTHERN IRELAND, DEPARTMENT OF
EMPLOYMENT, DEPARTMENT OF
ENERGY, DEPARTMENT OF
ENVIRONMENT, DEPARTMENT OF THE
ENVIRONMENT FOR NORTHERN IRELAND, DEPARTMENT OF
EXCHEQUER AND AUDIT DEPARTMENT, NORTHERN IRELAND
EXPORT CREDIT GUARANTEE DEPARTMENT
FAIR TRADING, OFFICE OF
FINANCE AND PERSONNEL, NORTHERN IRELAND, DEPARTMENT OF
FOREIGN AND COMMONWEALTH OFFICE
FORESTRY COMMISSION
GENERAL REGISTER OFFICE, SCOTLAND
GOVERNMENT ACTUARY'S DEPARTMENT
GOVERNMENT WHIPS (HOUSE OF COMMONS)
GOVERNMENT WHIPS (HOUSE OF LORDS)
GREENWICH HOSPITAL
HEALTH AND SAFETY EXECUTIVE
HEALTH AND SOCIAL SECURITY, DEPARTMENT OF
HEALTH AND SOCIAL SERVICES, NORTHERN IRELAND DEPARTMENT OF

HOME OFFICE

INDUSTRY DEPARTMENT FOR SCOTLAND

INLAND REVENUE, BOARD OF

INTERVENTION BOARD FOR AGRICULTURAL PRODUCE

LAND REGISTRY, HER MAJESTY'S

LAW OFFICERS' DEPARTMENT

LORD ADVOCATE'S DEPARTMENT

LORD CHANCELLOR'S DEPARTMENT

LORD CHANCELLOR'S DEPARTMENT, NORTHERN IRELAND

LORD PRIVY SEAL'S OFFICE

MANPOWER ECONOMICS, OFFICE OF

MANPOWER SERVICES COMMISSION

METROPOLITAN POLICE OFFICE

NATIONAL INVESTMENT AND LOANS OFFICE

NHS HEALTH AUTHORITIES - ALL REGIONAL, DISTRICT AND SPECIAL
HEALTH AUTHORITIES

NATIONAL SAVINGS, DEPARTMENT FOR

NORTHERN IRELAND CIVIL SERVICE

NORTHERN IRELAND OFFICE

NORTHERN IRELAND PARLIAMENTARY COMMISSIONER FOR ADMINISTRATION,
OFFICE OF THE

OFGAS

OFTEL

ORDNANCE SURVEY

OVERSEAS DEVELOPMENT ADMINISTRATION

PARLIAMENTARY COMMISSIONER FOR ADMINISTRATION AND HEALTH SERVICE
COMMISSIONERS, OFFICE OF THE

PARLIAMENTARY COUNSEL

PAYMASTER GENERAL'S OFFICE

POPULATION CENSUSES AND SURVEYS, OFFICE OF

PRIME MINISTER'S OFFICE

PRIVY COUNCIL OFFICE

PROPERTY SERVICES AGENCY

PUBLIC RECORD OFFICE

QUEEN'S HOUSEHOLD, THE

RATING OF GOVERNMENT PROPERTY, DEPARTMENT OF

REGISTRY OF FRIENDLY SOCIETIES

ROYAL HOSPITAL CHELSEA

ROYAL MINT

SCOTTISH COURTS ADMINISTRATION

SCOTTISH OFFICE
SCOTTISH DEVELOPMENT DEPARTMENT
SCOTTISH EDUCATION DEPARTMENT
SCOTTISH HOME AND HEALTH DEPARTMENT
SCOTTISH RECORD OFFICE
SPECIALISTS AND TECHNICAL CO-OPERATION OFFICERS, CORPS OF
STATIONERY OFFICE, HER MAJESTY'S
STATUTE LAW COMMITTEE, NORTHERN IRELAND
STATUTORY PUBLICATIONS OFFICE
TRADE AND INDUSTRY, DEPARTMENT OF
TRANSPORT, DEPARTMENT OF
TREASURY, HER MAJESTY'S
TREASURY SOLICITOR'S DEPARTMENT
WELSH OFFICE



MANAGEMENT AND PERSONNEL OFFICE
70 Whitehall
London SW1A 2AS
Telephone 233 8389

CABINET OFFICE

Machinery of Government Division

Mr C Bridge
Room 511
Department of Trade and Industry
1 Victoria Street
LONDON SW1H 0ET

21 February, 1984

Dear Charles,

DEFINITION OF "CROWN SERVICE"

1 You phoned to ask whether we could provide a list of bodies which perform their functions under the Crown. If I understood you correctly, you need this because the "Crown" is to be a promoter for the flotation of British Telecommunications shares, and a legal requirement is that the prospectus should spell out any interests of the promoter in the business.

2 I explained that it is not possible to provide a definitive list of Crown bodies. "The Crown" is a concept rooted in antiquity, whose significance has changed over time, and which rests on a combination of Prerogative and statutory powers, and interpretation by the Courts. Accordingly, it would be easier for us to start at the other end, by considering which of a list of BT's customers are Crown bodies. However, given that you are unable to provide such a list, I promised to send some guidance.

3 Generally speaking the Courts regard the Crown as representing the "sum total of Government powers", that is, as synonymous with the Executive. Accordingly the Crown includes:

- a) the Royal Household;
- b) Ministerial offices covered by the Ministerial and other Salaries Act 1975;
- c) the Armed Forces; and
- d) Government Departments operating under the direction of Ministers. (This concept has been modified by the practice over recent decades of conferring statutory functions on bodies outside the traditional structure of Government Departments.)

4 Legal opinion is that all bodies included in Schedule 2 to the Parliamentary Commissioner Act, 1967, and in the list published by the Minister for the Civil Service in pursuance of S.17 of the Crown Proceedings Act 1947, perform their functions under the Crown. Other bodies regarded as Crown bodies on the basis of express statutory provision or legal advice include the following:

The Royal Hospital, Chelsea
Greenwich Hospital Department
Cabinet Office
Lord Advocate's Department
Office of the Parliamentary Counsel
Office of the Paymaster General
Prime Minister's Office
Privy Council Office

Parliamentary Commissioner for Administration
Northern Ireland Civil Service
Northern Ireland Court Service
Corps of Specialists and Technical Cooperation Officers
Council of Territorial, Auxiliary and Volunteer Reserve Association
NHS Health Authorities
Overseas Civil Service (constituted on 1.10.54 under Special Regulations
by the Secretary of State for the Colonies)
Metropolitan Police (but not other police authorities)

It follows from what I have said earlier that this is not an exhaustive definition;
I hope that, nevertheless, it is of some help.

Yours sincerely
Helen Leiser

HELEN LEISER



PRIME MINISTER

John Moore discussed with me this afternoon his thinking on the tactics for pushing forward our campaign for introducing more competition and consumer choice for airline passengers.

A UK Presidency compromise will be discussed at a Transport Council early next week. The French are proving difficult, and will, John Moore thinks, block any agreement (though David Williamson is not so sure).

If agreement is blocked, the question arises of what to do then. In particular, John Moore is wondering whether you should be involved and make this a big issue at the Anglo-French Summit and at the European Council in December. His inclination is not to involve you at this stage.

His reasoning is as follows. The UK Presidency compromise on airline deregulation is a fairly weak one. Already, the consumer lobbies, such as 'Which', are castigating John Moore for weakness, arguing that the outcome will not bring much benefit to the airline passengers. You would thus be espousing a Presidency compromise in which we have not got much faith. Far better, according to John Moore, for you to keep your powder dry until after our Presidency and then weigh in on the side of a really good package which brings real benefit to the airline passengers.

I told John Moore that I thought that you would agree with his tactic. (David Williamson told me that he certainly does).

N.L.W

N. L. Wicks

7 November 1986

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CC PG



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NW K HED
←

SECRETARY OF STATE FOR TRANSPORT

European Community Aviation Negotiations

1. Thank you for your letter of 5 November about how we should handle EC negotiations on air transport liberalisation over the next few weeks.
2. I agree that at the 10-11 November Transport Council we need to make clear to our partners that the Presidency's compromise package really does represent the UK's bottom line. In the light of what happens at that meeting we shall need to decide our tactics at the European Council. We certainly should raise the issue at the Anglo-French summit if French Ministers appear to be going back on earlier positions.
3. I am copying this minute to members of OD(E) and to Sir Robert Armstrong.

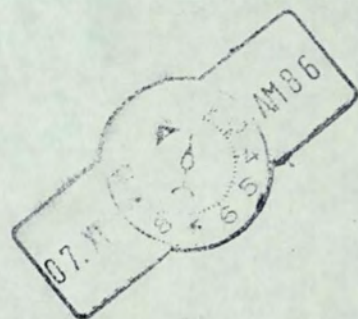
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(GEOFFREY HOWE)

Foreign & Commonwealth Office

7 November 1986


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CEB



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DWS
20/10

PRIME MINISTER

W

BRITISH AIRWAYS PRIVATISATION

You and colleagues will wish to know that I plan to announce on 21 October important details of the offer for sale for British Airways. I shall give an arranged Parliamentary answer, and shall be holding a press conference at 3.30 pm. This, combined with a flight for journalists on Concorde beforehand, should ensure good coverage. I attach for information a copy of the proposed Parliamentary answer.

I should also like to take this opportunity to remind colleagues that now that the marketing campaign for the sale of British Airways has started, and will, I believe, generate considerable public interest, many of us are likely to be asked questions about the company or the flotation. Unguarded or inaccurate comments, or answers to any questions, could have very serious consequences for the flotation and in some circumstances could make it necessary for there to be a delay in the flotation itself. I therefore hope that wherever possible my colleagues will try to sidestep such questions. My Department will, of course, provide briefing where this is requested, and it will be most important in those circumstances to keep carefully to the wording of the brief.

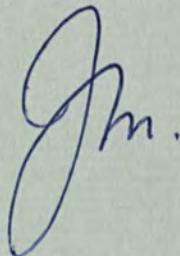
It may not always be possible to avoid all comment, and if such instances arise, it is most important that we all observe the following guidelines:

- i) anything said about the share offer, BA itself or BA's trading environment must be factual, accurate and fair;

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- ii) no opinion should be expressed, and no predictions made, about the prospects for the shares or for BA's business or about BA's competitors or the aviation industry generally (beyond, of course, whatever forecasts are set out in the prospectus and even these statements must be set in context);
- iii) enquirers should be urged to obtain their own copies of the prospectus, once this has been published, and to make up their own minds after reading it. No statements should be made which could be interpreted as an inducement or recommendation to buy BA shares.

I am copying this minute and attachment to all members of the Cabinet, and to the Chief Whip: I should be grateful if they would circulate this guidance to junior Ministers in their Departments. A copy also goes to Sir Robert Armstrong.



JOHN MOORE

20 October 1986

Question

To ask the Secretary of State for Transport whether he will announce details of the offer for sale of British Airways.

Draft Answer

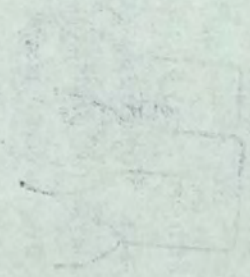
As I announced on 11 September the Government has decided to sell its shareholding in British Airways in the early weeks of 1987. The offer will be payable in two instalments. I am delighted that it will now prove possible to free the company from the constraints of Government control and to enable the employees, customers and members of the public to take a real stake in its future.

The flotation will provide a further major opportunity to strengthen the basis of individual share ownership in this country. I therefore intend to build on the success of previous privatisations by publicising details of the offer for sale and of how to apply for shares widely in the press and on television. A Share Opportunity Office has been established to register enquiries and despatch information about the company and the offer for sale. British Airways' senior management will be touring the country extensively to promote the issue, and to assist in this process I have selected regional co-ordinators for the whole of the United Kingdom. To foster the commitment of the new generation of shareholders, a small portion of the equity will be retained to enable a loyalty bonus to be paid to those initial purchasers who retain their holdings continuously for three years. One free share will be offered for ten, up to a maximum value of £5,000 of shares initially purchased.

I recognise and want to pay tribute to the management and staff of British Airways whose efforts have made it possible to look forward to a successful flotation. It is right that they should have a special opportunity to take a stake in the company's future. I have accordingly decided that they should have the opportunity to acquire free, matching and discounted shares on broadly the same terms as British Gas employees.

Finally, British Airways is an international business and it will benefit both its commercial interests, and the Government's as vendor in maximising demand if a limited portion of the equity is allocated to overseas markets. The Government already has an adviser on the US market. I have decided in addition to appoint advisers on the European, Japanese and Canadian markets. Final decisions on which, if any, of these markets to use and the size of any overseas allocation will not be taken until close to the start of the offer period. I would not, however, envisage that the allocation to overseas markets will exceed 20%.

I am placing details of my announcement on 11 September, the regional co-ordinators selected, the terms of the preferential share offer to employees, and the advisers to overseas markets in the Library.



010

RESTRICTED

ce/c



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

01-212 3434

Charles Powell Esq
10 Downing Street
LONDON
SW1

*Don to see
NBEM CDP
18/9*

17 September 1986

Dear Charles,

UK/CANADA AIR SERVICES

You will wish to know that our negotiators acted on the instructions confirmed by your letter of 15 September. The Canadians had nothing new to say about the air services dispute, and we therefore had no choice but to tell them that steps would now have to be taken through diplomatic channels to terminate the Agreement. Instructions have already been sent to the British High Commission in Ottawa, who are expected to act on them within the next day or two.

Mr Spicer will be visiting Ottawa on 26 September, and will take that opportunity to confirm to the Canadian Minister of Transport, and publicly, our willingness to engage in constructive negotiations for a new Agreement in good time before the 12 months period of notice expires.

I am sending copies of this letter to Robert Culshaw (FCO), Alex Allan (Treasury), Tim Walker (DTI) and Michael Stark (Cabinet Office).

*Yours,
Richard.*

R A ALLAN
Private Secretary

RESTRICTED

THE UNIVERSITY OF CHICAGO
DIVISION OF PHYSICAL SCIENCES



CONFIDENTIAL

18

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le ve
PC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 September 1986

UK/CANADA AIR SERVICES

The Prime Minister has noted the Transport Secretary's minute of 11 September about our efforts to resolve the dispute over air services with the Canadian government. She agrees that, if it is impossible to find a satisfactory basis for agreement as a result of next week's talks with the Canadians, we should give notice of termination of the Air Services Agreement.

I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and Sir Robert Armstrong.

(CHARLES POWELL)

Ms Vivien Life,
HM Treasury.

CONFIDENTIAL

BM

✓ CFC ①
COP



PRIME MINISTER

*I should have thought
the threat would be
enough to
secure rejection
no*

*Prime Minister
Agree that we
should if necessary
give notice to
terminate this agreement?*

UK: CANADA AIR SERVICES

We should try to resolve the dispute about air services with the Canadians, now that the immediate problems with the US are settled.

*COP
12/9*

The brief on air services prepared for your meeting on 13 July with the Canadian Prime Minister outlined our current problems with Canadians. The present arrangements are very disadvantageous to British Airways. I felt at that time that termination of the Air Services Agreement, followed by a completely new negotiation, seemed to be the only way forward.

But I was prepared to accept the advice of our High Commission in Ottawa, which was endorsed by the Secretary of State for Foreign and Commonwealth Affairs, that we should give negotiation one more try. It was agreed that if this failed, or if the Canadians played for time, I should terminate the agreement.

The talks scheduled for late July to discuss proposals made earlier by my officials were postponed by the Canadians. They have since rejected those proposals, and have counter-proposed a meeting on 16 September to discuss their own alternative ideas. We have agreed to meet the Canadians. But on the basis of the two rounds of talks held earlier this year I frankly doubt that the Canadian Government will come forward with any ideas which will be acceptable to us. This is confirmed by recent messages from our High Commission in Ottawa.

I propose that my officials should start next week's talks with a real attempt to see if a basis for agreement exists.



If it does not, I propose to give immediate twelve months' notice of termination of the agreement. This dispute has been going on for too long, and it is time that we settled it. Termination may be the only means to get serious negotiations started, and I should like to authorise my negotiators to use it if necessary.

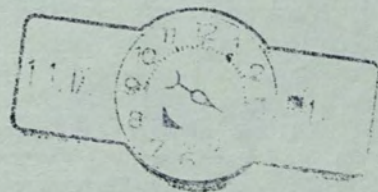
I have considered the implications for British Airways privatisation and have consulted my banking advisers. I am satisfied that termination would not cause difficulties. The market is, of course, much smaller than the UK/US market, and the present arrangements are clearly disadvantageous to BA.

I should be grateful to know, if possible by close of business on Monday 15 September, whether you are content for me to proceed in this way.

Copies of this minute go to the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and Sir Robert Armstrong.

JOHN MOORE

11 September 1986



CONFIDENTIAL

cejs



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

11 September 1986

cc B/T
and px

Dear David,

BRITISH AIRWAYS PRIVATISATION

Following the agreement of MISC 112 yesterday afternoon that British Airways should be privatised in January/February of 1987, my Secretary of State circulated to members of the Committee a draft announcement. The Committee was content.

/ I enclose, for information, a final draft press notice which my Secretary of State proposes to issue at 2.30 this afternoon. Some changes have been made to para. 3 which do not alter the substance but refer to the outcome of the US negotiations in terms which are more helpful for our future dealings with the Americans on air services.

Copies of this letter and the enclosure go to the Private Secretaries to members of the Cabinet, the Chief Whips of the Commons and the Lords and to Sir Robert Armstrong.

yours ever

PP. RICHARD ALLAN
Private Secretary

CONFIDENTIAL

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FINAL DRAFT PRESS NOTICE (FOR RELEASE 14.30 11 SEPTEMBER 1986)

JOHN MOORE TO PRIVATISE BRITISH AIRWAYS EARLY NEXT YEAR

John Moore, Secretary of State for Transport, today announced the Government's decision to privatise British Airways in the early weeks of 1987. This is the first opportunity for a major privatisation after the flotation of British Gas which is expected to be sold in November. He said:

"I am delighted to say that the way is now clear for a successful flotation of British Airways.

"The major uncertainties caused by negotiations on the air service arrangements between the UK and the USA are now resolved. We have negotiated with the US Government satisfactory and more liberal arrangements for determining the frequencies to be operated by the airlines of both countries. I am satisfied that anti trust issues need no longer delay the flotation.

"British Airways aims to be the best and most successful airline in the world. This can only come about if it is free from the constraints of public ownership. This will soon be achieved.

"This is good news for the airline. It is also good news for its employees, its customers and the public all of whom will now have the opportunity of taking a real stake in its exciting future."

CONFIDENTIAL

COMMUNICATIONS





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P 02224

From: J B UNWIN
10 September 1986

MR NORGROVE - No 10

JBM

BRITISH AIRWAYS PRIVATISATION

I understand from the Department of Transport that, subject to confirmation later this morning that the documents have actually been initialled, a satisfactory capacity agreement has been reached with the Americans in Washington. In essence, it amounts to a roll over for at least 3 years of the old capacity control mechanism (Annex 2 of the Bermuda Agreement) and, according to the Department, represents a better deal than the one the Americans rejected in August.

2. This means that, subject to the formal confirmation referred to above, the Transport Secretary will this afternoon recommend privatisation of British Airways next January.

J B UNWIN

Cabinet Office

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10: (mirrored text) 1866

1866



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CCB/CP

P 02221

PRIME MINISTER

British Airways Privatisation

MISC 112(86)2, 3, 4 and 5

CONCLUSIONS

You will wish to decide:-

(i) whether to go ahead with privatisation of British Airways (BA) in January 1987 (for this to be possible requires a firm decision by the end of this month);

(ii) if not, whether to bring forward the privatisation of the British Airports Authority (BAA) from June 1987 to next January, and to defer the flotation of BA to next June (leaving Rolls Royce, as at present planned, to come forward next April.

BACKGROUND AND MAIN ISSUES

2. Because of difficulties first with anti-trust litigation in the US, and subsequently in the negotiation of new arrangements to regulate capacity on US/UK air services, there have been extensive delays in the Government's plans for the privatisation of BA. The latest position reached on UK/US air services negotiations, on BA's residual anti-trust liabilities, and on the financial aspects and timing of the flotation are covered in the Transport Secretary's separate papers MISC 112(86)3, 5 and 4.

Air Services Capacity

3. Annex 2 to the Bermuda 2 Agreement, which regulates capacity on US/UK air routes, expired on 23 July. It has not proved possible to reach agreement with the US on new principles for the regulation of air services capacity; the US would really prefer a situation in which there were no restraints, and their airlines were free to exploit to the maximum the competitive advantage they have through the exclusion of UK airlines from internal US routes. They have, however, eventually accepted that the resulting situation would not give UK airlines the 'fair and equal opportunity to compete' provided for in the main Bermuda 2 Agreement, and have offered to renew the previous capacity control arrangement for a further three years, subject to certain modifications. Negotiations on this are currently in progress in Washington, and the Transport Secretary will need to make an oral report on their progress; success is by no means guaranteed, but the prospects are a good deal better than they were a few weeks ago.

Residual Anti-Trust Liabilities

4. Last Summer the difficulty of making a sufficient disclosure in the flotation Prospectus without precipitating further litigation in the US which could have cost £100s of millions made it impossible to go ahead with privatisation. Since then the settlement at little cost of the 'class action' arising out of the Laker liquidation, together with the dismissal of two further suits mounted by Mr Beckman (Laker's erstwhile counsel) have reduced BA's potential further anti-trust liabilities to the point where the legal advisers can now recommend as sufficient a Prospectus text which effectively relies on the £25 million provision already published in BA's 1985 Accounts. The four-year statute of limitations together with progress with BA's anti-trust compliance programme, including their document control programme, provide further assurance that potential anti-trust liabilities have been reduced to manageable proportions.

Although there may be appeals in Beckman's two further cases, the Attorney General is now satisfied that it would be prudent and proper for the flotation to go ahead on the basis of the Prospectus text attached as Annex 1 to MISC 112(86)5. In view of this, there is no point in further consideration of devices - none of which overcome the Prospectus disclosure problem - to separate the residual anti-trust liabilities from the business to be privatised.

Financial Questions and Timing

5. The fall in the value of the dollar, combined with the perceived threat from international terrorism, led to a marked decline in transatlantic passenger numbers earlier this year. As a result, BA forecast pre-tax profits of only £125 million, for 1986-87 as against a budgeted profit of £205 million and last year's pre-tax profit of £183 million. More recently, however, traffic has shown substantial recovery, with revenue now running only 4-5 per cent below budget. Inevitably this means that the proceeds from the privatisation, currently estimated at £700-800 million, will be substantially less than had earlier been expected. Moreover a January flotation would have to be on the basis of forecast rather than actual results for the current financial year; the fact that a safety margin always has to be allowed to ensure that the actual results do not fall below the forecast tells in favour of a June rather than a January 1987 flotation, other things being equal. Furthermore a later flotation would give time for evidence to become available of renewed traffic growth in the first half of 1987 - if such growth actually materialised.

Present Privatisation Plans

6. Present privatisation plans provide for the two air transport nationalised industries (BA and the British Airports Authority (BAA)) to be floated in January and June 1987, with Rolls Royce coming forward in April. BAA's is a much steadier

business, not subject to the currency and other fluctuations which have affected BA this year. There is nothing in BAA's business which would lead to expectations of substantially higher proceeds in June than in January 1987. The market/political argument put by the Transport Secretary in paragraph 4 of MISC 112(86)2 in favour of going ahead with BA in January tells in principle equally in favour of BAA on that timescale. In favour of giving the earlier slot to BA are the considerations that the earlier delays have increased the political 'visibility' of this issue, and that further delay might lead to the loss of senior managers essential to the Company's continuing commercial success. You will recall the severe criticism of the Government when the previous Transport Secretary announced postponement in March, and the general scepticism about the reasons given for that postponement.

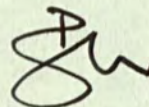
OVERALL BALANCE OF THE ARGUMENTS

7. City opinion is clear that privatisation of BA cannot go ahead until the question of air services capacity has been resolved. If negotiations cannot be completed successfully within the next few days, privatisation will have to be postponed at least until June 1987, subject to further consideration of the position in the light of continuing negotiations on air services capacity and BA's future financial performance. Unless the Trade and Industry Secretary takes the opportunity to argue that Rolls Royce should have precedence over BAA, BAA would then fill the January 1987 slot. Anti-trust is no longer a problem for BA. The only immediate question is the specific decision whether to allocate the January 1987 slot to BA or to BAA. Leaving aside questions about political timing and the overall evolution of the UK economy and UK financial markets, the strictly financial arguments would seem to favour waiting until June 1987 for BA: more time would be available for market preparations, the Prospectus would be based on actual rather than forecast 1986-87 results, and some credit could be secured from evidence of renewed traffic growth if it materialises. In the case of BAA,

by contrast, there are no reasons to expect higher proceeds in June than in January. But Ministers may nonetheless feel that political and managerial considerations in favour of privatising BA at the earliest possible date are overriding.

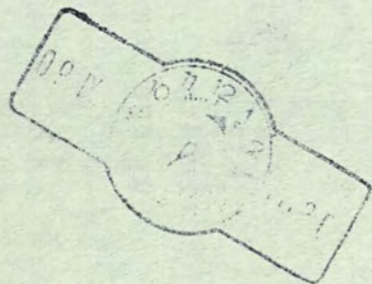
HANDLING

7. You will wish to invite the Secretary of State for Transport to introduce the discussion, and to report on progress in negotiations with the US on air services capacity. The Chancellor of the Exchequer will wish to contribute on the financial and timing aspects of the decision, while the Attorney General will need to advise on the legal considerations. The Secretary of State for Trade and Industry (not least from the standpoint of his responsibility for the privatisation of Rolls Royce), the Secretary of State for Foreign and Commonwealth Affairs and the Chancellor of the Duchy of Lancaster will all wish to contribute to the discussion.



J B UNWIN

Cabinet Office
9 September 1986



CONFIDENTIAL

5 September 1986

BA PRIVATISATION

The problematic, highly-publicised history of BA privatisation, the Government's repeated intention to proceed at the first available opportunity, and the corresponding assurances to BA's frustrated management mean that we should go for a January 1987 launch unless the case against is compelling.

Is John Moore right to conclude that the only factor which is sufficiently compelling to justify the further postponement of BA privatisation would be the unsatisfactory outcome of next week's negotiations with the US Government over the North Atlantic air services regime?

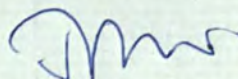
He is certainly right to conclude that the residual anti-trust liabilities are no longer a constraining factor; likewise the influence of timing on the prospects for higher proceeds from the flotation.

Reluctantly we concur with the Department of Transport as regards the hazards of proceeding with BA privatisation if the negotiations over the North Atlantic air services regime have not been satisfactorily concluded.

What is at stake is the credibility of the Government's successful privatisation programme in the run-up to the election. There is every promise that British Gas privatisation will be a resounding success. The public memory is short. The last thing we want to do is to mar that success by following it with a damaging flop, especially when there are two other candidates - BAA and Rolls Royce - of similar scale and at least as much merit.

Conclusion

We would support the line proposed by John Moore.



JOHN WYBREW

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CONFIDENTIAL

CC BSG



Foreign and Commonwealth Office

London SW1A 2AH

19 August 1986

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Dear Jon,

UK/US Air Services

Thank you for your letter of 14 August to Robert Culshaw. We are glad to know that DTp officials are assessing the options open to Ministers if the Americans decide not to accept the ideas put to them last week after the failure of the Annex 2 negotiations, ^{WITH TLP?}

I assume that your officials will be consulting ours before recommendations are put to Ministers.

I am copying this letter to the recipients of yours.

Yours Sincerely,
Colin Budd

(C R Budd)
Private Secretary

J Cunliffe Esq
Private Secretary
Department of Transport
2 Marsham Street
LONDON SW1P 3EB

CONFIDENTIAL

C O N F I D E N T I A L

ECBG
CJL



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

Robert Culshaw Esq
Private Secretary to the
Secretary of State for Foreign &
Commonwealth Affairs
Foreign & Commonwealth Office
Downing Street
LONDON SW1

Prime Minister

JF 15/8

14 August 1986

Dear Robert,

ms

UK/US AIR SERVICES

In his letter of 30 July to the Foreign Secretary, my Secretary of State reported the limited progress made in the negotiations which had just taken place in Washington, and undertook to report to colleagues again after the further round which had been arranged to take place in London in mid-August.

These further negotiations were held between 11-13 August, but he has to report that no agreement was reached. Our negotiating team stretched to the limit the brief Ministers had agreed in MISC 112 but to no avail. The US side are still thinking about the final positions we put to them, and they may yet come round, but we cannot rely on that. In the circumstances the Secretary of State has instructed officials here to proceed urgently with a full assessment of the alternative options sketched in the paper he circulated to MISC 112 on 7 July, so that Ministers can decide in September what further steps to take in relation to the privatisation of BA.

I am copying this letter to Charles Powell, to the other Private Secretaries of Members of MISC 112 and to Michael Stark.

Yours Sincerely,

Jon Cunliffe.

JON CUNLIFFE
Private Secretary

C O N F I D E N T I A L

Future of BA: AEROSPACE

P45



CLB



CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE
DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215) 5144
GTN 215)
(Switchboard) 01-215 7877

From the Minister for Trade

Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

14 August 1986

WJM

John Moore

CHOICE OF ENGINES FOR BA'S 747-400'S

Thank you for sending Paul Channon a copy of your minute of 13 August to the Prime Minister. I am responding in his absence on leave.

I think he would have wished to record more clearly the misgivings which he has concerning both the guarantee of asset value and the performance bond which have been offered by Rolls-Royce. As you note, both these features carry implications for the capital injection which Rolls-Royce will require at privatisation. But the requirement for a performance bond also carries substantial risks: not just commercial risks (most obviously in respect of RR's future sales negotiations), but also the risk of adversely affecting potential investors' perception of Rolls-Royce if the impression was to be gained that the request for a bond implied a lack of confidence in Rolls-Royce's future. This could have an adverse effect on RR's share price. It must also be said that Samuel Montagu have expressed the view that a performance bond offers little real additional protection to BA, though I believe that Hill Samuel take a different view. However, despite the risks and despite the likely cost to Government implied by Rolls-Royce's offer, Paul Channon concluded that in the circumstances he would not wish to press these misgivings.

