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

18 September 1985

Dear Sir Geoffrey,

US/UK AVIATION: FUTURE STRATEGY

I attach a paper which sets out our views on the best way of seeking to make progress with the US Government, particularly over anti-trust, now that the Laker suit has been settled. I understand that the conclusions contained in the paper are broadly shared by your officials.

In my view we need a political initiative to re-establish the dialogue which the Americans broke off late last year and to build on the encouraging progress which was being made up to that point. The first opportunity will occur on 3 October when Michael Spicer meets the US Secretary of Transportation, Elizabeth Dole, and, if you and other colleagues are content, I propose that we should use that occasion to press for an early resumption of negotiations and to pursue those negotiations on the basis of the strategy set out in the attached paper.

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

Yours sincerely,

Richard Allan

(Private Secretary)

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

UK/US AVIATION: FUTURE STRATEGY

Irrespective of the settlement of current anti trust cases it remains a primary and important objective to resolve the anti trust dispute with the US. Indeed, the cost of settling the Laker liquidator's case and the continuing risk of new cases which, however spurious, would nevertheless engage substantial financial and management resources, has effectively underlined the need to achieve a satisfactory settlement which removes the risk of anti trust action and especially the costly private suits.

2. A settlement of the dispute may require a mixture of pressure and persuasion - eg. the "stick" of a highly restrictive/protectionist approach to aviation so long as the dispute remains unresolved and British airlines remain potentially exposed to anti trust action in the US courts or the "carrot" of a liberal and competitive regime provided we get an agreed approach to competition/anti trust problems.

3. The steps which the UK could take under the existing Bermuda 2 agreement to bring pressure to bear on the US authorities and their airlines are as follows:

(i) <u>New gateways</u>

Under the current agreement, new gateways have been

added year by year, but this period of growth will shortly come to an end. The US would probably like it to continue, but our airlines are more interested in access to points behind the existing US gateways. We shall be under no obligation to add new gateways not already foreseen, although a tough stance in this area might be particularly difficult to sell to Manchester.

(ii) Tariffs

We might, in theory, be much more restrictive about approving tariffs for US airlines, or even perhaps insist that each and every tariff (other than those we are obliged to approve under the ECAC/US Agreement) should be negotiated directly between governments in order to minimise the risk of anti trust actions; but we could find ourselves in serious difficulty if the US Government and their airlines chose to ignore our requirements and, in effect challenged us to stop them.

(iii) Charters

We could be more difficult about approving charters, particularly in the area of fifth freedom rights.

(iv) Operating permits

In order to improve our enforcement powers, we envisage tightening up in this field in any case. But we could invent more tedious and lengthy bureaucratic processes for the granting of permits to US airlines, to match

those which UK airlines have to go through in the United States.

(v) All-cargo services

We have already sought consultations under the Cargo Annex and could in effect reintroduce regulation into what is a virtually deregulated area of activity which US airlines virtually monopolise.

4. We are very doubtful whether these measures would prove effective, if put to the test, in forcing the United States Government to remove international aviation from the purview of their anti trust laws. Effective capacity control (the control which would bite deepest) is not available to us without a replacement for Annex 2 of Bermuda 2 (which expires next year and a successor for which we are attempting to negotiate), at least until after the damage has been done. Clamping down on charters and inventing new tangles of red tape for operating permits would cause a good deal of irritation but not, we fear, a change of heart. The US airlines might indeed like new gateways, but they could get along very nicely without any more for some years. Direct negotiation of tariffs between governments would be a monumental task in a market where new offers spring up like mushrooms, and one which the US Government would find distasteful, but it would only work if they accepted an obligation to negotiate every fare with us and if we could be sure that the UK courts would back us up in preventing a US airline carrying passengers at fares which had

not been approved. We are studying the scope for effective action against US airline tariffs, but we would be reluctant to recommend at this stage that such action should be made to bear any great weight in a negotiating strategy. Quite apart from its doubtful chances of success against very powerful market forces, it would be a difficult policy to present politically; the public would not see why they should be denied prompt access to cheap fares so that UK airlines could win exemption from the US anti trust laws.

5. We conclude that, short of termination of Bermuda 2, we do not have at our disposal means which might possibly force the United States Government against their will to exempt UK/US aviation from the purview of the anti trust laws; and that it would be politically difficult to justify terminating the Agreement at this stage ie. before a serious attempt to reach agreement over anti trust has been made or before real damage to our airlines can be demonstrated in the field of capacity control (eg. "swamping"). In any event termination of Bermuda 2 could create so much uncertainty about BA's prospects in their most important long haul market that it would put privatisation at risk once again.

