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CC(84) 21

COPY NO 34

30 July 1984

CABINET

CIVIL AVIATION AUTHORITY REVIEW

Memorandum by the Secretary of State for Transport

This paper sets out the options in respect of our decisions on the report on airline competition policy by the Civil Aviation Authority (CAA) (CC(84) 28th Conclusions, Minute 1).

COMPETITION POLICY

2. I believe the Cabinet will wish to endorse those proposals in the review which call for increased competition among British airlines (CC(84) 27th Conclusions, Minute 1), also discussed in the Ministerial Steering Committee on Economic Strategy, Sub-Committee on Economic Affairs (E(A)(84) 19th Meeting, Minute 3).

RESTRUCTURING POWERS

3. I believe the Cabinet will wish to reject those proposals which give the CAA power to reallocate routes at a later stage in the interest of "the structure of the Industry". They give the CAA too much power (although the use of the powers would be subject to appeal to me), and they might well delay or harm the sale of British Airways (BA) (see Annex B).

ROUTE TRANSFERS

4. The CAA propose that BA should relinquish the following scheduled service routes:-

- a. Manchester and Birmingham to a wide variety of Western European points; and Glasgow/Paris;
- b. Heathrow to Saudi Arabia and to Harare (Zimbabwe);
- c. Gatwick to points in Spain, Portugal, Gibraltar, Italy and Scandinavia; BA's main service to the last two is from Heathrow.

5. The issue is whether we are prepared to take action to avert risks to our multi-airline industry on scheduled services. The CAA consider that British Caledonian (BCal), the only British airline other than BA significant on long haul routes, has an inherently weak route structure; and that the smaller scheduled airlines lack opportunities for growth. The CAA's key recommendation is for a second scheduled airline strong enough to

competes and to be able to replace BA should the need arise. The reason for the CAA suggesting the transfer of routes in paragraph 4 above is that they judge this to be the minimum necessary to ensure that BCal will be able to fulfil this role. BA's operating profits last year were £280 million, and BCal's £18 million.

6. The Manchester and Birmingham International routes have been suggested for divestment by the CAA for the benefit of the other, smaller international airlines. I suggest we should not accept this recommendation, because we cannot accept all of the proposed transfers without unacceptable delay to BA privatisation and the BCal issues are more important. Since the routes already served by BA do not have the traffic for more than one British airline, the smaller airlines could not expect early opportunities to serve these. On the other hand there is a widespread fear, reflected among our supporters in the House of Commons, that loss of BA would weaken the major regional airports.

7. I have discussed with the Chairman of BCal, Sir Adam Thomson, what is the minimum transfer of routes which would usefully strengthen BCal. He claims that the package recommended by the CAA is the minimum which he could accept. When pressed, he said that he would not reject a smaller transfer. But he would continue to campaign and pursue licence applications for more of BA's routes. He would also apply to operate from Heathrow (this could not be accepted without wholly disrupting our already difficult policy to deal with the Heathrow capacity problem). If he got no substantially profitable additional routes, he says he would have to retrench by pulling off his less profitable routes. He has also said that if he got no transfers at all, he would seek to merge with BA. If this proposed merger were referred to the Monopolies and Mergers Commission and if they were to find against it, he believes BCal would decline and eventually be forced out of business. He is in no doubt bluffing to some extent. He said that the order of importance of the routes to BCal was:-

1. Saudi Arabia - estimates for 1985-86 £30 million profit.
2. Harare - estimates £7½ million profit.
3. Gatwick - the Iberian business routes: Madrid, Lisbon, Barcelona, Bilbao - he estimates £3 million profit.
4. He is not interested in routes out of Birmingham and Manchester; nor, I think, the other destinations served from Gatwick.

He claims, and the CAA accept, that he could raise the money necessary to finance these routes as a package. He claims to need these routes because they yield monopoly-type profits; and that it is only by having such a secure profit base that he will have continuing financial strength to compete with BA and other airlines.