You minute touched finally on the subject of public announcements about this order. The terms of discussion about these arrangements will require careful handling to minimise potential damage to Rolls-Royce's position. As far as immediate announcements are concerned, I hope it will be possible to avoid any reference to the

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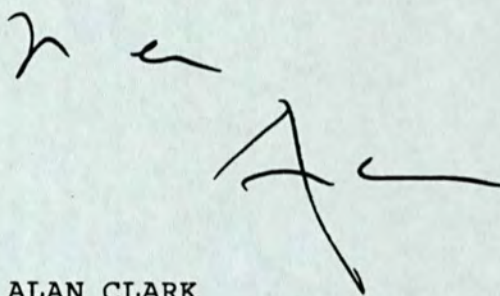


Rt Hon John Moore MP

August 1986

performance bond, though I agree that if the subject comes up, the response should be along the lines you suggest. In the longer term there will be questions relating to possible disclosure of certain aspects of the contract in both BA's and RR's prospectus and accounts, and I believe it will be essential to have the closest consultations between all concerned to ensure a consistency of approach in a situation where the immediate interests of the parties may be expected to show some divergence.

I am copying this to the members of E(A) and Sir Robert Armstrong.


ALAN CLARK

CONFIDENTIAL

CFBS



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

NSP

14 August 1986

Dear John

Choice of Engines for BA's 747-400s

col King

I have seen a copy of your minute of 13 August to the Prime Minister.

There are clearly many attractive features in the deal which BA and RR have been able to reach, and I do not dissent from your proposal to approve the investment or, on balance, with your view of the overall outcome. I would, however, like to make some comments on the disadvantages which the proposals involve.

If there were no prospect of BA leaving the public sector, I think we would need to think very carefully indeed about the terms of the lease. Unconventional finance for public sector investment nearly always involves additional costs by comparison with outright purchase. In this case, I understand that those costs may be equivalent to about 6 per cent of the total capital costs involved which amounts to a substantial sum in absolute terms. We therefore need to consider the justification for agreeing to a lease. In my view it would not be enough to point to the advantages to privatisation of having this investment financed off BA's balance sheet. The strong argument is that BA themselves see commercial benefit in the terms of the lease, particularly as regards the flexibility to return aircraft after 5 or 9 years and that point should be added to those mentioned in the last full paragraph of your minute about presentation.

I am of course pleased that Lord King has now firmly accepted that there will be no need for a capital injection into BA. But I am concerned at the prospect of our having to make a larger capital injection into Rolls Royce than we might

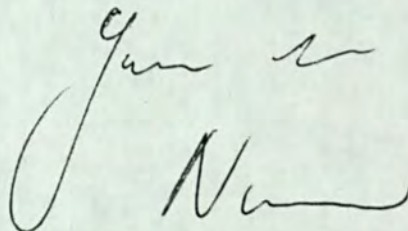
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otherwise have hoped for. - Whilst I can see that the factors you mention might call for some further strengthening of RR's balance sheet on privatisation, my officials will need to look into Samuel Montagu's arguments very fully. I would regard the figures you mention as the absolute maximum I could contemplate and agree to the proposals on that basis.

The performance bond is also a matter of great concern to me. Its very existence might be taken to cast doubt on RR's commercial viability. I am sure that in any immediate announcement of this deal we should avoid mentioning the performance bond, and indeed all the other detailed terms of the deal. I understand that these details will need to be included in both prospectuses when BA and RR are privatised, but it would be wrong to draw any special attention to the bond either now or then. If, despite all this, any questions are asked about the performance bond, we certainly need to make the points you suggest about the importance of the order to BA and the advice they received. We should also say that a similar bond would have been available from other competitors for the order, but I think we should avoid any reference to lack of confidence in RR unless it is necessary for defensive purposes.

I am sending copies of this to the recipients of your minute.

A handwritten signature in dark ink, appearing to read 'Norman Lamont', written in a cursive style.

NORMAN LAMONT

AEROSPACE ; Future of BA Pt. 5

PM's agreement conveyed to
DTI by TF 14-8-86

Duty
Clear
"PW

15
14/8

PRIME MINISTER

CHOICE OF ENGINES FOR BA'S 747-400s

I can now report that I have considered BA's investment case for 16 Boeing 747-400s and have concluded that all 16 should be approved; that BA and RR have reached agreement on the two points which were outstanding when I reported on 30 July; that on the basis of that agreement BA's management have now concluded that they should recommend that RR rather than GE engines should be ordered; that Paul Channon has considered the implications of the terms agreed for the privatisation of RR and has concluded that they are acceptable even though they may necessitate some increase in the capital injection which RR will require on flotation. Subject to your views and those of colleagues I would now propose to approve BA's proposal to acquire 16 Rolls Royce powered Boeing 747-400s on operating lease for delivery in 1989 and 1990. The proposal would also enable BA to acquire options on a further 12 of these aircraft but that would involve no commitment now or in the near future to exercising those options.

My officials have examined the investment appraisal with Treasury officials and they have concluded that the case for the investment is sound. You will recall that one of the outstanding problems between BA and RR was the terms on which exposure should be shared between them on any shortfall in the resale value of the aircraft compared with the unexpired portion of the lease, if the aircraft were turned back at 5 or 9 years. Further negotiation between BA and RR has produced terms which are mutually acceptable to the two companies, and which compare satisfactorily with the terms on offer from General Electric. The other outstanding problem, BA's request for a performance bond has also been resolved on terms acceptable both to BA and Rolls Royce.

I understand that Paul Channon has considered the implications of RR's offer for that company's privatisation, and that Samuel Montagu, DTI's merchant bank advisers on RR have advised that the guarantee of asset value given at the turnback points under the lease would create identifiable contingent liabilities which could require an additional capital injection for RR at privatisation - a figure in the range £20-40m has been suggested. I should however mention that BA believe that these contingent liabilities can be dealt with adequately by a note in their accounts, and that no strengthening of their balance sheet will be needed for the equivalent asset guarantee which they will provide.

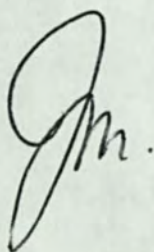
Samuel Montagu believe that the offer of the performance bond carries potential commercial risks for RR and that this too could lead to a requirement for additional capital at privatisation - a figure of up to £30m has been suggested for this element. Despite the risks and despite the likely cost to Government in terms of additional capital requirements for RR, I understand Paul Channon has concluded that it would be appropriate to proceed with the agreement.

I would also conclude that an increase in the capital injection which RR may require has been accepted. There are no better options: losing the order to GE would be more damaging to RR; insisting that BA accept an outright purchase rather than a lease would necessitate an injection to BA on flotation which would be far larger than the likely increase in the already planned injection to RR. As it is Lord King has accepted that with these financing agreements BA will need no capital injection or flotation.

Overall, I believe this represents a satisfactory outcome for the Government, and unless I have heard to the contrary by 10.00 am on 15 August I shall assume that you and other colleagues are content. I believe that the decision has to be taken quickly, because both engine manufacturers are pressing for an answer and the decision is likely to leak in any case if there is a delay.

The main public announcement must be for BA and RR to make. The deal is a commercial one freely negotiated between the two companies, and it is essential to the successful privatisation of both that a contrary impression should not be given. I would, however, propose to explain simultaneously with the companies' announcement that I have given BA investment approval for the order and to welcome it as good news for the future both of BA and of Rolls Royce. If asked about the performance bond, my Department and the DTI can make it clear that BA were advised to take this step, in view of the importance of the order to BA's business. But it implied no lack of confidence in RR's ability to complete the order or to trade profitably as a result of it.

/ I am copying this minute to the members of E(A) and to Sir Robert Armstrong.



JOHN MOORE

13 August 1986

FOLLOWING IS A MINUTE FROM JOHN MOORE ABOUT THE CHOICE OF ENGINES FOR BRITISH AIRWAYS. AS YOU WILL SEE HE IS NOW PROPOSING TO APPROVE BA'S PROPOSAL TO ACQUIRE 16 ROLLS ROYCE POWERED BOEING 747S FOR DELIVERY IN 1989 AND 1990. I UNDERSTAND THAT THE TREASURY ARE RECOMMENDING TO THE FINANCIAL SECRETARY THAT HE ACCEPTS THE PROPOSAL. DO YOU AGREE WITH WHAT JOHN MOORE PROPOSES SUBJECT TO COLLEAGUES? A DECISION IS NEEDED BY TOMORROW MORNING.

I CAN NOW REPORT THAT I HAVE CONSIDERED BA'S INVESTMENT CASE FOR 16 BOEING 747-400S AND HAVE CONCLUDED THAT ALL 16 SHOULD BE APPROVED SEMI COLON THAT BA AND RR HAVE REACHED AGREEMENT ON THE TWO POINTS WHICH WERE OUTSTANDING WHEN I REPORTED ON 30 JULY SEMI COLON THAT ON THE BASIS OF THAT AGREEMENT BA'S MANAGEMENT HAVE NOW CONCLUDED THAT THEY SHOULD RECOMMEND THAT RR RATHER THAN GE ENGINES SHOULD BE ORDERED SEMI COLON THAT PAUL CHANNON HAS CONSIDERED THE IMPLICATIONS OF THE TERMS AGREED FOR THE PRIVATISATION OF RR AND HAS CONCLUDED THAT THEY ARE ACCEPTABLE EVEN THOUGH THEY MAY NECESSITATE SOME INCREASE IN THE CAPITAL INJECTION WHICH RR WILL REQUIRE ON FLOTATION. SUBJECT TO YOUR VIEWS AND THOSE OF COLLEAGUES I WOULD NOW PROPOSE TO APPROVE BA'S PROPOSAL TO ACQUIRE 16 ROLLS ROYCE POWERED BOEING 747-400S ON OPERATING LEASE FOR DELIVERY IN 1989 AND 1990. THE PROPOSAL WOULD ALSO ENABLE BA *mm*

TO ACQUIRE OPTIONS ON A FURTHER 12 OF THESE AIRCRAFT BUT THAT WOULD INVOLVE NO COMMITMENT NOW OR IN THE NEAR FUTURE TO EXERCISING THOSE OPTIONS.

MY OFFICIALS HAVE EXAMINED THE INVESTMENT APPRAISAL WITH TREASURY OFFICIALS AND THEY HAVE CONCLUDED THAT THE CASE FOR THE INVESTMENT IS SOUND. YOU WILL RECALL THAT ONE OF THE OUTSTANDING PROBLEMS BETWEEN BA AND RR WAS THE TERMS ON WHICH EXPOSURE SHOULD BE SHARED BETWEEN THEM ON ANY SHORTFALL IN THE RESALE VALUE OF THE AIRCRAFT COMPARED WITH THE UNEXPIRED PORTION OF THE LEASE, IF THE AIRCRAFT WERE TURNED BACK AT 5 OR 9 YEARS. FURTHER NEGOTIATION BETWEEN BA AND RR HAS PRODUCED TERMS WHICH ARE MUTUALLY ACCEPTABLE TO THE TWO COMPANIES, AND WHICH COMPARE SATISFACTORILY WITH THE TERMS ON OFFER FROM GENERAL ELECTRIC. THE OTHER OUTSTANDING PROBLEM, BA'S REQUEST FOR A PERFORMANCE BOND HAS ALSO BEEN RESOLVED ON TERMS ACCEPTABLE BOTH TO BA AND ROLLS ROYCE.

I UNDERSTAND THAT PAUL CHANNON HAS CONSIDERED THE IMPLICATIONS OF RR'S OFFER FOR THAT COMPANY'S PRIVATISATION, AND THAT SAMUEL MONTAGU, DTI'S MERCHANT BANK ADVISERS ON RR HAVE ADVISED THAT THE GUARANTEE OF ASSET VALUE GIVEN AT THE TURNBACK POINTS UNDER THE LEASE WOULD CREATE IDENTIFIABLE CONTINGENT LIABILITIES WHICH COULD REQUIRE AN ADDITIONAL CAPITAL INJECTION FOR RR AT PRIVATISATION - A FIGURE IN THE RANGE £20-40M HAS BEEN SUGGESTED. I SHOULD HOWEVER MENTION THAT BA BELIEVE THAT THESE CONTINGENT LIABILITIES CAN BE DEALT WITH ADEQUATELY BY A NOTE IN THEIR ACCOUNTS, AND THAT NO STRENGTHENING OF THEIR BALANCE SHEET WILL BE NEEDED FOR THE EQUIVALENT ASSET GUARANTEE WHICH THEY WILL PROVIDE.

SAMUEL MONTAGU BELIEVE THAT THE OFFER OF THE PERFORMANCE BOND CARRIES POTENTIAL COMMERCIAL RISKS FOR RR AND THAT THIS TOO COULD LEAD TO A REQUIREMENT FOR ADDITIONAL CAPITAL AT PRIVATISATION - A FIGURE OF UP TO £30M HAS BEEN SUGGESTED FOR THIS ELEMENT. DESPITE THE RISKS AND DESPITE THE LIKELY COST TO GOVERNMENT IN TERMS OF ADDITIONAL CAPITAL REQUIREMENTS FOR RR, I UNDERSTAND PAUL CHANNON HAS CONCLUDED THAT IT WOULD BE APPROPRIATE TO PROCEED WITH THE AGREEMENT.

I WOULD ALSO CONCLUDE THAT AN INCREASE IN THE CAPITAL INJECTION WHICH RR MAY REQUIRE HAS BEEN ACCEPTED. THERE ARE NO BETTER OPTIONS COLON LOSING THE ORDER TO GE WOULD BE MORE DAMAGING TO RR SEMI COLON INSISTING THAT BA ACCEPT AN OUTRIGHT PURCHASE RATHER THAN A LEASE WOULD NECESSITATE AN INJECTION TO BA ON FLOTATION WHICH WOULD NBE FAR LARGER THAN THE LIKELY INCREASE IN THE ALREADY PLANNED INJECTION TO RR. AS IT IS LORD KING HAS ACCEPTED THAT WITH THESE FINANCING AGREEMENTS BA WILL NEED NO CAPITAL INJECTION OR FLOTATION.

OVERALL, I BELIEVE THIS REPRESENTS A SATISFACTORY OUTCOME FOR THE GOVERNMENT, AND UNLESS I HAVE HEARD TO THE CONTRARY BY 10.00 AM ON 15 AUGUST I SHALL ASSUME THAT YOU AND OTHER COLLEAGUES ARE CONTENT. I BELIEVE THAT THE DECISION HAS TO BE TAKEN QUICKLY, BECAUSE BOTH ENGINE MANUFACTURERS ARE PRESSING FOR AN ANSWER AND THE DECISION IS LIKELY TO LEAK IN ANY CASE IF THERE IS A DELAY.

THE MAIN PUBLIC ANNOUNCEMENT MUST BE FOR BA AND RR TO MAKE. THE DEAL IS A COMMERCIAL ONE FREELY NEGOTIATED BETWEEN THE TWO COMPANIES, AND IT IS ESSENTIAL TO THE SUCCESSFUL PRIVATISATION OF BOTH THAT A CONTRARY IMPRESSION SHOULD NOT BE GIVEN. I WOULD, HOWEVER, PROPOSE TO EXPLAIN SIMULTANEOUSLY WITH THE COMPANIES' ANNOUNCEMENT THAT I HAVE GIVEN BA INVESTMENT APPROVAL FOR THE ORDER AND TO WELCOME IT AS GOOD NEWS FOR THE FUTURE BOTH OF BA AND OF ROLLS ROYCE. IF ASKED ABOUT THE PERFORMANCE BOND, MY DEPARTMENT AND THE DTI CAN MAKE IT CLEAR THAT BA WERE ADVISED TO TAKE THIS STEP, IN VIEW OF THE IMPORTANCE OF THE ORDER TO BA'S BUSINESS. BUT IT IMPLIED NO LACK OF CONFIDENCE IN RR'S ABILITY TO COMPLETE THE ORDER OR TO TRADE PROFITABLY AS A RESULT OF IT.

I AM COPYING THIS MINUTE TO THE MEMBERS OF E(A) AND TO SIR ROBERT ARMSTRONG.

ENDS



PRIME MINISTER

CHOICE OF ENGINES FOR BA'S 747-400s

I can now report that I have considered BA's investment case for 16 Boeing 747-400s and have concluded that all 16 should be approved; that BA and RR have reached agreement on the two points which were outstanding when I reported on 30 July; that on the basis of that agreement BA's management have now concluded that they should recommend that RR rather than GE engines should be ordered; that Paul Channon has considered the implications of the terms agreed for the privatisation of RR and has concluded that they are acceptable even though they may necessitate some increase in the capital injection which RR will require on flotation. Subject to your views and those of colleagues I would now propose to approve BA's proposal to acquire 16 Rolls Royce powered Boeing 747-400s on operating lease for delivery in 1989 and 1990. The proposal would also enable BA to acquire options on a further 12 of these aircraft but that would involve no commitment now or in the near future to exercising those options.

My officials have examined the investment appraisal with Treasury officials and they have concluded that the case for the investment is sound. You will recall that one of the outstanding problems between BA and RR was the terms on which exposure should be shared between them on any shortfall in the resale value of the aircraft compared with the unexpired portion of the lease, if the aircraft were turned back at 5 or 9 years. Further negotiation between BA and RR has produced terms which are mutually acceptable to the two companies, and which compare satisfactorily with the terms on offer from General Electric. The other outstanding problem, BA's request for a performance bond has also been resolved on terms acceptable both to BA and Rolls Royce.



I understand that Paul Channon has considered the implications of RR's offer for that company's privatisation, and that Samuel Montagu, DTI's merchant bank advisers on RR have advised that the guarantee of asset value given at the turnback points under the lease would create identifiable contingent liabilities which could require an additional capital injection for RR at privatisation - a figure in the range £20-40m has been suggested. I should however mention that BA believe that these contingent liabilities can be dealt with adequately by a note in their accounts, and that no strengthening of their balance sheet will be needed for the equivalent asset guarantee which they will provide.

Samuel Montagu believe that the offer of the performance bond carries potential commercial risks for RR and that this too could lead to a requirement for additional capital at privatisation - a figure of up to £30m has been suggested for this element. Despite the risks and despite the likely cost to Government in terms of additional capital requirements for RR, I understand Paul Channon has concluded that it would be appropriate to proceed with the agreement.

I would also conclude that an increase in the capital injection which RR may require has been accepted. There are no better options: losing the order to GE would be more damaging to RR; insisting that BA accept an outright purchase rather than a lease would necessitate an injection to BA on flotation which would be far larger than the likely increase in the already planned injection to RR. As it is Lord King has accepted that with these financing agreements BA will need no capital injection or flotation.

Overall, I believe this represents a satisfactory outcome for the Government, and unless I have heard to the contrary by 10.00 am on 15 August I shall assume that you and other colleagues are content. I believe that the decision has to be taken quickly, because both engine manufacturers are pressing for an answer and the decision is likely to leak in any case if there is a delay.



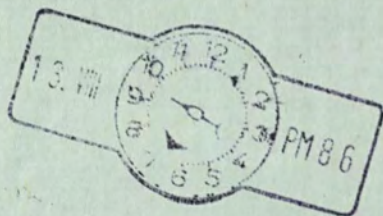
The main public announcement must be for BA and RR to make. The deal is a commercial one freely negotiated between the two companies, and it is essential to the successful privatisation of both that a contrary impression should not be given. I would, however, propose to explain simultaneously with the companies' announcement that I have given BA investment approval for the order and to welcome it as good news for the future both of BA and of Rolls Royce. If asked about the performance bond, my Department and the DTI can make it clear that BA were advised to take this step, in view of the importance of the order to BA's business. But it implied no lack of confidence in RR's ability to complete the order or to trade profitably as a result of it.

/ I am copying this minute to the members of E(A) and to Sir Robert Armstrong.

A handwritten signature in blue ink, appearing to be 'Jm.', is written above the typed name.

JOHN MOORE

13 August 1986





bc BG

SRW
(45)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

31 July 1986

Dear Richard,

ENGINES FOR BRITISH AIRWAYS 747-400s

The Prime Minister was grateful for your Secretary of State's minute of 30 July which described the position reached so far on the choice of engines for British Airways 747-400s and has noted his conclusion that it is in everybody's interests that commercial logic and the Government's interests as owner of both companies should point in the same direction.

I am sending a copy of this letter to the Private Secretaries to members of E(A), Murdo Maclean and Michael Stark.

Yours,
David

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport.

RM



10 DOWNING STREET

Prime Minister 2

The Chancellor is very
concerned at the idea
that RR should be required
to put up a full performance
bond, He has taken this
up with John Rose.

RRW

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RRW

b.c. Mr. Norgrove No 10 ^{CCB}

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DR WALKER

cc Mr Unwin (o.r.)

W
1/8

Engines for British Airways 747-400s

The Transport Secretary has now sent an ^{attached} interim report to the Prime Minister and other colleagues (his minute of 30 July) on the current position. This makes clear that the economic balance is in favour of placing the order with Rolls Royce rather than GE, subject to the outstanding points about a ninth-year 'window' under which BA could dispose of the aircraft, and about BA's demand for a performance bond from RR.

2. It emerged at Mr Holmes' meeting yesterday that the demand for a performance bond could be a serious problem. The idea seems to have come from Lazards, who were involved in the MOD demand for performance bonds in respect of ships to be constructed at the warship yards privatised by management buy-out. BA's argument is that RR have gone bust once, and that their order for the D4D engine is equivalent to RR's entire net worth on their balance sheet. It would be very damaging to BA's business if the engines were not delivered on time, and BA found itself without the aircraft it needed to continue profitable operations. Since it is very hard to define the assumptions necessary to quantify the losses, BA are simply asking for a performance bond for the entire value of the contract, which they would collect immediately if RR failed to perform. BA further argue that, having once made the demand, they cannot simply withdraw it; the matter is bound to become public, and would have to be dealt with within the Prospectus. BA see no need to make a comparable demand of GE, although they have now done so in the cause of 'fairness'; they say that they are satisfied that GE is a large enough company for there to be no risk of it going out of business - and the engine in question is already in service, rather than still under development.

3. It would be a very serious matter for RR to give a performance bond of the

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kind demanded by BA. The banks who provided the bond would probably demand some preferential position among RR's creditors, and this would react back on the company's ability to borrow, and so on the privatisation balance sheet. As the DTI see it, RR would have to be allowed to retain more of the proceeds from the share issue, so as to reduce the gearing of the company; this would obviously reduce the Government's proceeds from the privatisation. Moreover, the existence of the performance bond could not be concealed; it would have to be declared to investors, and if BA felt they had to have it, no doubt all RR's other customers would demand equal treatment. RR have not previously given such bonds to any customers, and this would put them at a serious disadvantage in relation to their competitors in the world market. DTI do not quite say that privatisation could not go ahead if RR complied with BA's demand, but at the very least the issue would raise a major doubt about privatisation.

4. As the Transport Secretary says, the only satisfactory way of resolving this issue is for BA and RR to come to a freely negotiated commercial agreement. Despite the claim in his minute that the choice for BA between RR and GE is fairly evenly balanced, it seems that - the performance bond apart - the economic assessment points clearly to RR (by £35 million on BA's owning biased figures, and up to £100 million on reasonable alternative assumptions). Department of Transport officials believe that BA top management are genuine in wanting to go to RR unless economic considerations point clearly in the other direction, and that they are not using the performance bond question simply as a means of shutting RR out. RR have offered a restricted performance bond assessed by reference to the extra costs BA could incur in the unlikely event that RR were the sole cause of late delivery of aircraft - RR's estimate of this is about £50 million, as against the total value of the contract of £400 million. RR point out that BA would in any event have the normal contractual remedies available to them if they suffered losses as a result of RR's failure to perform. But there has been no meeting of minds between the two companies; Lord King has been reluctant to meet Sir Francis Toombs, indicating that he thought the issue was one which should be settled by accountants. In practice it seems unlikely that this would happen unless both chairmen gave instructions that an accommodation was to be reached. DTI consider that BA greatly

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exaggerate the risks to, which they would be subject; the further development work RR need to do to prove the D4D version of the RB 211 engine is quite modest; RR's expectation of good profits from it (which is reflected in the concessions they have offered to secure the order) depends on exploiting much development work already done, and equipment already in place.

5. Mr Moore is to see Lord King today. Attempts were being made to arrange a meeting before hand between Transport, DTI and Treasury Ministers to consider what should be said to Lord King. It would clearly be very unfortunate for the privatisation of RR if BA were either to persist in the demand for the performance bond, or to take the position that the problem could only be avoided by giving the order to GE. RR's failure to win the order from its principal civil customer would undoubtedly be a major blow to flotation. The Government's proceeds from each privatisation are currently put at about £700 million. It would be very unsatisfactory if, in order to boost the proceeds from one of the privatisations by a relatively small amount, the value of the other company was very substantially reduced, or its privatisation frustrated.

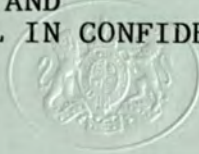
JW

A J WIGGINS

Economic Secretariat.

31 July 1986.





CEB

Prime Minister 2

A cautious minute.

*Any ...
by ...
DRS
30/7*

PRIME MINISTER

ENGINES FOR BRITISH AIRWAYS 747-400S

In my minute of 25 June, I explained that both Rolls Royce (RR) and General Electric (GE) were making new offers in the bid to provide the engines for British Airways' next generation of Boeing 747, and that Pratt and Whitney had also made a late request to bid. My Private Secretary subsequently explained that both RR and GE had asked for longer in which to complete the terms of their offers. I thought that you and colleagues would find it helpful to have a further report now on where matters stand.

BA's management are still considering a comparison of the offers, and some matters are still being explored. The key elements of the analysis are as follows.

Technical Evaluation

BA have now completed their technical evaluation of the three offers. They quickly discarded the Pratt and Whitney offer. It was substantially less attractive commercially, and offered no compensating operational advantages. On purely technical grounds, BA's engineers believe that while the RR engine would do the job adequately, the GE engine would do a better one. However, some of the judgements made by BA's engineers have been questioned by the Government's own technical experts in the Ministry of Defence, and they are exploring these questions further with BA.

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Commercial Evaluation

Both GE and RR have offered a complex package of concessions associated with this order. In GE's case the concessions relate mainly to tooling up costs and to free spare parts which would assist BA both in the servicing of the engines bought for the 747 and any future BA aircraft types using the GE engine, and to compete for third party engine overhaul work. In RR's case the concessions relate to modification work and discounts on spare parts on other variants of the engine already in service in BA's fleet. When these factors are taken into account the balance of advantage in BA's evaluation swings in favour of RR. Our probing of technical questions may improve RR's margin, but it is at present relatively small for so large a project and sensitive to many of the assumptions made.

Financing Terms

Both GE and RR have arranged for the aircraft acquisition to be by means of operating leases which would not appear on BA's balance sheet (or RR's). In both cases, BA would have the option to surrender the aircraft after 5 years and after 9 years. The second "window" is particularly important, because, in addition to the greater flexibility, it will give BA the opportunity to exchange relatively easily the 747-400 for a successor version if by that time the state of technology has developed further. However, in the event that BA do surrender the aircraft at 5 or 9 years and they are then sold for a price equivalent to less than the unexpired portion of the lease, the various parties to the agreement have to make good the difference to the organisations providing the finance in a predetermined order and proportion. In all cases, BA would have to meet the first layer of liability, but

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in this respect the GE offer is slightly more attractive to BA at the 5 year point, and substantially more attractive to BA at 9 years. BA have asked RR to think again about this aspect of the offer, but as yet have not had a response.

Performance Bond

On the advice of their merchant bankers, BA have judged it prudent to ask RR for a performance bond, as a safeguard against non-delivery or non-certification of the engines. This investment by BA is expected to earn about 40% of their revenue. The order, at some £400m, is a very substantial one for RR in respect of its order book and current net worth. In these circumstances, and given the forthcoming privatisation of RR, my merchant bankers, Hill Samuel, advise that it is reasonable for BA to have asked for a bond to the value of the contract price. The bond so far offered by RR falls a long way short of this. BA have also asked GE for a performance bond, though given their very much greater net worth and order book they would not have judged it necessary in other circumstances to do so, and would not expect GE to have any difficulty in providing one.

Overall Investment Decision

I had hoped that it would prove possible to resolve the engine choice in advance of the overall decision on the size and timing of the order for new aircraft. However, both manufacturers have made their bids in relation to an order for 16 aircraft and there can be no certainty that the terms would remain the same for a smaller order. I do not think therefore that we can reach a decision on the choice of engine until BA have satisfied me that, on the basis of the normal tests

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applied by Government to investment appraisals, the case for investment in 16 aircraft is justified. This will involve a complex evaluation of alternatives, and BA will not be able to complete this work until the middle of August.

Next Steps

If the BA Board were to come to a decision at their meeting on 1 August on the engine choice, I fear that the news would quickly leak and that we would also find ourselves boxed into giving approval for 16 aircraft irrespective of the strength of the case, because it would then be argued by BA and the manufacturers that the full order was needed to secure the terms on offer for the engine. The issues on the engine choice are in any case finely balanced, and I think it is essential to discuss the position further with Lord King before the Board next meets. I had a preliminary meeting yesterday at which he warned me about the problem on the performance bond, and I shall be seeing him again on 31 July.

At our meeting I shall say to him that since the terms offered by the engine manufacturers have been based on an order for 16 aircraft, I want first to be satisfied that an order of that size is justified before the Board considers the question of the choice of engine, but I would not object if the Board wished to take their own decision that the order should be for 16 aircraft and not some other number before putting their full evaluation to me. I shall make it clear to Lord King that this issue must be resolved before we take a decision in September on the timing of BA privatisation. I shall also impress upon him the desirability of using the time available to iron out any remaining difficulties over financing terms.

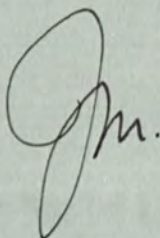
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AND
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In my view, the best outcome would be if the BA Board were freely to be able to conclude that the company's commercial interest lay in ordering from RR. I understand that this order is important to RR, and that the consequences for RR's privatisation could be serious if they do not win it.

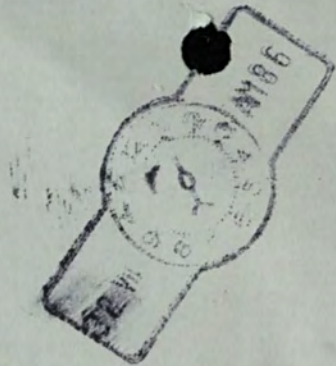
I am sure that the importance the Government attaches to the successful flotation of RR will not be lost on Lord King. But equally, the Board of BA have a duty to safeguard the company's commercial interests, and for me to require them to act in any other way on so major a decision would be very damaging for BA's privatisation prospects. It is therefore in everybody's interests that commercial logic and the Government's interests as owner of both companies should point in the same direction.

