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CABINET

CIVIL AVIATION AUTHORITY'S REVIEW OF COMPETITION IN AIR TRANSPORT

Memorandum by the Secretary of State for Transport

Cabinet discussed this topic on 2 August (CC(84) 29th Conclusions, Minute 5) and asked me to prepare a further paper analysing a number of considerations. In this note I examine the main points; they are addressed in more detail in the Annexes.

COMPETITION

2. Air transport in many areas has for many years been heavily protected from real competition. Our policies since 1979 have been to bring full and fair competition into the airline market, and we will eventually be judged by the extent to which we succeed in securing the benefits of increased competition between British and foreign airlines as well as among British airlines themselves. We want to privatise British Airways (BA) to make competition fair between our airlines, and because in the private sector BA will be more efficient than it has been in the public sector.
3. Both nationally and internationally we want to ensure that the regulatory regime encourages competition. This is already the case on the North Atlantic, on many long-haul routes and on European charters. Until recently our own domestic services and European scheduled services have been much less open to effective competition. But now, within the United Kingdom, we have authorised United Kingdom airlines to compete with BA on several routes with a marked effect both on fares and on the quality of service. In Europe I hope that our recent agreement with the Netherlands will be followed by others opening the way to more competing services at keener prices; we have embarked on bilateral discussions with Belgium, Germany and Italy, as well as multilateral negotiations within the European Community. But this will take time: the powerful national airlines which dominate short-haul services between the United Kingdom and Europe have a strong interest in ensuring that any competition which may be allowed does not seriously threaten their position, especially on the valuable trunk routes to and from London.

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

5. Competition needs strong competitors. We need independent airlines - rather than just one airline - strong enough to compete on international routes for four reasons -

a. Without the stimulus of actual or potential competition from other British airlines, it will be too easy for a single carrier to slip back into the cosy arrangements BA has enjoyed for so long with other national airlines.

b. The very existence of alternative, viable British airlines ensures competing management styles and philosophies so that, even where direct competition with BA is impossible, indirectly our airlines set standards of performance for each other higher than might otherwise be obtained.

c. By ensuring other British airlines can compete with BA, particularly BCal at Gatwick, we also ensure that because of the competitive spur our civil air transport is better placed to take advantage of growing liberalisation in Europe and elsewhere, thereby enhancing the benefits to the consumer.

d. Total reliance on BA would mean reinforcing the dominant position which Heathrow enjoys in international scheduled services. Unless we allow other carriers to develop their networks at other airports, we will be condemning Gatwick to permanent second class status and the regional airports to being ancillary satellites largely feeding international passengers down to Heathrow.

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

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

a. On international routes whenever possible to encourage through the licensing system other British airlines to compete with BA.

b. On domestic routes to liberalise market entry and cease to regulate fares (apart from safeguards against predatory pricing).

c. To strengthen by legislation the Authority's powers to promote the sound development of the industry and deal with anti-competitive behaviour.

d. To strengthen both BCal and the other independent airlines against being forced out of business and to enhance their ability to compete, by making available to them BA's licences for routes to Saudi Arabia and Harare (Zimbabwe) from Heathrow; and to certain European points from Gatwick, Manchester, Birmingham and Glasgow.

8. a and b can be achieved within the existing statutory framework, by an amendment to the Authority's licensing policy. We have already agreed that they should be encouraged. c (powers to promote the sound development of the industry) was strongly opposed in the House of Commons. The CAA already have a good deal of freedom under the statute and there is widespread opposition to widening it so that they would have delegated to them responsibility for deciding the structure of the industry. Moreover, to do so would put great uncertainties in the minds of investors at the time of BA's privatisation. I am sure we all want to prevent anti-competitive behaviour. This function might fall either to the CAA to monitor and safeguard or alternatively to the Director General of Fair Trading to control, perhaps with extended powers in respect of civil aviation. d (the proposals for route transfers) present a more difficult problem. There can be no doubt that they would benefit the other airlines. Annex B gives some figures which try to quantify that benefit and relate it to those airlines' present financial performance. They are probably essential to ensure the viability of the private sector carriers. This is particularly true of BCal, whose present route structure is insufficiently profitable and too heavily oriented towards countries which are politically unstable or have currency problems or both.