6. In the anti trust field, the essence of what we are seeking is US legislation removing the damaging private treble damage anti trust suit from international aviation - at least on UK/US routes. This will not be easy to achieve and much will depend not only on the willingness of the US administration to

introduce such legislation but also on the receptiveness of Congress to such a proposition. Nevertheless last autumn the two sides made considerable progress towards a package which envisaged the introduction of such legislation on the one hand and changes to Bermuda 2 (incorporating greater transparency of airline discussions and a more liberal tariff regime) on the other. UK airlines would, on balance, welcome the greater commercial freedom inherent in a more liberal tariff regime. In the capacity field (Annex 2) BA in particular also favour a more liberal capacity regime, provided that they can also get certain improvements in access to the US market; BCal are more nervous about the competition they face at their US gateways and are therefore more interested in capacity safety nets; Virgin Atlantic is currently protected by the special deal we have for them and People Express, and would want that to continue. In short, the sort of deal already put to the Americans in this area, trading enhanced market access for capacity freedom within 40:60 market shares and safety nets beyond, was designed to reconcile the divergent interests of the UK airlines and should be beneficial to them. Of course, it has attractions to the US side as well, as it needs to do if there is to be any replacement at all for the existing Annex 2 capacity control mechanism which runs out in July 1986.

7. Liberalization on the terms we have put to the Americans, which includes both removal of the private anti trust suit from international aviation and enhanced access to the US market, should allow both UK and US airlines to benefit from a more

liberal environment, but it is probably true to say that only BA face a more competitive future on the North Atlantic with real confidence. BCal and Virgin, despite their public images, are much more nervous about the prospects. On balance, however, given that we wish to encourage more competition in international aviation where possible, we believe that the liberalization packages we have put to the Americans represent a risk worth taking.

8. If the analysis in the preceding paragraphs is anything like right, we have quite a nice carrot to offer the Americans in negotiations, but, short of termination of Bermuda 2, rather a weak stick. It would certainly help our negotiating position if the Americans could be brought to believe that failure to resolve the anti trust dispute and to grasp liberal arrangements on more or less the terms we have offered would be likely to have serious consequences for their airlines. There are two main arguments which can be deployed to this end:

(a) <u>The political and legal case on anti trust</u>

The Laker case has been costly to our airlines and a political minefield; and both sides have done well to avoid worse damage to our relations, both in aviation and more widely; any further actions in the US courts could delay BA privatisation beyond the lifetime of the present Government; in such circumstances we should have nothing to lose by terminating the agreement; the only sensible course for two friendly governments whose political and economic philosophies are broadly similar

must be to negotiate jointly agreed satisfactory bilateral arrangements to encourage competition and to ensure that it is fair without the unilateral application of either side's competition laws, before there is any risk of the situation becoming further complicated by new actions in the courts. If there is one thing on which the Courts on both sides of the Atlantic are agreed, it is that the Laker case has uncovered a dispute between the two governments about the proper meaning and interpretation of the Bermuda 2 agreement, which it is for the two governments to resolve.

(b) The aviation case for replacing Annex 2

US airlines currently have about 60% of the UK/US market. This is a reflection in part of the growing concentration of the US aviation industry post-deregulation which is making it increasingly difficult to assure conditions of fair and equal opportunity for UK airlines at US hubs dominated by US carriers protected by the combined strengths of their cabotage networks and heavily biased computer reservation systems. If the US Government fails to negotiate on a satisfactory replacement for Annex 2, they will have only themselves to blame if we are forced to terminate the agreement and start again, as we did ten years ago.

9. The best way forward in the immediate future is to approach the US at the political level and draw on the arguments in

paragraph 9 above to emphasise the importance of resuming negotiations, both on the tariff liberalization/anti trust package and on the capacity liberalization/market access package, with a view to reaching agreement in both areas within six months - ie. before the planned privatisation of BA. We should also stress the political importance which will be attached to conducting the negotiations in a constructive spirit with both sides committed (publicly if possible) to a satisfactory outcome which will lead to a more liberal regime on the North Atlantic under conditions of fair and equal competition bilaterally agreed and bilaterally applied.

Department of Transport