I am copying this minute to the members of E(A), the Chief Whip and Sir Robert Armstrong.



JOHN MOORE
30 July 1986

BA : Aerospace Pt 5.





DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

CONFIDENTIAL

30 July 1986

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign
& Commonwealth Affairs
Foreign & Commonwealth Office
LONDON SW1

Prime Minister
CDP
30/7.

Dear Geoffrey,

UK/US AIR SERVICES

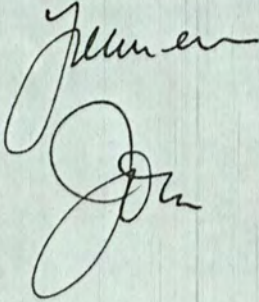
As you know it was not possible, at the negotiations held in Washington last week, to conclude an agreement on the capacity control issue along the lines set out in the paper I circulated on 7 July to Members of MISC 112. But sufficient progress was made to justify the hope that one more round in London, in the week commencing 11 August, may be enough to bring the negotiations to a conclusion. Extending the negotiating period into mid August in this way does not put at risk our timetable for taking decisions about the privatisation of BA, though any further significant delay might begin to do so.

It is difficult to judge the chances of success. Important differences remain between the two sides. However I am advised that there is no reason to conclude at this stage that an agreement cannot be reached within the perimeters of the agreed negotiating brief which establishes our bottom line. I would not want to change that anyway. The Americans showed sufficient flexibility last week (as we did too) to suggest that they are negotiating constructively and that they recognise the need to bring matters to a conclusion quickly, but it is very much in their interest to press us to the limits of our negotiating flexibility in every possible respect, and in ours to continue working for a successful outcome to the negotiation until time really does run out for us and we have to face up to the alternative options set out in my paper. I will report again after the talks in mid August.

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I am copying this letter to the Prime Minister, to other members of MISC at 112, and to Sir Robert Armstrong.

A handwritten signature in cursive script, appearing to read 'John Moore', written in dark ink.

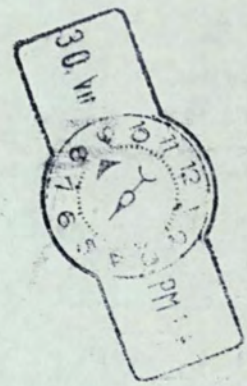
JOHN MOORE

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1. Copying this report for the purpose of disseminating information to other personnel is prohibited.

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DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215 5422
GTN 215
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Secretary of State for Trade and Industry

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30 July 1986

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON,
SW1

DN

NBPN

Jean John

ENGINES FOR BRITISH AIRWAYS 747-400s

Thank you for sending me a copy of your minute of 30 July to the Prime Minister.

I am content with your proposals for handling the matter, involving a delay in BA's final consideration of the engine choice. It is however important to resolve this matter quickly, from Rolls-Royce's point of view as well as BA.

So far as BA's preliminary evaluation is concerned, I would make two points at this stage. First, as you say there are a number of features in BA's technical and operational analysis which are open to debate. These could have a material impact on the commercial evaluation. Second, even on the basis of BA's current evaluation, the financial margin in favour of Rolls-Royce is over £30 million, or nearly 12 per cent, in present value terms. I consider that a substantial advantage.

My principal concern is British Airways' request for a performance bond to the total value of the engine contract. It is not clear what BA's reasons are for seeking such a bond, which would I believe be unprecedented in the aircraft industry. The request seems to imply doubt on BA's part about Rolls-Royce's ability to continue its operations in the private sector. But the Board of Rolls-Royce could not issue a prospectus for privatisation next

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year unless they were sufficiently confident that the business would continue at least over the period within which the BA engines would be delivered; the Government has announced that it will ensure Rolls-Royce has an appropriate capital structure for its operations in the private sector; and Cathay Pacific have recently placed a major order for the engine in question, the D4D, without any such bond. If an overseas airline does not require such a bond, it seems perverse that BA should do so.

There may also be a question in BA's mind whether the D4D project is consistent with the collaboration agreement between Rolls Royce and GE. It is true that there was some concern on this point at a earlier stage. However, Rolls-Royce have a written agreement with GE which permits the continuation of the D4D project in parallel with the CF6-80C2 collaboration.

The implications for Rolls-Royce and the Government of R-R giving a performance bond for the full value of the contract could well be serious. The capital injection required by Rolls-Royce on privatisation would be substantially increased and the granting of the bond, which would have to be disclosed in the prospectus, would be regarded as indicating a lack of confidence in the company's future. Other customers would no doubt seek similar bonds in relation to future contracts with Rolls-Royce. It would therefore be damaging both to Rolls-Royce's commercial future and to the prospects for a successful privatisation.

Rolls-Royce have offered a limited bond calculated to cover BA against what they consider is a reasonable level of risk. I would hope BA and RR can reach agreement on this issue through normal commercial negotiation. But I believe we shall need to probe thoroughly the justification for a performance bond to the full value of the engines, if BA continue to press the case for it. In the meantime, I believe it would be right for you to tell Lord King that the Government has serious reservations about the request and will want to examine the case for it critically.

I look forward to discussing this matter with you tomorrow before your meeting with Lord King.

I am sending copies of this letter to the Prime Minister, the other members of E(A), the Secretary of State for Defence, and the Chief Whip, and to Sir Robert Armstrong.

ms

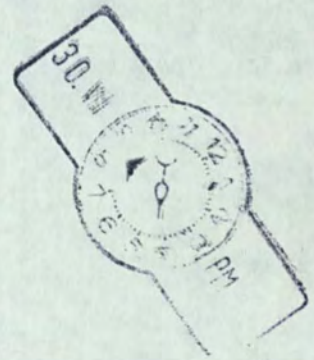
Paul

JF3APG

PAUL CHANNON

17 19 **86**
BOARD OF TRADE
BICENTENARY

AEROSPACE I BA Future 1 PE 5.





CABINET OFFICE

pc

With the compliments of

J. B. UNWIN

**70 Whitehall, London SW1A 2AS
Telephone 01 233**

343/7

cc. Dr Walker

Mr Wiggins

Cg/BG

Mr Noyne (for info).

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Many thanks.
Given this or one
or two other
outstanding issues,
we had better start
enmarking some E(A)
dates in September.

MR UNWIN

cc Dr Walker

Engines for BA 747-400s

JW
29/v.

As I mentioned to you, it now appears unlikely that this issue can be taken by E(A) before the holidays.

2. The problem arises because of the strange way in which BA do business with the Department of Transport. The expectation is that BA will need replacements for their oldest 747s if their business is to retain its present shape in the 1990s. The only replacement now on the horizon is the 400 series, for which General Electric and Rolls Royce have contending engines. BA have taken the line that they cannot submit their case to the Department of Transport for investment approval until they have made their choice between the two engines; but the Department of Transport cannot confirm the choice of engines until they have considered the investment case. There seems now to be a fair prospect that the necessary studies can be carried through during August, so that the issue will be ready for E(A) in the early part of September.

3. The Prime Minister was worried that public sector constraints, or the requirements of privatisation, might result in the order going to GE in circumstances which were damaging to the overall national interest, taking account of the position of Rolls Royce as well as of BA. Further work suggests that BA are not behaving markedly differently from other airlines in seeking to acquire new aircraft on an operating lease, i.e. off balance sheet, and with relatively flexible terms for ending the lease without heavy responsibility for capital losses if the air travel market does not justify the retention of the aircraft, or if other, better aircraft should become available. Rolls Royce have

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Commercial in Confidence

arranged terms for the operating lease of the aircraft with their engines which appear to be fully competitive with those offered by GE for the aircraft with their engines. Given this development, the choice should in the end now be made on purely economic grounds without a special balance sheet constraint.

4. Rolls Royce as sub-contractors have a 25 per cent share in the work on the GE engine, but this is not a genuine collaborative arrangement, and they do not share in the profits. The DTI have considered whether, rather than match GE's terms on the financing of the new aircraft, Rolls Royce would be better advised in effect to abandon their engine and concentrate on developing a more satisfactory relationship with GE. The DTI's provisional conclusion is that it would be better for the company to undertake 100 per cent of the work on supplying their own engines on whatever terms were necessary to secure the order than to rely on work as a sub-contractor for GE. The Rolls Royce engine apparently incorporates many well-proven parts, so that it should be capable of earning good profits; because of this Rolls Royce have offered a substantial discount on other spares which they will be supplying to BA, and this factor seems likely to be sufficient to secure them the contract. From the standpoint of the privatisation of Rolls Royce, the DTI are clear that they are better off securing the order on the terms offered than having to relay on Sub-contract work for GE.

5. Assuming that the BA Management accept the logic of the economic case in favour of Rolls Royce (which appears to be robust enough to withstand a good many biases in favour of GE), work will go ahead immediately on the necessary investment appraisal, with a view to a final decision early in September. Provided this timetable can be adhered to, there should be no difficulty with either privatisation.

JW

A J WIGGINS

Economic Secretariat.

28 July 1986.



CC/Ba



QUEEN ANNE'S GATE LONDON SW1H 9AT

22 July 1986

NBP7

Dear Jan,

AIR TRAFFIC DISTRIBUTION IN THE LONDON AREA

Thank you for your letter of 14 July ^{at trap} about your decision on the CAA advice to you.

I very much welcome your conclusion that the regional services (including the services to and from the Channel Islands and Isle of Man) should not be displaced from Heathrow. As you say, this was a politically sensitive issue and one on which the Islands in their isolated position felt very strongly. I am particularly grateful to Michael Spicer for seeing their delegations and acknowledging sympathetically not only their isolation but also their unusual constitutional position outside the UK.

I have no comments on the other proposals in your letter and recognise that the capping of frequencies is necessary for the future.

Copies of this letter go to the recipients of yours.

Yours,

Doyle.

AGROSPAC B Airways PTS





bc BG.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

21 July 1986

BAA PRIVATISATION

The Prime Minister has seen your letter to me of 17 July and is content that your Secretary of State should write to Sir Norman Payne to seek an assurance about his willingness to stay on as Chairman of BAA after its privatisation.

I am copying this letter to Rachel Lomax (H.M. Treasury), Murdo Maclean (Chief Whip's Office) and Michael Stark (Cabinet Office).

(David Norgrove)

Richard Allan, Esq.,
Department of Transport.

6

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CCB



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

17 July 1986

Prime Minister

Dear David,

Content?

mt

DW
18/7

BAA PRIVATISATION

As you know, we plan to privatise BAA either in January/February or June/July 1987. In preparation for flotation, the BAA will be restructured on 31 July and the successor company vested on 1 August. My Secretary of State intends that the present Chairman and the existing Board members should be appointed to the board of the new company shortly before vesting, and that Sir Norman Payne should be invited to give an assurance that he is prepared to stay on as Chairman for 2-3 years after flotation. Although he is 64 years old, Sir Norman is still a very vigorous Chairman, and is widely recognised as the driving force largely responsible for BAA's successes. There is no obvious successor, and it will be important that the sale prospectus includes such an assurance. At the same time as seeking this assurance, my Secretary of State will ask Sir Norman to give very early consideration to determining the succession.

Since the company might remain in the public sector beyond the date of expiry of his present appointment (28 February 1987) I am writing to seek your confirmation that the Prime Minister is content that my Secretary of State should write to Sir Norman Payne to seek an assurance about his willingness to stay on as Chairman of BAA after its privatisation. I would be grateful if you could let me know by noon on Monday that there is no objection to this.

I am copying this letter to Rachael Lomax (Treasury), Murdo Maclean (Chief Whip's Office) and Michael Stark (Cabinet Office).

Yours,
Richard.

R A ALLAN
Private Secretary

DEPARTMENT OF TRANSPORT
100 WATERLOO STREET LONDON W1C 9EJ



CONDOR





~~CORB~~
SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

The Rt Hon John Moore MP
Secretary of State for Transport
2 Marsham Street
LONDON
SW1P 3EB

16 July 1986

Dear John

NBN

AIR TRAFFIC DISTRIBUTION IN THE LONDON AREA

Thank you for copying to me your letter of 14 July.

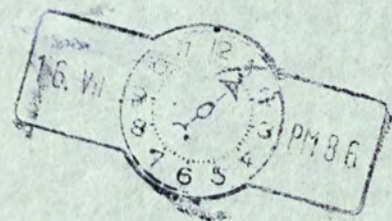
ATTACHED

I am entirely content with what you propose, and grateful for the careful account you have taken of the regional implications of the CAA's proposals. I do agree that it is important to make an early announcement, so that local interests and the airlines know where they stand, and I hope that you will be able to do so next Monday.

I am copying this letter to the Prime Minister, Willie Whitelaw, Geoffrey Howe, Douglas Hurd, George Younger, Nicholas Edwards, John Biffen, Norman Tebbit, John Wakeham, and Sir Robert Armstrong.

Yours ever,

MALCOLM RIFKIND



CCBG



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Douglas Hurd MP
Secretary of State for the Home Department
Home Office
50 Queen Anne's Gate
LONDON SW1

14 July 1986

1. ITR
2. NEA

To see the sentences marked.

Douglas

3. NDA.

DK
15/7

AIR TRAFFIC DISTRIBUTION IN THE LONDON AREA

In view of your responsibilities for the Insular Authorities I am writing to you to set out the response I propose to make to the Civil Aviation Authority's advice on traffic distribution rules for the London area (CAP522).

The CAA has produced a very thorough and professional report which advances a comprehensive strategy for the development of the four London airports into the 1990s. The rules which the CAA has proposed can conveniently be viewed in two groups: those which should be implemented as soon as the necessary powers under the Airports Act 1986 commence on 8 September; and those which should be made at some later date.

I am disposed to accept the CAA's advice for rules to be introduced as soon as the necessary legislation commences. These rules will be:

- (i) confirmation of the existing restrictions at Heathrow (no charter services, and no international scheduled services by operators who have not previously mounted such services from Heathrow);
- (ii) new domestic scheduled services will continue to be permitted at Heathrow, but only where the benefits to the user are likely to outweigh all other considerations; and
- (iii) that general and business aviation and all-cargo services at Heathrow and Gatwick should be excluded from the peak hours subject to certain exemptions to ensure that flights such as those made by the Royal Family, Government Ministers, visiting foreign dignitaries etc will be permitted.

I would not expect any of these rules to have any significant impact on the interests of the Insular Authorities.

I propose also to confirm as formal rules, under Section 31 of the Airports Act 1986, the existing controls which apply at the three Scottish Lowland Airports, Prestwick, Glasgow and Edinburgh (ie that Prestwick will cater for long-haul flights while Glasgow and Edinburgh handle domestic and shorthaul services). I do not propose that the formalisation of the existing controls should alter our White Paper view that the policy for Prestwick should be reviewed if the airport's financial results have not improved by 1989.

The most controversial of the CAA's recommendations for later rules, and the most sensitive politically, is the proposal that six regional services should be displaced from Heathrow. As you have explained to me, Guernsey, Jersey and the Isle of Man have been particularly concerned by the CAA's recommendation that the first of the rules designed for deferred implementation should displace flights to the Islands from Heathrow and Gatwick. Hamish Gray of the Scottish Office has made representations to me on behalf of the Inverness service, while Peter Morrison has done so on behalf of the Plymouth/Newquay service. Over recent weeks Michael Spicer has seen delegations on behalf of all the routes threatened with displacement, including that to Carlisle and Dundee. I have been impressed with the very great importance which the regions attach to continuing links with Heathrow. I have naturally given the CAA's recommendation very careful consideration, prompted as it is by our policy for the development of Gatwick as a second scheduled "hub" airport. But in each case, I have weighed the CAA's recommendations against the regional implications: and I have judged that the civil aviation benefits of displacement at Heathrow are outweighed by other considerations. I do not, therefore, propose to implement the CAA recommendations for the future displacement of Heathrow domestic services. I am convinced that a clear decision of this kind is necessary to assuage the deep concerns which have been expressed by the regions involved.

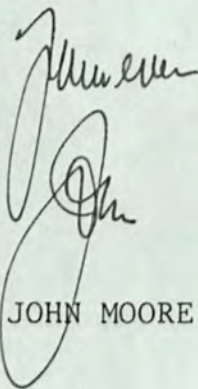
I propose to follow the CAA's advice on the other rules which they have suggested for deferred introduction: these concern giving priority to scheduled carriers over charter operators at Gatwick, and the capping of frequencies with which carriers are allowed to operate services at Heathrow. I envisage such frequency capping being applied initially to domestic operators and non-reciprocated international scheduled services. Capping would later apply to most remaining international services. We shall, of course, be careful to ensure that our international obligations will be met. Both of these later rules at Heathrow and Gatwick would be introduced on the advice of the CAA itself and the local scheduling committees. One of the threads which runs throughout the CAA's review is the Authority's high regard - which I share - for the airlines' own voluntary scheduling committee system, which allocates landing and take-off slots at congested airports like Heathrow and Gatwick. The scheduling committees have a commendable record of eking out scarce capacity; I have no doubt that they still have much to contribute to the development of the civil aviation industry and the rules that I have proposed will enable them to fulfill that central role.

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Throughout the latter stages of the CAA's review a number of airlines and individuals have argued vehemently that there is considerable remaining capacity at both Heathrow and Gatwick but that its release is precluded because of over-stringent procedures operated by the National Air Traffic Service. There is a risk that later rules which involve further restrictions, like frequency capping, may not command acceptance unless there is clear and generally accepted evidence of saturation of capacity. I propose, therefore, to invite the CAA to carry out a study of the inter-relationship between runway capacity and airspace management. The study will be assisted by a committee under the chairmanship of the Chairman of the CAA, Mr Christopher Tugendhat, who is ready to proceed on this basis. Members of the Committee will be drawn from the UK civil aviation industry and one or more independent experts. The Ministry of Defence (in their role of airspace users) should also provide an input.

I am, of course, conscious of the risk of commercial "blight" which exists in the case of those operators whose regional services have been threatened with displacement from Heathrow and I am therefore anxious to make an announcement before the Recess begins - so as to avoid any unnecessary prolongation of uncertainty. I have in mind to make an announcement on Monday 21 July. I should, therefore, be grateful to have any comments on my proposals as quickly as possible. I shall assume, unless I hear to the contrary by noon on Thursday 17 July, that you and colleagues are content for me to proceed as I propose.

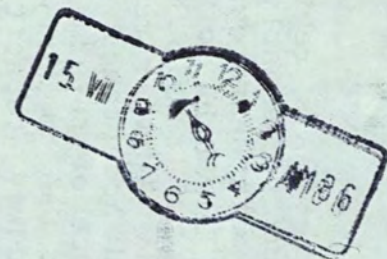
I am copying this letter to the Prime Minister, Willie Whitelaw, Geoffrey Howe, George Younger, Nick Edwards, John Biffen, Norman Tebbit, Malcolm Rifkind, John Wakeham and Sir Robert Armstrong.



JOHN MOORE

CONFIDENTIAL

3F.



cc/c



JU852

Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY

1-19 VICTORIA STREET

LONDON SW1H 0ET

Telephone (Direct dialling) 01-215 5422

GTN 215

(Switchboard) 01-215 7877

11 July 1986

CONFIDENTIAL

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London SW1

Dear John,

NBPN

at trap

Thank you for copying to me your minute of 7 July to the Prime Minister, circulating your proposals to MISC 112 for concluding negotiations with the United States on capacity control arrangements under the Bermuda 2 Air Services Agreement.

I have no difficulty with what you propose, and I see no need for a meeting. My Department has, of course, been greatly concerned with the anti-trust obstacles to BA's privatisation; and I look forward to the report by officials making a revised assessment. As regards the further round of the negotiations on capacity under Bermuda 2, I can also go along with your proposals. Our policy will, however, need to be presented carefully if these negotiations are successfully concluded on the basis you envisage. While I understand very well your reasons for preventing the lesser carriers' market share falling below 33% - 35%, this might be seen by consumer interests here as being at odds with our generally liberal approach to the international aviation market, particularly as regards the European Community. It will be necessary to make clear that we have had to vary our stance in this instance, given the special features of the US market, and in particular the denial of access for our airlines to the internal US market.

I am sending copies of this letter to the Prime Minister, to other members of MISC 112 and to Sir Robert Armstrong.

*Yours,
Paul*

PAUL CHANNON

**17
1986**
BOARD OF TRADE
BICENTENARY

AGROSPACE : British Airways PTS





CG/BG

Foreign and Commonwealth Office

London SW1A 2AH

From the Parliamentary Under Secretary of State

10 July 1986

NBP 12.

UK/US AIR SERVICES AND BA PRIVATISATION

In Geoffrey Howe's ^{at time} absence I am replying on his behalf to your minute of 7 July.

I am pleased that there has been close cooperation between officials on this difficult matter. I agree that the UK should have the negotiating flexibility you suggest in para 7(a) of your minute and I share your view that we should not be prepared to reach agreement regardless of the cost to our airlines. Geoffrey will be consulted about a message to Mr Shultz on his return from Southern Africa (your paragraph 7(b)) and we shall inform MISC 112 colleagues as soon as he has replied.

I am not convinced (para 7(c) of your paper) that we need now to agree that the Prime Minister should send a message should the July talks fail. I quite agree that we may need to consider such an idea as a means of reaching a successful outcome, but feel it is premature to commit ourselves to such a step at this stage before we know the outcome of the July talks. If the gap between the two sides remains great at the end of July then it may be an unwise use of our political capital to attempt to bridge too wide a gap. I am sure we would wish the Prime Minister to send a message only if there were at least a reasonable chance of success.

The decision on how we safeguard our interests if the talks fail completely (your paragraph 7(d)) is one which, I think, can also be left until after we know the outcome of the July talks. Similarly, any discussion of the implications of the July outcome for the privatisation of British Airways is, as you suggest, at this stage premature.

I am sending copies of this letter to the members of MISC 112 and Sir Robert Armstrong.

Tim Eggar

Tim Eggar

The Rt Hon John Moore MP
Secretary of State for Transport
2 Marsden Street
LONDON SW1P 3EE

CBC



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

NSM

9 July 1986

*Dear John***UK/US AIR SERVICES AND BA PRIVATISATION**

I have seen your minute of 7 July to the Prime Minister.

I am content with your proposals on the negotiating position and on the handling of the negotiations, and I see no need for a meeting.

I am writing, however, about the timing of the decisions which you propose should be taken in September. You expect to have better information than on BA's financial position this year and on the company's prospects, and we should be clearer about the state of the negotiations with the US Government.

But given the time which we have been advised that a proper marketing campaign for BA, or BAA, will take, it is very important that we should take a firm decision as early as possible in September. Even if we did not have all the information we would ideally like, we must resist the temptation to delay the decision beyond the end of that month, as that could prejudice a successful flotation in January.

I am sending copies of this letter to the recipients of your minute.

*Yours -
Norman Lamont***NORMAN LAMONT**

AEROSPACE, future of BA Pt 5,



CONFIDENTIAL



bc: 89

MFT

10 DOWNING STREET

From the Private Secretary

9 July 1986

Dear Richard,

UK/US SERVICES AND BA PRIVATISATION

The Prime Minister has seen the Secretary of State for Transport's minute of 7 July and paper about UK/US Air Services and BA privatisation.

The Prime Minister is content, subject to the views of colleagues, with the Transport Secretary's proposed negotiating position on Bermuda 2. She notes that a meeting of MISC 112 is likely to be needed in September, both to review the outcome of the negotiations and to decide the timing of privatisation of BA.

I am copying this letter to the Private Secretaries to the members of MISC 112 and to Sir Robert Armstrong.

Yours,
David.

David Norgrove

Richard Allan, Esq.,
Department of Transport

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alb/g

Agree the recommendations in paragraph 5? (See also the Policy Unit note below.)

Yes no

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DNW
8/8

From: J B UNWIN
8 July 1986

MR NORRGROVE

cc Sir R Armstrong
Mr Wiggins

UK/US AIR SERVICES AND BA PRIVATISATION

WITH DN?

The Transport Secretary's minute of 7 July to the Prime Minister seeks agreement to the UK negotiating position at the meeting with the Americans on the Bermuda 2 Air Services Agreement starting on 21 July; and reports on the present prospects for privatising British Airways (BA) in early 1987. Mr Moore suggests that, if colleagues are content with his proposals, there is no need for a meeting of MISC 112 this week (we have provisionally earmarked the vacant E(A) slot after Cabinet on Thursday).

Bermuda 2

2. The proposal in essence is that, although we should be prepared to make some concessions to the Americans on matters such as access to UK regional airports and a more liberal regime for charter and cargo services, we should dig our heels in on the concept of a 40-60 per cent free zone* so as to prevent our airlines' share of North Atlantic traffic falling below about one-third of the market. If we fail to secure this, we shall then have to choose between the options of applying the terms of the existing Agreement itself as they relate to capacity, or giving notice of termination of the Agreement with a view to the negotiation of an entirely new one. But it would not be sensible to come to any conclusions on these options in advance of the outcome of the forthcoming negotiations; and in an attempt to strengthen our hand the Foreign and Commonwealth Secretary should send a personal message to Mr Schulz.

* ie there is a free for all between 40% and 60%, but inside that zone action is taken to prevent one country's airlines wiping out the other's.



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Privatisation of BA

3. The Transport Secretary's report is curate's eggish. Although the position on anti-trust liabilities looks much better, and this problem may largely have been cracked, there are worrying downside factors in the form of the uncertainties about Bermuda 2 and the deterioration in BA's financial performance due in the main to the effects on air travel of terrorism and the Libyan crisis. Although flotation may still be possible, the proceeds could be substantially reduced. The Treasury tell me that, on present prospects, a January 1987 flotation could realise only some £700 million compared with the £1 to 1.25 billion pencilled in for this sale. However, no decisions on this can be taken now and, as the Transport Secretary suggests, it will have to be looked at again in the autumn in the light of the various developments.

Comment

4. I think the Transport Secretary's proposals on both the Bermuda 2 negotiations and the handling of privatisation are sensible, and that there is no need for a MISC 112 meeting on Thursday. I am not optimistic about the outcome of the negotiations starting on 21 July, but there seems no advantage in a collective discussion of fall-back options in advance of knowing the outcome of them. Nor is there much that Ministers collectively could usefully contribute at this stage on privatisation. It will, however, be necessary to take a firm decision on the latter before the end of September if the option of substituting the British Airports Authority (BAA) for BA in the January 1987 privatisation slot is still to be exercised. You may recall that it was earlier agreed between the Ministers concerned that the first preference for next January should be BA, but that BAA should be substituted if the BA flotation could still not proceed.



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Recommendation

5. Subject to the view of other colleagues (and I understand that both the Treasury and the FCO are likely to support Mr Moore's proposal) I recommend that:-

(i) there is no need for a MISC 112 meeting on Thursday;

(ii) the Prime Minister should broadly endorse the Transport Secretary's proposals, but note that a meeting of MISC 112 is likely to be necessary in September both to review the outcome of the negotiations with the Americans and to take a firm decision on privatisation.

If the Prime Minister agrees, we will earmark now a time for a MISC 112 meeting round about the second or third week of September.

Approved

J B UNWIN



PRIME MINISTER

8 July 1986

UK/US AIR SERVICES AND BA PRIVATISATION

Our goal is a satisfactory renegotiation of the capacity control annex of the Air Services Agreement covering scheduled North Atlantic traffic and, early in 1987, the successful flotation of BA. BA's remaining anti-trust liabilities are no longer a serious obstacle in this regard.

However, the Bermuda 2 negotiations will not be easy and the Government is likely to face some tough decisions. At this stage, we need consider only the most immediate - the UK team's remit for the forthcoming Bermuda 2 capacity control negotiations.

The Department of Transport make a strong case for not budging from the existing basic safeguards for British airlines operating scheduled services across the North Atlantic. Whereas the UK airline industry is dominantly international (95%), the huge US airline industry is dominantly domestic (80%). From this strong domestic base, characterised by a handful of giant airlines controlling hub and spoke systems centred on major airports, the US Government would like unfettered freedom to compete for North Atlantic business. Yet the supposed champions of deregulated competition are not prepared to give foreign competitors access to US business beyond the major gateway airports, or

access to the computer reservation systems through which the great majority of US airline bookings are made.

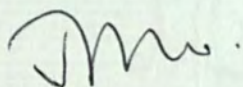
It might seem that the basic issue is one of priorities, between:

- the liberalisation of air services to benefit consumers - and the most efficient and competitive airlines;
- upholding the interests of our successful and growing commercial airline industry (which is diverse, well managed, enterprising and has little to fear from liberalisation based on fair and equal competition);
- early in 1987, successfully privatising BA (which can expect to prosper in fair competition with its peers).

But there are no real conflicts of priority. None of these objectives will be served by conceding ground to the US Government over the basic safeguards of the Bermuda 2 capacity control annex. If privatising BA early in 1987 was our overriding objective, there would indeed be a case to take a more conciliatory line in the Bermuda 2 negotiations. But if that were so, the diminished commercial prospects for BA would be evident and the privatisation could easily flop. BA's £80 million loss of North Atlantic revenue since Libya/Chernobyl has reminded investors of the importance of this market.

Recommendations

There seems to be little need for a meeting of MISC 112 at this point. John Moore's remit for his negotiating team on basic safeguards is sound; likewise, the conciliatory aspects. Giving US airlines increased access to UK regional airports - presumably in the North and Scotland - should provide a much needed boost to business activity in these areas. In the case of charter and cargo services, there are fewer obstacles to fair competition and our airlines have nothing to fear from a more liberal régime.



JOHN WYBREW



SECRETARY OF STATE FOR TRANSPORT

WSP?

UK/US AIR SERVICES AND BA PRIVATISATION

WITH DN?

The paper which you sent to the Prime Minister and Members of MISC 112 on 7 July records the current problem on the capacity control annex to Bermuda 2 and also your intention to consult the Law Officers on whether the anti-trust issues still pose a problem on the prospectus.

On the first issue, I should record that, at the request of our Embassy in Washington, I expressed our concern about capacity control to Mr. Shultz when I saw him on 2 July. He was not briefed on the subject and there was no substantive discussion, but he will be to some extent prepared for the approach which you suggest from Geoffrey Howe. For what it is worth, I also emphasised the importance we attach to this issue - at rather greater length - to the Deputy Legal Adviser to the State Department.

