



CONFIDENTIAL

Michael Scholar Esq
10 Downing Street
London SW1

From the Secretary of State

Prime Minister 1
Mr Heseltine has already said that he wishes to comment in detail on Lord Cockfield's earlier paper, and I think we should keep this on the E(NI) agenda. A meeting

5 August 1982

has been provisionally fixed for Wednesday, 8 September. Agree?

Dear Michael,

BRITISH AIRPORTS AUTHORITY: E(NI) (82)19

Thank you for your letter of 26 July in which you reported the doubts expressed by the Prime Minister about my Secretary of State's paper on the British Airports Authority. I attach, as requested, a note on the points raised by the Prime Minister.

In your letter, you referred to the current legal action over the BAA's airport charges, in particular at Heathrow. This litigation has been brought against both the BAA and my Secretary of State. It was initiated following the very sharp increases in airport charges which were introduced in April 1980 following our decision in 1979 to set a zero EFL for the Authority and to establish a financial target of 6% CCA for the three financial years 1980/81 to 1982/83. The points at issue are complex but, from the Government's point of view, the most serious are the allegations:

(i) that the increases in airport charges were caused by unlawful directions by the Government whose dominant purpose was the implementation of a policy to reduce the public sector borrowing requirement;

(ii) that the Government's approach to BAA's finances has resulted in its maintaining in force a measure requiring the BAA to abuse a dominant position in the EEC in breach of Article 90 of the Treaty of Rome.

The trial date has just been postponed again until February 1983 at the earliest. We shall defend the action as vigorously as possible since, if the airlines were to succeed in their case, it could have serious consequences for our policy towards the rest of the nationalised industry sector.

Yes not Wm
G/S



From the Secretary of State

Our analysis of BAA's performance over the last three years suggests that while the real increase in prices in April 1980 has been a substantial factor in the improved financial performance of the BAA, there have also been real improvements in keeping costs under control. This is exemplified by their success in keeping pay settlements below the rate of inflation for four successive years.

Quite a large proportion of the BAA's costs is fixed (eg depreciation) or externally imposed (eg rates and energy) which limits the scope for making substantial reductions in current operating costs. Moreover staff and other costs cannot be reduced instantly to match reductions in traffic: there is a time lag, as Section 3 of the attached paper shows, before the adjustments can be made.

BAA's traffic charges are high compared with those at other airports because we are alone in seeking to recover from the users the full economic cost of the services they require. In other countries a measure of direct subsidy and/or cross subsidisation is normal.

If, as is suggested in E(NI)(82)19, we are to reduce the IFR bid by £50 million to keep within the White Paper ceilings on external finance, without further reducing the planned capital investment programme, there would almost certainly have to be further real increases in airport charges next April. The precise amount of that increase will depend on the extent to which traffic continues to increase over the next year or so and is something we shall be considering with the Authority once final decisions are taken in the Autumn on the EFL for 1983/84.

Perhaps you could let me know if the Prime Minister would like any further information and whether she wishes to have a discussion at a further meeting of E(NI) after the recess.

I am copying this letter and attachment to the Private Secretaries to other members of E(NI) and to David Wright (Cabinet Office).

Yours ever,

Jonathan Rees
JONATHAN REES
Private Secretary

JONATHAN REES
Private Secretary

All this depends on some extent on efficiency. use of space - many.

Yes please - see note above



BRITISH AIRPORTS AUTHORITY

BACKGROUND NOTE

1. Pricing Policy

The Government's approach to the pricing policies of the BAA has been based on the main principles set out in the White Paper on Nationalised Industries (Cmnd 7131) which required:-

- (a) that nationalised industries should price to cover their long run marginal costs;
- (b) that the industries should earn the 5% required rate of return on the whole of their new investment programme;
- (c) that within the overall level of prices, industries should ensure that peak and off-peak usage are related to the relative costs of supply; and
- (d) that there should not be arbitrary cross-subsidisation between different groups of consumers.

