

B/P for a July meeting
AT 3/7

C/NO

Prime Minister (2)

PRIME MINISTER

No decisions are being sought at this stage.

Mr Ridley seeks a preliminary meeting before he circulates a paper to E(DL)

AT 3/7

CIVIL AVIATION REVIEW

The Civil Aviation Authority (CAA) are due to report in the middle of July on the review which I asked them to undertake, of the implications of privatising British Airways (BA) for competition and the sound development of the British airline industry. In this minute I summarise the general lines on which they seem likely to report.

The Authority, in a consultation with the aviation industry and its users, have been considering the issues under five broad heads -

- (a) Domestic routes: route entry. The CAA proposed to introduce a kind of open general licence, allowing easy market entry for airlines using smaller aircraft, to domestic routes not involving Heathrow (because of the congestion there) and not involving vulnerable lifeline services (eg some Scottish island routes);
- (b) Domestic routes: fares deregulation. The CAA proposed the removal of their positive control over domestic tariffs, but with the retention of some reserve power to intervene in cases challenged as involving predatory pricing.
- (c) The charter (non-scheduled) services market: proposals by independent airlines that British Airways should be debarred from competing in this market and should dispose of their charter subsidiary.



- (d) British Airways' international scheduled services from Manchester and Birmingham, and their domestic services: proposals by the independent airlines generally that such routes should be taken away from BA or thrown open to greater competition.
- (e) British Airways' international routes from London: British Caledonian's (BCal) proposals that a number of such routes should be transferred from British Airways to them.

The CAA seem likely to go ahead with (a) and (b); decisions on both are a matter for them, under the Civil Aviation Act. I make no further comment on them.

As regards (c), the indications are that the CAA think it would be retrograde to debar British Airways from competing in the charter market.

On (d), the CAA seem likely to recommend to me that the international services from Manchester and Birmingham should be taken away from BA and made available to the smaller independent airlines; but that no special regulatory intervention is required in BA's domestic services, which already face competition, and would be open to greater competition in future.

The most controversial part of the CAA's emerging views is on the proposals for transfer of international routes from BA to BCal. The CAA's interim consultation document at the end of April implied that they were not persuaded of the case for straight transfers of international routes from British Airways to BCal, on the ground that whatever this might do for "balance" within the industry, it would add nothing to competition. Instead they seemed inclined to recommend that the opportunities for BCal (beyond their present routes) should be -



- (a) where they are or can be licensed to compete directly with British Airways. The market realities and attitudes of other countries are likely to limit these, as at present, to some United States and European points and Hong Kong, but some further points might be added over the next decade);
- (b) the development of a concept of "indirect competition" in which another airline - usually in practice BCal - would be licensed to serve a second point in some of the bigger markets which BA serves at present. The CAA made a start on this recently by licensing BCal to serve Riyadh in Saudi Arabia and they envisaged other possibilities such as Canada, Australia and South Africa.

BCal's reaction to this was that without a substantial part of the route transfers they sought, they would not have the financial strength to compete effectively with BA in these ways, nor would they have the clear prospects which would enable them to raise substantial further capital to gain that strength. The CAA now seem to be coming to accept this: and to be taking the view that without route transfers there is a risk that BCal would gradually decline, perhaps leaving no substantial British alternative to British Airways (as distinct from the much smaller scale scheduled airlines such as Dan Air, or the new entrant Virgin Atlantic). Even though the direct competition for British Airways on most international routes comes from foreign airlines, the CAA judge that the threat of substitution by a credible British alternative is desirable to avoid British Airways becoming complacent, especially on routes where foreign competition is weak or muted.



So the CAA now seem likely to recommend route transfers to BCal, on a scale less than BCal's opening bid but which, together with the other route changes they are likely to recommend, might reduce British Airways' revenue by around 10% and their profits by rather more.

72 - £30m.

Recommendations on these lines would face us with difficult decisions, partly because they are highly contentious and partly because of the effects on the timing of privatising British Airways. Legislation would be needed to effect such route transfers and it would have to be through Parliament by the New Year. There would need to be negotiations over the sale of associated assets and any transfers of staff. The effect on BA's prospects would need to be assessed to provide the basis for the sale prospectus. We would have to move swiftly to maintain the possibility of privatising BA by early 1985. On the other hand it is important, before we privatise so large a part of this industry, to establish a sound basis for competition in the industry. There is also a strong point in favour of accepting the CAA's recommendations in toto if we can - that it gives us "expert" cover for what will be highly controversial decisions in a field where there is great public interest.