Appendix 2 to your paper tends, I think, to underestimate the difficulties which would face us if we took unilateral action against US airlines after the expiry of the capacity control annex but without having terminated Bermuda 2 itself. Article 11 of Bermuda 2, with which Appendix 2 to your paper deals, contains a provision (paragraph 6) which specifically limits the right of the UK and US Governments to have recourse to unilateral action. I think we would have to look at this very carefully, in the light of the then circumstances, before concluding that it was right to act unilaterally and risk an adverse finding on arbitration.

/Turning

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-2-

Turning to the anti-trust issues and the BA prospectus, I shall of course look at these as soon as I have received the necessary papers. It is however perhaps worth making the point now that if, at the time of privatisation, we are contemplating termination of Bermuda 2 in order to obtain leverage against the US this may create a new range of disclosure problems.

I am copying this minute to the Prime Minister, Members of MISC 112 and to Sir Robert Armstrong.

MH

8 July, 1986

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CBG

PRIME MINISTER

UK/US AIR SERVICES AND BA PRIVATIZATION

/ The attached paper was prepared for circulation to MISC 112, and seeks agreement to the UK negotiating position at the negotiations with the United States which commence on 21 July. I understand that MISC 112 members could meet briefly after Cabinet on Thursday 10 July if necessary, but if colleagues are content with the proposals in paragraph 7 (including the negotiating position) there is probably no need for a meeting at this stage. The really difficult decisions in relation to privatization arise only when the outcome of these negotiations is known, and particularly if these negotiations do not result in satisfactory new arrangements for capacity control on the North Atlantic to replace the present ones when they lapse on 23 July.

/ I am sending copies of this minute to the members of MISC 112, and to Sir Robert Armstrong.

JOHN MOORE
7 July 1986

UK/US AIR SERVICES AND BRITISH AIRWAYS PRIVATISATION

Paper by the Secretary of State for Transport

1. Colleagues will recall (MISC 112(86)1) that a decision on the privatisation of British Airways (BA) was deferred on two main counts - continuing difficulty over current and possibly future private anti trust treble damage suits in the US courts; and uncertainty about the UK/US market in view of the need to renegotiate a key part of the current Bermuda 2 Air Services Agreement - a capacity control annex (Annex 2) which expires on 23 July. This paper:

(a) seeks agreement to the handling of the negotiations with the US: and

(b) reports on the present prospects for privatising BA in early 1987.

US Negotiations

2. The state of negotiations on the Bermuda 2 capacity control annex remains difficult, quite apart from the implications it has for the privatisation of BA. The US market is very important to BA (and to British Caledonian (BCal) and Virgin Atlantic (VAt)) and, I am very concerned that unless we can safeguard legitimate UK interests we shall

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increasingly see UK/US air services dominated by US airlines to the detriment of the UK aviation industry as a whole. The annex to this paper sets out the reasons why this particular annex is important to us, the current state of the negotiations and the options available.

3. I am satisfied that in the July negotiations we must not be negotiated down into acceptance of an agreed mechanism which would entrench the dominant position of US airlines in the UK/US market in a way which would prevent our challenging that situation in the future. In the first place an unsatisfactory agreement would be against the proper interests of BA as an airline, whether or not privatised; and in the second place we would be open to justifiable criticism from other British airlines (notably BCal, about whose future I am greatly concerned) that we had sacrificed the interests of UK aviation as a whole in order to privatise BA.

4. Nevertheless we must have regard for BA privatisation in evaluating the options available if we fail to get agreement to a new capacity annex on acceptable terms. If the annex lapses the first option is to apply the terms of the Bermuda 2 Agreement itself as they relate to capacity. This could lead to challenges at international arbitration or in the UK courts, though we have just taken steps to minimize the risk of successful UK litigation by initiating procedures leading to amendment of the terms of the permits under which US airlines operate here. The second option is to give notice of termination of the Agreement with a view to the negotiation of

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a new one. In either case there is bound to be great uncertainty about the UK/US market and the regime which would eventually emerge, but equally investors should be reassured by evidence that HMG is prepared to take firm action to prevent British airlines from being swamped on UK/US routes.

5. Termination of Bermuda 2 is not a step to be undertaken lightly, but nor is it ruled out. At bottom Bermuda 2 is simply a commercial agreement which either party is at liberty to terminate on giving 12 months notice if it is no longer satisfied with the arrangements. Even if the actual termination date were to be reached without a new agreement in place to succeed it, flights between the UK and the US would not automatically cease. If either side were then to insist on a complete cessation of air services, this would be an extremely hostile and unfriendly act. There would be no incentive for HMG to take such a step and although the US did threaten this in 1977 during the Bermuda 2 negotiations I believe they would be no more likely than we are to risk such a drastic step today, given the importance of the UK/US market to the US airline industry and to certain of their airlines in particular. The chances are therefore that air services would continue in more or less the existing pattern for some time even after a notice of termination had run its course. There would be continual negotiations to accommodate market growth, and with strong nerves these could lead gradually to a better balanced agreement.

6. However I am not recommending termination at this stage.

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For the present we need to concentrate our efforts on achieving a satisfactory agreement in the week of July 21 or within a few weeks thereafter. I myself have sought to stress the importance and urgency of this issue with the US Embassy in London, and I think that it would be helpful if the Foreign Secretary could send a message in similar terms to Mr Schulz. I also think that, if the July talks do not succeed, it would be worth considering one final effort on the part of the Prime Minister to press the US Administration to reach an early accommodation with us. If even that does not succeed I recommend at that stage a final consideration of the options available together with the implications for BA privatisation.

7. I invite colleagues to agree that:-

(a) the UK negotiating position for the consultations to take place in the week of 21 July be that set out in para 14 of the annex to this paper; and that we should not accept arrangements which could result in the UK being unable to prevent our airlines share of North Atlantic traffic falling below one third of the market.

(b) the Foreign Secretary sends a message to Mr Schulz to stress the urgency and importance of these negotiations.

(c) if we fail to secure agreement on acceptable terms in July we should consider making one final attempt,

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supported by a message from the Prime Minister, to reach a successful conclusion before the end of the summer.

(d) if we fail to get agreement before the end of the summer we then have to decide between attempting to safeguard our interests on a unilateral basis within the existing framework of Bermuda 2, or terminating the agreement and negotiating a new one.

BA Privatisation

8. We shall need to decide not later than September whether we can aim for an issue in January/February 1987. A successful flotation at an acceptable price depends on three conditions:

(i) arrangements governing services on the North Atlantic which give the investor sufficient confidence about the US market, which is 23% of BA's revenue

(ii) confidence that BA's anti trust liabilities can be described in the prospectus in terms which fully meet the standards of law and propriety which HMG must apply as vendor without impairing the successful marketing of the issue

(iii) assurance of a satisfactory profit performance, and resolution of the balance sheet.

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9. (i) is discussed in the first half of this paper. If the July negotiations are successful, the question falls away. If not we will have to assess the effect on investor confidence of each of the two options discussed in paragraphs 4 and 5 above.

10. As regards (ii) BA have very recently put to my Department a reassessment of their likely exposure to anti-trust litigation in the light of recent developments in the US courts. It is much more optimistic than the estimate of £100m which their advisers made in February (MISC 112(86)1 refers). My officials, with those of the Treasury and the Law Officers Department, are discussing this reassessment urgently with my advisers, and I shall be consulting the Law Officers. An official group will shortly complete the review commissioned by MISC 112 of alternative options. I shall report to colleagues as soon as possible. I am hopeful that the anti-trust problem will no longer prove an obstacle.

11. BA's financial results in the current year are expected to be substantially below budget, (some £100m - £120m) and below those of the last two years. The shortfall is due mainly to the effects of terrorism and the Libyan crisis on the major markets. My officials are discussing with Hill Samuel the implications for a flotation and for the capital structure. Preliminary indications are that provided that the drop in traffic and profits is temporary, and the investor can be satisfied that the business will recover, a successful flotation may still be possible. But we shall need to

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consider in September what the latest prospects are, and will of course need to be satisfied that the taxpayers will receive sufficient value for the business. Further shocks to the market, such as renewed fear of terrorism or a cessation of services to South Africa would obviously make the prospects much more difficult.

12. I invite colleagues to note the position on privatisation set out in paragraphs 10 and 11. We will need to review the position again in September, by which time we should have a clearer assessment of all the major factors identified in paragraph 8. We shall then be able to decide whether to proceed with a January/February flotation, or wait for our alternative Departmental slot in June.

7 July 1986

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BERMUDA 2 (ANNEX 2): PRESENT POSITION; UK'S OBJECTIVES AND OPTIONS

I THE CURRENT POSITION

Information about the UK/US market is set out in Appendix I to this paper. This reflects the working out in practice of the Bermuda 2 arrangements negotiated in 1977; the main features are a system of selected gateway cities, a limitation on the number of airlines which may be designated to serve each gateway city to and from the UK and a capacity control mechanism (Annex 2).

2. Annex 2, which expires on 23 July, works on the basis that before each summer or winter traffic season each airline must file the schedule of the number of flights/capacity for that season with the authorities of the other side, which may call for consultations if the filing gives rise to concern about excessive capacity on the route in relation to passenger demand. The Annex 2 mechanism sets out the factors which have to be taken into account during such intergovernmental consultations, and a formula for resolving differences of view, including a fallback provision which allows airlines to have a modest increase in capacity if the two sides fail to agree. This mechanism has been particularly important for the UK since the full effects of domestic US deregulation of air

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services have been realized - both in terms of the attitude of US airlines, which have become progressively accustomed domestically to using capacity on routes as an aggressive means of attacking the competition, and in the attitude of the US Government itself, which as a believer in the benefits of deregulation, has lent its full support to the aggressive plans of US airlines irrespective of the effects of such plans on the overall economics of the route. The result of this change in the US position is that they now perceive the agreed principles and mechanics of Annex 2 as operating against their free-for-all philosophy and against the aggressively expansionist aspirations of their airlines. The fact that in pursuit of our own pro-competitive policies we have sought to intervene only in those cases where demonstrable and very damaging excessive capacity would have arisen has not softened the US attitude.

3. The Americans cannot justify any claim that Bermuda 2, its capacity annex or the way in which the UK has operated the Agreement has resulted in a disadvantageous position for US airlines. As Appendix I shows, nine different US airlines operate between 20 US gateway cities and the UK and earn approximately £1047 million as opposed to roughly £741 million for British airlines. Last year US airlines carried 3.8 million passengers as opposed to approximately 1.5 million passengers carried by British airlines. The UK/US market is one of the most competitive of all international markets; Annex 2 has allowed capacity to keep pace with demand and there is a wide variety of airline products, not least in

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terms of attractive low fares. This is a market in which (in normal times) the travelling public and the airlines do very well and one in which the US airlines are allowed to flourish in ways in which they are not able in other international markets.

4. On the UK side it remains the firmly held view that a replacement for the capacity control annex - ie some form of continuing control mechanism to regulate capacity - is necessary if British airlines are to continue to enjoy the commercial rights and benefits conferred by the Bermuda 2 Agreement. Since Bermuda 2 was signed there has been a total transformation in the policies and philosophies of the US in the aviation field - including, and most notably, domestic deregulation within the US. British airlines are fully competitive with US airlines in terms of product, price etc., but they find themselves at a serious disadvantage in the US market (as do other foreign airlines) because of the following features of the US aviation scene which weight the scales of fair competition against them:

(a) The growth within the US of airline hub and spoke systems. US airlines have developed their networks on the basis of hub airports through which the vast majority of their traffic is channelled. Thus, apart from the major trunk routes, the position of the average US passenger wishing to travel between two US cities is the choice of travelling on, say, United Airlines between those two cities by way of transit at Chicago, by Delta

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with transit at Atlanta, by Eastern with transit at Miami, by TWA with transit at St Louis, by American Airlines with transit at Dallas, by Continental with transit at Houston, and so on. This hub and spoke phenomenon, based on economic use of aircraft, and maximization of local market dominance, has resulted in many major US airports becoming dominated by the inter-connecting services of one or perhaps two very large and powerful US airlines.

(b) The deliberate policy of the US Government in designating for international services from particular US cities, the local dominant hub operator;

(c) The accelerating growth of the huge US airlines and the elimination of competition through mergers, acquisitions etc. Objective observers expect to see the US market dominated within the next five years by perhaps half a dozen huge US airlines with nothing between them and local commuter airlines, most of whom will be forced into commercial links with the large airlines.

(d) The absolute stranglehold within the market which is exercised by computer reservation systems (CRS). Within the US 80% of all travel is booked through travel agents 90% of whom use airline-owned CRS systems - in particular either American Airlines' Sabre system or United's Apollo system. Thus the computer reservation systems of the two largest US airlines virtually control the US travel

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market.

5. What all this means is that British airlines flying into a US gateway city find themselves now, and will increasingly find themselves in the future, attempting to compete with huge US airlines (American Airlines for example is already twice as big as BA) operating from airports which they more or less monopolize and where the computer reservation systems to all intents and purposes exclude the availability of service by British airlines from booking screens. It is already extremely difficult for British airlines to find US domestic airlines with whom it is possible to reach commercial agreements for feeding passengers onto transatlantic services and this will get even more difficult as time goes on.

6. The consequence is therefore that without some form of capacity control (the simplest means of ensuring a reasonable market share in circumstances where this cannot be achieved by means of fair and equal competition) the UK would be powerless to prevent British airlines being progressively forced off its US routes. In this respect BCal are currently more vulnerable than BA or Virgin Atlantic, because it so happens that the routes which BCal operate (primarily their routes to Atlanta, Houston and Dallas) are those where the market features described above currently exist in their most acute form. Although BA are starting to run across the sort of problems which BCal already experience, BA in the main operate the older and long established US routes where their competitors are the traditional US airlines (TWA and Pan Am) which do not operate huge domestic networks, and which are themselves in

difficulty as is People Express at Newark. Unless some restraint is exercised on US airline capacity, there is little doubt that US airlines for many of whom international services are marginal to their main domestic business, would have both the ability and the incentive to swamp British airlines off the routes.

II UK NEGOTIATING OBJECTIVES

7. Against the background that it can be demonstrated beyond reasonable argument that British airlines do not have fair and equal opportunity to compete for traffic, particularly traffic with origin or destination other than the gateway cities ("behind-point traffic", which represents up to 40% of the total UK/US market), the negotiating objectives of the UK have been two-fold:-

(a) to secure a continuing capacity control mechanism to replace Annex 2 when it expires on 23 July.

(b) to secure greater equality of access for UK airlines to UK/US traffic.

8. So far as capacity control is concerned we have proposed arrangements which are more liberal, more streamlined and less bureaucratic than Annex 2 itself, but which nevertheless retain essential safeguards for British airlines. The safeguards are built around the concept of a regulatory hands-off role where the market share/capacity share of

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individual routes falls within the range 40/60%; where restrictions in growth by the dominant airline are triggered when the 60% threshold is crossed, and where there is a complete halt on capacity growth by the dominant airline where its market share/capacity share exceeds 60% and where the load factor of the smaller airline falls below economic levels. The figure of 40% is regarded as a critical trigger for capacity control because theory and practice both show that this is the point at which the economics and viability of a route start to nose-dive for the disadvantaged airline. Anything less than one third is not viable commercially (exceptional circumstances aside) and not acceptable as a UK share of this vital market. The objective of our proposals has been to maximize competition above 40%, to give airlines time to respond competitively below 40%, and to enable us to call a halt if market shares are still falling below about 33-35%.

9. As regards market access, the UK's position is that a truly free and competitive market would require the US to permit British airlines to carry passengers and freight freely between the US cities (cabotage) and to have the ability to acquire US domestic airlines (and vice versa). However the US have made it clear that this is not negotiable (the US domestic market is to remain protected) and we have concentrated on certain marginal but significant improvements to market access eg by seeking changes in the US rules regarding computer reservation systems and by seeking parity of treatment for British airlines to enable them to reach

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agreements with US domestic airlines to provide feed traffic and to advertise and market such feeder services as an integral part of the British airlines' operations. We have also indicated in the negotiations that there is a possible trade-off - in that a serious attempt on the part of the US to address the market inequality problems faced by British airlines might enable the UK to take a more relaxed view of the capacity control mechanism.

10. The US position on capacity control is that they would prefer to have no such mechanism, and that they are reluctantly prepared to negotiate such a mechanism only because it is important to the UK. However there is support among US airlines for a continuing mechanism, some nervousness on the US side about what the UK might do unilaterally in the absence of an agreed mechanism, and considerable nervousness at the prospect of pushing the UK into a corner and into terminating Bermuda 2. But having agreed in principle that they are prepared to negotiate a new mechanism, their actual response has been disappointing. So far they have indicated some willingness to deal with the case of the in extremis airline - ie the airline which is about to be forced off a route because it has become unviable. They have proposed that such a situation only becomes a matter of concern on a single designation route where total revenues of the disadvantaged airline on the route fall to 25% and that even then there may only be a case for some constraint on the growth of the dominant airline.

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11. On market access the US response has been even more disappointing. They have not been able to deny the validity of the evidence we have produced for our case that the competitive position as between British and US airlines is not equal or fair. But the proposals that we have put forward for making some modest improvements in the position have made no headway; the US Government is either unable or unwilling to do anything about this at least in the near future (there are reasons for this to do with domestic complications and the fact that other foreign airlines would inevitably also benefit from concessions made to the UK). The only hint that we have received is that the US might be prepared to offer British airlines the ability to serve a limited number of points in the US behind the gateway cities (ie the ability to fly on beyond the gateway cities to deliver and collect passengers to or from London - not the ability to carry US domestic passengers between those points). In hinting at this possible approach, they have however made it clear that they would regard this as a valuable grant of additional traffic rights to UK airlines for which they would expect additional traffic rights for US airlines in return. In other words they seem to be seeing this as a concession to be traded for equivalent concessions on our part rather than an attempt to address the equality of the market place, although this is supposed to be guaranteed under Bermuda 2.

12. The position reached in the negotiations seems to be therefore that there is a large gap between the two sides as to the criteria which should be adopted in any continuing

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capacity control mechanism and no evidence that the US is prepared to address seriously at this stage the problems which British airlines are experiencing in obtaining fair and equal access to an important part of the UK/US market. The US proposals for capacity control would allow US airlines to take advantage of their protected market position and to eliminate competition from British airlines on more and more UK/US routes. Air Services Agreements are intended to represent a balanced and mutual exchange of fair and equal opportunities and traffic rights for the airlines of the two bilateral partners; the US are not entitled to claim a right to an overwhelming domination of the UK/US market, and it is totally unrealistic of the US to expect HMG to accept such a position, let alone enter into a formal agreement with the US which would amount to UK acceptance that such an imbalance is appropriate.

III RECOMMENDED POSITION FOR THE FINAL ROUND OF NEGOTIATIONS (21-25 JULY)

13. Under these circumstances it is in the UK's interests to reach agreement on a continuing mechanism for the control of capacity only if it contains reasonable safeguards for British airlines. If this can be done it is well worth the effort involved, and some concessions to the US in order to get it. Without an agreed mechanism both sides would have to rely on the general principles set out in the main body of the Bermuda 2 Agreement. Under these circumstances the UK would have to seek unilaterally to impose constraints on US airlines' capacity against a background of legal disputation

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and continuing friction between the two governments. For a fuller analysis of the position in the absence of an agreement see Appendix 2.

14. For this reason it is recommended that while the UK should have a firm bottom line in the capacity annex negotiations, we should, if necessary, be prepared to make unreciprocated concessions to the US in other areas relating to air services where they are seeking such concessions from us. (These include increased access to UK regional airports and a more liberal regime for charter and cargo services.) But on the main issue it is recommended that we should not go beyond our basic concept of a 40-60% free zone and the triggering in of constraints outside that zone, designed to prevent the lesser carrier's market share falling below about 33-35% (see paragraph 8 above). To go beyond this in our view would be to legislate for the progressive decline of British airlines in the UK/US market.

IV FURTHER OPTIONS IF THE NEGOTIATIONS FAIL

15. If in the negotiations commencing 21 July we fail to get our bottom line, even in spite of the concessions that we are prepared to make, we would face the following options:-

(a) to continue to operate on the basis of the Bermuda 2 Agreement without an agreed mechanism for the control of capacity. (See Appendix 2). Sooner or later this will provoke a major disagreement between the two governments, with each side having to consider the options of:

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(i) a renewed attempt to negotiate an agreed capacity mechanism

(ii) international arbitration (an option for the US more than the UK since they are likely to be objecting to action by the UK)

(iii) termination of the Agreement and the renegotiation of a completely new Agreement.

(b) to expend high level political capital to bring pressure on the US in a final attempt to get an acceptable agreement before the end of the summer.

(c) to terminate Bermuda 2 and negotiate a completely new Agreement. (See Appendix 2 also for an analysis of this option).

UK/US AIR SERVICES: BACKGROUND INFORMATION (Based on 1985 figures)

1. The total output of the US airline industry - measured in terms of passenger kilometres performed by scheduled services - is huge in relation to the rest of the world. The US output is 527900m followed by the USSR with 186876m, Japan with 64700m, the UK with 63230m (12% of US output) and France with 39500m. 80% of the total US output is domestic. In contrast to this 95% of UK output is international.
2. When international output is looked at in isolation the US still heads the world ranking but less dramatically. The US figure is 112040m; in second place is the UK with 59800m (53% of US output) followed by Japan with 31600m, France with 28260m and the Federal Republic of Germany with 22058m.
3. So far as scheduled international passenger between the US and other countries is concerned, with the exception of Canada (which is almost an extension of the US domestic market for this purpose) the international services covered by the Bermuda 2 Agreement (ie the UK and its overseas territories) is far and away the most important single market. The UK tops the league with 7.4m passengers followed by Mexico (4.5m) Japan (4m) and West Germany (2.8m).
4. UK/US services operate on the basis set out below:

US GATEWAY CITY	AIRLINE	NUMBER OF PASSENGERS (000s)	UK MARKET SHARE %	AVERAGE FLIGHTS PER WEEK DURING THE SUMMER SEASON
Anchorage	BA	162	100	5
Atlanta	BCal Delta	237	40	9
Baltimore	BA World	220	14	3 7
Boston	BA Northwest TWA	532	37	7 7 7
Chicago	BA TWA	322	54	7 7
Dallas	BCal American	255	27	7 14
Detroit	BA Pan Am	65	29	4
Houston	BCal Continental	209	53	7 7
Los Angeles	BA BCal TWA Pan Am	559	47	7 7 7 7
Miami	BA Pan Am	386	47	7 7
Minneapolis	Northwest Orient	132	0	6
Philadelphia	BA TWA	111	55	7 7
New York (JFK)	BA BCal Pan Am TWA	1728	38	21 7 21 28
Newark	Virgin Atlantic People Express	489	43	7 10-14
St Louis	TWA	115	0	12
Seattle	BA Pan Am	151	52	5 7
Washington	BA Pan Am	361	51	7 7
San Francisco	BA Pan Am	269	47	7 7

NOTES

(i) BA also serve Pittsburg, Orlando and Tampa on a one-stop basis. This makes it difficult to break down the figures.

(ii) Miami is now also operated by Virgin Atlantic and by Eastern Airlines, the former on the basis of three flights per week the latter with seven.

(iii) The table excludes Concorde operations, which operate on the basis of two flights per day to New York and one flight per day to Washington/Miami.

(iv) A number of BA's services from Detroit operated via Toronto, and from Baltimore via Bermuda.

(v) Overall UK airlines' market share was approximately 40% of passengers.

(vi) Average total weekly flights: UK 129, US 192.

5. UK-US North Atlantic Scheduled Traffic by Country of Residence

	<u>UK</u>	<u>US</u>	<u>OTHER</u>	<u>TOTAL</u>	<u>£:\$</u>
				(millions)	<u>Relationship:June</u>
1981	44%	42%	14%	5.39	2.058
1982	42%	45%	13%	4.70	1.758
1983	33%	55%	12%	4.80	1.603
1984	29%	60%	11%	5.32	1.401
1985	25%	64%	11%	5.93	1.27575
					16 June 86: 1.5225

UK market share over this five year period was 49.6, 40.5, 36.3, 37.8 and 40.1

6. In terms of total passenger revenues in 1985, the UK airlines' share was just over 40% - £740m as against £1048m by US airlines. For Bermuda 2 earnings as a whole (ie including UK overseas territories and Hong Kong) the UK share falls to 35.6% with earnings of £745m as against total US earnings of £2090m.

7. The UK/US market accounts for roughly 25% of BA's revenue, 35% of BCal's revenue and nearly all of Virgin Atlantic's revenue.

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APPENDIX 2

UK/US AIR SERVICES: POSITION AFTER A LAPSE OF ANNEX 2 OF BERMUDA 2 AND THE POSITION IF BERMUDA 2 IS TERMINATED

I THE POSITION IF ANNEX 2 OF BERMUDA 2 LAPSES

1. Annex 2 represents an agreed mechanism for capacity control - in particular the control of excessive capacity, in accordance with the general principles established in the main body of the agreement in Article 11. Article 11 states inter alia that

- airlines of one contracting party shall have a fair and equal opportunity to compete with the airlines of the other contracting party
- the designated airline of one contracting party shall take into consideration the interests of the designated airline of the other contracting party so as not to affect unduly that airline's services on the same routes
- frequency and capacity of services shall be closely related to the requirements of all categories of public demand, provide adequate service to the public and permit the reasonable development of routes and viable airline operations
- regard shall be paid to efficiency of operation so that frequency and capacity are provided at levels

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appropriate to accommodate the traffic at load factors consistent with tariffs based on reasonable economic criteria

- airline actions leading to excess capacity or to the under provision of capacity can both run counter to the interests of the travelling public.

2. In the absence of an agreed Annex 2 mechanism it would be for each government to reach its own conclusions as to whether these broad principles were being breached in particular instances, and it would be open to either government, to see that the principles are maintained. However Annex 2 applies only to the North Atlantic routes; other routes covered by Bermuda 2 (eg Hong Kong and UK overseas territories in the Caribbean) are subject to a different procedure which envisages that where one party believes that the operations of the airlines of the other party have been inconsistent with the principles of Article 11, it may request consultations in order to review the position and to determine whether the principles have been adhered to. Annex 2 differs importantly from these other routes by incorporating a mechanism which is prospective - ie looks at airline filings in advance of actual operations, and established what happens when the two sides disagree. It is open to legal argument whether, if Annex 2 lapses, the regime which applies to other Bermuda 2 routes then applies to the North Atlantic routes, and in particular whether a party is entitled to take action to restrict airline

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operations on the basis of damaging proposals rather than ex post facto on the basis of damage actually sustained.

3. Unilateral exercise of capacity control by the UK in the absence of Annex 2 might therefore be challenged by the US Government either on the basis of disagreement as to whether the general principles of Article 11 had been breached or on the basis that the UK, in the absence of Annex 2, was not entitled to impose capacity constraints prospectively as opposed to retrospectively. Any action to constrain capacity of US airlines, which would be achieved by writing in limitations in the operating permits of the US airlines, could be challenged by the US either by way of international arbitration or even possibly by reciprocal action (retaliation) by the US Government - though this latter possibility is perhaps unlikely given US vulnerability to further action by us. The legal view is that our chances in international arbitration would very much depend on the particular facts of the case - our prospects for success would be greater in a case where we could demonstrate blatant dumping of capacity.

4. In practice difficulties are likely to occur in the following way. US airlines will submit (as they will be required to do under new operating permits) schedules of flights and capacity in advance of each winter or summer traffic season. Sooner or later (probably sooner) there will be a particular filing which on the UK side will be viewed as

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an intention to mount excessive or damaging capacity on that route. If the UK so concludes, the airline in question, and, as a matter of bilateral propriety, the US Government will be informed as to the UK's conclusions and the levels of capacity which the UK regards as appropriate to be included in the airline's operating permit. At this stage the US airline itself would have the possibility of challenging the UK decision in the UK domestic courts (judicial review) - though the proposed new permits which are currently being circulated for comment should offer US airlines little prospect of success. The US Government on the other hand may choose to take up the issue on behalf of their airline and to seek consultations under Article 16 of Bermuda 2. If those consultations are inconclusive - ie there is no agreement, the UK then has to decide whether to proceed with imposing a limit in the US airline's operating permit and, if the UK did so, the US Government would then be faced with a decision as to whether to react and if so how. It might consider retaliation against a British airline, international arbitration or termination of Bermuda 2. If the US decided on either of the first two options, the UK in turn might then have to consider termination of Bermuda 2.

5. All that can be said with any certainty is that the situation would be messy and unpredictable. It is extremely doubtful whether this situation could drag on indefinitely and it is most likely that sooner or later the two sides would either agree to a renewed effort to negotiate a replacement for Annex 2 or one government or the other would give notice of termination of Bermuda 2.

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II TERMINATION OF BERMUDA 2

6. Bermuda 2 provides for termination of the Agreement after giving one year's notice of termination. The likelihood is that during that year's grace a new Bermuda 3 agreement would be worked out.

7. However if there is no new agreement immediately in place there are two possible scenarios. The first would be a period when there is no formal air services agreement in being, but when air services continue to operate between the UK and the US on much the same basis as they do at present. This is perfectly possible and it could be argued that this would be a workable arrangement which would benefit the UK most. Under such a regime, air services would tend to operate on the basis of reciprocity and the granting of necessary traffic rights, capacity etc would be effected by operating permits.

8. Since such an arrangement might well suit the UK the US might be much less happy with it and might, as they did in 1977, threaten complete cessation of air services in order to force the UK to the negotiating table and to agree a new air services agreement more in tune with US needs. This would be a higher risk strategy for the US since they enjoy a greater market share of the UK/US services and since the wider range of air services covered by Bermuda 2 represent a very significant portion of total US international traffic. Furthermore certain individual US airlines (notably Pan Am and TWA) are very heavily dependent on the UK/US routes for their viability. The UK/US market for Pan Am (which is in any case

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a struggling airline) is for example more important comparatively speaking than it is for BA.

9. Nevertheless the US market is of very great importance to the British airlines (25% of BA's business, 35% of BCal's business and virtually all of Virgin Atlantic's business), and, against the possibility that the US might be more prepared to sacrifice their airline than would HMG, it might be necessary or advisable for the UK to make contingency plans to safeguard so far as possible transatlantic revenues of British airlines. The fact that there may be a break in non-stop flights between the UK and the US (and in reality it is difficult to see any such break lasting for any significant amount of time) would not of course mean that large amounts of traffic would cease to travel between the two countries. Travel would continue but on a one-stop basis eg via Canada or Europe. Contingency planning would therefore involve such things as the pooling of effort and revenues amongst UK airlines and between UK airlines and eg European or Canadian airlines.

