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Foreign and Commonwealth Office

London SW1A 2AH

From the Parliamentary Under Secretary of State

10 July 1986

NBP 12.

UK/US AIR SERVICES AND BA PRIVATISATION

In Geoffrey Howe's <sup>at time</sup> absence I am replying on his behalf to your minute of 7 July.

I am pleased that there has been close cooperation between officials on this difficult matter. I agree that the UK should have the negotiating flexibility you suggest in para 7(a) of your minute and I share your view that we should not be prepared to reach agreement regardless of the cost to our airlines. Geoffrey will be consulted about a message to Mr Shultz on his return from Southern Africa (your paragraph 7(b)) and we shall inform MISC 112 colleagues as soon as he has replied.

I am not convinced (para 7(c) of your paper) that we need now to agree that the Prime Minister should send a message should the July talks fail. I quite agree that we may need to consider such an idea as a means of reaching a successful outcome, but feel it is premature to commit ourselves to such a step at this stage before we know the outcome of the July talks. If the gap between the two sides remains great at the end of July then it may be an unwise use of our political capital to attempt to bridge too wide a gap. I am sure we would wish the Prime Minister to send a message only if there were at least a reasonable chance of success.

The decision on how we safeguard our interests if the talks fail completely (your paragraph 7(d)) is one which, I think, can also be left until after we know the outcome of the July talks. Similarly, any discussion of the implications of the July outcome for the privatisation of British Airways is, as you suggest, at this stage premature.

I am sending copies of this letter to the members of MISC 112 and Sir Robert Armstrong.

*Tim Eggar*

Tim Eggar

The Rt Hon John Moore MP  
Secretary of State for Transport  
2 Marsden Street  
LONDON SW1P 3EE

CBC



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP  
Secretary of State for Transport  
Department of Transport  
2 Marsham Street  
LONDON  
SW1P 3EB

NSM

9 July 1986

*Dear John***UK/US AIR SERVICES AND BA PRIVATISATION**

I have seen your minute of 7 July to the Prime Minister.

I am content with your proposals on the negotiating position and on the handling of the negotiations, and I see no need for a meeting.

I am writing, however, about the timing of the decisions which you propose should be taken in September. You expect to have better information than on BA's financial position this year and on the company's prospects, and we should be clearer about the state of the negotiations with the US Government.

But given the time which we have been advised that a proper marketing campaign for BA, or BAA, will take, it is very important that we should take a firm decision as early as possible in September. Even if we did not have all the information we would ideally like, we must resist the temptation to delay the decision beyond the end of that month, as that could prejudice a successful flotation in January.

I am sending copies of this letter to the recipients of your minute.

**NORMAN LAMONT**

AEROSPACE, future of BA Pt 5,



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10 DOWNING STREET

From the Private Secretary

9 July 1986

Dear Richard,

UK/US SERVICES AND BA PRIVATISATION

The Prime Minister has seen the Secretary of State for Transport's minute of 7 July and paper about UK/US Air Services and BA privatisation.

The Prime Minister is content, subject to the views of colleagues, with the Transport Secretary's proposed negotiating position on Bermuda 2. She notes that a meeting of MISC 112 is likely to be needed in September, both to review the outcome of the negotiations and to decide the timing of privatisation of BA.

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

Yours,  
David.

David Norgrove

Richard Allan, Esq.,  
Department of Transport

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Agree the recommendations in paragraph 5? (See also the Policy Unit note below.)



Yes no

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From: J B UNWIN  
8 July 1986

MR NORRGROVE

cc Sir R Armstrong  
Mr Wiggins

UK/US AIR SERVICES AND BA PRIVATISATION

WITH DN?

The Transport Secretary's minute of 7 July to the Prime Minister seeks agreement to the UK negotiating position at the meeting with the Americans on the Bermuda 2 Air Services Agreement starting on 21 July; and reports on the present prospects for privatising British Airways (BA) in early 1987. Mr Moore suggests that, if colleagues are content with his proposals, there is no need for a meeting of MISC 112 this week (we have provisionally earmarked the vacant E(A) slot after Cabinet on Thursday).

Bermuda 2

2. The proposal in essence is that, although we should be prepared to make some concessions to the Americans on matters such as access to UK regional airports and a more liberal regime for charter and cargo services, we should dig our heels in on the concept of a 40-60 per cent free zone\* so as to prevent our airlines' share of North Atlantic traffic falling below about one-third of the market. If we fail to secure this, we shall then have to choose between the options of applying the terms of the existing Agreement itself as they relate to capacity, or giving notice of termination of the Agreement with a view to the negotiation of an entirely new one. But it would not be sensible to come to any conclusions on these options in advance of the outcome of the forthcoming negotiations; and in an attempt to strengthen our hand the Foreign and Commonwealth Secretary should send a personal message to Mr Schulz.

