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P.0821

PRIME MINISTER

British Airways

(E(NI)(82)20)

BACKGROUND

The Secretary of State for Trade reports on the current position of British Airways (BA); invites E(NI) to approve the general approach of the airline's Corporate Plan, subject to some modifications which he proposes, and to agree that the Plan should form the basis of BA's financial target for the next three years; and discusses the possibility of privatising BA in late 1983.

2. BA's recent performance (summarised in Annex A to the Secretary of State for Trade's paper) has been marked by an over-optimistic commercial strategy, excessive investment, low productivity and large losses in 1980-81 and 1981-82. Under its new Chairman, Sir John King, BA appears to have begun putting its house in order, although the Corporation expects to do little more than break-even in 1982-83.

3. British Airways' Corporate Plan is summarised in Annex B to E(NI)(82)20. The Plan continues BA's recent strategy of improving profits by reviewing unprofitable routes and contracting manpower and investment. This is particularly the case with 'Option C', the variant of the Corporate Plan which the BA Board favours and which has the least ambitious programme of investment in new aircraft. On this basis BA forecast profits rising from £59 million in 1983-84 to £249 million in 1986-87 and a real rate of return on net assets of 4 per cent or more in each year from 1983-84 which compares well with the average rate of return achieved by British industry in recent years.

4. The BA Board will be considering next month whether there is scope for a more profitable approach than suggested by Option C of the Corporate Plan.

MAIN ISSUES

5. There are two areas for discussion:



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- i. BA's Corporate Plan and the related question of the financial target;
- ii. privatisation.

Corporate Plan

6. I understand that BA's current plan has been prepared on conservative assumptions and takes good account of Price Waterhouse's comments on the airline's past failings: for example the Corporation assume that their share of the world travel market will fall somewhat. The Sub-Committee may well endorse Lord Cockfield's judgement that the strategy is on the right lines, while noting his words of caution that BA do not have a good record in meeting their own targets and that they will need considerable management and industrial relations skills to achieve their plan.

7. The main possible criticisms of the Corporate Plan appear to be as follows, (the first three are Lord Cockfield's own):

a. Manpower

BA have reduced staff numbers by 20 per cent since last September. The Corporate Plan assumes a further reduction in manpower from about 42,500 now to 34,000 by 1986-87. Recent comparisons with other airlines however suggest that BA ought to be able to make do now with about 35,000 staff. The Sub-Committee may want to express its support for the Secretary of State for Trade's efforts to encourage BA to get down to about this figure much sooner than the Corporate Plan assumes, perhaps during 1982-83.

b. Routes

The Sub-Committee may also want to endorse the Secretary of State for Trade's efforts to ensure that BA should undertake a radical appraisal of their route structure. The Corporate Plan seems to imply the retention of a good number of routes which do not cover their full costs.

c. Uncommitted investment

The Corporate Plan proposes uncommitted investment of over £600 million. The Sub-Committee may again want to endorse the Secretary of State for Trade's intention to probe whether the Plan should include this item.



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d. 'Headroom'

The Plan includes a general contingency element or 'headroom' of £50 million in each year from 1983-84 onwards; the Corporation's bid for external finance in the context of the Nationalised Industries Investment and Financing Review also includes this item. Given their past record, it is perhaps prudent of BA to build a sizeable contingencies element into their plans. On the other hand £50 million a year on top of the £30 or £40 million which the Plans already include for specific contingencies perhaps provides too much leeway for the airline's management. The Chancellor of the Exchequer may want to indicate that the Chief Secretary and he will be unwilling to take full account of the £50 million headroom in setting next year's external financing limit for British Airways and public expenditure provision in the following years.

e. Pay

According to the press British Airways have just agreed to a pay increase of 11 per cent from October for 12,000 engineering maintenance and ground services staff. All BA employees have been subject to a pay freeze since the beginning of this year, and the new settlement will run for 15 months. In effect therefore the 11 per cent is spread over two years and in annual terms is modest compared with the average level of settlements. Nevertheless Ministers may want to be sure that BA is adopting a sufficiently rigorous approach to pay.

Financial target

8. The Sub-Committee will probably be able to agree with the Secretary of State for Trade's proposal that BA should be set a financial target over the next three years consistent with their Corporate Plan; and that his officials should sort out the details with the Treasury and CPRS.