8. The medium-run loss of profits for BA from losing routes in which BCal are interested would be of a similar order of magnitude to what BCal hope to earn; in the short run - and this is what the market would focus on - it could be higher.

9. The difficulties with acceding to Sir Adam Thomson's request are twofold: the danger of delaying the privatisation of BA; and the political opposition which the transfer proposal has stirred up.

DELAY TO PRIVATISATION

10. There are already two problems with the sale of BA. We aim to sell 100 per cent of the equity, though given uncertainty about what market conditions will be and the novelty in the United Kingdom market of airline stock, we cannot be sure that the market will be able to take all in one bite. To achieve a debt:equity ratio at which BA will be saleable, we shall have to leave perhaps as much as £400 million of the gross proceeds of perhaps £800-£1,000 million, with the airline to repay debt. (We cannot have firm figures; no decision on these matters can properly be made until much nearer the time.) While this simply reflects heavy past losses, critics will call it a handout to the airline.

11. The other difficulty is the antitrust litigation in the United States (arising from the collapse of Laker Airways) against BA, BCal and other airlines, which is unlikely to have been resolved by next spring. Total possible claims could be as high as £1.8 billion, though vast claims are customary in such cases, which are usually settled out of court for far less. To keep to the timetable, the Government may need to retain all or part of the liability after flotation through an indemnity, unless there is an early settlement or BA can obtain adequate insurance against an adverse judgment. The disadvantage would be that the claimants would be more likely to hold out for a higher settlement if the Government was seen to be giving a permanent indemnity in respect of the damages; but this may prove to be unavoidable (Annex A).

12. BA claim that the transfer of routes will delay privatisation. Our advisers (Hill Samuel) believe that the transfer of the Saudi Arabia and Harare routes from BA would indeed cause a delay of up to two years, because the market will wish to see BA's track record of profits after the transfers have been made. The overhead associated with these routes is inevitably mixed up with the general Heathrow overhead; and the market will be alarmed if BA's Heathrow operation is disturbed. Hill Samuel also advise that relinquishing the Gatwick-Iberia routes would not necessarily delay privatisation, provided it was done quickly; that BA publicly took a positive line over privatisation immediately the decision was announced; co-operated in transferring the equipment and personnel; and gave a clear and true indication of the loss or profit and financial effects upon them of such a transfer. In other words, we would need their goodwill. I suspect that with such goodwill it might be possible to transfer the Harare route as well, but our merchant bank advisers advise otherwise.

13. The Chancellor of the Exchequer and I have discussed with the Chairman of BA, Lord King, the possibility of a voluntary transfer of routes. Lord King and his Board are absolutely opposed to this and have said only that they will not object to BCal being licensed from Gatwick in competition with them on some of the routes which BA serve from Heathrow; and that they would be content also for BCal to serve the Iberian routes from Gatwick provided that BA were permitted to return their own Iberian services to Heathrow (which would also damage the policy on Heathrow capacity). I see no prospect of the Board voluntarily changing this position.

METHODS AND CONSEQUENCES OF EFFECTING ROUTE TRANSFERS

14. We could effect transfers either by legislation or by using our powers as sole shareholder. Legislation would be short but highly contentious; it would run the risk of amendment by aggrieved interests, and have to be rushed through the House by the end of the year. Using our shareholder's powers to instruct the Directors to release the route licences could be swift, but equally contentious, in that it bypassed Parliament. The reallocation of the routes would be through the licensing process. In the light of their report, it seems probable that the CAA would award licences for the major business routes to BCal (I could express no view on that in view of my appellate function). If Lord King and the BA Board were publicly prepared to accept the decision of the Government, having been forced to do so by either of these methods, and thereafter co-operate fully, we would have less likelihood of delay. But it would be in their power to delay by obstruction, although it is not in their interests to delay the sale, any more than it is in ours. It is conceivable they might resign, but unlikely in my opinion. There might be adverse reactions from staff which could be damaging.