\* ie there is a free for all between 40% and 60%, but outside that zone action is taken to prevent one country's airlines wiping out the other's.



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Privatisation of BA

3. The Transport Secretary's report is curate's eggish. Although the position on anti-trust liabilities looks much better, and this problem may largely have been cracked, there are worrying downside factors in the form of the uncertainties about Bermuda 2 and the deterioration in BA's financial performance due in the main to the effects on air travel of terrorism and the Libyan crisis. Although flotation may still be possible, the proceeds could be substantially reduced. The Treasury tell me that, on present prospects, a January 1987 flotation could realise only some £700 million compared with the £1 to 1.25 billion pencilled in for this sale. However, no decisions on this can be taken now and, as the Transport Secretary suggests, it will have to be looked at again in the autumn in the light of the various developments.

Comment

4. I think the Transport Secretary's proposals on both the Bermuda 2 negotiations and the handling of privatisation are sensible, and that there is no need for a MISC 112 meeting on Thursday. I am not optimistic about the outcome of the negotiations starting on 21 July, but there seems no advantage in a collective discussion of fall-back options in advance of knowing the outcome of them. Nor is there much that Ministers collectively could usefully contribute at this stage on privatisation. It will, however, be necessary to take a firm decision on the latter before the end of September if the option of substituting the British Airports Authority (BAA) for BA in the January 1987 privatisation slot is still to be exercised. You may recall that it was earlier agreed between the Ministers concerned that the first preference for next January should be BA, but that BAA should be substituted if the BA flotation could still not proceed.



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Recommendation

5. Subject to the view of other colleagues (and I understand that both the Treasury and the FCO are likely to support Mr Moore's proposal) I recommend that:-

(i) there is no need for a MISC 112 meeting on Thursday;

(ii) the Prime Minister should broadly endorse the Transport Secretary's proposals, but note that a meeting of MISC 112 is likely to be necessary in September both to review the outcome of the negotiations with the Americans and to take a firm decision on privatisation.

If the Prime Minister agrees, we will earmark now a time for a MISC 112 meeting round about the second or third week of September.

*Approved*

J B UNWIN







*CBG*

PRIME MINISTER

UK/US AIR SERVICES AND BA PRIVATIZATION

/ The attached paper was prepared for circulation to MISC 112, and seeks agreement to the UK negotiating position at the negotiations with the United States which commence on 21 July. I understand that MISC 112 members could meet briefly after Cabinet on Thursday 10 July if necessary, but if colleagues are content with the proposals in paragraph 7 (including the negotiating position) there is probably no need for a meeting at this stage. The really difficult decisions in relation to privatization arise only when the outcome of these negotiations is known, and particularly if these negotiations do not result in satisfactory new arrangements for capacity control on the North Atlantic to replace the present ones when they lapse on 23 July.

/ I am sending copies of this minute to the members of MISC 112, and to Sir Robert Armstrong.

JOHN MOORE  
7 July 1986

## UK/US AIR SERVICES AND BRITISH AIRWAYS PRIVATISATION

Paper by the Secretary of State for Transport

1. Colleagues will recall (MISC 112(86)1) that a decision on the privatisation of British Airways (BA) was deferred on two main counts - continuing difficulty over current and possibly future private anti trust treble damage suits in the US courts; and uncertainty about the UK/US market in view of the need to renegotiate a key part of the current Bermuda 2 Air Services Agreement - a capacity control annex (Annex 2) which expires on 23 July. This paper:

(a) seeks agreement to the handling of the negotiations with the US: and

(b) reports on the present prospects for privatising BA in early 1987.

### US Negotiations

2. The state of negotiations on the Bermuda 2 capacity control annex remains difficult, quite apart from the implications it has for the privatisation of BA. The US market is very important to BA (and to British Caledonian (BCal) and Virgin Atlantic (VAt)) and, I am very concerned that unless we can safeguard legitimate UK interests we shall

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increasingly see UK/US air services dominated by US airlines to the detriment of the UK aviation industry as a whole. The annex to this paper sets out the reasons why this particular annex is important to us, the current state of the negotiations and the options available.

3. I am satisfied that in the July negotiations we must not be negotiated down into acceptance of an agreed mechanism which would entrench the dominant position of US airlines in the UK/US market in a way which would prevent our challenging that situation in the future. In the first place an unsatisfactory agreement would be against the proper interests of BA as an airline, whether or not privatised; and in the second place we would be open to justifiable criticism from other British airlines (notably BCal, about whose future I am greatly concerned) that we had sacrificed the interests of UK aviation as a whole in order to privatise BA.