10. It is difficult to conceive that any reasonable government whose airlines enjoy such a healthy share of an important market would contemplate the threat of cessation of air services in order to achieve even more advantageous terms and privileges. But the need to resist any such threat if it materializes has to be accepted if the UK is to remain a major force in international aviation.

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CCBB



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1A 2AA

nd

1st July 1986

Bonnie Minister²

Dear David,

*ALW
2/7*

ENGINES FOR BRITISH AIRWAYS 747-400s

My Secretary of State's minute to the Prime Minister of 25 June said that British Airways hoped to complete their evaluation of the proposals of all three engine manufacturers early in July.

However, as I have already mentioned to you, late last week both General Electric and Rolls Royce asked for an extension in the time they could have to answer BA's questions, and BA have agreed to this. Co-incidentally, both engine companies asked for a deadline of 18 July.

This means that the report which my Secretary of State promised will be similarly delayed. I can, however, confirm that Lord King will provide the results of BA's preliminary evaluation so that the issues can be considered by Ministers before a proposal is put to the BA Board for decision.

I am copying this letter to the Private Secretaries to members of E(A), to Murdo Maclean (Chief Whip's Office) and to Michael Stark (Cabinet Office).

*Yours,
Richard.*

R A ALLAN
Private Secretary

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ACCOSPACE

BA

PTS



COMPUTER



file DA 64
cc PC

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

26 June 1986

Dear Richard,

BRITISH AIRWAYS ENGINES

The Prime Minister was grateful for your Secretary of State's minute of 25 June reporting the present position on BA's choice of engine for the Boeing 747-400. She agrees strongly with the line which your Secretary of State proposed to take in discussion with Lord King, namely welcoming BA's wish to stick with Rolls Royce as a supplier, other things being equal, and impressing upon him the sensitivity of the decision.

I am copying this to the Private Secretaries to members of E(A), Murdo Maclean (Chief Whip's Office) and Michael Stark (Cabinet Office).

Yours,

David,

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport.

RA



cc, PC
 cc, BR
 Graham

2
 PRIME MINISTER

DRS
 25/6

ms
 at top

This is an interim response to your request for a report on the financial and other aspects of BA's choice of engine for the Boeing 747-400. There have been a number of significant developments since my minute to you of 11 June:

- a) Pratt and Whitney, who had previously told BA that they believed the result would be a foregone conclusion have now changed their minds and asked if they may submit a quotation. Since BA are still in discussion with both the other manufacturers they felt bound to agree, but have insisted that it must be submitted quickly, it must be their final offer, and it must include operating lease finance proposals.
- b) General Electric have said that they are ready to improve the terms of their offer, and BA should have the details by the end of this week.
- c) Rolls Royce have produced a new offer which, I understand, includes an operating lease finance proposal. They will need to discuss the details with Boeing and will not be able to finalise their offer until next week. It does, however, seem that Rolls Royce's status as a public sector company is not preventing them from offering off-balance sheet financing to BA, a point which particularly concerned Norman Tebbit, though it remains to be seen whether they can match their competitor's terms. We shall need to consider whether the Government's interest as shareholder and the impending privatisation may exercise a degree of restraint on the terms they can offer.



Despite these developments, BA will still aim to complete their evaluation early in July. We will need to await BA's evaluation before we are able to compare the financial packages offered and to assess the balance of commercial and technical advantage, and to identify the wider implications for the two companies. My officials have, however, had a preliminary meeting with those of the Treasury, DTI, Cabinet Office, MOD Procurement Executive and Number 10 Policy Unit to identify the work which can usefully be completed internally before we receive BA's proposals.

I am meeting Lord King today. I shall urge him to keep my Department closely in touch with developments, and in particular to let us have details of the competing proposals and to tell us how BA' evaluation is turning out before the Board take a decision so that Ministers can first have a collective discussion of the issues if necessary. I shall also say that I welcome BA's wish to stick with Rolls Royce as a supplier, other things being equal, and impress upon him the sensitivity of this decision.

I am copying this minute to the members of E(A), to the Chief Whip and to Sir Robert Armstrong.

JOHN MOORE

25 June 1986

AGROSPACE : BA 175.





JU616
Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215 5422
GTN 215
(Switchboard) 01-215 7877

ACB

CONFIDENTIAL

23 June 1986

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London SW1

NBN

Dear John

ENGINES FOR BRITISH AIRWAYS BOEING 747-400s

Thank you for sending me a copy of your minute of 11 June to the Prime Minister. I have also seen the response from No 10 to your Private Secretary and Norman Tebbit's letter of 16 June.

I understand that our officials met last week to put in hand the report the Prime Minister has asked for.

I agree with Norman Tebbit that this is an issue of very great potential sensitivity. Your minute sets out very fairly the importance of this order to Rolls-Royce; and my hope remains that BA will conclude that they wish to buy Rolls-Royce engines. If they conclude otherwise we will be faced with difficult decisions, and I am sure we will need a collective discussion of the issue.

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

Yours,

PAUL CHANNON

Paul

1786
BOARD OF TRADE
BICENTENARY



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CONFIDENTIAL

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CCP



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

JW to see

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1A 2AA

20 June 1986

Prime Minister

Dear David,

Mr

CDP
20/6.

UK/US AIR SERVICES: BERMUDA 2 NEGOTIATIONS

You asked how things stand on this. The answer is that matters are coming to a head, albeit in an unsatisfactory way from our point of view.

As you will recall, apart from the anti trust issue (on which we hope to make useful progress in the near future based on a much more constructive approach by the US Department of Transportation to their powers under existing US law to remove a number of difficulties) our main efforts have been directed at securing an agreed capacity control mechanism to replace the existing Bermuda 2 mechanism (Annex 2) which expires on 23 July. Some form of agreed capacity control mechanism on the North Atlantic is in our view essential if BA, BCal and Virgin Atlantic are to retain an adequate market share in the all important UK/US market.

Negotiations on this Annex have been going on for some time but, following a disappointing round at the end of May, my Secretary of State saw Mr Seitz of the US Embassy to emphasize the importance and urgency of this issue as far as we are concerned. This was followed up by a Working Group meeting in Washington last week at which the US negotiators took an unhelpful line, but which at least clarified a number of the important issues so far as we are concerned. There is to be what we regard as a final round of negotiations in the week of 21 July in Washington. In the short run, our aim must be to create a favourable climate for these talks, at the political level in Washington, and officials will be discussing with the FCO what additional steps can be taken. Within the next two weeks my Secretary of State will circulate to members of MISC 112 a paper setting out the UK's negotiating objectives, the options available, and the implications for the privatisation of British Airways.

CONFIDENTIAL

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CONFIDENTIAL

I am copying this letter to Robert Culshaw (FCO).

Yours,
Richard.

R A ALLAN
Private Secretary

CONFIDENTIAL



Confidential



10 DOWNING STREET

From the Private Secretary

Prime Minister 2

BA

Bobo Joyce intend to place their final
bid by Friday this week. They
believe BA intend to make their
recommendation to Mr Moore by

July 4.

DRS

17/6



Chancellor of the Duchy of Lancaster

CONFIDENTIAL

CLG

CABINET OFFICE,
WHITEHALL, LONDON SW1A 2AS

Tel No: 233 3299
7471

16 June 1986

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

Prime Minister ²
To note that Mr Tebbit
is also concerned, (I had
already made all these
points on your behalf.)

mb

DLF
16/6.

D. John.

ENGINES FOR BRITISH AIRWAYS 747-400s

Thank you for the copy of your minute of 11 June. I have also seen Mr Norgrove's letter of 12 June to your private secretary in response.

I welcome the Prime Minister's view that Departments should consider this urgently, including from the point of view of Government as owner of both BA and Rolls Royce.

You say in your minute that GE would appear to be willing to offer particularly attractive terms for the prestige of becoming a BA supplier. It goes, of course, far beyond prestige. This order would have a substantial market impact, particularly in the damage it could do Rolls Royce in seeking other orders. We therefore need to be very sure of the circumstances leading up to this decision.

As regards the financing, it would not be understood if we allowed BA to take advantage of a method of financing this deal which, at the same time, by virtue of the restrictions on public sector companies, was not available to Rolls-Royce. It would be said, with some justification, that we had allowed the national interest to be lost sight of. I hope that we can investigate fully this aspect of the deal and see that Rolls-Royce is not hampered by its public sector status.

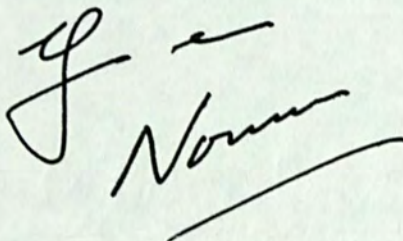
I agree that a decision that either overrides BA's commercial judgement or loses Rolls Royce the order will be difficult to present. There is therefore every reason to be active now in considering the deal, so that these unpalatable choices may be avoided.

h

- 2 -
CONFIDENTIAL

I would welcome the opportunity for a discussion between colleagues as soon as officials have completed the work sought in Mr Norgrove's letter.

I am sending a copy of this letter to the Prime Minister, members of E(A), to John Wakeham, and to Sir Robert Armstrong.

A handwritten signature in black ink, appearing to read 'Norman Tebbit', with a long horizontal flourish underneath.

NORMAN TEBBIT

AEROSPACE

BA
PTS





10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 June 1986

Thank you for copying to the Prime Minister your letter of today to Mr. Channon about the British Airways engines order. The Prime Minister is following this closely and I shall bring your letter to her attention.

(David Norgrove)

Sir Francis Tombs.

15/6

Mr. Noyce

You will wish to note the contents of this minute, which we discussed briefly this morning.

CONFIDENTIAL
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CDP
for para 6,

From: A J WIGGINS
13 June 1986

[Signature]
18/6/86.

MR UNWIN

cc Mr Stark
Mr Roberts
Dr Walker

DW
19/6

ISSUES RELATING TO PRIVATISATION OF BRITISH AIRWAYS

You and Mr Stark asked me separately when Ministers were likely to be asked to decide on the choice of engine for BA's Boeing 747-400s. I have discussed the whole range of inter-related issues arising on the BA privatisation with Mr Holmes, Department of Transport.

2. The position on the choice of engine is generally covered in the Transport Secretary's minute of 11 June to the Prime Minister. BA are currently investigating the technical and financial implications of the offers by GE and RR. The first indications are that GE have the edge on economy and maintenance costs, although neither engine yet exists and all such claims will need careful evaluation in the light of the two companies' past performance. Cathay Pacific told the Department of Transport that they had chosen the RR engine because there was very little difference between it and the GE rival; the Department suspect that CP are influenced by the fact that their Hong Kong depot has ~~only~~ ever serviced RR engines. So far as the Government are concerned, Ministers will need to take into account not only the direct financial impact on BA but also the prospective importance to RR of manufacture of their engine in the 1990s. If it appears that the world market for this engine is always likely to be very restricted, even if the BA order could be secured, RR might in the end be well advised to settle for a substantial sub-contract share of GE work - it would be open to them to seek a share of the benefits of other orders than that placed by BA.



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3. A further complicating factor is the impact on BA's privatisation balance sheet. Boeing's original position was that they were only interested in selling these aircraft, not leasing them. More recently it appears that they may be willing to lease them to BA, provided BA at the same time convert some existing operational leases into finance leases. GE are very anxious to secure BA as a customer for the first time, and have apparently offered to arrange for BA to have both aircraft and engines on an operational lease through a financial affiliate. The Department of Transport think this would help them to resist BA's demand for a cash injection to strengthen their balance sheet before privatisation; BA's position appears to be that they will need the cash injection in any event, since analysts will adjust whatever balance sheet is presented to take account of major leases. From BA's standpoint an operational lease has the advantage over both outright purchase and a finance lease in that the airline has flexibility to adjust the size of its fleet without suffering severe financial penalties. No doubt BA's intention is that they should have both operational lease terms and the cash injection, with the Government losing out both through the cash provided to BA and through the reduction in the value of RR (assuming they cannot meet the operational lease terms). BA have told the Department of Transport that RR's financial terms are so complicated that they will take some weeks to elucidate.

4. The Department of Transport envisage that BA will complete their study of the alternative proposals in the earlier part of July, so enabling Ministers to take a view on this investment before the summer holiday. This would point to an E(A) discussion around 20 July.

5. Ministers will also need to consider in July the timing of the BA privatisation. Further interdepartmental work organised by the Department of Transport has failed to find a new way of separating the contingent anti-trust liabilities from the company to be privatised, leaving a Government indemnity (which Ministers have all along resisted) as the only practical approach to this objective. However, one of the two outstanding anti-trust suits against BA has already been dismissed (although there is the possibility of an appeal), and a hearing is expected on the other case in the course of this month. As a result



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of these developments, the estimate of BA's maximum liability in the event of further litigation in relation to Laker is likely to be reduced substantially below the estimates given a few months ago, so that it may become easier to tackle the issue head-on in the initial Prospectus. There is thus some prospect that this obstacle to privatisation will have been dismantled sufficiently for the sale of the airline to go ahead next January. The Department of Transport expect to put a paper to MISC 112 in the course of July; this would then enable preparations to go ahead for a January flotation, leaving a final decision on this to be taken in September.

6. There remains the issue of US/UK airline capacity. Negotiations with the US have not gone well, although working level discussions are actually going on this week. A further formal negotiating session is scheduled for 21 July, prior to the expiry of the Bermuda 2 arrangements on 23 July. Mr Moore has given clear private indications to the US Administration that the UK must be assured of a reasonable share in the traffic. It may be necessary for the Prime Minister to intervene with President Reagan. Mr Holmes intends that Mr Moore should circulate a paper to MISC 112 next week on the future conduct of these negotiations with the US; it is not clear whether a discussion will be required, but there may be a need for a meeting around the end of the month. If new arrangements cannot be concluded with the US, the implications of the uncertainty will need to be described clearly in the privatisation Prospectus.

7. The final question on privatisation is the commercial outlook for BA, and its effect on the balance sheet. The hope had been that good profits in 1986 would improve the debt-equity ratio to 30:70, but the fall-off in North Atlantic traffic had suggested that the ratio would be 46:54 (with obvious implications for the size of any pre-privatisation capital injection). However, North Atlantic traffic is now said to be improving again, so that the outlook may be somewhat better.

JW

A J Wiggins
Economic Secretariat
16 June, 1986

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COMMISSION





clh

ROLLS-ROYCE plc
65 Buckingham Gate, London SW1E 6AT
Telephone: 01-222 9020, Telex: 918091

PRIVATE & CONFIDENTIAL

Chairman's Office

BY HAND

Prime Minister 2

Departments are working
urgently on this issue, though
even DTI think this letter

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

13th June, 1986

mf

is exaggerated.

DHS
13/6.

Dear Prime Minister,

The order for engines for British Airways' intended fleet of 747-400 airliners is of such great importance that I am enclosing, in the interests of speed, a copy of my letter of today's date to Mr. Paul Channon. ...

Yours sincerely,

Francis Tombs

Sir Francis Tombs

Encl:



ROLLS-ROYCE plc
65 Buckingham Gate, London SW1E 6AT
Telephone: 01-222 9020, Telex: 918091

BY HAND

Chairman's Office

PRIVATE & CONFIDENTIAL

The Rt. Hon. Paul Channon, MP.,
Secretary of State for Trade & Industry,
Department of Trade & Industry,
1, Victoria Street, London, SW1.

13th June, 1986

Dear Secretary of State,

Events of the past few days lead me to fear that British Airways have proceeded much further towards a commitment to buy G/E engines for their new fleet of Boeing 747-400 aircraft than we had understood to be the case.

There are indications that they may have moved towards this conclusion prior to submission of final bids from the three competitors, discussions on which are only just beginning.

If my fears are correct, it is clear that your Department is not aware of such developments, since we have had no recent approaches from you or your officials.

In such circumstances, it is of the utmost importance that you should understand the following points:-

1. We understand and sympathise with BA's need to obtain off-Balance Sheet financing for the aircraft. There is no difficulty in this being done by BA or by us, but there may be some problems of residual guarantees for turn-round options or of financial rates. No discussions have yet taken place between us and BA on these points, but I believe they are capable of solution.
2. Our 524D4D engine is fully competitive with G/E and P&W engines. This is demonstrated by the fact that Boeing offer all three engines on the 400 series as well as earlier marques and, more particularly, by Cathay-Pacific's selection of the D4D engine for their recent purchase of 747-400 airliners.

/ 2 ...

3. Any suggestion that our work-sharing arrangements with G/E on the CF680C engine would provide a satisfactory alternative to the selection of our engine would be incorrect, as would any suggestion that our work-share could be increased beyond the envisaged 25%. We are already having difficulty in obtaining as much as 25% of work, and see no prospect of an increase.
4. A decision to buy G/E engines would have the following effects:-
 - (a) it would result in the loss of about 20,000 man-years of work divided roughly equally between Rolls-Royce and its suppliers,
 - (b) it would have a serious effect on the credibility of Rolls-Royce in general and, in particular, on our capacity to win orders for the 524D4D engine,
 - (c) it would have a serious effect on investors' perceptions for Rolls-Royce and, therefore, our ability to privatise.

These are, indeed, serious matters - so much so that I must ask for an urgent meeting with you to discuss them.

I have copied this letter to the Prime Minister.

Yours sincerely,

Francis Tombs

Sir Francis Tombs



10 DOWNING STREET

From the Private Secretary

12 June 1986

ENGINES FOR BRITISH AIRWAYS BOEING 747 - 400s

The Prime Minister was grateful for your Secretary of State's minute of 11 June about the competition to sell engines to British Airways.

The Prime Minister agrees with Mr. Moore that BA should be free to put proposals based on an objective assessment of the relative merits of the quotations from Rolls Royce and GE. However, the Prime Minister has asked that the Departments of Transport and Trade and Industry, with the Treasury, should consider urgently the financial and other aspects of the deal from the point of view of the Government as owner of both BA and Rolls Royce, and prepare a report. The ability of Rolls Royce to match the financial terms offered by GE should also be considered, bearing in mind that its room for manoeuvre may be reduced by its position as a company in public ownership.

I am copying this letter to the Private Secretaries to the members of E(A), to Murdo Maclean (Chief Whip's Office) and Michael Stark (Cabinet Office).

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport

055

PRIME MINISTER

ENGINES FOR BRITISH AIRWAYS BOEING 747s

The Transport Secretary does not intend to raise this at Cabinet tomorrow unless others do so.

He concludes that BA should be free to put proposals to him based on an objective assessment of the relative merits of the two quotations. The line he proposes runs strictly in accordance with the line you took in the House on Tuesday.

I wonder though whether this is not too purist and also whether as a new Minister John Moore is following too rigidly your position elaborated on the spot in answer to Mr Kinnock.

This decision is too important for the Department of Transport to sit back passively and wait for BA to make their proposals. The Government also has some responsibility to Rolls Royce because public ownership may inhibit its ability to offer special financing deals in the way GE can. It may be possible to help Rolls Royce (if at some cost) without infringing the position that BA should be free to make its own recommendation.

The options should be explored, whatever the final decision.

Agree the line proposed by Mr Moore, but invite DTI, Treasury and Transport to consider urgently the financial aspects of this deal, and particularly the position of Rolls Royce in seeking to match GE, bearing in mind that the Government owns both BA and Rolls Royce?

Yes not

DLW

David Norgrove

11 June 1986

MJ2CAY

Aerospace - pt 5.

Future & Structure of BAHK Airways

ENGINEER FOR BRITISH AIRWAYS BOEING 747

[Faint, illegible text, likely bleed-through from the reverse side of the page.]

*cejh*

PRIME MINISTER

ENGINES FOR BRITISH AIRWAYS BOEING 747 - 400s

I thought you would find it helpful if I explained the background to the story which appeared in the 10 June edition of the Guardian that British Airways were contemplating buying American General Electric in preference to Rolls Royce engines to power future B747s.

BA's Investment Plans

BA believe that they need to acquire 16 of the Boeing 747 - 400 series quickly, to replace the oldest 747s in their fleet which have suffered structural cracking problems and are expensive to maintain. The current average age of these aircraft is just under 14 years. The new version of the 747 would also have greater range and capacity which BA believe is necessary to match their competitors.

They have therefore bought options, which simply reserve a place in the production line, on 16 Boeing 747 - 400 aircraft. The cost of the options was \$6.4m (\$400,000 each) which is refundable. A decision on whether to exercise the first 3 options has to be taken by January 1987, with the remainder exercised in 3 successive batches at 12 monthly intervals. As part of their evaluation BA invited the 3 engine manufacturers (Pratt and Whitney, General Electric and Rolls Royce) to submit quotations by the end of May. They are still in discussion with General Electric and Rolls Royce. Pratt and Whitney, however, have declined to tender.

Government Powers

Under the Memorandum of Understanding with the company and the Articles of Association all investment in new aircraft has to come to me for approval.

Financial Terms

BA have not yet received firm financing proposals from either contender. They think it likely, however, that General Electric will be able to arrange for the aircraft to be supplied on an operating lease. This would enable BA to surrender the aircraft virtually without penalty after 5 years and after 9 years. After 5 or 9 years BA could convert the leases to a full finance lease to cover the remaining book life of the aircraft. Alternatively, after 9 years BA may be able to exchange these aircraft for a later version of the 747.

Rolls Royce have a 25% work share commitment in the General Electric engine, and General Electric have assured BA that they would be willing to negotiate an increase in the Rolls Royce share up to 33% including assembly. General Electric are not at present a BA supplier, and appear to be willing to offer particularly attractive terms for the prestige of becoming one.

BA have given Rolls Royce as much detail as they properly can about the likely General Electric financing package, to see whether Rolls Royce can match it. Other things being equal, BA would like to stick with Rolls Royce as a supplier. Privately, however, BA doubt whether Rolls Royce will be able to match these terms. While the aircraft are on operating lease the engine and airframe manufacturers have to carry the residual value on their balance sheets. The full value of the order for the 16 completed aircraft would be about £1.5bn, of which the engines (80 and initial spares) would account for about £400m.

BA's Preliminary Assessment of Quotations

To acquire the aircraft on an operating lease would have considerable attractions for BA:

- it would provide flexibility in fleet management, since BA could respond to changed market conditions by returning the aircraft to the manufacturer or replacing them with a different model



- until the conversion to full finance lease, the aircraft acquired in this way would not be capitalised in BA's balance sheet or for purposes of the PSBR
- this in turn would take most of the substance out of BA's claim that their balance sheet gearing is too high and that they would need a capital injection on flotation essentially in order to complete their fleet modernisation programme. Politically, I would find it very damaging to agree to a capital injection, particularly now, because BA's competitors have suffered more than BA from the recent fall in international traffic. They would claim that an injection would amount to a subsidy to get the airline off to a good start in the private sector. I shall in any case find it difficult to resist BA's arguments, because their business has suffered too, and they are no longer projecting any improvement in gearing in the current financial year.

BA's preliminary view of the technical merits of the proposals is that the General Electric engine may be preferable, having greater thrust, better fuel economy, lower maintenance costs and more stretch. They think too that it may prove more adaptable to use with other future aircraft types, including in particular the Airbus A330 which BA look upon favourably. However, they have not reached a final view on the technical merits, and the Rolls Royce engine appears to be broadly competitive; the same engine has recently won an important launch order from Cathay Pacific.

Implications for Rolls Royce

If Rolls Royce were to lose this order the commercial effects, and the impact on privatisation, could be serious. Rolls Royce have recently launched this version of the D4 engine (the D4D) and I understand that the revenue forecast to be generated from it is an important element in their cash flow from 1988 onwards. BA is a major customer and failure to win this order with the national flag carrier when the engine had only just been launched would have a damaging effect on the viability of the project,



with knock on effects for companies such as Lucas who supply important components. More generally the loss of this major order would inevitably attract adverse publicity - indeed the mere possibility already has. This could have a depressing effect on the market's view of Rolls Royce and hence on sale proceeds either by reducing the price, or by increasing the size of the capital injection which will be needed.

Employment Implications

Preliminary inquiries suggest that the number of Rolls Royce jobs affected by the loss of this order may not in the short term be very large, though if the D4D project itself were to be called into question the employment effects could be more serious. The impact on supplying companies could also be serious though at this stage it is not possible to quantify.

Public Presentation

The decision if it either overrides BA's commercial judgement or results in Rolls Royce losing the order will be difficult to handle. I think that, whatever the outcome, if the technical and commercial arguments are clear, we should have a defensible case to make. But the consequences for the balance sheet of either BA or Rolls Royce, and the effects on the sale proceeds realised by the Government, will be a difficult calculation which is likely to require careful presentation.

Conclusions

I firmly believe that we should leave BA free to put proposals to me based on an objective assessment of the relative merits of the two quotations, and not try to influence their decision in advance. I appreciate that if Rolls Royce do not win this order they are unlikely to win many others for this engine type, and that could have serious implications for privatisation. But the implications would be equally serious if Rolls Royce could not win this order on the merits of their proposal and would



contradict our belief that such companies should be able to withstand the forces of competition. If we oblige BA to act against their commercial judgement that too would have important consequences, not only for the balance sheet and the outcry any capital injection would provoke, but also for the sale proceeds if we had committed the directors to an investment option, spanning several years' expenditure and a 15-20 year asset life, which they believed was wrong.

I understand that BA should be ready with an investment submission for me by about the middle of July. Meanwhile, no action is called for on the part of the Government, but I shall of course consult you and other colleagues if BA decide to favour the General Electric option.

I am copying this minute to the member of E(A), to the Chief Whip, and to Sir Robert Armstrong.

R. A. Allan.
(Private Secretary)

for JOHN MOORE

11 June 1986

(approved by the Secretary of State
and signed in his absence.)



Prime Minister 2

MS
19/5.

PRIME MINISTER

19 May 1986

BA AND BCAL - ECONOMY MEASURES

The rapid deterioration in the trading conditions for BA and BCAL reminds us that the airline business is not only cyclical but also prone to unpredictable risks. Moreover, commercial aviation is increasingly becoming a business, where customers have little regard for the name of the airline and the frills; the dominant factor is getting rapidly from A to B at the lowest cost.

Managers like Colin Marshall of BA know that you don't survive in this sort of industry unless you act rapidly and decisively to correct for a downturn of business; it is no good riding high in a boom if the sequel is bust. That is what happened to BA after the last oil shock.

The Jeremiahs will be wringing their hands over the economy measures proposed by BA and BCAL. In my view, the bad news is substantially outweighed by the evidence that both airlines are on their toes and responsive to market conditions. No-one is surprised that the oil production companies are reacting in much the same way to lower oil prices.

The tide of airline deregulation is irreversible. Europe will follow the US - more rapidly now that the European Court has declared that the air transport industry is subject to the

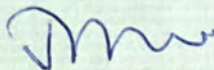
Community's normal laws of competition. The opportunities stemming from deregulation and lower air fares are huge. The Boeing Corporation is forecasting nearly 7% pa growth in the demand for commercial air travel over the remainder of the 1980s and 5-6% pa growth over the 1990s.

The recent upheavals in the US airline industry demonstrate that the future is for the lean, hungry and cost-conscious (eg Texas Air - now incorporating Eastern - American and Delta) and not familiar names like Pan Am and TWA who grew fat as protected national flag carriers.

BA and BCal already have the considerable advantage of their Heathrow and Gatwick airport hubs. British airlines are no mean operators in a tough, competitive commodity business, as our successful chartered airlines have shown. It now looks more likely that BA and BCal have learnt the same commercial lessons. If so, they will be ready to carve up protected competitors like Air France, Lufthansa and Alitalia in a deregulated Europe.

Conclusion

BA and BCal are right to respond rapidly and decisively to a business downturn. Their action bodes well for the future. For the Government to intervene and undermine the management's resolve would be most damaging.



JOHN WYBREW

TOTAL COPIES 7

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JU812

Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY

1-19 VICTORIA STREET

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5422

GTN 215

(Switchboard) 01-215 7877

19 March 1986

SECRET

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

NBM

Dear David,

BRITISH AIRWAYS: ANTI-TRUST SUITS

My Secretary of State was very grateful for the agreement of the Prime Minister and MISC 112 Colleagues to the use of his powers under the Protection of Trading Interests Act in relation to the two anti-trust cases about which I wrote on 17 March.

In the event, developments in the USA on 17-18 March have had a small effect on the timing of any measures. The earlier Laker action (which had been expected to be settled on 17 or 18 March bringing with it the expiry of the existing Direction under the Act) is now expected to be settled within the next few days. The existing Direction therefore has a very brief extra period to run.

These developments do not, in our view, change the fundamental case for taking early measures under the Act; and the Department of Transport agree with this view. We are, however, discussing with the Foreign and Commonwealth Office what the best moment might be for the exercise of powers.

Against this background, we expect to take these measures very shortly. This Department will remain in touch with the Department of Transport and the Foreign and Commonwealth Office on the precise timing.

I am copying this letter to Robert Culshaw (FCO), Philip Wynn Owen (Treasury), Richard Allan (Transport), Henry Steel (Law Officers' Department) and Michael Stark (Cabinet Office).

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

17
19
86
BOARD OF TRADE
BICENTENARY



DEPARTMENT OF TRADE AND INDUSTRY
TODD'S BUILDING
119 VICTORIA STREET

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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London
SW1P 3EB

NBPN

19 March 1986

Doc Niddly

BA PAY

Thank you for your letter of 10 March.

I remain very concerned about the position which BA have got themselves into. They have been shedding staff over the past years to reduce a surplus. That is quite different from the civil service having to pay more to computer staff and specialist grades because there is a shortage. Even taking into account that BA are restructuring the workforce, I cannot see how offers as high as have been made can be justified. Nor is it obvious that a large increase to the paybill will improve BA's long term profitability, particularly, as you say, in their highly competitive market.

With an even larger offer to the pilots it may be helpful presentationally to concentrate on the paybill increase; and I hope that BA will do so publicly. Even then the figure is very large. But I should make it quite clear that although the paybill effect is relevant, it does not give a satisfactory basis for assessing pay offers and settlements.

You mention that the other airlines are considering freezing pilot's pay because of BA's extremely competitive position. I am nonetheless surprised that BA feel they can make such large pay offers without damaging their competitive edge.

Moreover, while I recognise that BA have to plan for the future, a large award this year, at the same time as one for the engineers, will make it all the harder to hold the line with other groups.

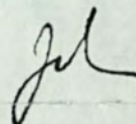
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It is therefore with great reluctance, and taking account of all the circumstances, that I accept your judgement that at the stage these negotiations have now reached, an intervention with Lord King would not be helpful.

