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Qa 06129

To: PRIME MINISTER

From: JOHN SPARROW

Prime Minister

please also see Lord

Cockfield's minute and paper  
(attached) for Tuesday's meeting.

5 November 1982

MCS 5/11

British Airways

1. Lord Cockfield sent me a copy of his letter of 4 November, which we will be discussing on Tuesday. In his letter he proposes an early capital reconstruction of the balance sheet of British Airways (BA) and the vesting of BA in a successor company for flotation at the earliest feasible date.

2. I agree that a capital reconstruction of BA is necessary, simply because its losses have left it under-capitalised. Even without the prospect of privatisation, it would be necessary to correct the present position, as would happen in any comparable private sector company whose owners did not wish to liquidate it. An injection of funds to restore past losses should not therefore lead to serious presentational problems.

3. Restoring the amounts written off in 1981/82 alone would involve about £550m., giving a debt:equity ratio of 55:45, whilst additionally funding the 1980/81 loss would increase the amount to about £700m., giving a debt:equity ratio of 37:63. Just to get back to a going-concern basis, I believe that the former figure would be sufficient, but Lord Cockfield is understandably concerned about the prospect of things then going amiss again before flotation. In considering the higher figure, however, we should remember that the circumstances in which further funding would be necessary (namely, profits below forecast) are precisely those which would lead to the postponement of privatisation until BA was fully fit for sale.

4. Lord Cockfield's paper says, and I agree, that a flotation will be well-nigh impossible if a General Election is still in prospect, and that the proceeds could well be substantially higher in late 1984 than a year earlier.

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5. Despite the considerable progress made under Sir John King, BA still has a long way to go before it becomes a commercially sound business; many doubts remain about its ability to achieve enduring profitability. I believe that BA will fetch a reasonable price only after it has achieved an audited record of healthy past profits, perhaps for two years or more; in the absence of such a record the financial market will have little faith in forecasts of future profits, particularly in the current parlous state of the international airline business where forecasting is inherently difficult and particularly in the case of BA which (under previous management) has an unenviable reputation for over-optimistic forecasts. Thus the flotation of BA is unlikely to be a sound business proposition before late-1984.

6. Even that timing must be doubtful. BA forecasts profits for 1983/84, before interest and supplementary depreciation, of around £265m. This figure, which appears to be about 13 per cent of forecast revenue, is an ambitious and perhaps optimistic target; by comparison Delta, one of the most successful US airlines, earned a margin of only 10 per cent in its most successful recent years, when the market was more buoyant than now.

7. Despite the doubts about the timing of privatisation, however, the case for reconstruction before April makes it highly desirable to legislate this Session. BA will then be able to report its financial results for 1982/83 on the basis of a respectable, commercial-looking, balance sheet; and, when we come to a prospectus, will not need to make retrospective adjustments to the figures.

8. There are two other points raised by Lord Cockfield. First, I agree with Hill Samuel's advice that BA's pension liabilities should be clarified and limited as soon as possible. Ministers will need a clear understanding of the burdens that the Airways Pension Scheme may place either on a future privatised company or, possibly, as residual obligation on Government after privatisation, including any effect that these may have on the amount of capital reconstruction required.

9. Finally, BA is not yet in a state when Ministers can afford to release it from the control proper for a nationalised industry in difficulty; it will probably not have reached such a state by next April. I note that

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Lord Cockfield intends to retain a measure of control during the period between vesting and privatisation through the successor company's Memorandum and Articles of Association and his power as sole shareholder, but this will need to be sufficient to cover the points listed on the attachment to this minute.

10. I am sending a copy of this to Lord Cockfield and to the other recipients of his letter.

B.

Att

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Some BA matters needing Government attention between vesting and privatisation

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1. Management team: The composition of the Board and the senior executive team needs to be determined soon, so as to give them time to establish a convincing track record in the period leading up to privatisation; ideally this matter should be settled before next April.
2. Financial performance: Ministers will need to set BA demanding but attainable targets and to monitor carefully BA's progress towards them.
3. Size of the business: Even after the reductions announced in BA's latest Financial Plan it is still not evident, at least outside BA, that they will have established a route structure that will generate a stream of future profits that is sufficiently robust to the uncertainties of the airline business. BA's profits appear to be vulnerable to adverse events on a relatively small number of their routes. The Board could be asked to examine whether changes to the route structure, either by cutting back or by exchanges with British Caledonian, might lead to a more secure profit position.
4. Investment: Ministers should retain some measures of control over new investment, particularly in view of BA's previous tendency to over-invest on the basis of optimistic forecasts. Ministers will need to be reassured that the cash surplus that BA will be able to earn after reconstruction does not encourage over-ambitious investment.

  
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5. Pay and Redundancy Agreements: For as long as BA's financial performance remains insecure it would be a sound general principle for the Chairman to consult the Secretary of State before entering into any major new agreements.

6. Corporate Plan: Privatisation should be preceded by the submission of a Corporate Plan to the Secretary of State. Given the scale of the changes being wrought at BA there will, in any event, be a continuing need for the Board to reassess the medium term prospects for the business, taking account of the new split into three operating divisions. This will involve them in assumptions on the key parameters of the business especially those identified in the Price Waterhouse report as needing attention, such as fleet utilisation and labour productivity. A Corporate Plan would also cover in more detail the issues raised in the recent Financial Plan, such as tighter commercial policies and the generation of additional business.

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