



Ref. A082/0034

PRIME MINISTER

British Airways

BACKGROUND

When the Ministerial Sub-Committee on the Nationalised Industries considered British Airways (BA) in July, they expressed some doubt whether it would be possible to privatise BA as soon as late 1983, but agreed to continue to plan on that basis. They recognised that it would require legislation to permit the reconstruction of BA's capital (E(NI)(82) 6th Meeting, Item 3).

2. The minute of 4 November from the Secretary of State for Trade and the paper attached to it are in accordance with that decision. The Secretary of State favours early privatisation, in late 1983 or early 1984; in order to keep open the option of such a course he recommends the introduction of legislation early in the current Session. He suggests that this might take the form of either a short separate Bill, or an addition to the 1983 Finance Bill or to a Miscellaneous Financial Provisions Bill. When it had been enacted, BA's capital would be reconstructed: between £600 million and £750 million of BA's debts, which are mainly owed to overseas banks, would be discharged by the Government. Directly after the reconstruction BA's business would be vested in a Companies Act Company under the Civil Aviation Act 1980.

3. The Secretary of State also says that it is possible that a condition for privatisation might be that the Government should in some way underwrite the liabilities of BA's existing index-linked pensions scheme. Legislation would be required for such a guarantee. However, the need for a guarantee will not be clear for some months. Immediate legislation would therefore have to be prepared on the assumption that it will not be needed. The Secretary of State implies that this assumption is likely to be correct.

4. The paper is to be discussed by yourself and a small group of Ministers at 5.00 pm on Tuesday 9 November.



MAIN ISSUES

5. The essential issues before Ministers are:

(i) Should legislation as proposed by the Secretary of State for Trade be introduced early in the current Session of Parliament?

(ii) If so, what should it provide?

The answer to the first of these questions will depend largely on the answers to the following:

(iii) What are the prospects for privatisation in late 1983 or early 1984?

(iv) Even if privatisation on such a timescale is feasible, is it prudent?

Prospects for Early Privatisation

6. BA operates in an industry which is currently very badly depressed; it has a record of serious inefficiency and commercial misjudgment; and in 1981-82 it recorded a loss of some £550 million. Investors are bound to look for hard evidence of an improvement before they will buy shares in such a business. It is true that the figures for 1981-82 were heavily influenced by exceptional items (mainly severance payments and a change in depreciation policies). But that is not necessarily a helpful point: on the contrary, commentators in the financial Press have suggested that so much was loaded on to the 1981-82 figures that profit forecasts for the following years will be distorted and give no reliable indication of long-term prospects.

7. Hill Samuel have advised (Annex A to the Secretary of State for Trade's paper) that privatisation in late 1983 by means of a conventional offer for sale is 'highly unlikely'. They suggest that there is a better chance of privatisation in early 1984. But, as the Secretary of State points out, there is the potential complication of the date of the next General Election.

8. A point which you will wish to investigate further is the Secretary of State's suggestion that if privatisation is not achieved by early 1984 it will probably have to be put off until 'much later'. Why should this be so? One would have thought that privatisation in, say, early 1985 should be feasible: the effects of the losses in 1981-82 should be less; and the benefits of the drive to improve efficiency should be more clearly evident.

Prudence

9. Legislation in the 1982-83 Session followed by privatisation in early 1984 would be certain to attract criticism on the following lines:

(a) As the Secretary of State admits, if BA's recovery proves well-founded, the proceeds of sale in late 1984 would probably be substantially higher. If the recovery does not prove well-founded, then either early privatisation will be impossible, or it will be followed by a campaign of complaints from disappointed investors.

(b) The Government will have paid out between £600 million and £750 million of the taxpayers' money in exchange for sale proceeds of £200 to £250 million, plus a half-share in the business, worth the same amount: it will be hard to present that as anything other than a loss of at best £100 million and at worst £350 million. It will be hard to justify paying any premium, let alone such a large one, in order to dispose of a business forecast to make operating profits of £200 million a year.

(c) There will be strong objections from the private airlines, such as British Caledonian. These airlines cannot legitimately complain if there is a capital reconstruction. This is inevitable if privatisation is to take place; and it is really no more than a recognition of past losses. But they will have a legitimate complaint if the reconstruction is over-generous, since that will leave BA with surplus cash which could be used to subsidise competition against other airlines. The earlier the sale, the more generous the reconstruction will have to be in order to induce private investors to buy shares in a business with a poor track record.

10. The counter-argument advanced by the Secretary of State for Trade is that BA will be an embarrassment to the Government as long as it is in the public sector. It is not entirely clear what this means. If it means that the business of BA will continue to be in difficulties, the Government, as 50 per cent owner and recent seller of shares, would hardly be able to stand aside.