THE OPTIONS

15. We can dismiss the CAA's suggested route transfers and argue that they add nothing to creating competition in the industry. We will be criticised strongly - if irrationally - if we then "give" up to £400 million of public money to BA on privatisation. BCal will probably seek a merger with BA, and if that were denied would not be in a position to expand, and might have to retrench. If in addition it then ran into cash flow problems because of further difficulty in repatriating its revenues from its African routes, it might even have to go out of business. If so, we would then effectively be left with only one major scheduled international carrier. This would remove a pressure to keep BA on its toes generally; and it would make it harder to liberalise air transport in Europe.

16. Alternatively we can insist on the transfer of sufficient routes to strengthen BCal's position. We would need to force this through by one of the methods described in paragraph 14 above. We would only be able to achieve a successful result if the BA Board agreed to show public and practical co-operation (paragraph 12) and if BCal accepted that the package was adequate for them. It would be necessary to negotiate both conditions. A possible package which might meet these conditions would be the most profitable of BA's routes out of Gatwick - those to Madrid, Lisbon, Barcelona and Bilbao - plus the Harare route which BA serve from Heathrow. It would be necessary to see at the highest level if the two parties could be persuaded to accept this compromise before we could make a final decision.

COMMITMENTS

17. There are two commitments given by Sir John Nott in 1979, both of which are fairly circumscribing:

- a. "... there will be no arbitrary reallocation of routes" - it would be necessary to argue that the transfers we effected were not "arbitrary" but were the result of a policy decision to provide an enhanced multi-airline environment.

b. "... my proposal [that BA be privatised] does not involve a separate disposal of any part of British Airways". It would be necessary to argue here that this referred to enforced divestment of activities and subsidiaries rather than of routes. The existence of these quotations ensures a monumental row if we seek to justify compulsory transfer of route licences.

POLITICAL ATTITUDES

18. Among our supporters there was earlier a substantial groundswell in favour of BCal and another group supporting the interests of the smaller airlines. Others, while recognising the considerable contribution which Lord King has made to turning round BA, have felt that he showed an arrogance which boded ill for the restrained exercise by the airline of its market power after privatisation.

19. More recently, BA's case has attracted stronger support in the House of Commons. Many Members on both sides are critical of the CAA's recommendations. I understand Conservative peers may show strong support for BA's position when they debate the Earl of Kinnoull's unstarred Question on Monday evening. It is fair to say that Members are not aware of BCal's weakness because it would be damaging to that airline if its full position had been deployed. The Labour Party can be expected to oppose route transfers, since they reduce the scope of the airline they wish to nationalise.

TIMING

20. Our decision should be announced without delay to resolve the uncertainty in the industry. We have prepared the House for an announcement in the Recess.

Department of Transport

30 July 1984

1 Will the Laker case in any event delay privatisation of BA?

Not necessarily; but a price may have to be paid for avoiding delay. The time is not ripe for decisions on the course to follow.

There are several legal actions in train:

i. US Government Grand Jury Investigation. Conclusions expected within weeks. Not more than one charge in relation to price fixing. Maximum fine US \$ 1 million, but would be a major encouragement to civil suits.

ii. Private action: Laker liquidator's case. Following House of Lords decision on 19 July Laker liquidator is now free to pursue this case in the US courts. He will be calling for documents which we may or may not decide to release under PFI Act Order and Directions. Case not expected to come to trial in district court for at least six months. Allowing for appeals to higher courts could run for up to two years if not settled out of court. Maximum sum claimed (treble damages) is US \$ 1050 million.

iii. Other private class actions brought by individuals claiming that they paid higher fares because Laker was put out of business. First cases not likely to come to trial this year. Damages claimed could amount to as much as £900 million, but regarded as highly speculative at present.

Thus total claims in private suits so far are around £1600-1700 million.

