



Ref. A084/2642

PRIME MINISTER

Airline Competition Policy

(C(84) 27)

## BACKGROUND

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

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

B. 2. Ministers collectively have considered the recommendations on several occasions, both in E(A) (E(A)(84) 19th Meeting, Item 3) and in Cabinet (CC(84) 27th, 28th and 29th Conclusions). It has been common ground that the recommendations summarised at (ii) above should be accepted and those at (iii) rejected. There has, however, been a sharp difference of view on the recommendations



concerning route transfers. At their meeting on 2 August (CC(84) 29th Conclusions, Minute 5) the Cabinet invited the Secretary of State for Transport to prepare a further paper discussing the issues. You said that you would arrange for a small Group of Ministers under your chairmanship to give preliminary consideration to those issues before the Cabinet resumed their discussion.

3. At the beginning of September, the Secretary of State for C Transport circulated a paper to the Cabinet (C(84) 22) discussing a number of possible route transfers from BA to BCal and suggesting that if, as seemed likely, they were not acceptable to Lord King and his Board, it would be necessary to promote primary legislation in the new Session of Parliament to achieve them.

4. The proposals in C(84) 22 were not discussed by the Cabinet. Instead, they were considered by a small Group of Ministers at a meeting under your chairmanship on 11 September. The main conclusions of that meeting are summarised in paragraph 3 of Mr Ridley's current memorandum (C(84) 27). In particular, the meeting agreed that it would not be feasible to legislate; and that the right approach was therefore to try to persuade BA and BCal to agree to a negotiated "route swap".

5. C(84) 27 puts forward proposals on the basis of Mr Ridley's negotiations with BA and BCal. He proposes that BA should give up its routes to Saudi Arabia in return for the route to Atlanta in the Southern United States, and a number of other routes, mainly to Latin America. Details are given in Annex B to C(84) 27.

6. Neither BA nor BCal has given a definitive statement of its views. Discussions are still in progress; but I understand that the situation is as follows:

- (a) BCal has said that it would accept the package in C(84) 27 if it could keep the Atlanta route; it has not said that it would reject the package if it could not keep that route, but the Department of Transport consider that it might well do so.



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(b) BA has said that it would accept the package as it stands; the Department of Transport assessment is that it would probably not accept if it did not obtain the Atlanta route.

7. The proposed deal would, according to BA, reduce their profits by £17 million a year and increase BCal's by £15 million a year. Mr Ridley suggests that it might reduce the proceeds from floating BA by £80-£100 million.

8. C(84) 27 also contains proposals on the other CAA recommendations, as follows:

- (i) The CAA's recommendations on domestic air services and dual designation on those overseas routes where dual designation is possible should be accepted (paragraphs 5 and 6 of the memorandum).
- (ii) Instead of transferring BA's European routes out of provincial airports to other British airlines, Mr Ridley proposes to accept an offer from BA of limited financial and other support for airlines wishing to set up on such routes (paragraphs 7 and 8 of the memorandum).
- (iii) Stronger action, on the lines described in paragraph 13 of the memorandum, should be taken against predatory pricing and other anti-competitive behaviour.
- (iv) The CAA's request for wider licensing powers should be rejected.
- (v) Nothing can be done about increasing capacity at Heathrow and Gatwick for the time being (paragraph 14ii. of the memorandum).

9. Mr Ridley proposes that the Government's conclusions should be made known in a White Paper to be published forthwith: the aim would be to make the Government's decisions public before the Party Conference.

#### MAIN ISSUES

10. The main issues before the Cabinet are as follows:

- (i) Is the proposed deal between BA and BCal satisfactory?



- (ii) If it is not, what prospects are there of obtaining a better one:
  - (a) by legislation; or
  - (b) by other means?
- (iii) Are Mr Ridley's other proposals acceptable?
- (iv) How should the Government's decisions be announced?

In practice, questions (i) and (ii) cannot be divorced: there is no point discussing what might be ideal arrangements if there is no way of bringing them about.

Is the deal satisfactory?

11. The following main considerations seem relevant:

- (a) The effects on competition. Clearly it would be desirable to have two, or more, strong British airlines freely competing on all international routes. Unfortunately, because competition in air transport is so heavily restricted by international agreements, it is not a possibility for the foreseeable future. The CAA's proposals are rather directed at strengthening the financial position of BCal by allowing it to enjoy monopoly-type profits on some routes, so that it can compete more effectively on others. Is this a valid approach? If it is, do Mr Ridley's proposals go far enough in that direction?
- (b) The implications for privatisation. Hill Samuel, the merchant bankers advising the Government on the BA flotation, suggested earlier that any package of route transfers which reduced BA's profits by more than 10 per cent would carry an unacceptable risk to privatisation. BA estimate that the effect of Mr Ridley's proposals would be to reduce their profits by £17 million a year (about 6 per cent). Presumably this would not be a bar to privatisation. Nevertheless, it would entail a reduction in the proceeds of sale and probably, for the reasons outlined in paragraph 10ii. and iii. of the memorandum, in the amount received by the Government.