Pensions

11. The Secretary of State for Trade suggests that it is unlikely that the Government would be called upon to underwrite the liabilities of BA's existing pension scheme; and that legislation should proceed on the assumption that it will not be so called. But if the assumption proved to be wrong, the Government would be in great difficulty. If it refused to give some form of comfort or guarantee it might be unable to proceed with privatisation; but to give a guarantee would:

- (a) require fresh legislation; and
- (b) create difficulties elsewhere: the Government does not, in general, underwrite the pension liabilities of the nationalised industries, still less of private sector organisations.

These are arguments for waiting until the pension situation is clearer next year.

Case for Legislation in the Current Session

12. The matters discussed in paragraphs 6 to 11 above have an obvious bearing on the case for early legislation. The legislation, though short, would certainly be contentious. It would almost certainly have to be the subject of a separate Bill: the Miscellaneous Financial Provisions Bill is to be taken through procedures suitable only for uncontentious matters; and I understand that Parliamentary Counsel has advised that the Finance Bill could not be used. The Lord President will no doubt argue that a Bill should not be added to the existing programme unless it is judged to be of such priority as to displace some other Bill already there. Colleagues will be unwilling to agree that it has such priority unless they are convinced that there is a genuine chance of privatisation by early 1984.

13. A rather different line of argument in the Secretary of State for Trade's paper is that a capital reconstruction would improve morale in BA. It is often suggested that it is undesirable for the management of a nationalised industry to face a prospect of permanent deficit, on the grounds that they will not be sufficiently motivated by the aim of marginally reducing the deficit. But that appears not



to be the situation here: BA are forecasting operating profits of about £200 million a year in real terms, substantially more than interest charges with the present debt structure (£111 million in 1981-82). Again, although legislation to improve motivation may well be desirable, the question is whether it commands sufficient priority to be put into the 1982-83 programme.

Content of Legislation

14. If it is decided that the case for early legislation is not made out, it will not be necessary to discuss the content. If the meeting favours early legislation it will be necessary to consider, in particular, the size of the proposed capital reconstruction. The Secretary of State for Trade seeks discretion, in agreement with the Chief Secretary, Treasury, to decide on a sum between £600 million (to achieve a debt/equity ratio of 50/50, which Hill Samuel advise is the minimum necessary for early privatisation) and £750 million (requested by BA - this would give a ration of 30/70). The transaction does not affect the PSBR, since it replaces debts owed by BA to the banks by debt owed by the Government to holders of gilt-edged stock. But it does transfer to the taxpayer and away from BA's customers the cost of servicing the debt. As noted earlier, write-off of this size would be criticised as being significantly more than the prospective total of sale proceeds and the value of the Government's remaining share in BA's business.

15. Treasury Ministers are likely to argue strongly for much smaller figures, to give a debt/equity ratio of between 85/15 (which would be sufficient to extinguish the existing negative reserve on BA's balance sheet) and 70/30 (which would be in line with the gearing ratio of British Caledonian and some other leading private airlines). Such an approach would almost certainly rule out early privatisation: investors will look for either a much more favourable debt/equity ratio or a longer and better track record. But it could form the basis of a package involving capital reconstruction, and vesting of BA's business in a Companies Act Company in preparation for privatisation at a more appropriate time. This could have political attractions, since it would demonstrate that the Government intended to press ahead with privatisation, but without offering the same scope for criticism of lack of financial prudence. The Treasury consider



that the Government could set up arrangements giving it adequate control of 'British Airways PLC' while it was wholly-owned by the Government. But again, it would be necessary to assess whether the desirability of the package outweighed the difficulties of early legislation.

Machinery for Any Further Consideration

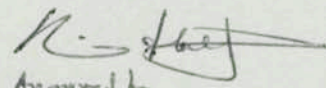
16. Depending on the course of discussion, it may be necessary to involve other Ministers, at least on some aspects. For example, there may be European Community implications, which would need to be discussed with the Foreign and Commonwealth Secretary. If there are serious differences of view at the meeting, the issues may have to be put to E or E(NI).

HANDLING

17. You will wish to ask the Secretary of State for Trade to introduce his paper. The Chancellor of the Exchequer and Chief Secretary, Treasury are both likely to have extensive comments. The Lord President of the Council will advise on the implications for the legislative programme.

CONCLUSIONS

18. You will wish the meeting to reach conclusions on the following:
- (i) Should there be legislation in the 1982-83 Session of Parliament as proposed by the Secretary of State for Trade?
 - (ii) If so, what should it provide regarding:
 - (a) The size of the proposed capital reconstruction.
 - (b) The liabilities of BA's existing index-linked pension scheme?
 - (iii) Should it take the form of a separate Bill, or is there any other vehicle (apart from those suggested by the Secretary of State for Trade, which do not seem suitable) which could be used?
 - (iv) (Depending on the course of discussion) whether other Ministers need to be consulted.


 Approved by
 ROBERT ARMSTRONG
 and signed in his absence.

8 November 1982