Options for privatisation on the planned timescale include the following:

i. Flotation with the liability. Anti-trust liabilities are not regarded as an insuperable obstacle to company flotations in the United States. UK merchant banks may take a different view because the London market is less used to such liabilities, but there is little point in seeking definitive advice until we are much nearer to the date when a prospectus would have to be issued.

ii. The airlines might reach an acceptable out of court settlement, but the timing of this is unpredictable.

iii. BA may be able to insure their interest though probably only up to a maximum limit. They are exploring this possibility but are unlikely to know definitely before September.

iv. The Government have guaranteed BA's creditors against a BA default before privatisation. The Government could decide, at the time when the prospectus is finalised, to continue after privatisation a guarantee, limited to damages in the Laker suits, or to the excess over a predetermined sum.

The first three options may not prove viable or acceptable. Only the fourth option can at this stage be relied upon to ensure that privatisation goes ahead on the planned timescale. In addition to its direct and unwelcome financial consequences this course would encourage plaintiffs to hold out for higher sums in any settlement negotiations.

The Department of Transport are doing everything possible to bring about an early and favourable settlement in relation to the Grand Jury: we may need to recommend resort to arbitration in this context. Our ability to influence developments in the civil suits is extremely limited. And we would not wish to encourage a settlement at any price by the airlines.

STRENGTHENING THE POWERS OF THE
CIVIL AVIATION AUTHORITY

The CAA recommends that, in order to maintain a multi-airline industry it should be given a direct statutory duty to secure the sound development of the industry (at present it is required only to take decisions consistent with securing such development). It believes a change to the legislation would make its existing policies more secure and permit their extension into areas where present powers may not be sufficient; would reinforce the Authority's ability to deal with anti-competitive practices and, more generally, would enable it to react to unforeseeable circumstances in which regulatory action might be essential to safeguard a multi-airline industry.

The CAA has never been successfully challenged over a licensing decision and it must be very doubtful if the legislation needs amendment in this respect. Discussion with the Authority suggests that, with its present powers, it ought in many instances to be able to foster competitive developments, where airlines seek to compete directly or indirectly with British Airways. The exception is likely to be when a competitor seeks either to replace BA on a route or to operate in preference to it to a new point and yet proposes what would be an inferior service, if only initially. Depending on the circumstances of the case, the Authority might be obliged by the present legislation to licence BA, even if it felt that licensing a competitor would in the longer term promote a more healthy industry structure.

Anti-competitive practices are basically of two kinds: predatory pricing, often accompanied by dumped capacity, and other practices intended to reduce or eliminate competition eg computer reservation systems designed to favour a particular airline. The Authority accepts it can probably already deal with predatory pricing wherever this can be demonstrated. Its licensing process is, however, less well designed for dealing with other kinds of anti-competitive practice, for which existing competition legislation is probably better suited. The Competition Act 1980 applies to airlines, except where an anti-competitive course of conduct is pursued solely in respect of international carriage by air, as do the monopoly and merger provisions of the Fair Trading Act 1973. It is for consideration whether international carriage by air should be brought any further within the scope of the Competition Act, but the international implications of this need examination.

The CAA's final reason for wanting greater powers is unacceptable. It feels BA could be so efficient that the operation of market forces alone might cause other airlines to

fail; and that to prevent this it should be able, if necessary, to circumscribe BA's activities. However the point is speculative; and it would mean giving the Authority wide powers to restrain BA perhaps to force its exit from a market, which - even subject to appeal to the Secretary of State for Transport - in other fields are reserved to Ministers and Parliament following an investigation by the Monopolies and Mergers Commission..

In summary, there seems no justification for enhancing the Authority's powers. Its present ones are probably sufficient to do much of what it envisages by way of extension to its existing policies. A general power primarily intended to constrain BA in unspecified ways in the future, even when it is not acting anti-competitively, is unacceptably wide in its potential application. It would also result in a degree of uncertainty about the operation of the licensing system which could be damaging to the flotation of BA.