Privatisation

9. The Secretary of State for Trade proposes that the Government should, as BA's Chairman wishes, provisionally plan to sell some 50 per cent of the shares in BA to the private sector late next year. This would require a capital reconstruction of BA so as greatly to improve its present debt : equity ratio of over 90 per cent. The Government would have to take over responsibility for about half of BA's debt of about £1,000 million. The capital reconstruction could cost more than privatisation would raise (depending how the market valued the company). The Secretary of State accordingly proposes that he should arrange for urgent detailed discussions on the arrangements and



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timetable for a capital reconstruction and privatisation; and that he should report in the autumn.

10. There are two problems about this timetable:

i. Privatisation in late 1983 may be too ambitious. A prospectus issued in the autumn of next year could not avoid giving prominence to BA's substantial losses in 1980-81 and 1981-82: all it could set against that gloomy record would be a small profit in 1982-83 and the prospect of some improvement in 1983-84. On the face of it the best time to float BA would be when the profits forecast for 1984-85 are within reach and there is a reasonable expectation of further improvement in 1985-86, ie privatisation late in 1984. On the other hand a provisional target of late 1983 might help to sustain the momentum which Sir John King appears to have created towards making BA more profitable.

ii. Legislation, for which there is at present no place in the programme, would be needed in the next session. Powers to turn BA into a Companies Act company and sell its shares already exist; but a capital reconstruction would require legislation. The Bill would be short, and Lord Cockfield suggests that it could be introduced early in the 1982-83 session. It would in effect be making a present of £500 million to BA as a prelude to privatisation and could therefore be contentious.

11. The conclusion may be that the Government should continue to plan for the possibility of privatisation in late 1983, mainly so as to keep up the pressure on BA, and that the Secretary of State should, as he proposes, report back to the Sub-Committee after the Summer Recess; but that in reality it is unlikely that privatisation will be possible next year. Ministers may feel that, even so, the capital reconstruction of BA cannot be deferred for much longer and that time should be found for a short Bill in the next Session if this were to prove possible.

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HANDLING

12. The Secretary of State for Trade will want to introduce his proposals. You will want to invite comments from the Chancellor of the Exchequer and Mr Sparrow. Any other member of the Sub-Committee may wish to comment, especially perhaps on the possible privatisation of BA.

CONCLUSIONS

13. You will want to reach conclusions on the following questions:

i. Does the Sub-Committee endorse the general direction proposed in BA's Corporate Plan, subject to the Secretary of State for Trade's impressing on the BA Board that further manpower reductions may be needed, that they should be prepared to take a radical approach to the Corporation's route structure and that the provision for uncommitted investment in the later years of the Plan may be overgenerous? Are there any other comments on BA's Plan and performance (for example 'headroom' and pay)?

ii. Does the Sub-Committee agree that the Plan should form the basis of BA's financial targets for the next three years, and that the Secretary of State should agree detailed arrangements with Treasury Ministers and the CPRS?

iii. Should the Government plan provisionally for a flotation of BA in late 1983? Should the Secretary of State arrange for urgent detailed discussions of the arrangements and timetable for a capital reconstruction and privatisation and report progress to the Sub-Committee in the autumn?

PLG

P L GREGSON

23 July 1982

Prime Minister (2)

PRIVY COUNCIL OFFICE
WHITEHALL LONDON SW1A 2AI

Lord Cockfield

26 July 1982

will quarrel with

any of this!

MUS 27/7

Dear Arthur,

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I have seen a copy of E(NI) (82)20, in which you suggest that we should aim for a flotation of British Airways in late 1983, to be preceded by a capital reconstruction of the airline for which powers would be taken, if necessary, in a short bill introduced early next Session.

I must point out that the legislative programme for the 1982/83 Session which has been approved by the Cabinet makes no provision for a bill of this kind, even on a contingent basis. The business managers have all along made it clear that the very tight constraints under which we shall be operating next Session make it essential to avoid net additions to the agreed programme. The possible legislation mentioned in E(NI) (82)20, though short, would clearly be highly controversial, and it is very likely that we should have to drop something else from the programme if it had to be accommodated. Although I do not wish to comment in detail on the substance of your proposals at the moment, I do wonder whether the autumn of 1983 - not more than six months before the next General Election - would be the most propitious time for a flotation of BA, or whether it would not be better to leave it, and the capital reconstruction legislation, until early in the next Parliament.

I am copying this letter to the Prime Minister and other members of E(NI), to the Home Secretary, the Lord Privy Seal, and the Chief Whip, and to Sir Robert Armstrong.

John Biffen

JOHN BIFFEN

27 JUL 1982