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

Yours ever,



JOHN MacGREGOR

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Secretary of State for Trade and Industry

COPY No. 1
DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215 5422
GTN 215
(Switchboard) 01-215 7877

17 March 1986

SECRET

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister!
Content that the Director
should issue? (Subject to colleagues).
Yes *and* *DW*
17/3

Dear David,

BRITISH AIRWAYS : US ANTI-TRUST SUITS

This is give notice of action which my Secretary of State proposes to take tomorrow to exercise his powers under the Protection of Trading Interests Act in relation to anti-trust cases in which British Airways is currently involved in the US Courts.

2 As will be known from discussions in MISC 112, two cases have been brought in the wake of the Laker collapse four years ago. Both are private suits, one alleging British Airways' involvement in anti-competitive practices in the air ticket agency market. Both may well be largely or wholly dismissed on grounds of "standing" (ie that British Airways has no case to answer).

3 It was with the prospect of such cases in mind that the then Secretary of State (Mr Brittan) made his statement on 11 December 1985 (Cols 623-624):

"I therefore intend to exercise powers under the Act to whatever extent is necessary if proceedings under the anti-trust laws were to be taken in the future in United States Courts against any United Kingdom airline in relation to air services operated by it under Bermuda 2, and would not envisage consenting to requests to comply with discovery orders made by US Courts in such cases".

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In both the present cases the question of discovery of documents arises. With the possibility of the cases being dismissed on grounds of "standing" my Secretary of State had been very reluctant to exercise his powers under the Protection of Trading Interests Act, both because the powers are controversial and because British Airways' case could be prejudiced. But factors brought to his attention late this week persuade him that there is no alternative to doing so; and with apologies for the shortness of notice - he accordingly proposes to act tomorrow.

4 There are two reasons for this step. The first relates to the US procedures, and British Airways' position. Up to now British Airways have felt justified in not shipping documents to the United States, despite requests for discovery, on the grounds that they are protected by an existing direction under the Act (made in connection with an earlier Laker action). But that direction will shortly expire (probably tomorrow if there is final settlement of the earlier action); and officials in this Department were told late last week that, in the absence of any fresh direction, British Airways would feel bound to begin the process of shipment of documents to the United States.

5 The second reason relates to British Airways' privatisation, and the reliance placed on Mr Brittan's December statement by their financial advisers, when framing estimates of British Airways' likely liabilities from anti-trust suits. The existing level of provision (which is matched by a substantial insurance element) is only just below the threshold of materiality. If the Government were to show reluctance to use the Protection of Trading Interests Act, with the consequences that this might have in facilitating the progress of suits against British Airways, British Airways' estimated liabilities would be revised producing an increase which could well raise them above the materiality threshold, with implications for any future flotation prospects. This would have serious consequences for any future chances of privatising British Airways.

6 Exercise of powers under the Protection of Interests Act is never easy. Use of the powers raises controversial issues of UK/US relations; and the consequences in terms of US Court procedures can never be predicted with complete certainty. However, taking account of the two issues set out above my Secretary of State believes that it is now right to take the steps indicated in Mr Brittan's statement of last year; and the Secretary of State for Transport has endorsed this view. My Secretary of State therefore proposes to give appropriate Directions under the Act, subject to

Strongly, I am told.

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any views which other MISC 112 colleagues may have (for which he would be grateful by 1 pm tomorrow on 18 March). The Directions would then be signed tomorrow afternoon.

7 I am sending copies of this minute to Robert Culshaw (FCO), Philip Wynn Owen (Treasury), Richard Allan (Transport), Henry Steel (Law Officers' Department) and Michael Stark (Cabinet Office).

*Yours ever,
Michael*

MICHAEL GILBERTSON
Private Secretary

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SUBJECT cc
MASTER

File



cc: B1
B9

10 DOWNING STREET

From the Private Secretary

17 March 1986

BRITISH AIRWAYS

The Prime Minister this afternoon saw Lord King to discuss the privatisation of British Airways.

Lord King explained that the news stories over the weekend about a conflict between Government and British Airways management were "manufactured news". He had not heard of the stories until Friday last week. Of course the management had held discussions about the possibility of a management buy out as of other forms of privatisation. And of course he from time to time had disagreements with Mr. Ridley, but then he did not always agree with his own wife either. He hoped that Mr. Ridley and the Government would make every possible effort to put across their determination to privatise British Airways as soon as possible. There would be problems in maintaining morale in the airline and also in keeping the management together.

The Prime Minister said that the decision not to set a new timetable for privatising the airline was in part in order to weaken the determination of present and possibly also prospective mitigants. Any prospectus, whether for a management buy out or a flotation, had to be prepared with scrupulous accuracy and it was important to settle the discussions about Bermuda 2 and to resolve the uncertainties about the application of US anti trust law before the airline could be privatised.

The Prime Minister thanked Lord King for his letter of today (copy attached). Lord King and the Prime Minister also agreed that the line to take, attached, would be followed with the Press after the meeting.

(DAVID NORGROVE)

Richard Allan, Esq.,
Department of Transport.

cc Transport
cc BL

BRITISH AIRWAYS

British Airways Plc
Cleveland House
19 St James's Square
London SW1Y 4LN

Telephone: 01-930 9766

Chairman:
Lord King of Wartnaby

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

17th March, 1986

Dear Prime Minister

In view of the media coverage this weekend which gave rise to a number of questions, I want to reassure you that I and my Board are committed to your and our common objective of a successful privatisation of British Airways as soon as possible.

We would prefer this to be accomplished by means of a public flotation and will pursue such intention with much vigour while continuing to work closely with Nicholas Ridley and his Department. Furthermore, we support HMG's efforts to achieve a successful outcome in the current negotiations with the United States Government over the capacity annex to the Bermuda II agreement.

I am most appreciative of the invitation you extended to me through Nicholas last week and I look forward to our meeting this afternoon.

*Yours ever
Dun*



British Airways Plc,
Registered office:
Speedbird House,
Heathrow Airport (London)
Hounslow TW6 2JA,
Registered in England No. 1777777.

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4



BRITISH AIRWAYS



Yes
excellent
mb

10 DOWNING STREET

Prime Minister

Lord King would like to send you this letter if you think it would be helpful. Mr Ridley thinks it would be helpful, partly because it would help him at Quentin's this afternoon.

Agree?

(Transport have at my request prepared a line to take with the press after your meeting with Lord King this afternoon. This is now being agreed with Lord King.)

DS

17/3

D R A F T

cc B9

THE RT HON MRS MARGARET THATCHER MP, PRIME MINISTER

In view of the media coverage this weekend which gave rise to a number of questions, I want to reassure you that I and my Board are committed to your and our common objective of a successful privatisation of British Airways as soon as possible.

We would prefer this to be accomplished by means of a public flotation and will pursue such intention with much vigour while continuing to work closely with Nicholas Ridley and his Department. Furthermore, we support HMG's efforts to achieve a successful outcome in the current negotiations with the United States Government over the capacity annex to the Bermuda II agreement.

I am most appreciative of the invitation you extended to me through Nicholas last week and I look forward to our meeting this afternoon.

LORD KING OF WARTNABY



ce BL



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

17 March 1986

Dear David,

PRIME MINISTER'S MEETING WITH LORD KING, 17 MARCH 1986

/ We spoke. I now enclose a copy of the line which we suggest No 10, and Lord King, should take with the Press after Lord King has seen the Prime Minister this afternoon - subject, of course, to what is said at the meeting! This has been discussed with my Secretary of State and agreed between Jean Caines here and Bernard Ingham and, subsequently, with Colin Marshall, Chief Executive of British Airways.

David Burnside (Head of Public Relations at BA) and Jean Caines will be in touch with Bernard Ingham after the meeting.

I am copying this letter and enclosure to Bernard Ingham.

*Yours,
Richard.*

R A ALLAN
Private Secretary

PM'S MEETING WITH LORD KING, BA 17 MARCH 1986

The Prime Minister met Lord King this afternoon to discuss the Government's recently announced decision not to set a timetable yet for the privatisation of British Airways. The invitation had been issued by the Prime Minister last week at the time of the decision.

LINE TO TAKE

The Government and British Airways have the common objective of privatising the airline as soon as possible. It is a matter of great regret to both that the uncertainties arising from the current state of the Bermuda 2 negotiations and the application of US anti-trust law to international aviation have led the Government to conclude that a timetable cannot be set yet. The Board of BA respect the Government's decision and hope that the negotiations which are vital to the continuing success of BA can be brought to a speedy and successful conclusion.

The Government and the Board agree that the preferred method of privatisation is a public offer for sale. This would enable the market to be tested properly, and assist the Government's objective of widening share ownership.

Lord King confirmed that the Board had not put proposals for a management buy-out to the Government. The company look forward to a successful public offer for sale as soon as the Government judge that privatisation can proceed.

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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley AMICE MP
 Secretary of State for Transport
 Department of Transport
 2 Marsham Street
 London
 SW1P 3EB

NBRN

17th
 March 1986

Dear Nicholas,

BAA PAY

Thank you for your letter of 12th March.

In the circumstances, I think we must regard the outcome of these negotiations as satisfactory. It is rather unfortunate though that the Press have concentrated on the maximum increase in basic rates and not the effect on average earnings.

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

Yours,
John
 JOHN MacGREGOR

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AEROSPACE, Future of RA

PKS



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CC BG
BU



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

Mark Addison Esq
Private Secretary
10 Downing Street
LONDON SW1

13 March 1986

DN.

Dear Mark,

I think you need to decide what
the S/P should be present. He is willing
to be if you want him. MBT
12/3

PRIME MINISTER'S MEETING WITH LORD KING,
17 MARCH

The Prime Minister is meeting Lord King, the Chairman of British Airways, at 3.30 pm on Monday, 17 March. I enclose a short brief for the meeting which my Secretary of State has seen and approved. The Prime Minister is, of course, familiar with the background from this week's MISC 112 discussion.

Yours,
Richard

R A ALLAN
Private Secretary

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BRIEF FOR MEETING BETWEEN PRIME MINISTER AND LORD KING

LINE TO TAKE

Reasons For Delay

- Greatly regret that still cannot set a timetable
- But vital to be able to take tough line with the Americans if necessary to protect interests of British civil aviation industry as a whole
- Also worried about propriety of proceeding. Prospectus satisfied HMG's legal obligations, but extent of disclosure created unacceptable risks

Timetable

- Hope privatisation still possible soon. But cannot say when because simply would not be believed, and anyway depends on progress on Bermuda 2 and anti-trust
- Will review possibility of agreeing on a timetable in the summer in light of progress on these matters
- Must be confident that any target date really is achievable. Cannot afford to build up false expectations again

Alternatives - Management Buy Out

- Our objective remains to sell all the company by means of a public offer
- Alternative of a management buy out would not on the face of it meet our objectives or yours because:

would not achieve wider share ownership

some means needed to test the market to be sure that Government receiving full value by selling the business in this way

sale document to same standards as prospectus would be needed, especially if large numbers of employees participate. So disclosure problem would remain

sale proceeds could be affected by current uncertainties over Bermuda 2

- Nevertheless would consider this option if Board can see way of overcoming these difficulties
- But most important not to jeopardise prospects for eventual successful public offering by approaches to institutions to finance different method of sale
- Nicholas Ridley will be writing shortly about method of approach if BA want to pursue this further

/NB Do not mention alternatives being considered within Government to relieve BA of past anti-trust liabilities. If they thought this were a possibility there would be no prospect of persuading them to take these liabilities to the private sector/

Capital Investment

- Public expenditure controls must apply while BA remains in public sector. Necessary therefore when BA's budget is complete to set EFL for 1986-87 and capital expenditure limit for 1987-88
- Will need to look at long term fleet plan in the light of that, and consider financing implications of decisions to be taken this year, both for public expenditure and for the balance sheet of BA when privatised
- Government need to see financial case for six 747's well before January 1987 when decision needed on whether to place orders. There should be no problem provided case is robust and financing can be accommodated within agreed expenditure limits.



CC Pres
BG
Q



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

12 March 1986

David Norgrove Esq
10 Downing Street
LONDON
SW1

BA

Dear David

PRIVATISATION PROCEEDS 1986-87

I attach a very short line to take, on the lines I gave you over the phone this morning, in case the announcement today of the postponement of the BA sale gives rise to suggestions that the 1986-87 privatisation proceeds target will not be reached.

I am copying this to Richard Allan (Department of Transport).

Yours ever,

Tony

A W KUCZYS
Private Secretary

1987/23

PRIVATISATION PROCEEDS 1986-87

Factual 1986-87 target for privatisation proceeds is £4¾ billion. £1.2 billion already guaranteed from third instalment of 1984 BT sale (due 9 April).

Line to take The fact that BA will not be sold this summer does not jeopardize 1986-87 proceeds targets. Other sales expected during the lifetime of this Parliament include British Gas, Royal Ordnance, Rolls Royce, British Airports Authority, and parts of the water industry. There is no fear that overall proceeds will not live up to the Government's expectations.



C O N F I D E N T I A L



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON
SW1

NB

12 March 1986

Dear David,

BRITISH AIRWAYS PRIVATISATION

I circulated on 10 March the draft of a written PQ and Answer about this subject. Ministers agreed the Answer in MISC 112 yesterday, subject to certain minor amendments: and agreed that my Secretary of State should convey the Government's decision to the Chairman of British Airways.

My Secretary of State saw Lord King yesterday afternoon. Lord King argued strongly that the Answer should make no specific reference to the two new legal suits which have recently been filed against BA in the United States. My Secretary of State agrees that it is most important to give the plaintiffs no encouragement to pursue these cases. The fourth paragraph of the proposed Answer has therefore been revised to meet BA's concerns. It also takes account of advice from the Embassy in Washington received this morning that the Answer should refer to the existence of a serious dispute with the US over Bermuda 2. The revised draft attached has been discussed with FCO and DTI at official level.

A PQ is now on the Order Paper in the name of Mr Gary Waller, and my Secretary of State proposes to give the attached Answer at 3.30 pm today. I should be grateful if any comments on the draft could reach this office by 1.00 pm today: otherwise my Secretary of State will assume that colleagues are content for him to give this Answer.

I am copying this letter to the Private Secretaries to the Lord President, the Foreign Secretary, the Chancellor of the Exchequer, the Lord Privy Seal, the Chancellor of the Duchy, the Secretary of State for Trade and Industry, the Attorney General, the Chief Whip and the Financial Secretary: and to Michael Stark and John Wiggins at the Cabinet Office.

*Yours,
Richard.*

R A ALLAN
Private Secretary

C O N F I D E N T I A L

QUESTION

To ask the Secretary of State if he will make a further statement about the privatisation of British Airways.

DRAFT ANSWER

The Government's aim remains to privatise British Airways as soon as possible.

The Government is currently engaged in important negotiations with the US Government about UK/US air services and the competition law that applies to them.

The North Atlantic market is of great importance to all the British airlines which serve it, accounting, for example, for about 23% of British Airways' total revenue and about 36% of British Caledonian's total revenue. It is most important for all British airlines, not least British Airways, that we secure an agreement with the US Government which either enables them to compete on fair and equal terms for all the traffic between our two countries or, failing that, safeguards our vital interests. Without such an agreement the ability of our airlines to maintain or improve their competitive position would be severely undermined. I made our position perfectly clear during my recent visit to the United States. I am hopeful that it will be possible to negotiate acceptable arrangements before the present ones expire this summer. But before we proceed with the privatisation of British Airways we must clarify with the United States Government the air services arrangements which govern a large part of the company's business.

During my visit to the USA, I also set out our continuing concern to resolve the serious dispute between our two Governments with regard to the application of US anti-trust laws to international civil aviation. My officials are in discussion with the US Departments concerned, but no solution of the problems has yet been found. Until such time as the US authorities rectify the situation, it is for British Airways and other British airlines

to decide how best to deal with the implications of US anti-trust laws, subject only to such restrictions as Her Majesty's Government may consider it necessary to impose to protect the trading interests of the UK. The seriousness of the Government's concern is amply demonstrated by the fact that four years after the collapse of Laker Airways, anti-trust litigation arising from it has not yet been concluded. The company has consistently denied any liability in this litigation, which in the view of HMG should not have been brought.

In view of these factors I have decided, with great reluctance, that I can still not set a firm timetable for privatisation for the time being. I shall watch the situation closely, and proceed as soon as I judge the situation to be sufficiently clarified.

AEROSPACE

BA

PT 5



COMMUNICATIONS

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CCBG



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon John MacGregor OBE MP
Chief Secretary to the Treasury
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

NBM
W
r/s
12 March 1986

Dear John

BAA PAY

After long and difficult negotiations BAA are now close to securing a pay settlement covering all their staff. To reach this position BAA have had to make a final offer worth an overall 5.4% on average earnings. The offer includes significant productivity strings, particularly in relation to craftsmen with the introduction of 'multi-skilling' and the resulting reduction in traditional single skilled craftsmen and their 'mates'.

Some groups, notably the fire service staff, continue to dissent, but BAA believe that they can secure agreement with the majority of the ten trade unions with whom they negotiate on the basis of the offer I have described. Although 0.4% higher than originally hoped for, it is a considerable improvement on the 6% initially floated by BAA and is below last year's 5.5% settlement.

*see
Pt 4
below*

Against a background of privatisation, improved performance and the difficulties outlined in my earlier letters of 30 December and 14 January, I am sure you will agree that a settlement along these lines would be very satisfactory in the prevailing circumstances.

I am sending copies of this letter to the Prime Minister, other members of E(PSP) and to Sir Robert Armstrong.

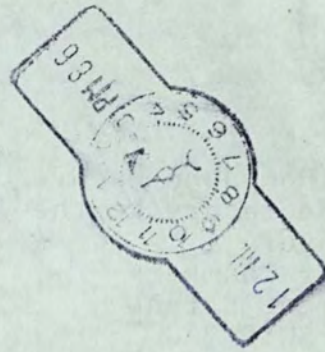
Nicholas Ridley
N Ridley

NICHOLAS RIDLEY

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AEROSPACE, BA PLS





10 DOWNING STREET

From the Private Secretary

Prime Minister

I would advise against you
proceeding chasing with individual
Ministers : it would cut across the
financial Secretary's sense of
responsibility.

Agree to invite the financial
Secretary to produce a position report?

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PRIME MINISTER

BRITISH AIRWAYS PRIVATISATION AND NEGOTIATIONS OVER THE UK/US
AIR SERVICES AGREEMENT (BERMUDA 2)

1 I shall not be able to attend the meeting of MISC 112 arranged for 11 March to discuss Nick Ridley's Memorandum (MISC 112 (86)1).

2 While I sympathise with Nick Ridley's difficulties, I am naturally sorry that he has found it necessary to reach the conclusions set out in his Memorandum. As far as prospectus disclosure is concerned, my officials have analysed carefully the arguments for and against the degree of disclosure currently proposed; and our general view would be that compliance with the terms set out in the draft prospectus passage enclosed with Nick Ridley's Memorandum would be entirely satisfactory. Assuming that a prospectus on those lines were issued, the privatisation of British Airways would be a welcome step towards distancing from Government a company with a history of anti-trust difficulties. As colleagues know only too well, these difficulties have spread into the wider field of our relations with the United States; and British Airways' close links with Government may have deprived the company of some of the freedom which, as a

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private entity, it might have enjoyed in settling these difficulties. For all these reasons, early privatisation would have been welcome.

3 I accept, however, that Nick Ridley must be the best judge of the different issues involved. This applies equally to the Government's objectives for the regulation of capacity on the North Atlantic routes. As I understand Nick Ridley's arguments, the need for freedom in negotiating a satisfactory regime for North Atlantic capacity - which would secure the future of such airlines as BCal and Virgin, as well as British Airways - could well outweigh the more immediate objective of privatising British Airways. I would not necessarily quarrel with that view. But I am somewhat concerned that our assessment of a satisfactory regime for North Atlantic capacity could prove at odds with that of British Airways. The reasons for this would be understandable: we need to have regard to the lesser UK airlines' requirements, as well as those of British Airways as our leading airline. But, given the critical bearing of the negotiations on British Airways own approach towards its flotation, I hope that a way can be found of discussing the issues candidly with the company, rather than considering them in the current highly confidential forum, and handing

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down a decision to defer privatisation which could result in a damaging misunderstanding with the company, or even public controversy.

4

I am copying this letter to the other members of MISC 112. the Lord Chancellor and to Sir Robert Armstrong.

PC

PAUL CHANNON

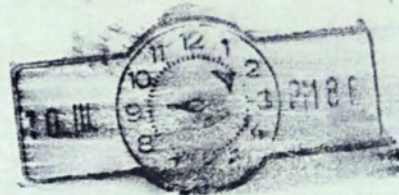
10 March 1986

Department of Trade & Industry

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SUBMIT TO GRADE
TRANSMITTERS

PRIME MINISTER

Two comments from Mr Wiggins on the draft answer below:

1) Last sentence of third paragraph: the successor to the present Air Service Agreement with the United States, which expires in the summer, may have to be a temporary one year Agreement while negotiations continue for a more permanent arrangement. This sentence ought therefore to be presented less firmly, for example "... it is necessary to have a better idea about the arrangements which will ...".

2) Can we get away with a written answer? The Chief Whip's and Lord Privy Seal's advice is necessary here?

N.L.W.

N.L.WICKS
10 March 1986

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PRIME MINISTER

British Airways Privatisation and
Negotiations over the UK/US Air Services Agreement (Bermuda 2)

A - MISC 112(86) 1

BACKGROUND

1. The purpose of this meeting is to consider the current state of play on plans for the privatisation of British Airways (BA), and relations with the USA over anti-trust law and its application to civil aviation.
2. It had been intended that BA should be privatised this summer, subject to the successful conclusion of the outstanding US litigation arising from the collapse of Laker Airways. Once the main cases have been settled, the plan had been to destroy BA's documents currently blocked under the Protection of Trading Interests Act, while British Caledonian (BCAL) would meanwhile repatriate and destroy the comparable documents now in their possession in the USA. This would have substantially reduced the risk of further litigation in the USA, leaving BA much less exposed to the possibility of further major losses arising from anti-trust cases.
3. In his memorandum MISC 112(86)1 the Secretary of State for Transport sets out the position on the risks and propriety of proceedings with early privatisation, and concludes that it would not be safe to proceed at present. He also reviews the state of current relations with the USA over the renewal of Bermuda 2, which expires in July 1986.

MAIN ISSUES

4. The main issues are:



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- (i) whether the privatisation of BA should be postponed;
- (ii) the tactics to be used in negotiations over Bermuda 2, and in particular whether the threat to terminate the agreement may be used.

The Propriety of Early Privatisation

5. It had been hoped that with the settlement of the liquidator's suit and the class action, the main obstacles to privatisation would have been overcome, notwithstanding the existence of a number of the documents described above. Since then there have been two further claims lodged by the US contingency fee lawyer Beckman on behalf of a travel agent and of former Laker employees. These cases have very little merit, but are nevertheless relevant to the flotation because the documents must be retained until the actions are settled. The principal difficulty is the need for the flotation prospectus to disclose all material considerations.

6. It had been hoped that the problem could be overcome by:

- (i) setting aside £25 million to meet any further claims, and disclosing this in BA's accounts;
- (ii) taking out an insurance indemnity for a further £40 million to cover anti-trust risks other than those arising from the Laker collapse;
- (iii) including in the prospectus a carefully drafted piece disclosing enough of the facts, but not too ostentatiously.

7. The Attorney General has advised that the draft prospectus passage (Annex 1 to the paper), which is substantially franker than earlier drafts, is sufficiently candid about the risks and the precautions BA have taken to satisfy the legal requirements as to disclosure. But the Transport Secretary has concluded that on balance it would be risky



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to proceed with privatisation, on the current timetable, because the disclosure of large provision and the insurance policy together would draw undue attention to the problem. The effect could be to stimulate still further litigation, and the risks would inhibit the successful marketing of the issue. Furthermore, privatisation while the future regime for regulating trans-Atlantic air traffic remains unclear could prove difficult: either BA would have to be sold at a discount reflecting the uncertainty, or the Government would have now to surrender its main negotiating cards.

8. On the other hand delay would not itself be free of difficulties: Lord King is already campaigning vigorously for early privatisation and will be exceedingly upset if it is postponed; and Beckman may be encouraged by the sight of the Government on the defensive. It will also knock a large hole in the privatisation programme. Some £1.25 billion has been expected from this sale during 1986-87, although the Treasury seem to think that it might be possible to fill at least most of the gap by some reordering of the programme elsewhere (eg gas).

There needs to be a good press line to deal with the hole - we do not want the markets wobbly before the budget.
N.C.V.

9. If privatisation is delayed, the next available slot will be early 1987. Allowing three months for marketing, the Government would have to make final arrangements in September in the light of the position on litigation and on negotiations on Bermuda 2 and their implications for the relevant Prospectus texts. The Transport Secretary is likely to suggest that officials should also review before then possible alternative solutions to the anti-trust problem, including a Government indemnity, creating a new (shell) company to separate past liabilities from current operations, and establishing a compensation fund. These have all been considered and rejected before, but there is no harm in looking at them again.

Negotiation with the US

10. BA's difficulties stem from the extra-territorial application of US anti-trust legislation. The Transport Secretary has for some time



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been seeking a bilateral competition regime to replace the unilateral application of US anti-trust law. But the UK's approaches have been largely rebuffed, and the Transport Secretary's judgement is that there will be no substantive changes in the anti-trust law (beyond those already under consideration) during the remainder of President Reagan's term. The furthest the US Department of Transportation is prepared to go is to grant UK airlines some degree of immunity from US proceedings, but this would imply recognition of the principle that US law apply to trans Atlantic aviation.

11. In the meantime, negotiations have been proceeding on the regulation of North Atlantic capacity. The most recent US proposals have been totally unsatisfactory since they would allow US airlines to exploit their position to drive out BA and BCAL from many routes. The Department of Transport's view is that the gap is wide and may not be bridged, and that if a new agreement cannot be negotiated, the UK might ultimately have to suspend Bermuda 2, relying instead on individual licensing of flights. But the North Atlantic route is very important to BA (25 per cent of their revenue), and if the Government were prepared to contemplate termination, then it would not be realistic to go ahead with the privatisation this summer, especially because of the difficulty of handling this issue in the Prospectus. However, great care would be needed in referring to these negotiations as a reason for postponing privatisation; it would be some years before satisfactory permanent arrangements were agreed, and it might well be reasonable - given a solution to the other difficulties - to go ahead at some point with privatising BA while some form of interim air traffic regime was in force.

HANDLING

12. You will wish to ask the Transport Secretary to introduce his paper. The Attorney General may wish to expand on his legal advice. The Chancellor of the Exchequer will wish to state the Treasury viewpoint, both on the merits of the question and on the implications of postponement for the privatisation programme as a whole. The Trade and



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B --- Industry Secretary will not be able to be present, but has minuted you with his views (minute of 10 March). All members will wish to comment on the case for postponing privatisation, and on bilateral trade relations with the USA.

CONCLUSION

13. You will wish to reach decisions on:

(i) whether the risks associated with an early privatisation are too great to be acceptable;

(ii) subject to (i), whether to invite the Transport Secretary to report again in September, after examining a range of options;

(iii) whether to accept that it is unrealistic to invest further capital in challenging the extra territorial application of US anti-trust law;

(iv) whether the Government wishes to keep open the possibility of terminating, or at least threatening to terminate, Bermuda 2 in the context of the current negotiation of the North Atlantic air traffic regime;

(v) how any postponement of privatisation should be presented, ie how far this should be attributed to the position of the negotiations on replacing Bermuda 2.

J B UNWIN

10 March 1986
Cabinet Office



COMPTON

III

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cc TB/CP

7

PRIME MINISTER

BRITISH AIRWAYS

A decision tomorrow to postpone privatisation of British Airways would damage morale at British Airways. Is there any reassurance the Government can give to Lord King in breaking the news to him?

The obvious reassurance would be a further timetable for privatisation, though this is now wearing thin.

It would also help to be able to give assurance about any decisions that Lord King will have to refer to the Government before British Airways is privatised.

One decision, to be taken in January, 1987, is whether British Airways should convert into firm orders six options for Boeing 747s. Is the Government in a position to say that it will accept the views of British Airways management? What other major decisions are coming up in the next 18 months?

DKW

DN

10 March, 1986.

JD3AKK

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S E C R E T

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ceB/UP



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

6

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

10 March 1986

Dear David,

BRITISH AIRWAYS PRIVATISATION: MISC 112

MISC 112 will discuss tomorrow morning my Secretary of State's Paper MISC 112(86)1.

My Secretary of State has now asked me to circulate the draft of the written Parliamentary Answer which, if colleagues agree, he would give later this week. This is attached.

I am copying this letter to the Private Secretaries to all members of MISC 112, and to Michael Stark and John Wiggins (Cabinet Office).

Yours,

Richard Allan

R A ALLAN
Private Secretary

S E C R E T

DRAFT WRITTEN PARLIAMENTARY QUESTION

To ask the Secretary of State if he will make a statement about the privatisation of British Airways.

DRAFT ANSWER

The Government's aim remains to privatise British Airways as soon as possible.

The Government is currently engaged in important negotiations with the US Government about UK/US air services and the competition law that applies to them.

The North Atlantic market is of great importance to all the British airlines which serve it, accounting, for example, for about 25% of British Airways' total revenue and about 35% of British Caledonian's total revenue. It is most important for all British airlines, not least British Airways, that we secure an agreement with the US Government which either enables them to compete on fair and equal terms for all the traffic between our two countries or, failing that, safeguards our vital interests. Without such an agreement the ability of our airlines to maintain or improve their competitive position would be severely undermined. I made our position perfectly clear during my recent visit to the United States. I am hopeful that it will be possible to negotiate acceptable arrangements before the present ones expire this summer. But before we proceed with the privatisation of British Airways, it is necessary to have a satisfactory agreement with the American Government about the arrangements which will govern a large part of the company's business.

During my visit to the USA, I also set out our concern about the unilateral application of US anti-trust laws to international civil aviation. Until such time as the US authorities rectify the situation, it is for British Airways and other defendants to decide how best to deal with cases brought against them.

British Airways hope that the American court will shortly give its final agreement to the provisionally approved settlement of the Class Action brought on behalf of North Atlantic travellers who claim to have been disadvantaged as a result of the collapse of Laker Airways. But two further anti-trust actions relating to the collapse of Laker Airways have now been filed in the US against British Airways and other defendants. The company admitted no liability in the earlier litigation and strongly deny the claims in these two suits. I understand they will defend these cases vigorously but a successful result may take some time.