The CAA's report on their review is expected to be completed and published on or about 16 July. I shall wish to make a holding statement saying simply that we shall be considering it and will announce our conclusions as soon as possible. There may be pressure for a debate before the House rises; to accept this would make it easier to announce our conclusions during the Recess, which will be desirable to resolve uncertainty and maintain momentum on the privatisation of BA.



I shall, of course, bring the substantive issues to colleagues in E(DL) as soon as the CAA's report has been made and assessed. This is early warning of what is likely to happen, and it might be helpful if we could have a brief early discussion on the immediate political and handling implications.

Copies of this minute go to the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Lord Privy Seal. I ask that they will strictly limit any further circulation of it in their Departments.

NICHOLAS RIDLEY

3 July 1984

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CIVIL AVIATION
22nd June 1984

Dr. 20/6

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Conservative Research Department,
32 Smith Square,
London SW1
Tel. 222 9000

Enquiries on this brief to:

JEREMY MOODY

CIVIL AVIATION

Summary

On its election in 1979 the Government inherited an inefficient state owned airline with a poor reputation working within a highly regulated and protectionist market. All the evidence was that service was poorer, fares higher and the opportunities for initiative and enterprise fewer than they should be - all to the detriment of the traveller. The Government has worked hard on several fronts and its progress shows that continuing present policies will yield further benefits.

British Airways is now one of Europe's most efficient airlines and is in the process of privatisation. Government intervention in the domestic aviation market is much reduced, the liberal licensing policy of the Civil Aviation Authority (CAA) makes entry for new airlines relatively easy. In concert with other measures, there is now a genuinely competitive market for domestic public transport between air, train and coach.

There is wider competition on the transatlantic and Hong Kong routes, while the Government is actively working in Western Europe (both bilaterally and through the EEC) for broader competition, cheaper fares and a better route structure. The Government has reached the stage where it has asked the CAA to hold a review of competition policy.

The Government is also tackling the conflict between the rapidly growing passenger demand and the limited supply of airport space in the south east. An Inquiry has been held into the applications for a third London airport at Stansted and a fifth terminal at Heathrow. and a review initiated into the airport problems of lowland Scotland. Meanwhile, the fourth terminal at Heathrow is nearly complete and the improved West Midlands airport opened. Proposals for a Stolport in London's Royal Docks have been heard at public inquiry.

International Framework

Many countries regard their national airline as much as an object of national prestige as a commercial enterprise and will readily use protection and subsidy to hide any weaknesses. International aviation is conventionally regulated by bi-lateral agreements between Governments under which the rights to fly particular routes are divided between two national carriers and the fares fixed, so minimising competition. At present the only competition faced by many major national carriers is from surface transport which will normally only stand comparison over relatively short distances. This protection is commonly compounded by pooling agreements whereby the chosen airlines divide the revenue from a route between them by the seats flown allowing an airline to earn money while flying a poor service and protecting higher fares.

The disparity between European and American air fares has been one of the roots of British concern about aviation policy for some years. As the attached table shows, few European fares are below 22 pence per mile and few American fares above 16 pence. The International Chamber of Commerce, observing that European air fares are twice those in the USA, could see "No real competition in the price sense". (The Times, 25th April 1984). British Airways' Chief Executive, Colin Marshall, has said "There is no doubt that some fares on some routes are too high" (The Sunday Times, 6th May 1984) while Donald Barr of People Express has argued that the London-Paris fare should be \$25 and London-Geneva \$38.

The airlines argue that smaller aircraft are flown over shorter distances for less hours per day in Europe, specific costs for navigation and landing charges are four to five times higher, costs are rising twice as fast and the routes are uneconomical for historical and defence reasons: the Zurich-Brussels route is 40% longer than the direct distance.

European airlines, however, have a poor productivity record in general and are vastly over-manned by American standards. British Airways having shed 40% of its staff now heads the European efficiency league now with Lufthansa, Swissair, KLM and British Caledonian but an American airline such as Delta is estimated to be 25% better still. The pace is now set by People Express which has taken a well publicised and radical approach to establishing a low cost, low fare structure.

The USA has deregulated its domestic market and Canada, while retaining route licences, is currently decontrolling its fares and promising sympathetic consideration to low cost proposals.

Government Policy

British aviation is an important and growing part of our service sector with air travel growing even faster than motoring and with a volume one twelfth that of rail in 1981. Our airlines carry more international passengers than any country outside the USA while London's airports offer more international scheduled services to more destinations than any other city in the world.