4. Nevertheless we must have regard for BA privatisation in evaluating the options available if we fail to get agreement to a new capacity annex on acceptable terms. If the annex lapses the first option is to apply the terms of the Bermuda 2 Agreement itself as they relate to capacity. This could lead to challenges at international arbitration or in the UK courts, though we have just taken steps to minimize the risk of successful UK litigation by initiating procedures leading to amendment of the terms of the permits under which US airlines operate here. The second option is to give notice of termination of the Agreement with a view to the negotiation of

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a new one. In either case there is bound to be great uncertainty about the UK/US market and the regime which would eventually emerge, but equally investors should be reassured by evidence that HMG is prepared to take firm action to prevent British airlines from being swamped on UK/US routes.

5. Termination of Bermuda 2 is not a step to be undertaken lightly, but nor is it ruled out. At bottom Bermuda 2 is simply a commercial agreement which either party is at liberty to terminate on giving 12 months notice if it is no longer satisfied with the arrangements. Even if the actual termination date were to be reached without a new agreement in place to succeed it, flights between the UK and the US would not automatically cease. If either side were then to insist on a complete cessation of air services, this would be an extremely hostile and unfriendly act. There would be no incentive for HMG to take such a step and although the US did threaten this in 1977 during the Bermuda 2 negotiations I believe they would be no more likely than we are to risk such a drastic step today, given the importance of the UK/US market to the US airline industry and to certain of their airlines in particular. The chances are therefore that air services would continue in more or less the existing pattern for some time even after a notice of termination had run its course. There would be continual negotiations to accommodate market growth, and with strong nerves these could lead gradually to a better balanced agreement.

6. However I am not recommending termination at this stage.

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For the present we need to concentrate our efforts on achieving a satisfactory agreement in the week of July 21 or within a few weeks thereafter. I myself have sought to stress the importance and urgency of this issue with the US Embassy in London, and I think that it would be helpful if the Foreign Secretary could send a message in similar terms to Mr Schulz. I also think that, if the July talks do not succeed, it would be worth considering one final effort on the part of the Prime Minister to press the US Administration to reach an early accommodation with us. If even that does not succeed I recommend at that stage a final consideration of the options available together with the implications for BA privatisation.

7. I invite colleagues to agree that:-

(a) the UK negotiating position for the consultations to take place in the week of 21 July be that set out in para 14 of the annex to this paper; and that we should not accept arrangements which could result in the UK being unable to prevent our airlines share of North Atlantic traffic falling below one third of the market.

(b) the Foreign Secretary sends a message to Mr Schulz to stress the urgency and importance of these negotiations.

(c) if we fail to secure agreement on acceptable terms in July we should consider making one final attempt,

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supported by a message from the Prime Minister, to reach a successful conclusion before the end of the summer.

(d) if we fail to get agreement before the end of the summer we then have to decide between attempting to safeguard our interests on a unilateral basis within the existing framework of Bermuda 2, or terminating the agreement and negotiating a new one.

## BA Privatisation

8. We shall need to decide not later than September whether we can aim for an issue in January/February 1987. A successful flotation at an acceptable price depends on three conditions:

(i) arrangements governing services on the North Atlantic which give the investor sufficient confidence about the US market, which is 23% of BA's revenue

(ii) confidence that BA's anti trust liabilities can be described in the prospectus in terms which fully meet the standards of law and propriety which HMG must apply as vendor without impairing the successful marketing of the issue

(iii) assurance of a satisfactory profit performance, and resolution of the balance sheet.

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9. (i) is discussed in the first half of this paper. If the July negotiations are successful, the question falls away. If not we will have to assess the effect on investor confidence of each of the two options discussed in paragraphs 4 and 5 above.

10. As regards (ii) BA have very recently put to my Department a reassessment of their likely exposure to anti-trust litigation in the light of recent developments in the US courts. It is much more optimistic than the estimate of £100m which their advisers made in February (MISC 112(86)1 refers). My officials, with those of the Treasury and the Law Officers Department, are discussing this reassessment urgently with my advisers, and I shall be consulting the Law Officers. An official group will shortly complete the review commissioned by MISC 112 of alternative options. I shall report to colleagues as soon as possible. I am hopeful that the anti-trust problem will no longer prove an obstacle.

11. BA's financial results in the current year are expected to be substantially below budget, (some £100m - £120m) and below those of the last two years. The shortfall is due mainly to the effects of terrorism and the Libyan crisis on the major markets. My officials are discussing with Hill Samuel the implications for a flotation and for the capital structure. Preliminary indications are that provided that the drop in traffic and profits is temporary, and the investor can be satisfied that the business will recover, a successful flotation may still be possible. But we shall need to

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consider in September what the latest prospects are, and will of course need to be satisfied that the taxpayers will receive sufficient value for the business. Further shocks to the market, such as renewed fear of terrorism or a cessation of services to South Africa would obviously make the prospects much more difficult.