In view of these factors I have decided, with great reluctance, that I can still not set a firm timetable for privatisation for the time being. I shall watch the situation closely, and proceed as soon as I judge the situation to be sufficiently clarified.

cc B/JP

PRIME MINISTER

10 March 1986

BA'S PLACE IN THE PRIVATISATION PROGRAMME

The decision to be taken at MISC 112 tomorrow on the timing of BA privatisation needs to be put into the context of the whole of the privatisation programme between now and the Election.

Privatisation has been and could continue to be one of the most popular and successful measures of Government: it improves efficiency and motivation, removes industry from direct Government control, and has meant greater share-ownership. It is important that its momentum is kept up right until the Election (as well as finding a slot in the Manifesto).

The existing Treasury list of privatisation candidates is as follows:

Privatisation Programme

<u>Fiscal Year</u>	<u>Candidates</u>	
	<u>Probable</u>	<u>Possible</u>
<u>1986-87</u>		
July	Royal Ordnance (£200m)	
Nov.	British Gas (£6-£10bn)	Girobank (£70-80m)
Jan./Feb.	British Airways (£1bn)	
	British Airports Authority (£0.75bn)	
	Rolls Royce (£0.75bn)	
	[Trustee Savings Bank £1bn]	

1987-88

Any slippage from 1986-87 plus Water and BP.

Not mentioned in the existing programme are:

- Subsidiaries of British Steel
- Parts of British Leyland
- National Bus Company

Funding

Even with the delay of British Airways, there is no problem in terms of funding the published public expenditure plans of the Government. The Treasury can still raise sufficient cash to meet its asset sales target of £4.75bn for each of the next 2 fiscal years, largely because its holdings of BP shares can be regarded as similar to a tap stock (their current value is around £3bn).

Political Momentum

The continuing list of new candidates shows that the momentum of the privatisation programme is still being maintained. However, some of the candidates on the list have question marks over them, eg:

British Steel Corporation: A number of small trade sales have been made: BSC may well resist more (just like BL) until their profitability is improved - their intentions need to be known.

Trustee Savings Bank: A cloud of litigation hangs over this sale - which is technically not a privatisation.

Girobank: The issues are whether or not legislation is necessary, and the likely industrial relations problems.

National Bus Company: A large number of individual bus companies (about 60) will be for sale, hopefully in many cases to management consortia. The break-up has been controversial, and privatisation will continue to be so while it proceeds. It will need a determined management to push it through successfully.

Royal Ordnance: This is being reorganised on commercial lines. A number of decisions (affecting the Treasury and MOD) will be needed in the immediate future if the timetable is to be met. These cover: the appointment and remuneration of a new Chief Executive; negotiation of a tank contract; subsidisation of uneconomic explosive/propellant factories; payment of cost overruns on a contract for Alarm missiles; and a possibly expensive redundancy scheme for civil servants transferred to Royal Ordnance.

In the case of British Leyland, there are criticisms of the way in which privatisation has been carried out:

- a. It does not seem that the vendors (BL) and their agents (Hill Samuel) were ready with figures about what they were proposing to sell, prepared with the clarity that a purchaser from a public body might expect.
- b. The BL Board does not appear in the public eye as a willing seller; rather it seems that Ministers are acting as receivers without displaying the professional skills of insolvency practitioners, while the Board is conspicuous by its absence from the scene!

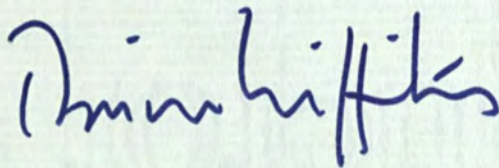
Recommendations

In view of the importance of co-ordination and timing in presenting the programme in the run-up to the Election:

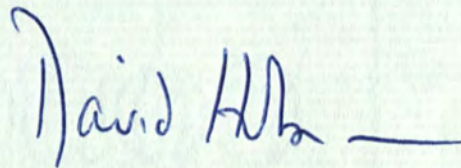
- i. It would be useful if the Financial Secretary could produce a statement on the current state of play for privatisation between now and the summer of 1988.
- ii. Ask individual Ministers concerned with parts of the programme for progress reports - especially British Steel, Girobank, Rolls Royce, TSB, National Bus Company, and Royal Ordnance - with a view to showing how and by

when the existing problems are to be overcome. (Rolls Royce and Girobank are coming to meetings this month).

iii. In view of the fact that the management of BA are eager for the company to be privatised, as well as the publicity given to its sale, it is important that a specific date is fixed for the sale at tomorrow's MISC 112.



BRIAN GRIFFITHS



DAVID HOBSON

CONFIDENTIAL

cc BA



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

Pmie Winter²

*DES
10/3*

The Rt Hon John MacGregor OBE MP
Chief Secretary to the Treasury
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

10 March 1986

[Handwritten signature]

Dear John

BA PAY

Thank you for your letter of 4 March about BA's pay negotiations.

You will recall that, at the outset of the negotiations, I explained that BA were facing a number of difficult issues this year. It was their perception, as confirmed by a survey commissioned from consultants, that pay rates for some important groups of staff had fallen behind those of certain of their UK competitors. In addition, during the period when BA substantially reduced their workforce a number of internal anomalies were inevitably created. What BA have therefore set out to do this year is to carry out a thoroughgoing restructuring of the workforce in an effort to ensure their long term profitability in a highly competitive market. I believe that the current pay negotiations must be seen in that light.

Negotiations are still in progress with the engineers, cabin crew and ground service staff where a range of productivity improvements and job restructuring is under discussion. I understand that it is still not at all certain that a settlement will be reached with the engineers on the basis of the current offer. Provisional agreement has been reached with the pilots on a deal which involves a complete revision of pay scales and new working schedules leading to productivity improvements of up to 15% and a reduction in the pilot requirement of 10%. As recorded in the PSP(O) report, the overall effect of the agreement is to increase the paybill for pilots by 7.8%. I appreciate that this will mean higher average earnings increases for some staff than we would have liked. But we must remember that BA are seeking to adjust the relativities within this

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group to take account of decreased promotion opportunities and the impact this will have on their overall earning capacity compared with that enjoyed by their counterparts in other airlines.

You referred in your letter to the fact that some other airlines are considering freezing pay for their employees. My understanding is that this is precisely because of BA's extremely competitive position. I do not believe they intend jeopardising that position in current circumstances. Of course, simple comparability arguments on their own should not be supported. But, as we have recently had to acknowledge in respect of civil service computer staff and other specialist grades, market forces cannot be totally ignored. As regards BA's pilot workforce, it is not simply a question of their wishing to shed pilots.

BA do not have a single pilot under thirty and stand to lose 60% of the current workforce over the next decade or so. They therefore need to ensure that conditions are created which will enable them to recruit pilots for the future.

I can understand your concern about increases for particular groups of workers which, on the face of it, appear large. The fact that the negotiations have been so prolonged, however, is a clear indication that the changes BA are seeking are by no means an easy option. While the average earnings effect may in some cases be higher, it is BA's intention to secure settlements this year which, overall, will average around 8% of total staff costs offset by significant savings from improved productivity.

Bearing in mind that the negotiations have been proceeding for 6 months and are now nearing their conclusion, I do not think there is anything to be gained from intervening with Lord King about them.

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

*Yours
arm*
Nicholas

NICHOLAS RIDLEY

AKROSPACE

B.A

P.T.S



CCB/UP

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SECRET

PRIME MINISTER

7 March 1986

BA PRIVATISATION

There are compelling reasons to press ahead with the
early flotation of BA. Lord King is right to claim that the
billion pound question over BA's future fleet replacement
programme is not a decision which should be taken in
Whitehall; nor the settlement of generous pay increases to
BA's engineers and pilots. Unfortunately, just as we have
devised a sufficiently candid disclosure of BA's remaining
anti-trust liabilities, a new obstacle blocks our way.

Two years ago, the Government opened negotiations with
the US on the capacity arrangements for North Atlantic air
services (Bermuda 2) following expiry of the current régime in
July 1986. It was hoped that by now a satisfactory outcome
would be in sight. But after the recent round of
negotiations, the two sides are still a long way apart and
will probably remain so until the July deadline; whilst
neither Government can relish the termination of Bermuda 2,
the possibility of threat becoming reality cannot be ruled
out.

Announcing a firm decision to privatise BA in July 1986,
would undoubtedly weaken the Government's negotiating position
over Bermuda 2. It would be one thing to contemplate a trade-
off of early privatisation versus a less favourable outcome of
the Bermuda 2 negotiations if BA alone were affected. It is

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another to disregard BCal's commercial interests. Over 35% of BCal's revenue comes from North Atlantic routes. They are more vulnerable than BA to competition from the powerful US airlines with exclusive access to domestic hub and spoke systems in the US. Sir Adam Thomson is a robust operator. In his position, I would challenge the Government in the courts and mount a fierce publicity campaign.

The gathering momentum within BA for a July 1986 flotation is about to run into this obstacle. Lord King and his colleagues began their privatisation roadshows in mid-January. Only yesterday, they repeated the razmatazz exercise in front of 150 enthusiastic Tory MPs.

The question now is how to prevent Lord King and his management team lashing out wildly in anger and frustration. This is not the time for a rancorous resignation by the Chairman of BA.

We need to execute a deft, matter-of-fact retreat in apparent unity with BA. The latter is crucial. This probably entails giving BA a firm undertaking to proceed towards a publicly-announced flotation date as soon as the Bermuda 2 negotiation has been completed. That could mean flotation as early as September 1986, although the probable date would be early in 1987 following a July resolution of the Bermuda 2 negotiations. The signs are that BA do not yet fully appreciate the importance of the Bermuda 2 negotiations for their own commercial prospects. (25% of their revenue comes

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from North Atlantic routes.) When they do, acceptance of a delay of some 6 months should be easier.

The press are already anticipating a delay. Provided a short statement explaining the background to the delay is backed by BA so that there is no evidence of conflict to be exploited by the press, a quiet retreat can be accomplished.

Attached is an initial draft of the sort of statement which Nicholas Ridley might issue in the form of a written Parliamentary answer. We would take issue only with the final paragraph. Now surely is the time to put a firm, publicly-stated limit on the exercise - ie before the end of the financial year 1986/7. Whitehall's caution needs to be checked.



JOHN WYBREW

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DRAFT WRITTEN PARLIAMENTARY ANSWER

To ask the Secretary of State if he will make a statement about the privatisation of British Airways [in the light of his recent visit to the USA]

DRAFT ANSWER

The Government's aim remains to privatise British Airways as soon as possible.

30 My Department is currently engaged in important negotiations with the US Government about UK/US air services and competition. This market is of great importance to all the British airlines which serve it, accounting, for example, for about 25% of British Airways' total revenue and [&] of British Caledonian's total revenue. It is most important in the interests of all British airlines, not least British Airways, that we secure an agreement with the US Government which enables our airlines either to compete on fair and equal terms for all the traffic between our two countries or failing that which safeguards our vital interests. Without such an agreement the ability of our airlines to maintain or improve their competitive position would be severely undermined. I made our position perfectly clear during my recent visit to the United States, and whilst I am hopeful that as a result of my visit it will be possible to negotiate acceptable arrangements over the coming weeks, it would be irresponsible to proceed with privatisation of BA while there is uncertainty about the air services agreements with the US on which such a large part of the business depends.

I also took the opportunity of my visit to the USA to explain our concern about the unilateral application of anti-trust laws to international civil aviation. Until such time as

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the US authorities rectify the situation, it is for British Airways and other defendants to decide how best to deal with cases brought against them. While British Airways hope that the American court will shortly give its final agreement to the provisionally approved settlement of the class action brought on behalf of North Atlantic travellers who claim to have been disadvantaged as a result of the collapse of Laker Airways, two further anti-trust actions relating to the collapse of Laker Airways have now been filed in the US against British Airways and other defendants. The company admitted no liability in the earlier litigation and have strongly denied the claims in these two suits. I understand they will defend these cases vigorously but a successful result may take some time.

Taking all these factors into account I have decided, with great reluctance, not to set a firm timetable for privatisation for the time being. I shall keep the matter under review, and take the first opportunity to proceed when I judge the situation has been sufficiently clarified.

SECRET

CBG



DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
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GTN 215
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From the Parliamentary Under Secretary of State
for Corporate and Consumer Affairs
Michael Howard QC MP

Michael Spicer Esq MP
Minister for Aviation
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

NBM

7th March 1986

Dear Michael

Following my letter of 14 February, our officials met as agreed to discuss the question of disaggregation in airports' published accounts. In the light of that meeting, I am now prepared to accept that there should be disaggregation only as between the traffic activities and the commercial activities as a whole of each airport. This is on the basis that the Airports will maintain a more detailed breakdown between different commercial activities and that it will be available to the regulatory authorities to enable them to discharge their functions under the Airports Bill and existing competition legislation.

I understand that there remain one or two points of detail on these provisions, on which our officials will be keeping in touch.

I am copying this letter to members of L and E(A) Committees.

Yours ever
Michael

MICHAEL HOWARD

LT5ADN

AGROSPACE
Fuller + BA PS



D. Holmes

Copy No. // of 12

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SECRET

SECRETARY OF STATE

cc:

Mr Spicer
Mr Bailey
Mr Clarke
Mr Stevens
Mr Yass
Miss Caines
Mr Fortnam
Mr Oates
Mr Rhodes

BA PRIVATISATION

I attach a first draft of a statement which you might make, in a Written Parliamentary Answer, if MISC 112 agrees to the proposals which you have put to them. It is fairly long, but I think that we need to set out properly the issues in the US negotiations, while keeping in something about the current anti-trust cases.

2. I expect that your colleagues will be anxious to know how you propose to handle the decision publicly, in view of the interest among MPs and in the Press which BA continues to stimulate for a summer flotation. You might like to consider circulating a draft statement to MISC 112 in advance of the meeting. That would enable us to get on quickly with arranging for you to see Lord King and Mr Marshall; you could give them, say, 24 hours to consider the draft statement, and make it perhaps on Thursday of next week.

DH

D HOLMES
6 March 1986

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DRAFT WRITTEN PARLIAMENTARY ANSWER

To ask the Secretary of State if he will make a statement about the privatisation of British Airways [in the light of his recent visit to the USA]

DRAFT ANSWER

The Government's aim remains to privatise British Airways as soon as possible.

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Taking all these factors into account I have decided, with great reluctance, not to set a firm timetable for privatisation for the time being. I shall keep the matter under review, and take the first opportunity to proceed when I judge the situation has been sufficiently clarified.

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cc/B9

Prime Minister²

DEW

7/3

Treasury Chambers, Parliament Street, SW1P 3AG
 The Rt Hon Nicholas Ridley AMICE MP
 Secretary of State for Transport
 Department of Transport
 2 Marsham Street
 London
 SW1P 3EB

4 March 1986

Dec Niddy,

BA PAY

We discussed British Airways' pay negotiations in the autumn, and you will recall that Kenneth Clarke and other colleagues shared my concern about their proposals. We were worried about the suggestion that the engineers would receive an extra 8 to 10 per cent on basic rates in the first year and 7 per cent in the second year. I see from the latest E(PSP) Monitoring Report that an offer along these lines was indeed made to the engineers, and discussions are continuing.

Even more worrying I see that an offer of a first year deal has apparently been made to the pilots, whose average earnings effect is not costed, but which looks like being worth around 18 per cent. I can see no justification for such an increase. I understand that BA has a surplus of pilots and that other British airlines, British Caledonian and Dan Air, are thinking of freezing pay for their employees. Apart from the absence of any recruitment and retention, or even comparability arguments (which we would not accept anyway) for such increases, I need hardly point out the potentially disastrous effects of such an award on negotiations for the rest of BA's employees and, indeed, more widely.

I would be grateful for clarification of the present situation and your thoughts on the possibility of Transport Ministers speaking to Lord King again about these negotiations.

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

Yours ever,

JOHN MacGREGOR

CONFIDENTIAL



206/2

Mr Norgrove

Prime Minister (Hot box)

3

I think it will

be helpful

to you also to see this.

MR UNWIN



SECRET

28/2

CABINET OFFICE
 E 0159
 28 FEB 1986
 FILING INSTRUCTIONS
 FILE No.

cc Mr Roberts

ms. [Signature] 28/2/86

PRIVATISATION OF BA

You asked where we stood on MISC 112.

2. The Department of Transport have prepared a new and much franker form of words for the prospectus about possible exposure to US Anti-Trust Litigation. I understand that their UK legal and banking advisers are satisfied that this proposed new text (which has not been seen outside the Department) meets the concerns previously expressed about the propriety of going ahead on the basis of a rather partial disclosure. The Department's and BA's US lawyers are said to think that publication of this text would not greatly add to the risks BA already faces of further litigation. Nevertheless to go ahead on this revised basis would plainly be risky, not least to British Caledonian, who remain very vulnerable to demands for the disclosure of documents still held in the US. Moreover it seems clear that privatisation could not go ahead while the two cases currently outstanding (on behalf of Laker employees and a Los Angeles travel agent) have not been settled; BA are said to be fairly confident that they can secure the early dismissal of the case on behalf of the Laker employees, who have said to have no standing, and the travel agent case could always be settled by purchase of his business. The Department of Transport are trying to establish how long it is likely to take to reach a conclusion on these cases.

3. Although officials of the Law Officers' Department have not dissented from the proposed new approach, the Attorney General has taken a close personal interest in the position of BA, and may well feel that the risks cannot be supported. In any event he will need to discuss the situation with Mr Ridley before the



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latter makes up his mind on a possible new approach to MISC 112. Unless it can be established quickly that the new approach offers a reliable route to privatisation in the course of the summer, it will be essential to make some statement quickly in order to call halt to current preliminary work on marketing the issue.

4. The Department of Transport hope to be in a position to put the matter to MISC 112 towards the end of next week. On previous form, there would not be a full paper, but officials of the other Departments concerned (including the Cabinet Office), would be given a detailed oral briefing in advance of the Ministerial discussion.

JW

A J WIGGINS
Economic Secretariat.
28 February 1986



COMMERCIAL



SCOTTISH OFFICE
NEW ST. ANDREW'S HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

Michael Howard Esq QC MP
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

27 February 1986

NBPN

Dear Michael,

AIRPORTS BILL: ECONOMIC REGULATION

I have been following with interest your correspondence with Department of Transport colleagues about the degree of transparency to be required in the accounts of airport companies.

Having seen your most recent letter of 14 February, I must say that my sympathies are entirely with Michael Spicer. The MMC's recent report on BAA's commercial activities needs careful consideration, and I would not assume that we should necessarily agree to its proposals, which would require much fuller transparency than has previously been required of a nationalised industry, and certainly much more than a private sector company would ever reveal in its accounts.

By all means let officials pursue the matter. But I think we must avoid an over-zealous approach. Are there not adequate powers for ad hoc investigations if there is any reason to suppose, at a future date, that an airport company is actually abusing monopoly power?

I am copying this letter to the members of L and E(A) Committees.

*Yours
Michael*

MICHAEL ANCRAM

AEROSPACE

BA

PTS



CC36



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

NBM

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1

24 February 1986

Dear Paul

A BILATERAL COMPETITION REGIME FOR UK/US AVIATION

Thank you for your letter of 10 February ^{at 11.30} about some of the broader anti-trust competition aspects of my visit to Washington last week. It was most useful to have your views on these matters.

As you will no doubt have seen from the reporting telegram we did not make much headway on aviation and anti-trust, but equally I was careful not to be dismissive of the anti-trust law reforms proposed more generally, knowing that these could be of some limited value both in aviation and in other sectors. At all events I do not think that anything I said will have discouraged the US Administration from pressing on with that work; indeed I was told that anything more far reaching on aviation and anti-trust would have to be considered later in the light of progress with Congress on the main package.

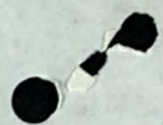
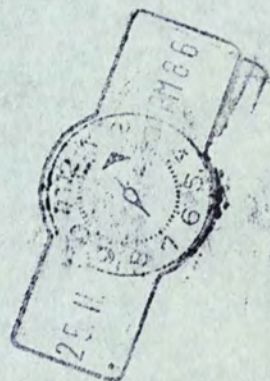
Meanwhile it was very helpful to have your agreement that we could discuss the broad principles of our proposed bilateral regime for aviation in more definitive terms, and we have accordingly given US officials a copy of the draft text for a bilateral understanding in this area which I circulated to colleagues on MISC 112 with my letter of 17 December. Despite the not very encouraging response which I encountered in Washington, I hope that we shall be able to keep the dialogue going constructively, and it is at least a good sign that the Americans have again agreed to spend one day on 25 February exploring these issues with us within the context of our air services discussions that week. We shall be reviewing the situation in the light of any response they may be able to make then.

I am sending a copy of this letter to colleagues on MISC 112, to the Lord Chancellor and to Sir Robert Armstrong.

Nicholas Ridley
Nicholas Ridley

NICHOLAS RIDLEY

АВКОСПАСС
РА ПТС.





DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215 4417
GTN 215)
(Switchboard) 01-215 7877

CCBQ

From the Parliamentary Under Secretary of State
for Corporate and Consumer Affairs
Michael Howard QC MP

Michael Spicer MP
Minister for Aviation
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

NBPN

14 February 1986

Dear Michael

Thank you for your letter of 22 January. ^{will revert if req.} I am, however, at a loss to understand how my letter to you of 13 January came as a surprise. It was only in the course of a meeting ^{see PART 4} between our officials on 9 January that it became clear that you did not intend to refer at L Committee to the outstanding point between us; and my officials immediately indicated that in those circumstances I would wish to raise it myself. In the event I was unable to attend L Committee and it became necessary to write raising the point.

Misunderstanding over the interpretation of my letter of 30 October only came to light when we had sight of draft clauses of the Bill circulated by your Department on 5 December. Your officials asked on 16 December to leave the point aside for the time being, while you considered the recommendations of the MMC Report. My officials pointed out, and confirmed in a letter of 23 December, that they regarded acceptance of the MMC's recommendation as necessary to meet the points made in my letter. In a further letter of 31 December, they drew attention again to a need to resolve the issue, if necessary, at Ministerial level; and they set out the level of disaggregation of accounting information about airport activities which they regarded as necessary to meet the point in my letter.

Against that background, it seemed reasonable to expect that the matter would be resolved quickly in the light of discussion at L Committee, and before introduction of your Bill. However, as no DTI Minister was available to attend L Committee, and your timetable was very tight, my officials reluctantly agreed to your Department's request in these circumstances not to block the Bill for a further week, but to pursue the outstanding points after publication.

PS/Secretary of State
PS/Sir Brian Hayes
Mr Liesner
Mr Treadgold
Mr Woolman - Sol
Mr Hall - GP5
Mr Allen - GP4
(w FILE)

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BOARD OF TRADE
BICENTENARY



I agree that our officials should now pursue this, and that the MMC report is relevant to the debate. But I do not regard this as simply, or even primarily, a matter of responding to the MMC recommendations. It is matter of determining the appropriate regulatory regime for a monopoly which is being removed from the restraints of the public sector. I suggest that our officials should report back to us in good time for appropriate amendments to be tabled, if we do decide, at Committee stage.

I am copying this letter to members of L and E(A) Committees.

*Yours ever
Michael*

MICHAEL HOWARD

AEROSPACE : Future of BA : Pt 5.



CCBA



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Telephone (Direct dialling) 01-215 5422

GTN 215

(Switchboard) 01-215 7877

JU353

Secretary of State for Trade and Industry

10 February 1986

CONFIDENTIAL

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

NBRN

Handwritten signature

A BILATERAL COMPETITION REGIME FOR UK/US AVIATION

I know that your prime objective in visiting Washington on 13-14 February will be to encourage the US administration to adopt a constructive new approach to some fairly far reaching changes to Bermuda 2; and I thought it might be helpful to offer some comments on the broader Anti-Trust and competition aspects, as they seem to me in the light of developments since Leon Brittan wrote to you on 20 December. *FLAP PT 4*

My main concern is with our overall stance on anti-trust, and the impression to be gained by the US Administration as your discussions move forward beyond the tentative stage reached in exchanges between officials last month. As you have said, it will be necessary to persuade the US that what is being proposed will bring benefits to both sides; and this involves making some tangible offers, on the lines set out in your letter to Geoffrey Howe of 17 December. Like Leon Brittan, I am ready to support this general line. But I think that it will be important to make clear to the Administration that we regard aviation, and the particular anti-trust problems accompanying it, as a special case, involving services that are by their nature traded between two countries and usually regulated by treaty. Beyond the field of aviation, there are wider issues of principle and practice involving anti-trust; and these will remain open for discussion.

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In making this suggestion, I have in mind that we are now aware of the President's response to the Task Force proposals on Anti-Trust. As you know, the US Administration's proposed changes to Anti-trust law do not go far enough to satisfy all our concerns. I believe nonetheless that it will be important, over the coming months, for us not to discount the limited changes that have been proposed, both because the President has evidently reached a firm decision on the reforms to be put to Congress, and because there are already signs that even the limited changes now proposed may encounter Congressional opposition. There must therefore be some risk that further representations on general Anti-trust issues would have a mixed reception; indeed they could prompt the Administration to seek a British quid pro quo (such as limitations on recourse to the Protection of Trading Interests Act) for changes already proposed. Again this seems to me a reason for trying to maintain some degree of distinction between our initiative on aviation and our attitude to wider anti-trust issues.

I understand, of course, that it is difficult to maintain distinctions in areas of policy that are closely bound together. My reasons for wishing to try to do so relate to my general concern with our domestic competition policy. This is itself to be reviewed; and the fact that our own policy will be under review needs to be borne in mind in developing our stance towards trading partners on competition issues. There are also various detailed points that need further consideration; and I am glad that our officials are discussing these together. Nevertheless I recognise that you need to be able to discuss the broad principles rather less tentatively than before; and I have no objection to your doing so.

I am sending a copy of this letter to colleagues on MISC 112, the Lord Chancellor and Sir Robert Armstrong.

Y
mm,
Paul

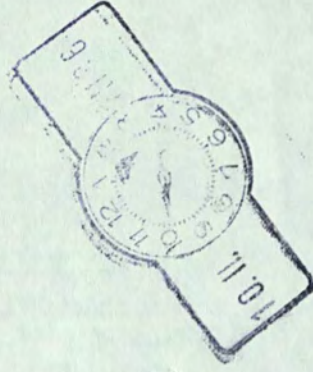
PAUL CHANNON

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BICENTENARY

AEROSPACE

B A

PT 5





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cc B/UP

2

P 01905

PRIME MINISTER

Privatisation of British Airways

BACKGROUND

MISC 112 is meeting on 11 February to consider the current state of play on plans for the privatisation of British Airways (BA).

2. It had been intended that BA should be privatised this coming Summer, subject to the successful conclusion of the outstanding US litigation arising from the collapse of Laker Airways. Once these cases had been settled, the plan had been to destroy BA's documents currently blocked under the Protection of Trading Interests Act, while British Caledonian would meanwhile repatriate and destroy the comparable documents now in their possession in the US. This would have substantially reduced the risks of further litigation in the US, leaving BA much less exposed to the possibility of major losses arising from further anti-trust cases.

3. BA have meanwhile provided £25 million in their accounts over the last three years against possible losses arising from such litigation, and taken out an insurance policy for £40 million against losses from anti-trust cases not connected with the Laker liquidation. A draft text has been prepared for the privatisation prospectus with the objective of achieving sufficient disclosure of the risks of further anti-trust cases while at the same time reassuring potential investors that there was little likelihood of BA sustaining 'material' losses therefrom. Because they would constitute an incitement to further litigation, the draft text mentions



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neither the provisions nor the insurance policy; omission of any mention of the latter would need to be cleared with the Stock Exchange.

4. Three developments have brought the prospects for privatisation into question:

(i) it has taken longer than expected to settle the 'class action' on behalf of passengers arising out of the Laker liquidation, and a final settlement is not now expected until next month, and may not be achieved even then;

(ii) Cravaths, the US legal advisers to the banks involved in the offer and to the UK solicitors to the issue (Slaughter and May) have indicated that for 'ethical' reasons they would not wish to be associated with an offer this summer shortly after the destruction of the documents in question - in other words they would only take part if the documents were still in existence; and

(iii) two further cases, on behalf of a travel agent and some Laker employees, have been filed in the US by Mr Beckman (the lawyer representing the plaintiffs in the action by the Laker liquidator and in the class action).

Against this background the feasibility and propriety of going ahead with a summer flotation of BA has been reconsidered in consultation with the Department of Transport's banking and legal advisers, and the Attorney-General has been consulted. City advice was that it would be just about acceptable to go ahead on the basis of the draft prospectus text previously intended, although this was on the assumption that there would be no further outstanding litigation arising from the Laker liquidation. This judgment reflected the view that the



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£35 million not covered by insurance or provisions of the total £100 million estimate of BA's exposure to anti-trust litigation could just be regarded as non-material for the purposes of the prospectus. The Transport Secretary and the Attorney General have considered, with the advice of officials, whether this is good enough; essentially because the Government must maintain the highest standards in the privatisation programme, the unanimous view has been that it would not be appropriate to go ahead this summer with the privatisation of BA on the basis previously intended.

MAIN ISSUES

5. The main issues before MISC 112 are

(i) Is the conclusion that privatisation cannot go ahead as previously intended generally accepted?

(ii) Is there any other basis on which privatisation could go ahead this summer?

(iii) Can a decision be taken when privatisation should go ahead, if not this summer?

(iv) If privatisation is not to go ahead this summer, how and when should the decision be announced, and in what terms?

Privatisation as previously intended

6. For the reasons already given, the risks of going ahead as previously intended, particularly with new litigation now pending in the US, do not appear to be acceptable.

Privatisation on another basis

7. It might in principle be possible to privatise BA

(a) by disclosing more of the risks arising out of anti-trust litigation, or



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(b) by pursuing the possibility of a management buy-out which would avoid the need for a public offer of shares.

In practice a higher degree of disclosure hardly seems a realistic possibility; the more that is disclosed, the greater the risk of a wave of contingency fee litigation in the US, which would precipitate demands for the disclosure of documents (with particular risks in the case of British Caledonian, whose documents are in the US and so not blocked under UK legislation), fines for non-disclosure of documents which would be blocked, and potential losses far in excess of the estimate of £100 million. Nor does the alternative of avoiding a public offer of shares provide a satisfactory alternative route; the standard of disclosure in order to achieve placements with institutional investors, as would be essential in the case of a company as large as BA, would not be significantly less than in the case of a public offer of shares, and the proceeds would almost certainly be a good deal lower.