The application of these principles to the BAA is complicated by the dual sources of revenue - from traffic operations on the one hand and commercial operations (e.g. duty free shops) on the other. Since 1974-75 the BAA has made a trading loss on its traffic operations, and a substantial trading profit on commercial operations. Despite the substantial increase in airport charges in April 1980, this pattern persists:-

	<u>CCA Trading Profit - £m</u>			
	<u>1978-79</u>	<u>1979-80</u>	<u>1980-81</u>	<u>1981-82</u>
Traffic	(£17.6)	(£25.7)	(£4.0)	(£9.2)
Commercial	<u>£30.0</u>	<u>£35.3</u>	<u>£41.9</u>	<u>£49.0</u>
Total	£9.5	£12.4	£37.9	£39.7

The present financial target was agreed on the assumption that the BAA would increase its charges so that the estimated revenue from traffic operations would produce a 5% RRR on the investment related to these operations alone. In practice, as a result of airline



pressure, the BAA held prices in 1981/82 slightly below the current level of inflation and have made no increase for the current financial year. This will inevitably affect performance against the financial target and future financial performance unless there are further real increases in charges.

Comparisons with airport charges overseas are invalidated by the existence of extensive overt and covert subsidies designed to prevent airlines paying the full cost of the facilities provided. Moreover most other airports do not impose peak/off-peak prices to reflect differences in costs. The trend overseas is, however, to follow the UK pattern and in the USA the Reagan Administration is also currently seeking to reduce the level of Federal subsidies to the air transport industry and to increase user charges.

2. Privatisation

Following the E(DL) remit (Meeting 27 November 1981) the then Secretary of State wrote about disposal prospects for BAA in his letter of 21 December 1981. His view, which was accepted by the Financial Secretary, was that it would be impossible to write a prospectus for the sale of equity in the Authority until there was a resolution of the current litigation over user charges and the uncertainties over the development of the South East Airports. BAA have received similar advice from their merchant bank.

Discussions have therefore focused on the short-term prospects for greater private sector involvement in BAA's capital expenditure programme and on 29 July it was announced in Parliament that the BAA, the Department of Trade and the Treasury were to establish a working group to consider urgently the prospects for either a general performance bond along the lines of that agreed for British Telecom or an equity sale in a subsidiary company with a royalty agreement linked to BAA's commercial revenues.

Prospects for privatisation of the airports industry in the longer-



term are being considered in the light of the Prime Minister's minute to the Chancellor of 28 July and the MISC(79) exercise which relates to local authority regional airports. A separate report will be circulated to the E(DL) Committee in September in response to the Prime Minister's request.

3. Productivity

The BAA agreed two productivity targets with the Government in early 1980. These require an average increase of 3% per annum in passengers handled per employee and an average reduction of 2½% per annum in operating costs per passenger over the three financial years 1980/81 to 1981/82. Results in the first year were affected by the recession in the air transport industry but, as a result of reductions in costs and staff, it is likely that the BAA will achieve the first target but miss the second:

	<u>Target</u>	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u> (Forecast)	Forecast Out-Turn Average
Passengers per employee	+3%	-1.1%	+4.9%	+6.6%	+3.4%
Cost per passenger	-2½%	+1.3%	-0.7%	-4.5%	-1.3%

Staff numbers have been cut by 2.6% (1980/81) and 4.5% (1981/82) and staff costs reduced from 36.9% of total expenditure in 1979/80 to 34.1% in 1981/82. Average staff costs per employee have been reduced from £10,929 in 1979/80 to £10,339 in 1981/82 (both at March 1981 prices) and other current costs (e.g. utility and general services) have been held below increases in inflation in those areas. However the amount of local rates paid on BAA airports has increased by 62.4% since 1979/80 and this has just about offset the reductions in controllable costs with the overall result that the increase in total expenditure over the two-year period has almost exactly matched the increase in retail prices.