12. I invite colleagues to note the position on privatisation set out in paragraphs 10 and 11. We will need to review the position again in September, by which time we should have a clearer assessment of all the major factors identified in paragraph 8. We shall then be able to decide whether to proceed with a January/February flotation, or wait for our alternative Departmental slot in June.

7 July 1986



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## BERMUDA 2 (ANNEX 2): PRESENT POSITION; UK'S OBJECTIVES AND OPTIONS

## I THE CURRENT POSITION

Information about the UK/US market is set out in Appendix I to this paper. This reflects the working out in practice of the Bermuda 2 arrangements negotiated in 1977; the main features are a system of selected gateway cities, a limitation on the number of airlines which may be designated to serve each gateway city to and from the UK and a capacity control mechanism (Annex 2).

2. Annex 2, which expires on 23 July, works on the basis that before each summer or winter traffic season each airline must file the schedule of the number of flights/capacity for that season with the authorities of the other side, which may call for consultations if the filing gives rise to concern about excessive capacity on the route in relation to passenger demand. The Annex 2 mechanism sets out the factors which have to be taken into account during such intergovernmental consultations, and a formula for resolving differences of view, including a fallback provision which allows airlines to have a modest increase in capacity if the two sides fail to agree. This mechanism has been particularly important for the UK since the full effects of domestic US deregulation of air

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services have been realized - both in terms of the attitude of US airlines, which have become progressively accustomed domestically to using capacity on routes as an aggressive means of attacking the competition, and in the attitude of the US Government itself, which as a believer in the benefits of deregulation, has lent its full support to the aggressive plans of US airlines irrespective of the effects of such plans on the overall economics of the route. The result of this change in the US position is that they now perceive the agreed principles and mechanics of Annex 2 as operating against their free-for-all philosophy and against the aggressively expansionist aspirations of their airlines. The fact that in pursuit of our own pro-competitive policies we have sought to intervene only in those cases where demonstrable and very damaging excessive capacity would have arisen has not softened the US attitude.

3. The Americans cannot justify any claim that Bermuda 2, its capacity annex or the way in which the UK has operated the Agreement has resulted in a disadvantageous position for US airlines. As Appendix I shows, nine different US airlines operate between 20 US gateway cities and the UK and earn approximately £1047 million as opposed to roughly £741 million for British airlines. Last year US airlines carried 3.8 million passengers as opposed to approximately 1.5 million passengers carried by British airlines. The UK/US market is one of the most competitive of all international markets; Annex 2 has allowed capacity to keep pace with demand and there is a wide variety of airline products, not least in

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terms of attractive low fares. This is a market in which (in normal times) the travelling public and the airlines do very well and one in which the US airlines are allowed to flourish in ways in which they are not able in other international markets.

4. On the UK side it remains the firmly held view that a replacement for the capacity control annex - ie some form of continuing control mechanism to regulate capacity - is necessary if British airlines are to continue to enjoy the commercial rights and benefits conferred by the Bermuda 2 Agreement. Since Bermuda 2 was signed there has been a total transformation in the policies and philosophies of the US in the aviation field - including, and most notably, domestic deregulation within the US. British airlines are fully competitive with US airlines in terms of product, price etc., but they find themselves at a serious disadvantage in the US market (as do other foreign airlines) because of the following features of the US aviation scene which weight the scales of fair competition against them:

(a) The growth within the US of airline hub and spoke systems. US airlines have developed their networks on the basis of hub airports through which the vast majority of their traffic is channelled. Thus, apart from the major trunk routes, the position of the average US passenger wishing to travel between two US cities is the choice of travelling on, say, United Airlines between those two cities by way of transit at Chicago, by Delta

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with transit at Atlanta, by Eastern with transit at Miami, by TWA with transit at St Louis, by American Airlines with transit at Dallas, by Continental with transit at Houston, and so on. This hub and spoke phenomenon, based on economic use of aircraft, and maximization of local market dominance, has resulted in many major US airports becoming dominated by the inter-connecting services of one or perhaps two very large and powerful US airlines.

(b) The deliberate policy of the US Government in designating for international services from particular US cities, the local dominant hub operator;

(c) The accelerating growth of the huge US airlines and the elimination of competition through mergers, acquisitions etc. Objective observers expect to see the US market dominated within the next five years by perhaps half a dozen huge US airlines with nothing between them and local commuter airlines, most of whom will be forced into commercial links with the large airlines.

(d) The absolute stranglehold within the market which is exercised by computer reservation systems (CRS). Within the US 80% of all travel is booked through travel agents 90% of whom use airline-owned CRS systems - in particular either American Airlines' Sabre system or United's Apollo system. Thus the computer reservation systems of the two largest US airlines virtually control the US travel

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market.