(c) The public attitude of the airlines. If BA and BCal will at least acquiesce in the deal, Ministers are likely to regard it as a satisfactory solution to a very difficult problem. But it is not clear that BCal, in particular, will. If they reject the deal, it is not clear that the defence outlined at the end of paragraph 12 of C(84) 27 will carry conviction in public debate. The deal which BCal would have rejected is much less favourable to the airline than the CAA's recommendations. The Government will presumably, at the very least, have to produce convincing reasons why it has departed from those recommendations.

12. It seems quite likely that, when the Cabinet take their decisions tomorrow, the positions of BA and BCal regarding either the proposed deal or possible modifications to it will not be known with certainty. If so, Ministers will need to decide on their response should either or both airlines reject the deal. Should they, in effect, say that the proposals were the Government's last word, and that if they are rejected that is an end of the matter; or do they wish to invite the Secretary of State for Transport to try to find an alternative?

Could a different deal be obtained?

13. If, for whatever reason, the Cabinet thought it desirable to try to secure different arrangements to those proposed in C(84) 27, it would be necessary to consider the means by which this might be done. The possibilities are as follows:

- (a) Legislation. This would be highly contentious and delay privatisation. Moreover, the business managers have advised that the passage of legislation could not be guaranteed. The meeting on 11 September decided that these were conclusive objections.
- (b) Amending BA's Articles of Association. There are legal difficulties about this course; it might well cause the Board of BA to resign; and there are objections of propriety to reducing the value of substantial public assets otherwise



than by legislation. In his earlier memorandum (C(84) 22) Mr Ridley regarded these objections as conclusive; and that view has not been challenged.

- (c) Further negotiations. Mr Ridley argues in paragraph 12 of his memorandum that further negotiation would serve no useful purpose. The Cabinet may wish to probe this. The Atlanta route is no doubt important to BCal. Are there other routes to America or elsewhere which might be less valuable to BCal but still attractive to BA? Does the contract for trooping flights to the Falklands (Mr Ridley's letter of 2 October to Mr Heseltine) offer a possible solution?

#### Other proposals

14. If, as seems likely, the Cabinet rule out the possibility of legislation, then there seems to be little alternative to accepting BA's offer on European routes from provincial airports. It seems unlikely that any Minister will challenge Mr Ridley's recommendations on domestic air services; dual designation; action against anti-competitive behaviour; CAA licensing powers; or traffic movements at Heathrow and Gatwick.

#### Announcements

15. There is no formal need to announce the Government's decisions by a White Paper: if Parliament were sitting a written or oral statement would probably suffice. But Parliament is, of course, in Recess; and Mr Ridley considers that a Press Notice would not be enough.

16. If the proposed deal is accepted by BA and BCal, then the draft White Paper attached to C(84) 27 seems broadly satisfactory. But if the deal is not accepted, Ministers will wish to consider whether a more aggressive justification than that recommended by Mr Ridley in paragraph 12 of C(84) 27 is needed. In previous discussions, some Ministers have argued that it would be necessary in such circumstances to argue publicly that the CAA's recommendations would not in fact promote competition and would indeed weaken BA, the main United Kingdom flag carrier, as a competitor to overseas airlines. If the Cabinet should decide to



adopt this approach, fairly substantial recasting of the draft White Paper will probably be needed. In such circumstances, you will probably wish to invite Mr Ridley to circulate a revised draft to the Cabinet, with sufficient time for Ministers to give it full consideration.

17. The timing of the announcement also requires consideration. Mr Ridley has proposed immediate publication of the White Paper, no doubt because it was felt that an announcement before the Party Conference would be desirable. But much will depend on what further progress Mr Ridley is able to report, on whether the Cabinet considers that further negotiations might be worth while and on how much extra work needs to be done on the draft White Paper. If no announcement is possible before the Party Conference, there will need to be agreement on a form of words to hold the position - for example that further discussions are taking place.

#### HANDLING

18. You will wish to invite the Secretary of State for Transport to open the discussion. The Chancellor of the Exchequer will wish to comment on the implications for competition and for the privatisation programme. The Secretary of State for Trade and Industry will also wish to comment on the implications for competition. The Lord Privy Seal and the Chief Whip can advise on the Parliamentary aspects.

#### CONCLUSIONS

19. You will wish the Cabinet to reach conclusions on the following:

- (i) Are the proposals in C(84) 27 for route transfers between BA and BCal satisfactory?
- (ii) If not, how should attempts be made to amend them?
- (iii) If they are rejected by either BA or BCal, what should be the Government's response?



(iv) Are the proposals in C(84) 27 on:

- (a) domestic air services;
- (b) dual designation;
- (c) European services from regional airports;
- (d) action against anti-competitive behaviour;
- (e) CAA licensing powers;
- (f) air traffic movements from Heathrow and Gatwick

acceptable?

(v) How and when should the Government's decisions be announced?

*R*  
Approved by  
ROBERT ARMSTRONG  
and signed in his absence

3 October 1984