CONFIDENTIAL

✓ JV

Prime Minister (2)

For Thursday's meeting.

MLS 6/4

PRIME MINISTER

BRITISH AIRWAYS: PRICE WATERHOUSE REPORT

I thought it would be helpful to let you have a few preliminary points in advance of our discussion with Sir John King on 8 April.

The Price Waterhouse report (of which you already have a copy and a summary) was of course commissioned by Sir John himself. Sir John has told me that "in essence" the report's recommendations have the British Airways Board's full support.

The report has done a good job in analysing past deficiencies in BA's performance and the over-optimism of their forecasts; it has also stressed that BA's priority must be to return to profitability. To this end it urges the airline to review its capital expenditure commitments, to cut out unprofitable routes and to improve aircraft utilisation and manning. It also makes sensible proposals for increasing the effectiveness of the Board and senior management.

I have already discussed the report on several occasions with Sir John King, and we have agreed that BA's priority must be to improve its operating results. It would be helpful if you could re-inforce this message on Thursday. On the more practical level, BA must now take urgent steps to draw up a detailed and agreed plan to implement the measures necessary to remedy the deficiencies highlighted by the Price Waterhouse report. Such a plan must consider alternative strategies based on lower as well as currently envisaged levels of capital expenditure, and should be ready by the beginning of June.

The Price Waterhouse report also made important recommendations about a capital reconstruction for BA, and the possibilities of privatising the Corporation by autumn 1983. I think we must encourage Sir John King to pursue this goal. However, as indicated above, his immediate priority must be to return to profitability, and we must do all we can to help him, since only then can we successfully seek the partnership of private capital for BA.

To sum up, therefore, I think the line we should take with Sir John at Thursday's meeting should be as follows:-

1 To acknowledge the measures Sir John has already taken (though as he himself will admit, these are not enough);

2 To confirm with Sir John that his priority must still be to improve the airline's operating results;

3 To express our support in principle for further remedial action, and to ask Sir John to let us have a detailed plan on the measures he intends to take by, say, June.

Jonathan Rees

PP WJB (Approved by the SoS and signed in his absence)

Department of Trade
1 Victoria Street
London, SW1H OET

5 April 1982

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DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

JV

(2)

Prime Minister

As promised; depressing reading. See now, Alan's note (attached)

MCS 16/3

From the Secretary of State

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COMMERCIAL IN CONFIDENCE

Michael Scholar Esq
Private Secretary
10 Downing Street
London, SW1

16th March 1982

Dear Michael,

BRITISH AIRWAYS: PRICE WATERHOUSE REPORT

... As promised last night, I enclose a summary of the Price Waterhouse Report. I am very sorry that we were unable to get it to you yesterday.

Yours Ever,

Jonathan Rees

J N REES
Private Secretary

(1) No business men in the Co.

(2) Disposal of assets

(3) Properly run - privately - it could be 'a joy' for passengers.

(4) Don't want to be monitored in detail.

(5) This financially, managerially operationally.

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SUMMARY OF PRICE WATERHOUSE REPORT

Section I

A 29-page summary of the 85 pages which follow.

Section II - The Group's results 1979/80 to 1981/82

During the 3 years to March 1979 British Airways did quite well: £200M of profits after tax, and a return on assets of 10%. During that period pressure for cheaper fares, US deregulation and IATA reform began to threaten airline yields. BA had ten different aircraft types, which were expensive in logistics, and many of them were heavy fuel burners. McKinsey advised BA to cut manpower by 30% to match competitors' productivity.

30%

The 1979 Corporate Plan GP7 set out a strategy for coping with these changes. It assumed that low yield traffic would grow by 38% and revenue by 60% in the next 3 years. Lower fares were introduced, 11 wide bodied aircraft were ordered and manpower was held stable to "grow out of our inefficiency".

!

The 1980 Corporate Plan acknowledged that 1979/80 had not turned out as expected, but continued to forecast traffic growth at more modest rates.

In the event growth in traffic over the 3 years was nil, BA had surplus capacity and was still overmanned. 5 wide-bodied aircraft have been sold at less than book value; 3 more are up for sale. BA have improved their productivity by about 25%, but so have competitors, hence relatively BA have not gained much ground. They will have lost over £400M after tax, against a predicted profit of about £180M for the triennium.

The reasons for the shortfall in revenue and profit, are analysed: pressure on fares; political events (Iran); higher fuel prices; exchange rate fluctuations and the ATC strike are the most important. Other airlines have suffered similarly.

The Action Plan of September 1981 is a belated, and hence very costly attempt to deal with the overmanning.

Section III - Forecast results for 1982/83 to 1985/86

A detailed analysis of BA's latest forecasts for the next 4 years, and the assumptions underlying them. After interest and tax Price Waterhouse predict a loss of £15M in 1982/83 and small profits in the ensuing 3 years. Over the 4 year period only

£5M would be available for retention. This does not allow for dividend to Government on PDC, nor for the Government's share of forecast Concorde surpluses. The figures are however struck after charging about £35M provisions each year in the airline's profit and loss accounts, and slightly smaller amounts in those of the subsidiaries for "sensitivities" - the probability that unplanned factors will affect the results. These provisions total £263M over the 4 years. They are explained on pp 54-58, and represent PW's view of the extent to which BA's forecasts, even on their "low growth" assumptions may be optimistic.

Five groups of routes will provide half the expected 1982/83 operating profit. BA's position on them is at some risk in various ways, political, competition and CAA licensing.