In aviation as in other areas of transport the Government regards the user rather than the provider as paramount and has sought to reduce the framework of regulation where this hampers initiative and enterprise. Mr Ridley has clearly set out the objectives of the Government's civil aviation policy: 'to further the interests of users of air transport services by seeing that British airlines provide services that satisfy all substantial categories of public demand at the lowest charges consistent with a high standard of safety, an economic return to efficient operators, and the sound development of the civil air transport industry of the United Kingdom'. (Hansard 18th November 1983, WA col 584)

Domestic Services

The 1980 Civil Aviation Act abolished the Government's powers of guidance and required the CAA to give greater emphasis to competition between British airlines and to give users' interests equal footing with those of carriers. This policy has been strengthened by the Government support at appeal of licences for several new air services offering travellers a wider choice. There are at present some 20 regular passenger airlines and the Government policy is enabling relatively easy entry to the airline market for competent and financially sound enterprises.

The major development in domestic services was the licensing in 1982 of competing services from Heathrow to Glasgow and Edinburgh where British Midland Airways challenged British Airways' monopoly and won almost a third of the market. This competition has increased passenger traffic on the shuttle services at lower fares - a direct benefit to the public. In August 1983 Genair was licensed to fly between Blackpool and Heathrow, in October 1983 Loganair took over an unprofitable British Airways Edinburgh - Manchester service, in January 1984 Air Ecosse was allowed the Manchester Aberdeen route and Dan Air the Gatwick-Aldergrove route. British Midland Airways now also competes with the British Airways Heathrow-Belfast Shuttle. British Airways has started two Scotland-Jersey routes and has just announced a £69 Heathrow-Aberdeen return to match the shuttles

and compete with British Rail.

EEC Countries

Internal EEC flights are still regulated bilaterally whatever the apparent implications of the Treaty of Rome. Within this structure the United Kingdom has been restricting fares increases on UK - EEC routes to encourage airlines to tailor their costs to the market rather than demanding fares to pay for protected inefficiency. Earlier this year the Government withdrew from the 1967 Civil Aviation Tariff Agreement which demanded Government consent for fare changes.

Negotiations are continuing with Holland both within and about the existing Anglo-Dutch bilateral agreement. Under the present arrangements four airlines have proposed an off-peak £49 London-Amsterdam return fare from 1st July (the cheapest British Airways rate is an Apex return at £87). The British Airways-KLM package would require the ticket to be reserved the day before travelling and may only be used if surplus space is available. If there is no room, the ticket holder must wait for a later flight. There will be a maximum seven-days stay condition. British Caledonian and Air UK are proposing a more liberal scheme under which no advanced booking is required and seats might be reserved.

While the Dutch argued that the independents would have an unfair advantage and should accept the conditions agreed by the state airlines, the Government has just obtained an agreement allowing both sets of schemes. It will enable any airline designated by either Government to fly on any route between Britain and Holland, deciding for themselves the frequency and capacity of their services. Fares will only need the approval of the country where the ticket is sold.

Virgin Atlantic have applied to operate a £20 single fare service from Gatwick to Maastricht.

Once a substantial breakthrough to cheaper fares is made on this front it should serve to encourage other European countries to follow suit rather than deny their citizens the opportunity of cheaper travel. British Caledonian have this week filed applications for cheap fare services to a number of European destinations.

Within the EEC the Commission has drafted Memorandum 2 containing proposals to reduce the level of regulation and pooling. Examining the need for the vast array of rules governing air transport in the EEC, it argues that Governments should only intervene when their national carriers' share of a particular route falls below 25%. Both Governments would have to approve air fares which should be related to costs with a limited (15%) flexibility in the event of disagreement. Pooling agreements should only allow for a revenue transfer of 1% of a route's earnings.

David Mitchell commenting on these proposals said, 'It is clear that they are very modest. Indeed I can already say that they do not go any where near far enough to meet our aspirations to introduce the degree of competition which we believe is desirable if airlines are to provide the varied services which their customers want at prices they can afford.... we shall seek to persuade our partners to adopt a more worthwhile series of measures which will introduce significant liberalisation into European air transport'. (Hansard, 11th April 1984, WA col 213)

As a result at the May Council of Ministers a high level working party was established to prepare proposals for more liberalisation.

British commuter airlines are developing continental services; recent developments include the Venture Airways Coventry Paris service, London European Airways flights from London to Amsterdam and a Connectair service from Gatwick to Antwerp.

Within the EEC, the 1979 initiative of the Conservative Government led to the Regional Air Services Directive being adopted in July 1983. This reduces Government control over scheduled flights by aircraft with not more than seventy seats between regional airports (in the UK this means all airports save Heathrow, Gatwick, Stansted and Luton) although governments will be able to decide which national airlines will be able to fly, they will be unable to refuse another country's service except in certain clearly defined circumstances.