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

- a. the means at our disposal to bring them about and the view Parliament would take of such action;
- b. the effect they would have on BA and on the prospects for privatising them early next year; the latter is also subject to:
- c. the risks associated with the anti-trust actions in the United States;
- d. undertakings given by Ministers in the last Parliament about the integrity of BA's route structure.

BA'S SOLUTION

10. As an alternative to route transfers BA has proposed that BCal be designated as the second British carrier on a number of routes. BA believe this could add substantially to BCal's revenue and profit. As a quid pro quo, BA would want to move their Lisbon and Madrid services back to Heathrow from Gatwick and estimate that this, together with extra traffic stimulated by the additional competition, would minimise the cost to them. BA have suggested a mix of 13 short and long-haul routes on which BCal could be added as the second British carrier. However, it seems unlikely we could secure BCal's designation at an acceptable price with the foreign Governments concerned on many of these routes. The prospects for dual designation are examined further in Annex C. The proposal does not in any case give BCal anything they cannot in theory already secure under the present licensing arrangements (except an assurance that BA would not seek to thwart BCal's entry on the routes). Indeed it would require BCal to fund such new route developments from their currently inadequate financial base. I cannot regard BA's proposal as a solution to the problem, although it goes in the right direction and I see no alternative to route transfers of some kind from BA.

OPTIONS FOR ROUTE TRANSFERS

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

- a. Saudi Arabia: thereby reducing BA's 1984-85 turnover by about £77 million or 3.3 per cent and operating profit by about £(22-25) million or (7.8-8.9) per cent.
- b. Harare plus those of BA's Gatwick services appropriate to BCal's operation: reducing BA's turnover by perhaps £32 million or 1.4 per cent and operating profit by about £7 million or 2.5 per cent.

c. The Caribbean: this was not suggested by the CAA who preferred to recommend the Saudi Arabia routes for transfer since they are more profitable and more easily extractable from BA's network. The Caribbean routes do, however, fit in quite well with BCal's existing operations to South America and southern United States. Their transfer would reduce BA's turnover by about £50 million or 2.1 per cent, depending on which particular routes were transferred, and operating profit by some £(5-10) million or (1.8-3.6) percent.

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

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

14. There is also the question of transferring BA's European services from regional airports to other independent airlines, as proposed by the CAA. Representations have been made to me about the proposal on behalf of the airports themselves and also on behalf of the independent carriers. The former see the loss of BA European services from their airports as a threat. They do not believe the independents will provide a satisfactory alternative, and passengers will increasingly have to travel via Heathrow. The independents deny this. They argue that they will offer better services at regional airports than BA because they wish to carry passengers direct to European destinations, while BA prefers to channel all their passengers via Heathrow in order to fill up existing services. I am reluctant to deny BA a presence at any airport since this would only diminish competition. At the same time, I should like to encourage the independents to develop regional

networks in competition with BA. We might therefore transfer to them some of BA's business routes to Europe leaving BA with, say, half of the routes in terms of capacity and in particular with the sort of European destinations they could eventually develop as points on medium and longer haul routes. This might cost BA around £27 million or 1.1 per cent of turnover and £2 million or 0.7 per cent of operating profit.

MEANS OF EFFECTING ROUTE TRANSFERS AND ATTITUDE OF PARLIAMENT

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

- a. BA agreeing to relinquish the routes without compulsion.
- b. Primary legislation giving me the necessary powers.
- c. Use of my powers as sole shareholder of BA plc.

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

- a. That I had gone beyond the intentions of the privatisation legislation (Civil Aviation Act 1980).
- b. That I had not safeguarded the value of the public assets entrusted to me by Parliament.

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

EFFECT OF ROUTE TRANSFERS ON BA AND ITS PRIVATISATION

18. Annex B sets out in detail the information we have on the impact of BA's finances and staff of possible route transfers. BA's estimates of the adverse effect of the CAA's recommendations are higher than the Authority's particularly on the profit contribution. This is partly because the routes bear £22 million of central overheads which would

have to be absorbed on other services, reducing their profitability at least for a while until offset by growth, or reduced by trimming back costs. Implementation of even the full package of transfers recommended by the CAA would still leave BA with one of the largest networks of international scheduled services in the world.