The forecasts show an unacceptable position which would not be greatly improved by higher assumptions of traffic growth, because interest charges would also increase. So a capital reconstruction should take place when the Board have reduced manpower further; improved fleet utilisation considerably; and reviewed BA's route strategy and capital expenditure plans.

Section IV - Capital expenditure and cash flows 1979/80 to 1985/86

This section starts with an account of BA's investment over the last three years; the assumption that a lower proportion than in the past would be financed from BA's own resources - a private sector company without Treasury guarantees would have hesitated to act this way; internal funds in the event were much less than forecast, so BA had to borrow more, worsening the debt/equity ratio further, and also had to adopt expedients to keep within the authorised limits of this borrowing, which were inadequate.

BA's aircraft fleet is then discussed, compared with those of other operators and the plans to replace older thirsty aircraft with new ones consuming less fuel examined. The rationale for the major purchase in prospect - 19 Boeing 757 aircraft is summarised. However BA's fleet utilisation is still lower than many other major airlines, it will still have more aircraft types, including some which are no longer produced, for which spares will be costly.

Part III showed that retained earnings will contribute only £5M. A £705M contribution from internal funds is forecast (mainly from depreciation provisions) towards capital expenditure over the 4 year period of £1400M. This includes £100M contingency and £160M progress payments on aircraft wanted in 1986 and 1987, for which £800M more will be needed in those years.

With these commitments and no capital restructuring the Group could not substantially improve its present gearing, although the measures suggested in Section III would help a little. To keep within the EFL of £-9m for 1982/83, the Board should consider selling IAL and other non-airline assets; deferring, cancelling or renegotiating terms for 757s; restructuring non-aircraft capital expenditure and other measures to improve profitability.

Section V - Capital restructuring

On the forecasts of future profits and cash flow PW have made BA will be unable to generate enough cash to service its existing debt, and pay for new capital expenditure. Its equity will be reduced to £60m by 31/3/83. Loans will total over £1.1b, and the debt/equity ratio will be 95:5. In this state the auditors would have difficulty, unless the Government gave them "comfort", in certifying the accounts on a "going concern" basis.

£812m

The debt/equity ratio BA needs is 25:75 (Hill Samuel thought no more than 50:50). To achieve this PW recommend the Government take over responsibility for up to £812m of BA's debt. In the best interests of the airline this should be done as soon as possible, but PW suggest not later than 31/3/83. This allows time for:

(a) discussion with Government over a politically difficult proposal;

(b) self-help measures by BA to increase cash flow and reduce demands on cash, viz

- (i) improvements in fleet utilisation
- (ii) disposal of assets, notably IAL
- (iii) improvement in use of manpower, and negotiation of 1983/84 pay;

(c) the other fundamental changes referred to in section VII.

Conversion of debt into Public Dividend Capital would not help because the PDC would still have to be serviced at much the same costs as debt.

Since only £41m of the Group's debt is due to the Government, most of the debt could not be written off: the Government over the years would have to pay interest and principal. PW do not forecast the cost of this as they do not precisely identify the debt to be transferred, commenting only on which kinds should preferably be retained by BA.

The transfer of debt would substantially increase the net worth of the Group, and hence the expected proceeds of privatisation. This would compensate the Government to a degree for the burden it has assumed.

Section VI - Privatisation

This summarises Government statements about privatisation of British Airways, and the relevant legislation (not entirely correctly). It lists 14 topics where the Government at present controls or affects BA's activities - borrowing, guarantees, licensing, noise regulations (~~which BA apparently intend to ignore~~), airport policy, support for Concorde, on which clarificatory statements will be needed in the prospectus.

The earliest practicable date for privatisation would be autumn 1983; it would require audited half-year accounts to September 1983. BA do not produce these now, and should do a dry run this year. Investors might be put off by the impending election, and fears of re-nationalisation if a Labour Government won.

A classical form of privatisation would be difficult or impossible to achieve before the next General Election. However, placing of convertible preferred securities with institutions might be possible in the late autumn of 1983, and should be investigated further. At worst, sale of BA's (99%) stake in International Aeradio (IAL) could be presented as a step towards privatisation.

Section VII - the future of the Group

BA, if it makes the necessary changes, could be on of the world's best airlines. The Action Plan of September 1981 is just a first step; the Board needs to give much clearer responsibility for profit to individual managers, and to broaden their career experience to equip them better for top posts. The structure of the Board should be reviewed; a financial director appointed to it; the non-executive directors given a clearer and fuller role; and the relationship with the Executive Board clarified. Board members ought to be paid more, otherwise no-one will want to succeed them.

The airline's strategy in recent years had relied on continuing growth, and been upset by recession. The positive returns arise from too few of the routes, and BA needs to review not just its strategy but its mission "what kind and size of airline it aims to be in the medium to long term" - which is not now clear. BA should not, PW say, be drawing up future plans and strategy on the basis of a capital expenditure programme of at least £2 billion over the next six years: a strategy of lower capital expenditure and fewer routes could well improve profitability.

Tactically BA needs to keep up the momentum in staff reduction and productivity gained from the Action Programme; to use its bargaining power to get better terms from suppliers; to give greater attention to customer service; and to disposing of tasks which can be sub-contracted, or of activities which do not contribute to profit or cash flow or strengthen and secure BA's market position, and their supplies or sales.

16 MAR 1982