5. What all this means is that British airlines flying into a US gateway city find themselves now, and will increasingly find themselves in the future, attempting to compete with huge US airlines (American Airlines for example is already twice as big as BA) operating from airports which they more or less monopolize and where the computer reservation systems to all intents and purposes exclude the availability of service by British airlines from booking screens. It is already extremely difficult for British airlines to find US domestic airlines with whom it is possible to reach commercial agreements for feeding passengers onto transatlantic services and this will get even more difficult as time goes on.

6. The consequence is therefore that without some form of capacity control (the simplest means of ensuring a reasonable market share in circumstances where this cannot be achieved by means of fair and equal competition) the UK would be powerless to prevent British airlines being progressively forced off its US routes. In this respect BCal are currently more vulnerable than BA or Virgin Atlantic, because it so happens that the routes which BCal operate (primarily their routes to Atlanta, Houston and Dallas) are those where the market features described above currently exist in their most acute form. Although BA are starting to run across the sort of problems which BCal already experience, BA in the main operate the older and long established US routes where their competitors are the traditional US airlines (TWA and Pan Am) which do not operate huge domestic networks, and which are themselves in

difficulty as is People Express at Newark. Unless some restraint is exercised on US airline capacity, there is little doubt that US airlines for many of whom international services are marginal to their main domestic business, would have both the ability and the incentive to swamp British airlines off the routes.

II UK NEGOTIATING OBJECTIVES

7. Against the background that it can be demonstrated beyond reasonable argument that British airlines do not have fair and equal opportunity to compete for traffic, particularly traffic with origin or destination other than the gateway cities ("behind-point traffic", which represents up to 40% of the total UK/US market), the negotiating objectives of the UK have been two-fold:-

(a) to secure a continuing capacity control mechanism to replace Annex 2 when it expires on 23 July.

(b) to secure greater equality of access for UK airlines to UK/US traffic.

8. So far as capacity control is concerned we have proposed arrangements which are more liberal, more streamlined and less bureaucratic than Annex 2 itself, but which nevertheless retain essential safeguards for British airlines. The safeguards are built around the concept of a regulatory hands-off role where the market share/capacity share of

individual routes falls within the range 40/60%; where restrictions in growth by the dominant airline are triggered when the 60% threshold is crossed, and where there is a complete halt on capacity growth by the dominant airline where its market share/capacity share exceeds 60% and where the load factor of the smaller airline falls below economic levels. The figure of 40% is regarded as a critical trigger for capacity control because theory and practice both show that this is the point at which the economics and viability of a route start to nose-dive for the disadvantaged airline. Anything less than one third is not viable commercially (exceptional circumstances aside) and not acceptable as a UK share of this vital market. The objective of our proposals has been to maximize competition above 40%, to give airlines time to respond competitively below 40%, and to enable us to call a halt if market shares are still falling below about 33-35%.

9. As regards market access, the UK's position is that a truly free and competitive market would require the US to permit British airlines to carry passengers and freight freely between the US cities (cabotage) and to have the ability to acquire US domestic airlines (and vice versa). However the US have made it clear that this is not negotiable (the US domestic market is to remain protected) and we have concentrated on certain marginal but significant improvements to market access eg by seeking changes in the US rules regarding computer reservation systems and by seeking parity of treatment for British airlines to enable them to reach

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agreements with US domestic airlines to provide feed traffic and to advertise and market such feeder services as an integral part of the British airlines' operations. We have also indicated in the negotiations that there is a possible trade-off - in that a serious attempt on the part of the US to address the market inequality problems faced by British airlines might enable the UK to take a more relaxed view of the capacity control mechanism.

10. The US position on capacity control is that they would prefer to have no such mechanism, and that they are reluctantly prepared to negotiate such a mechanism only because it is important to the UK. However there is support among US airlines for a continuing mechanism, some nervousness on the US side about what the UK might do unilaterally in the absence of an agreed mechanism, and considerable nervousness at the prospect of pushing the UK into a corner and into terminating Bermuda 2. But having agreed in principle that they are prepared to negotiate a new mechanism, their actual response has been disappointing. So far they have indicated some willingness to deal with the case of the in extremis airline - ie the airline which is about to be forced off a route because it has become unviable. They have proposed that such a situation only becomes a matter of concern on a single designation route where total revenues of the disadvantaged airline on the route fall to 25% and that even then there may only be a case for some constraint on the growth of the dominant airline.