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

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

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

THE "LAKER" LITIGATION

22. Our ability to privatise early in 1985 could be threatened by the anti-trust actions in the United States courts or by a serious row with the United States Government affecting the continued operation of United Kingdom/United States air services if we continue to resist United States anti-trust jurisdiction. Annex D summarises the present

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

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

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

GOVERNMENT UNDERTAKINGS ABOUT PRIVATISATION

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

OTHER CONSIDERATIONS

26. As an alternative to route transfers, BCal would be content if we allowed them to operate international services from Heathrow. BA have a further large competitive advantage from their Heathrow base. But I fear we cannot contemplate such a change. It would be totally against the policy followed by successive Governments for the last six years to reduce congestion at Heathrow. We have managed to impose the policy on foreign carriers because we have adhered to it ourselves resolutely. If we allowed BCal to move to Heathrow, we could not reasonably refuse to allow other British as well as foreign airlines to do the same, and we should have to force a proportion of BA's services to move to Gatwick.

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

RECOMMENDATION

28. My conclusions are that -

a. If we are to adhere to our plans to privatise BA early in 1985 we shall have to devote a considerable amount of the proceeds to strengthening BA's balance sheet.

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

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

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

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

I invite the Cabinet to endorse these conclusions.

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

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Department of Transport
7 September 1984

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ANNEX A

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

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

LEGAL ASPECTS

Voluntary action by the Directors

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

Use of the shareholders' powers

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

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

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

Risk of challenge to the use of the shareholders powers

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

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

be determined on its merits).

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

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

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

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

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

Legislation to provide for the transfer of routes

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

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

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

PROPRIETY ASPECTS

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

Means of effecting route transfers

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

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

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

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

make compulsory transfer the responsibility of Parliament as a whole.

Compensation

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

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

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

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

CONCLUSION

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

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ANNEX B

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

British Airways

1. The CAA calculates on the basis of 1984/85 estimates that its proposals for route transfers might reduce BA's scheduled service revenue by a maximum of 7.3% or £167 m. There could be a more marked reduction in profit, perhaps a maximum of 9.6% or £27m before contingencies and interest, reflecting the loss of the very profitable Saudi Arabian routes. These account for about 3% of BA's revenue but could at best generate nearly 6% of profit assuming that BCal in any case serves Riyadh - for which it holds the licence - although it is doubtful the Saudis will accept two British carriers to the Kingdom. Harare produces less than 1% of revenue and profit; the Gatwick based services less than 2% (the Iberian services are profitable, those to Italy and Gibraltar break even to Scandinavia lose money); and the routes to Europe from the regions generate some 2% of revenue and 1.4% of profit.

2. In addition BA would, over a period of years, progressively face increased competition if the CAA licences, as it proposes, a second carrier on selected short and long haul routes. The Authority estimates route transfers and this extra competition could together cost BA as much as £271m in revenue in a full year and some £38.5m in profit. BA's estimate of the total combined effect is rather higher: £293m in lost revenue and £58m in operating profit plus a further net loss of £18m in profit because of fixed costs which cannot be eliminated offset by some interest savings. This estimate is based on more pessimistic assumptions than those adopted by the CAA (eg BA suffer more than the CAA think possible from the licensing of a second British Carrier on some BA routes), assumes BA rather than BCal serves Riyadh and ignores the prospect that

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

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

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

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

British Caledonian

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

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

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

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

Other independent airlines

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

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

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

Competition

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

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

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

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

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

Consumer benefits

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

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

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DUAL DESIGNATION

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

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

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

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

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

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

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

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

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

ROUTES PROPOSED BY BA FOR DUAL DESIGNATION

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

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

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

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

(a) US Government Grand Jury Investigation

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

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

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

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

(c) Private "class" actions

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

(d) Other possible private "class" actions

These cannot be ruled out and could be

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

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

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

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

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

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

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

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

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