The possible timing of privatisation

8. It does not appear that privatisation will be possible until litigation in the US has ceased and there is no immediate further threat of litigation; once this point is reached, the documents in question can be destroyed and the future exposure of BA will be reduced to levels consistent with the sum of the provisions and the insurance policy against such losses. Since the US Statute of Limitations has a period of only four years, the risks of further litigation not related to the Laker liquidation will fall away sharply at the end of this year, so further reducing the scale of any residual problems, even if the documents have not been destroyed. However, it does not appear possible at this stage to say when the way will be open for privatisation; the two new cases are thought to be of little merit, and will be expensive for the plaintiffs and Mr Beckman to pursue, and it may be possible to



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secure their withdrawal or dismissal within a matter of months. If that were to happen, privatisation in early 1987 might become a possibility; but the chances of this do not at present look very good, and it may well be that privatisation will not now be possible before the Election.

9. The postponement of the expected privatisation receipts of between £1 and 1.25 billion in 1986-87 will undoubtedly be a matter of regret to the Treasury. However, the Chancellor of the Exchequer will have some scope for rephrasing the receipts from other privatisations so as to avoid problems with the public expenditure numbers. For example, airports and Rolls Royce are each expected to yield some £0.75 billion, while the staged payments in respect of the sale of gas are likely to be falling due over the same period. The capacity of the markets within a limited period is, however, constrained, and there could be problems if BA were to be privatised early in 1987.

Announcement and explanation

10. There is now a wide-spread expectation that privatisation will go ahead in the summer, and arrangements are going ahead for advertising campaigns, etc to begin within a matter of weeks. If privatisation must be postponed, an announcement in the near future is essential. However, postponement will need to be handled very carefully, given the risk that this may itself be seen as an invitation to further litigation. The Transport Secretary had originally thought that he might make the announcement in the course of a visit to Washington later this week, in which he would use the fact of postponement as a further argument addressed to the Administration and to Congress to exempt international air services from the application of US anti-trust laws. This would, however, be extremely rushed, and there seems no obvious merit in choosing this route. I understand Mr Ridley now proposes to make the announcement by way of a written Answer on Tuesday, 18 February. This will make it possible to convey



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the decision properly to Lord King, Chairman of BA, in advance of the announcement, and to coordinate the line to be taken by the Government closely with that of BA. It would, of course, carry some risk of a leak in, for example, this coming weekends press. But security has been held well so far, and you will want to enjoin your colleagues to continue to maintain the utmost discretion on these affairs.

HANDLING

11. You will wish to ask the Transport Secretary to set out the position, together with his proposals, for the Group to consider. The Attorney General will wish to comment on the proprieties of the course to be followed by the Government. The Chancellor of the Exchequer will wish to comment generally, as well as on the specific implications of postponement for the Government's privatisation programme and public expenditure plans (we understand that the Treasury have been kept closely in touch with recent developments, and that the Chancellor is unlikely to dissent from the main recommendation of the Transport Secretary). The Foreign Secretary will wish to comment on the impact of the decision on relations with the US Administration, and the Secretary of State for Trade and Industry may also wish to express views about the wider effect on commercial relations with the US. The Chancellor of the Duchy, who is being specially invited, may wish to comment on the political aspects of this issue.

CONCLUSIONS

12. You will wish the Group to reach conclusions on:

1. whether to discontinue now efforts to privatise BA in the summer of 1986;
2. whether to set an alternative timetable for BA privatisation, or to accept that action should be delayed until there is no immediate further threat of US anti-trust litigation; and



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3. the form, timing and content of the announcement of the Government's decision (you may wish to ask the Transport Secretary to circulate a draft if he has not already done so before tomorrow afternoon's meeting).

J B UNWIN

CONQUEROR

Cabinet Office
10 February 1986

SECRET

1630 Copy No 1 of 3.



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

5 February 1986

Dear David,

Please pass these papers
cc
to John Whybrew.

JW
8/2

BRITISH AIRWAYS PRIVATISATION

We spoke. My Secretary of State would be most grateful if a meeting of MISC 112 could be arranged to discuss this subject, preferably on Tuesday 11 or on the morning of Wednesday 12 February. As background, I enclose a copy of my Secretary of State's letter of 22 January to the Attorney General, with enclosure, and of an interim reply from the Attorney General's office: I should be grateful if you would pass these on to John Whybrew.

I am copying this letter to John Wiggins at the Cabinet Office.

Yours,
Richard.

R A ALLAN
Private Secretary

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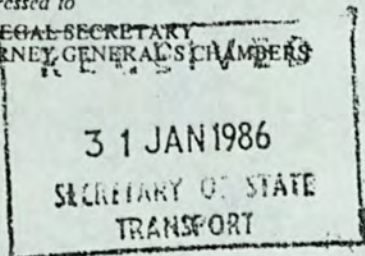


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936-6060
01 405 7644 EXT.

Communications on this subject should
be addressed to

THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS



1628

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

R A Allan Esq.
Private Secretary to the
Secretary of State for Transport
2 Marsham Street
London SW1

30 January 1986

Dear Richard,

BA PRIVATISATION

1. The Secretary of State for Transport wrote to the Attorney General on 22 January seeking urgent advice on HMG's obligations as to disclosure in a prospectus of certain matters (which have been described to the Attorney General orally and in relevant documents) and as to the propriety of proceeding with the sale of shares to the public on the basis of a draft prospectus passage covering the subject at issue. Taking account of the urgency, the Attorney General has asked me to give a progress report.
2. The Attorney General's present view is that the draft passage does not sufficiently inform potential investors of the true position in the sense that the steps the Directors have taken indicate that they view the position with a degree of seriousness which is not matched by the extent of the proposed disclosure in the prospectus. That degree of seriousness is such that it would be likely to have a material effect in the consideration given to the matter by a prospective investor in this country. HMG does not enjoy any special position in these matters but must comply with the high standards required by law.
3. The Attorney General is, however, aware that British Airways are seeking advice from the Leading Counsel on these very matters and that advice could be made available to the Attorney General. To ensure that every possible argument in favour of BA's privatisation as planned is fully taken into account, the Attorney General feels that he should see Counsel's advice before giving his own definitive view.

Yours ever,

Richard Gardiner

R K GARDINER

SECRET



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Sir Michael Havers QC
Attorney General
Law Officers' Department
Attorney General's Chambers
Royal Courts of Justice
Strand
LONDON WC2

22 January 1986

Dear Michael

BA PRIVATISATION

I attach a paper from my Department's Permanent Secretary relating to the timing of this proposed privatisation. Whilst I have formed no view on whether I should seek (notwithstanding the conclusion expressed in the paper) to proceed with a summer flotation, I would in any event appreciate your views.

The questions on which your advice is sought are as follows:-

- (1) Do you agree with the view of the solicitors to the offer, Slaughter & May, that (assuming the facts remain the same) the proposed disclosure of the relevant matters as contained in "draft K" of a prospectus passage would satisfy HMG's legal obligations?
- (2) Even if the answer to the first question is in the affirmative, are there other considerations which would make it improper for HMG to proceed with the sale of shares to the public on the basis of this draft?
- (3) If the answer to the second question is affirmative, what would have to happen before the sale can properly proceed?

I invite you to consider these questions on the basis either that the flotation is to proceed in the summer whilst the documents referred to in the paper remain in existence;

or it is postponed at least until early 1987. In this latter event there is the further period of time since the events which may have occurred as described in the documents which would have taken place, and it may be that some or all of the documents would no longer remain.

As to HMG's legal obligations, your attention is drawn to Article 4 of the Listing Particulars Directive (of 17 March 1980) as contained in Schedule 1 to the Stock Exchange (Listing) Regulations 1984 (SI No 716). This provides as follows:-

"The listing particulars shall contain the information which, according to the particular nature of the issuer and of the securities for the admission of which application is being made, is necessary to enable investors and their investment advisers to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of the rights attaching to such securities."

The duty of compliance falls upon HMG by virtue of Regulation 5 of the Regulations; and it is not necessary for me in this letter to explore the law relating to deceit, or liability for misrepresentation, mis-statement or under the principles of Hedley Byrne v Heller.

There is a reference in the paper to the question of disclosure of a material contract. There is a specific requirement contained in the Stock Exchange's Yellow Book that before the Stock Exchange will approve a prospectus it is satisfied that the prospectus discloses the principal contents of material contracts entered into within the previous two years by the company otherwise than in the ordinary course of business. The Stock Exchange on sufficient reason being shown may waive this requirement in a particular case.

I propose that my officials should explain to you orally the background facts and matters which are material to the advice sought. At such a meeting they can also explain the "Companies Act" point relating to the account of BA which is referred to in the paper.

The paper was written before we had received notification through our embassy in Washington that a further law suit on behalf of a Los Angeles travel agent has been filed seeking damages from BA (inter alia) in respect of the collapse of Laker. This is not a surprise (the possibility was noted in the paper); its implications can be discussed.

S E C R E T

In principle, it is to be assumed that "draft K" may still stand, but after a new paragraph describing the law suit and asserting either that the Board considers that it is without merit or that in any event it will not have a material adverse effect on the company.

You will appreciate the urgent implications of the matters to which I refer - as soon as I know your views I shall need to put the issue to a meeting of MISC 112.

Yours

Nicholas

NICHOLAS RIDLEY

S E C R E T

3F

Secretary of State

FROM: A M BAILEY
15 January 1986THE TIMING FOR BA PRIVATISATION

Following your meeting with Lord King on 20 December, we have been considering what advice to give on whether it would be right in all the circumstances to proceed on the present timetable for BA privatisation in June or July 1986, or whether we should defer preparations until we could be surer that some of the US legal complications had been reduced. Sir Peter Lazarus and I have discussed the legal issues with our advisers Slaughter and May and Hill Samuel, and Mr Holmes has had further discussions with Mr Marshall. There is a difficult balance to be struck between the various considerations, and I thought that it would be helpful if I set them out as I see them in the light of these discussions. The following note is therefore necessarily long; it has been largely drafted by Mr Holmes, and I am grateful to him for all this work. My conclusions are summarised at the end.

2. There are three options:

- (a) to proceed firmly on the present timetable, subject to a reappraisal in the light of an assessment of the US legal situation once the present class action has been settled;
- (b) to decide that no date for privatisation will be set, and no overt steps towards it taken, until the US legal complications have been reduced, and then to press on to the earliest possible date;
- (c) to decide now that privatisation will be deferred at least until the next available slot in the programme after summer 1986 - ie January/February 1987 assuming that BGC is sold in the autumn, as planned.

BA strong prefer (a). The judgement as between (b) and (c) depends on how far we believe (b) to be compatible with a summer 1986 flotation. We must have in mind that the Treasury would be reluctant to hold a summer 1986 date open for BA if there were a good chance that it might not, in the event, be achieved. And a strong expectation is building up in BA, and publicly, that the flotation will be in summer.

3. The target date of summer 1986 was thought achievable after the Laker liquidators suit was settled in July 1985. It was assumed at that time that the class action could be settled by early 1986 and that the risk of any further anti-trust litigation by any plaintiff with standing in front of a US Court was small. It was thought therefore to be proper for BA to destroy, before the issue of the prospectus, documents relating to events before the collapse of Laker Airways. Destruction of the documents, at the earliest opportunity in accordance with a properly established document control programme, has been strongly advocated by BA's US Counsel in the commercial interests of the company. He advised that it would nevertheless be prudent for the directors, in considering their obligation to disclose potential liabilities in the prospectus, to assume that the company's potential exposure to anti-trust litigation might be of the order of £70m.

4. It was also assumed that with a settlement of the class action, BCal would be able properly to repatriate from the US the documents relating to the Laker period, so that these would be protected against discovery under the Protection of Trading Interest Act and might, if their advisers considered it proper, be disposed of.

5. Subsequently, the situation has changed in three respects:

- (a) negotiations on the settlement of the class action took longer than expected largely because of the prolonged battle for control of TWA. The period for objections to be lodged before the US court does not expire until

16 February, and the judge is not expected to decide finally on the settlement before mid-March;

(b) Cravaths, the US legal advisers to the US and UK banks and to Slaughter and May told us that mainly on ethical grounds they would be unwilling to be associated with a flotation very soon after the class action settlement unless BA gave them an undertaking that no decision would be taken on the future of the documents until after the underwriters to the issue had ceased to be involved;

(c) two further US legal actions are threatened - by the ex-Laker employees and by a travel agent. Mr Beckman, who claims to act for the plaintiffs in both cases has indicated that he intends to file both of them this month.

6. If these two actions were brought, it would take months or perhaps years for BA to have them dismissed. If neither were brought, some months would have to elapse before BA could be satisfied that they were no longer threatened. It would therefore be unwise to proceed on the assumption that the documents could have been destroyed before a flotation this summer. Sullivan and Cromwell (BA's US Counsel) have advised that the potential exposure to anti-trust liabilities which the company should allow for in considering its prospectus obligations if the documents remained in existence would rise to about £100m.

7. Whether or not the documents exist at the time of flotation does not, of course, alter the underlying events which could be the subject of new litigation. Most of these should be more than four years old by the time of a summer flotation, and therefore covered by the US Statute of Limitations which applies to anti-trust actions, unless a plaintiff can show fraudulent concealment. But BA's Counsel and ours advise that so long as the documents exist, under the protection of a blocking direction

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Under the PTI Act, a US court could make adverse findings of fact against BA, or impose financial penalties for non-discovery, which would put great pressure on BA to settle with the plaintiffs even if the case were of little merit.

SUMMER 1986 FLOTATION

8. BA are convinced that a summer flotation is in the best interests of the company. They are taking steps to provide against the assumed £100m of exposure in ways which would reduce the amount of uncovered risk to a level which they believe could legitimately be regarded as non-material. In each of the last two years they have retained profits of £10m which have not been disclosed but instead included in amounts owed to creditors in the balance sheet. Initially these provisions were intended to help cover the cost of settling the Laker litigation, but in the 1984-85 accounts the provisions were retained and the costs of the Laker settlement were charged separately in full against profits in that year. BA propose to make a further undisclosed provision of £5m in the 1985-86 accounts, making a retention from profits against the risk of further anti-trust litigation of £25m in all. In addition BA have now negotiated commercial insurance cover worth £40m, up to the end of 1988. BA would be liable to meet up to the first £20m of any damages awarded before the insurance cover would become effective. The remaining £5m of their undisclosed provisions would provide a third layer of cover above the insurance, giving a total of £65m which could be called upon before any anti-trust damages awarded would have any effect on the future profits or net worth of the company.

9. BA have obtained advice from leading counsel to the effect that it is both prudent and proper for them to take these precautions, that they need not be specifically disclosed in the accounts, and that the remaining £35m of the exposure (starting from the estimate of £100m for total exposure - para 6) may be regarded as a non-material amount for purposes of prospectus disclosure. His conclusion that the sum would be non-material in relation to profits is based on the expectation that an award of

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damages in excess of the provisions and insurance would be unlikely to have to be set against a single year's profits. BA's advisers also felt that £35m, which represents about 7½% of BA's current net worth, could just about be regarded as non-material by that test as well. BA therefore believe, assuming that the class action is settled as envisaged, that whether or not the further litigation threatened by Beckman materialises, the directors can properly sign a prospectus which describes the remaining anti-trust exposure in the terms of the attached draft, and which says nothing about the provisions or the insurance.

Analysis of June 1986 flotation

10. We have considered three aspects of the course which BA favour:

- (a) are there any objections on the grounds of legality?
- (b) is anything likely to occur between now and the flotation which could force another postponement?
- (c) are there any objections on grounds of propriety?

Legality

11. We have considered with Slaughter and May and Hill Samuel the following questions:

- (a) Have the precautions by BA been prudently and properly taken?
- (b) is it right that the prospectus need not disclose the provisions or the insurance policy?
- (c) if answers to (a) and (b) are affirmative, is the remaining £35m, in relation to the attached prospectus draft, non-material?

12. On the question of making undisclosed provision against a remote future risk, Ernst and Whinney, who are BA's auditors, are satisfied that the arrangement is acceptable in the circumstances and this view has been confirmed in general terms by Coopers and Lybrand if the true and fair view of the company's accounts is not impaired. Slaughter and May and Linklaters and Paines consider that inclusion of the relevant £25m in amounts owed to creditors rather than as separately identifiable provision is "not necessarily unlawful" under the Companies Act (those words, which leave open a possibility that there could be a technical breach of the Companies Act, are subject to further urgent consultation among the advisers). So far as Slaughter and May can judge, such an arrangement, though unusual, is not unheard of. Our advisers acknowledged that one effect would be to reduce the present net worth of the company by £25m which might be available to be released to the new shareholders at a future date. Judgements on the size of the provision and the need to make it are the responsibility of the Board, in common with other provisions made. Clearly there is an effect on both the net worth and the profit stream of the business. But given that the accounting treatment gives a true and fair view of the company it is not relevant to consider what the proceeds might have been had a different view of what provisions were necessary been taken by the Board. The value of the proceeds to the taxpayer inevitably has to take account of this potential liability.

13. On the question of disclosing the provisions and the insurance policy in the prospectus, Slaughter and May's basic conclusion was that prospectus disclosure would not be necessary. However, the insurance policy would normally be regarded as a material contract for prospectus purposes, and a derogation would have to be sought from the Stock Exchange. Assuming such a derogation were granted, it would not absolve the directors and the Government from deciding whether disclosure was nevertheless necessary, in order to enable investors to make an informed assessment of the company's position. The granting of the derogation would not provide a defence against charges of

material omissions from the prospectus in the event of subsequent legal action against the signatories. However, Slaughter and May consider that in the circumstances disclosure is not a legal requirement.

14. On the question of materiality, Slaughter and May said that they would first have to be satisfied that the insurance policy was valid and that BA had taken all reasonable steps to ensure that it was not voidable. They would also have to review the position nearer the time to ensure that either the assumption that no further litigation was pending or threatened was satisfied, or alternatively if it was not, that the litigation in question did not lead Sullivan and Cromwell to increase their estimate of the level of exposure, and that nothing else had occurred to change their estimate. Finally some means would have to be found of ensuring that Sullivan and Cromwell took the potential impact of the BCal documents fully into account, unless they had by then been destroyed. Subject to those provisos, and in the circumstances in which it might be called upon, they accepted that the remaining £35m of uncovered exposure could just, but only just, be regarded as non-material in the terms of the draft prospectus passage. Hill Samuel agreed. However, it has to be recognised that in the event the Courts might take a different view.

How could matters change between now and the summer?

15. We do not know the outcome of a number of developments:

- (a) whether the proposed settlement of the class action will be approved. No objections have been lodged so far. If Virgin Atlantic object, as they are now expected to do, a decision is not likely before mid-March. If the settlement is not approved, it is unlikely that privatisation could proceed;

- (b) whether, and if so in what form, the cases on behalf of the ex-Laker employees and the travel agents will be brought. BA say that Sullivan and Cromwell's advice that they should provide for exposure of £100m took account of this possibility, and that if the cases are brought they could be defeated. But we cannot be sure now that Sullivan and Cromwell would continue to take this view if cases were actually brought, or that BA would not face orders for discovery of documents and threats of sanctions for non-compliance. The prospects for these cases may be clearer by mid to end-February;
- (c) there is always a possibility of new cases being brought or threatened, though none is in prospect at present.

16. We should also, before the prospectus is written, have to give BA and their lawyers the opportunity to assess the risk to them of discovery of BCal's documents if, as seems likely, they are still in existence. (This would need Sir Adam Thompson's agreement.) The best judgement that can be made at present is that Sullivan and Cromwell's assessment should not change materially in the light of knowledge of the BCal documents; but we cannot be sure.

17. Taking all these imponderables into account, our judgement is that though the risk of external events making a summer privatisation impossible is not large, it is significant. The consequences of that happening, if we were firmly embarked on a summer flotation, could be serious - not only politically, but also because having to halt privatisation could well encourage litigation.

Would it be proper to proceed?

18. We tested Hill Samuel's and Slaughter and May's judgements about the propriety of proceeding in these circumstances by

asking what their advice would have been if they had been faced with the same problem by a private sector company seeking to arrange a flotation. They said firstly that this would not be a precise analogy to our present situation. In a private sector flotation:

- (a) Hill Samuel would be acting as principals rather than merely as advisers and would have a more pronounced role as sponsor, and would thus have to take themselves the propriety points which now fall to the Government to take;
- (b) no private sector vendor carried as much weight as HMG in the City and HMG had to take account of political as well as commercial considerations;
- (c) HMG had a special relationship with the airline, both as regulatory authority on competition matters and for purposes of the PTI Act, and because of its relationship with the US Government, and as such could protect BA in ways not open to a private sector vendor;
- (d) but on the other hand the option of an indemnity was not open to HMG because of the Parliamentary disclosure problems which would arise.

So their advice was bound to be given from a different standpoint. Having taken account of that, their view was the the suggested way of proceeding was just within the margins of what would be accepted as commercially proper. If HMG wished to proceed on this basis they would too subject to satisfaction on a number of detailed points which they have not had an opportunity fully to consider yet. Nevertheless, it must be recognised that if in the event a claim or claims did have to be settled for amounts which could be regarded as material, even though there might well be no legal liability for misrepresentation in the prospectus, the propriety of the judgements taken by all the parties concerned would be likely to be heavily criticised.

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19. In the private sector, however, the need to disclose the problem would in itself normally be enough to deter a vendor from proceeding in the absence of any other solution. The attached draft prospectus passage represents the minimum level of disclosure which it is adjudged to be acceptable in law. The amount by which the precautions fall short of the assessment of exposure leaves room for no margin of error at all, and the estimate of exposure is not itself a precise and logically determined figure but a judgement based on experience to which uncertainty necessarily attaches. Normally, our advisers would expect a considerable safety margin on issues of this kind. In these circumstances Hill Samuel and Slaughter and May would not expect a private sector vendor to proceed on a summer timetable. Hill Samuel did stress however that all their advice could only be on the basis of their own knowledge which excluded certain elements within the Department's knowledge and was not based on a full involvement in the process of legal analysis which would normally occur in private sector transactions.

20. I do not believe HMG can take a less rigorous approach to the propriety of proceeding than would be acceptable commercially in the private sector; on the contrary, there are strong arguments for higher standards. Both investors and Parliament expect HMG to be straightforward in its commercial dealings, and we could not reconcile this expectation with the issue of a prospectus which would only just fall within the margins of legal acceptability. This consideration must apply whether or not subsequent events led the judgements we would have to make to float the company in the summer to be confounded. I therefore conclude that if the documents remain in existence it would not be proper to seek to float BA in the summer.

DEFERRING A DECISION UNTIL THE LEGAL COMPLICATIONS ARE REDUCED

21. There are two variants of this option:

- (a) to defer a decision until the class action settlement has been approved, the new cases have either been brought or the threat has receded, and Sullivan and Cromwell have considered the implications of the BCal documents. This point could be between mid-March and end-March;
- (b) to defer a decision until BA's documents had been destroyed and BCal's documents repatriated. This point could not be before end-March and could be much later.

22. Option (a) would not affect my conclusion about the impropriety of proceeding on the present BA course to a summer flotation. I do not believe that option (b) would be compatible with a summer flotation.

23. The attached outline timetable shows the earliest date by which a sale in the summer could conceivably be managed after settlement of the class action and on the basis of audited results for the full year 1985-86. There is no doubt that Cravaths would not be prepared to be associated with a prospectus issued on 9 June on the basis of document destruction on 1 April.

Hill Samuel and Slaughter and May do not think our doubts about the propriety of floating in the summer would be resolved by replacing Cravaths as US counsel by other advisers who took the view that the documents could properly be destroyed in the run up to privatisation. It would in itself be a dubious step to take and for prospectus disclosure purposes the problem arises from the actions which have taken place, rather than the existence of particular forms of evidence. In any case destruction could not take place while litigation or the threat of it remained. We will not know until early February whether Beckman intends to file further law suits. Virgin Atlantic have given notice that they intend to object to the class action settlement in the US court. We cannot therefore be certain that settlement of the class action will not be delayed or when document destruction would be permissible. In order further to reduce the

uncertainties BCal's documents also have to be repatriated and destroyed. We shall not be able to take a considered look at these matters until the end of March at the earliest. Deferring the sale from June to July would not alter the position.

POSTPONEMENT AT LEAST UNTIL EARLY 1987

24. If the sale is postponed until the current and threatened litigation has been disposed of and a judgement can be made which satisfied all our advisers that document destruction is legitimate, a better informed view could be taken about whether BA's exposure has been reduced to a level which does allow some margin for error. A delay until the problem diminishes to a level small enough for the prospectus to be able to ignore it could last for some years. A relatively short delay, even after document destruction, would still require a draft similar to the one attached to be included in the prospectus. However, subject to the uncertainties about fraudulent concealment, the Statute of Limitations should have run for most of the potential causes of action. The margin for error on the question of materiality should therefore be significantly greater. It may therefore be possible, provided that events have moved in the right direction meanwhile, to conclude in the autumn that privatisation is possible and could properly be undertaken early in 1987 - but we cannot be certain now. A decision would need to be taken in early autumn.

25. The difficulty with postponement, however, is how to present it publicly in terms which do not reduce the value of the company. BA's own marketing efforts are going to have to be put into reverse, and it will be a severe disappointment to their management. Early 1987 also coincides with the next round in the pay negotiations, and a downturn in the economic cycle may well be thought to be that much nearer. It will be difficult to justify delay by reference to legal difficulties when at present these seem to be proceeding towards a satisfactory conclusion. We must avoid giving any hint that would give encouragement to

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beckman or other contingency fee lawyers. It may be possible to use uncertainty or disagreement about the balance sheet as a reason for delay, but that will not inspire confidence among potential investors.

26. If you and your colleagues agree that postponement is the right course, it will require very careful handling with BA. We shall need to take action very soon to halt the momentum of their marketing activities and our own internal preparations which are currently geared to a June flotation.

OTHER OPTIONS

27. It is likely that if Lord King is faced with the prospect of further delay he will revert to the suggestion of a management buy-out. We have asked Hill Samuel to consider whether this or some other form of private placement would avoid the problem. Their preliminary view, however, is that such arrangements would still require a sale document, prepared to the same standards as a prospectus, for which HMG as vendor would have to accept responsibility. It would not therefore seem to deal with the problem.

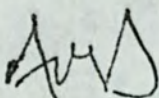
CONCLUSION

28. The conclusions from this analysis are as follows:

- (i) Though some of the risks will become clearer over the course of the next 4-6 weeks, a summer flotation could only take place with the documents in existence. On that basis the estimated potential exposure of the company is, even with the precautions which BA are taking, close to the margin of what could properly be described as non-material.

- (ii) BA have been punctilious in obtaining legal and accounting advice about the steps that they are taking towards a summer flotation, and our own advisers confirm that they are not necessarily unlawful. But there are risks, which seem small but not negligible, that external events will make a summer flotation impossible.
- (iii) In any case, to proceed with a prospectus which is necessarily uninformative about the legal risks which remain while the documents are still in existence could give rise to charges of material omissions from the prospectus, and would in my view give rise to an unacceptable risk of challenge to the propriety of HMG's action as vendor.
- (iv) A decision to defer privatisation until the documents have been disposed of would mean deferment at least until early 1987. It involves other risks: that it could in itself encourage litigation; that the prospects of the business may appear worse at that point than now; that there would be a serious effect on the morale of BA's management. On the worst hypothesis, it might prove impossible even to meet that timescale.
- (v) A decision to defer privatisation until the documents have been disposed of would need to be taken quickly, and given as a firm decision to BA, with a line to be agreed with them on presentation. They would need to be instructed to stop all preparations for privatisation and to modify the public position they are taking.

29. I conclude reluctantly that the proper course in all the circumstances is to decide now not to proceed with privatisation until the documents have been properly disposed of. I recognise that it is possible to reach a different conclusion, as the directors themselves have, and you may want to discuss the issues with us. The judgement involved is a difficult one, and if you and your colleagues wish to proceed with a summer flotation, you may think it prudent to consult the Law Officers before reaching a final decision.



A M BAILEY

15 January 1986

cc Mr Spicer
Mr Holmes
Mr Clarke
Mr Yass
Mr Oates
Mr Rhodes

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DRAFT K - Prospectus Passage

No other claims alleging breach of US anti-trust laws have been brought or are threatened against BA, but the possibility of such further claims being asserted in relation to BA's past services to and from North America cannot be excluded and, if asserted, such claims could, as is common in anti-trust actions in the US, seek substantial amounts. The Board is, however, of the opinion that the outcome of any such claims would not in the aggregate have a material adverse effect upon the business, financial condition or prospects of BA, although in view of the uncertainties of anti-trust litigation no assurance can be given that this would not be the case. The opinion of the Board is based on all relevant factors including a consideration of the grounds on which, if assented, such claims might be defended and of the methods by which they might be resolved and an expectation that HMG will continue its stated policies towards the application of US anti-trust laws to international air transport referred to under [].

NSW85/0152/T

9/13/12

TIMETABLE

	<u>Legal Events</u>	<u>Privatisation Key steps</u>
9 January		BA roadshows commence
14 January		ABM present advertising proposals to DTP
16 January		PR/Marketing Committee meeting with BA and their advisers
End January		Research of city opinion and advertising treatments should start
		Overall marketing strategy should be settled (principally institutional campaign)
		Brokers should start research on their circular on BA
6 February	Last date by which Beckman believes he may file Laker related law suits	
12 February		BA roadshows completed
16 February	Final date for class action objections and claims	
End February		BA press and TV financial image campaign starts
		Brokers issue circular on BA
		Production of DTP press and TV advertising commissioned. TV schedules booked.
		Appoint advisers on overseas sales
18 March	Final settlement of class action	Announce decision to proceed with issue
		Commence marketing
		Appoint receiving banks telephone answering service
		Decide on overseas sales

1 April

Earliest permissible
date for document
destruction

After 1 April the timetable is as suggested by Hill Samuel ie

9 May	Audit completed
14 May	DTP press and TV advertising starts
21 May	Pathfinder prospectus published
4 June	Issue priced
5 June	Prospectus filed and issue underwritten
9 June	Prospectus published
19 June	Offer closes
23 June	Dealings commence

PART 4 ends:-

PMG to CST 24.1.86

PART 5 begins:-

Transport to DN 5.2.86