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11. On market access the US response has been even more disappointing. They have not been able to deny the validity of the evidence we have produced for our case that the competitive position as between British and US airlines is not equal or fair. But the proposals that we have put forward for making some modest improvements in the position have made no headway; the US Government is either unable or unwilling to do anything about this at least in the near future (there are reasons for this to do with domestic complications and the fact that other foreign airlines would inevitably also benefit from concessions made to the UK). The only hint that we have received is that the US might be prepared to offer British airlines the ability to serve a limited number of points in the US behind the gateway cities (ie the ability to fly on beyond the gateway cities to deliver and collect passengers to or from London - not the ability to carry US domestic passengers between those points). In hinting at this possible approach, they have however made it clear that they would regard this as a valuable grant of additional traffic rights to UK airlines for which they would expect additional traffic rights for US airlines in return. In other words they seem to be seeing this as a concession to be traded for equivalent concessions on our part rather than an attempt to address the equality of the market place, although this is supposed to be guaranteed under Bermuda 2.

12. The position reached in the negotiations seems to be therefore that there is a large gap between the two sides as to the criteria which should be adopted in any continuing

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capacity control mechanism and no evidence that the US is prepared to address seriously at this stage the problems which British airlines are experiencing in obtaining fair and equal access to an important part of the UK/US market. The US proposals for capacity control would allow US airlines to take advantage of their protected market position and to eliminate competition from British airlines on more and more UK/US routes. Air Services Agreements are intended to represent a balanced and mutual exchange of fair and equal opportunities and traffic rights for the airlines of the two bilateral partners; the US are not entitled to claim a right to an overwhelming domination of the UK/US market, and it is totally unrealistic of the US to expect HMG to accept such a position, let alone enter into a formal agreement with the US which would amount to UK acceptance that such an imbalance is appropriate.

### III RECOMMENDED POSITION FOR THE FINAL ROUND OF NEGOTIATIONS (21-25 JULY)

13. Under these circumstances it is in the UK's interests to reach agreement on a continuing mechanism for the control of capacity only if it contains reasonable safeguards for British airlines. If this can be done it is well worth the effort involved, and some concessions to the US in order to get it. Without an agreed mechanism both sides would have to rely on the general principles set out in the main body of the Bermuda 2 Agreement. Under these circumstances the UK would have to seek unilaterally to impose constraints on US airlines' capacity against a background of legal disputation

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and continuing friction between the two governments. For a fuller analysis of the position in the absence of an agreement see Appendix 2.

14. For this reason it is recommended that while the UK should have a firm bottom line in the capacity annex negotiations, we should, if necessary, be prepared to make unreciprocated concessions to the US in other areas relating to air services where they are seeking such concessions from us. (These include increased access to UK regional airports and a more liberal regime for charter and cargo services.) But on the main issue it is recommended that we should not go beyond our basic concept of a 40-60% free zone and the triggering in of constraints outside that zone, designed to prevent the lesser carrier's market share falling below about 33-35% (see paragraph 8 above). To go beyond this in our view would be to legislate for the progressive decline of British airlines in the UK/US market.

#### IV FURTHER OPTIONS IF THE NEGOTIATIONS FAIL

15. If in the negotiations commencing 21 July we fail to get our bottom line, even in spite of the concessions that we are prepared to make, we would face the following options:-

(a) to continue to operate on the basis of the Bermuda 2 Agreement without an agreed mechanism for the control of capacity. (See Appendix 2). Sooner or later this will provoke a major disagreement between the two governments, with each side having to consider the options of:

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(i) a renewed attempt to negotiate an agreed capacity mechanism

(ii) international arbitration (an option for the US more than the UK since they are likely to be objecting to action by the UK)

(iii) termination of the Agreement and the renegotiation of a completely new Agreement.

(b) to expend high level political capital to bring pressure on the US in a final attempt to get an acceptable agreement before the end of the summer.

(c) to terminate Bermuda 2 and negotiate a completely new Agreement. (See Appendix 2 also for an analysis of this option).

UK/US AIR SERVICES: BACKGROUND INFORMATION (Based on 1985 figures)

1. The total output of the US airline industry - measured in terms of passenger kilometres performed by scheduled services - is huge in relation to the rest of the world. The US output is 527900m followed by the USSR with 186876m, Japan with 64700m, the UK with 63230m (12% of US output) and France with 39500m. 80% of the total US output is domestic. In contrast to this 95% of UK output is international.
2. When international output is looked at in isolation the US still heads the world ranking but less dramatically. The US figure is 112040m; in second place is the UK with 59800m (53% of US output) followed by Japan with 31600m, France with 28260m and the Federal Republic of Germany with 22058m.
3. So far as scheduled international passenger between the US and other countries is concerned, with the exception of Canada (which is almost an extension of the US domestic market for this purpose) the international services covered by the Bermuda 2 Agreement (ie the UK and its overseas territories) is far and away the most important single market. The UK tops the league with 7.4m passengers followed by Mexico (4.5m) Japan (4m) and West Germany (2.8m).
4. UK/US services operate on the basis set out below:

US GATEWAY CITY	AIRLINE	NUMBER OF PASSENGERS (000s)	UK MARKET SHARE %	AVERAGE FLIGHTS PER WEEK DURING THE SUMMER SEASON
Anchorage	BA	162	100	5
Atlanta	BCal Delta	237	40	9
Baltimore	BA World	220	14	3 7
Boston	BA Northwest TWA	532	37	7 7 7
Chicago	BA TWA	322	54	7 7
Dallas	BCal American	255	27	7 14
Detroit	BA Pan Am	65	29	4
Houston	BCal Continental	209	53	7 7
Los Angeles	BA BCal TWA Pan Am	559	47	7 7 7 7
Miami	BA Pan Am	386	47	7 7
Minneapolis	Northwest Orient	132	0	6
Philadelphia	BA TWA	111	55	7 7
New York (JFK)	BA BCal Pan Am TWA	1728	38	21 7 21 28
Newark	Virgin Atlantic People Express	489	43	7 10-14
St Louis	TWA	115	0	12
Seattle	BA Pan Am	151	52	5 7
Washington	BA Pan Am	361	51	7 7
San Francisco	BA Pan Am	269	47	7 7

NOTES

(i) BA also serve Pittsburg, Orlando and Tampa on a one-stop basis. This makes it difficult to break down the figures.

(ii) Miami is now also operated by Virgin Atlantic and by Eastern Airlines, the former on the basis of three flights per week the latter with seven.

(iii) The table excludes Concorde operations, which operate on the basis of two flights per day to New York and one flight per day to Washington/Miami.

(iv) A number of BA's services from Detroit operated via Toronto, and from Baltimore via Bermuda.

(v) Overall UK airlines' market share was approximately 40% of passengers.

(vi) Average total weekly flights: UK 129, US 192.

5. UK-US North Atlantic Scheduled Traffic by Country of Residence

	<u>UK</u>	<u>US</u>	<u>OTHER</u>	<u>TOTAL</u>	<u>£:\$</u>
				(millions)	Relationship:June
1981	44%	42%	14%	5.39	2.058
1982	42%	45%	13%	4.70	1.758
1983	33%	55%	12%	4.80	1.603
1984	29%	60%	11%	5.32	1.401
1985	25%	64%	11%	5.93	1.27575
					16 June 86: 1.5225

UK market share over this five year period was 49.6, 40.5, 36.3, 37.8 and 40.1

6. In terms of total passenger revenues in 1985, the UK airlines' share was just over 40% - £740m as against £1048m by US airlines. For Bermuda 2 earnings as a whole (ie including UK overseas territories and Hong Kong) the UK share falls to 35.6% with earnings of £745m as against total US earnings of £2090m.

7. The UK/US market accounts for roughly 25% of BA's revenue, 35% of BCal's revenue and nearly all of Virgin Atlantic's revenue.

# CONFIDENTIAL

APPENDIX 2

## UK/US AIR SERVICES: POSITION AFTER A LAPSE OF ANNEX 2 OF BERMUDA 2 AND THE POSITION IF BERMUDA 2 IS TERMINATED

### I THE POSITION IF ANNEX 2 OF BERMUDA 2 LAPSES

1. Annex 2 represents an agreed mechanism for capacity control - in particular the control of excessive capacity, in accordance with the general principles established in the main body of the agreement in Article 11. Article 11 states inter alia that

- airlines of one contracting party shall have a fair and equal opportunity to compete with the airlines of the other contracting party
- the designated airline of one contracting party shall take into consideration the interests of the designated airline of the other contracting party so as not to affect unduly that airline's services on the same routes
- frequency and capacity of services shall be closely related to the requirements of all categories of public demand, provide adequate service to the public and permit the reasonable development of routes and viable airline operations
- regard shall be paid to efficiency of operation so that frequency and capacity are provided at levels



# CONFIDENTIAL

appropriate to accommodate the traffic at load factors consistent with tariffs based on reasonable economic criteria

- airline actions leading to excess capacity or to the under provision of capacity can both run counter to the interests of the travelling public.

2. In the absence of an agreed Annex 2 mechanism it would be for each government to reach its own conclusions as to whether these broad principles were being breached in particular instances, and it would be open to either government, to see that the principles are maintained. However Annex 2 applies only to the North Atlantic routes; other routes covered by Bermuda 2 (eg Hong Kong and UK overseas territories in the Caribbean) are subject to a different procedure which envisages that where one party believes that the operations of the airlines of the other party have been inconsistent with the principles of Article 11, it may request consultations in order to review the position and to determine whether the principles have been adhered to. Annex 2 differs importantly from these other routes by incorporating a mechanism which is prospective - ie looks at airline filings in advance of actual operations, and established what happens when the two sides disagree. It is open to legal argument whether, if Annex 2 lapses, the regime which applies to other Bermuda 2 routes then applies to the North Atlantic routes, and in particular whether a party is entitled to take action to restrict airline

# CONFIDENTIAL

operations on the basis of damaging proposals rather than ex post facto on the basis of damage actually sustained.