Pay Settlements

BAA's annual pay settlements since 1979 have been as follows with the current rate of inflation at each settlement date in brackets:

1979

9% increase in basic rate coupled with certain productivity payments. Estimated increase in average earnings 10.5% (RPI 14%).

1980

15% increase in basic rates from 1 January with a further 2% from 1 April. Estimated increase in average earnings rather less than 15% (RPI 20%).

1981

9% increase in basic rates with certain improved productivity arrangements. Estimated increase in average earnings 9% (RPI 16%).

1982

6% increase in basic rate and shift allowance; productivity payments frozen at 1981 level. Estimated increase in average earnings 5.6% (RPI 12%).

Over the same period, the proportion of staff costs represented by overtime has been reduced as follows:

1979/80	9.5%
1980/81	6.9%
1981/82	6.4%

- 5 AUG 1982



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From the Private Secretary

9 August 1982

Dear Jonathan

British Airports Authority: E(NI)(82)19

Thank you for your letter to Michael Scholar of 5 August. I have consulted the Prime Minister, and she still wishes to have a discussion of this paper, and of your letter, at a further meeting of E(NI) after the Recess. I understand the meeting has been provisionally fixed for 8 September. You will also have seen David Edmonds letter of 2 August, in which he explains that Mr. Heseltine wishes to comment in detail on this subject:

The Prime Minister has also noted the comment in your letter that quite a large proportion of the BAA's costs is fixed or externally imposed, and that this limits the scope for making substantial reductions in current operating costs. She remains, however, unconvinced that the BAA could not achieve further reductions through efficiency, and particularly through the efficient use of space (thereby reducing rates) and energy.

I am copying this to the Private Secretaries to the other members of E(NI) and to Richard Hatfield (Cabinet Office).

Yours ever

Willie Rickett

Jonathan Rees, Esq.,
Department of Trade.

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Wh SK Ewon Pd.

MG



2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

2 August 1982

Dear John

As I mentioned to you on the phone this morning, my Secretary of State is not at all happy with the note circulated on the British Airports Authority (E(NI)(82)), referred to by your Secretary of State in his minute to the Prime Minister of 23 July 1982. He believes that the document as it stands is so broad brush as to be beyond any realistic scrutiny. He will wish to comment in more detail, and will write to Lord Cockfield shortly.

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I am copying letter to the Private Secretaries to the Prime Minister, the members of E (NI) and to Sir Robert Armstrong.

John Edmonds
DA

DA EDMONDS
Private Secretary

John Rhodes Esq



13 AUG 1962

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From the Private Secretary

26 July 1982

BF

BRITISH AIRPORTS AUTHORITY: E(NI)(82)19

Your Secretary of State minuted the Prime Minister on 23 July seeking to clear in correspondence his E(NI) paper on the performance and current position of the British Airports Authority (E(NI)(82)19).

The Prime Minister has expressed a number of doubts about this paper. She has enquired as to whether the BAA's success in keeping its costs under control is more apparent than real, on the grounds that it has done so by charging very high fees to airport users. The Prime Minister has commented that the fact that a number of foreign airlines have brought a major legal action against the Board is itself an indictment of the BAA's performance. Mrs. Thatcher notes that there is no reference in this paper to privatisation of the BAA. She has also enquired, in relation to the reference in paragraph 4 to "further" improvements in productivity, what productivity improvements have already been achieved. Finally, she would be grateful for information about the pay settlements which BAA have made over the last three years; she endorses the Secretary of State's view that it would be necessary to make adjustments to the Board's assumption that pay will rise in line with inflation.

BF I would be grateful if you would let me have a note on these points. The Prime Minister's present view is that it would be necessary to discuss this paper at a meeting of E(NI), after the recess.

Private Secretaries to the

I am sending copies of this letter to the other members of E(NI) and to David Wright (Cabinet Office).

M. C. SCHOLAR

Jonathan Rees, Esq.,
Department of Trade.

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