3. Unilateral exercise of capacity control by the UK in the absence of Annex 2 might therefore be challenged by the US Government either on the basis of disagreement as to whether the general principles of Article 11 had been breached or on the basis that the UK, in the absence of Annex 2, was not entitled to impose capacity constraints prospectively as opposed to retrospectively. Any action to constrain capacity of US airlines, which would be achieved by writing in limitations in the operating permits of the US airlines, could be challenged by the US either by way of international arbitration or even possibly by reciprocal action (retaliation) by the US Government - though this latter possibility is perhaps unlikely given US vulnerability to further action by us. The legal view is that our chances in international arbitration would very much depend on the particular facts of the case - our prospects for success would be greater in a case where we could demonstrate blatant dumping of capacity.

4. In practice difficulties are likely to occur in the following way. US airlines will submit (as they will be required to do under new operating permits) schedules of flights and capacity in advance of each winter or summer traffic season. Sooner or later (probably sooner) there will be a particular filing which on the UK side will be viewed as

# CONFIDENTIAL

an intention to mount excessive or damaging capacity on that route. If the UK so concludes, the airline in question, and, as a matter of bilateral propriety, the US Government will be informed as to the UK's conclusions and the levels of capacity which the UK regards as appropriate to be included in the airline's operating permit. At this stage the US airline itself would have the possibility of challenging the UK decision in the UK domestic courts (judicial review) - though the proposed new permits which are currently being circulated for comment should offer US airlines little prospect of success. The US Government on the other hand may choose to take up the issue on behalf of their airline and to seek consultations under Article 16 of Bermuda 2. If those consultations are inconclusive - ie there is no agreement, the UK then has to decide whether to proceed with imposing a limit in the US airline's operating permit and, if the UK did so, the US Government would then be faced with a decision as to whether to react and if so how. It might consider retaliation against a British airline, international arbitration or termination of Bermuda 2. If the US decided on either of the first two options, the UK in turn might then have to consider termination of Bermuda 2.

5. All that can be said with any certainty is that the situation would be messy and unpredictable. It is extremely doubtful whether this situation could drag on indefinitely and it is most likely that sooner or later the two sides would either agree to a renewed effort to negotiate a replacement for Annex 2 or one government or the other would give notice of termination of Bermuda 2.

# CONFIDENTIAL

## II TERMINATION OF BERMUDA 2

6. Bermuda 2 provides for termination of the Agreement after giving one year's notice of termination. The likelihood is that during that year's grace a new Bermuda 3 agreement would be worked out.

7. However if there is no new agreement immediately in place there are two possible scenarios. The first would be a period when there is no formal air services agreement in being, but when air services continue to operate between the UK and the US on much the same basis as they do at present. This is perfectly possible and it could be argued that this would be a workable arrangement which would benefit the UK most. Under such a regime, air services would tend to operate on the basis of reciprocity and the granting of necessary traffic rights, capacity etc would be effected by operating permits.

8. Since such an arrangement might well suit the UK the US might be much less happy with it and might, as they did in 1977, threaten complete cessation of air services in order to force the UK to the negotiating table and to agree a new air services agreement more in tune with US needs. This would be a higher risk strategy for the US since they enjoy a greater market share of the UK/US services and since the wider range of air services covered by Bermuda 2 represent a very significant portion of total US international traffic. Furthermore certain individual US airlines (notably Pan Am and TWA) are very heavily dependent on the UK/US routes for their viability. The UK/US market for Pan Am (which is in any case

a struggling airline) is for example more important comparatively speaking than it is for BA.

9. Nevertheless the US market is of very great importance to the British airlines (25% of BA's business, 35% of BCal's business and virtually all of Virgin Atlantic's business), and, against the possibility that the US might be more prepared to sacrifice their airline than would HMG, it might be necessary or advisable for the UK to make contingency plans to safeguard so far as possible transatlantic revenues of British airlines. The fact that there may be a break in non-stop flights between the UK and the US (and in reality it is difficult to see any such break lasting for any significant amount of time) would not of course mean that large amounts of traffic would cease to travel between the two countries. Travel would continue but on a one-stop basis eg via Canada or Europe. Contingency planning would therefore involve such things as the pooling of effort and revenues amongst UK airlines and between UK airlines and eg European or Canadian airlines.

10. It is difficult to conceive that any reasonable government whose airlines enjoy such a healthy share of an important market would contemplate the threat of cessation of air services in order to achieve even more advantageous terms and privileges. But the need to resist any such threat if it materializes has to be accepted if the UK is to remain a major force in international aviation.