International Services

Following deregulation in the USA a more flexible North Atlantic market has developed with a Memorandum of Understanding allowing operations within bands of fares and short notice changes. Recent developments include the entry of People Express on the Newark - Gatwick route, of Air National on the New York - Belfast - Athens route and the application by Virgin Atlantic to operate a £99 single trans-atlantic service while British Caledonian plans to revive its New York - Gatwick flights in 1985.

British Caledonian and Cathay Pacific are now competing with British Airways on the London-Hong Kong route.

Air routes

The European Air Navigation Group has made proposals for improvements in route alignments which are currently being considered by the International Civil Aviation Organisation. The UK has taken action in advance and last month introduced two week-end routes from Land's End to France and Spain and a new daily route from the Midhurst radio beacon to Dublin.

The CAA Review

Nicholas Ridley announced in December 1983 that he was asking the CAA to conduct a review of competition and licencing policy in civil aviation. The CAA is aiming to present its conclusions by mid July and as part of its extensive consultation published an interim report for discussion in mid April. This report argued the merits of competition as greater innovation, better service, alternative styles management and greater effectiveness in competing with foreign airlines and discusses the difficulties of balancing airports as well as airlines. It suggested that imbalances in the British Airline industry need to be moderated to allow more competition and that there is a case for licensing domestic services more freely still and de-controlling domestic air fares. It discusses British Airways dominant position due to its size and its monopoly of the UK flown international scheduled passenger services from Heathrow and seeks to balance the strength this gives Britain in the international market with the restrictions on opportunities for other British airlines. It suggests that rather than route transfers there be more dual designation of British carriers on international routes with the available capacity such as those to New York, Miami, Toronto and Australia. The dangers of a simple transfer of route monopolies between airlines is that the passenger would receive little benefit while shifting routes to Gatwick could harm Britain's large interlining trade.

The CAA is also conducting a review of its policy on discriminatory fares - reduced fares not available to the general public and only applying to particular groups or individuals. Since 1972 it has generally tried to block new schemes and see old ones withdrawn on the ground that the public which does not benefit has to pay through higher fares.

British Airways

Recognising that there are many airlines, including some of the larger ones, that are privately owned the Government can see no justification for state-ownership of British Airways. Indeed, as Nicholas Ridley has argued: "The best way to make the competition more fair is to have BA in the private sector. We know how much it was able to lose in the public sector, which could have been an anti-competitive measure - although it did not do it for that reason. Privatising BA will bring the same market disciplines to bear on both BA and its competitors" (Hansard, 12th December 1983 col. 690).

Accordingly, the Civil Aviation Act 1980 provided for the sale of shares in British Airways when market conditions allowed. The airline had a poor efficiency record even among European airlines and the effects of the recession on airline travel made an early sale impractical.

Lord King, Chairman since February 1981 has overseen the airline's dramatic increase in efficiency. In 1981-82 British Airways lost £544 million after extraordinary items. Staffing has fallen from 56,000 to 36,000, some 80 ageing or surplus aircraft have been retired or sold, some overseas stations closed, some routes cut and unwanted assets sold. It returned to profit in 1982-83 and in 1983-84 made £268 million before interest and tax. Between March and December 1983 it repaid over £100 million of its £1 billion debt guaranteed by the Government and hopes to pay off another £150 million this coming year. On 1st April 1984 it had a net worth of £126 million having returned to technical solvency. In 1983-84 productivity rose by 9% in available tonne kilometres per employee and freight and mail tonnage rose by 15%.

On 12th December 1983, Nicholas Ridley announced that British Airways would be established as a limited company in early 1984, becoming the successor to the British Airways Board on 1st April 1984 as a Companies Act company and so no longer bound by the British Airways Board Act 1977. The Government will continue to stand behind British Airways debts until flotation which is hoped to be in early 1985, the timing depending on BA PLC's performance, its general prospects and the state of the market.

Both Neil Kinnock in his recent speech to the POEU and John Prescott, Labour's Transport spokesman, have indicated that they would renationalise British Airways. There can be little rational justification for spending the taxpayer's money to buy a commercial enterprise like this while the prospect of state-ownership with the political arguments for doing it can only damage the proper working of the firm.

The Government has said that shares will be available to employees and earlier this month British Airways announced a scheme whereby the profit shares announced last November could be put in trust for share purchase on flotation under the rules for employee shareholdings.

Airports

There are some 50 airports in the United Kingdom which handle regular passenger flights - the British Airports Authority owns seven and most of the remainder are owned by local authorities or the Civil Aviation Authority.

The Government's general policy on airports was set out in 1981: 'To meet the growth and demand for air transport, first, by encouraging the fullest use of regional airports and, secondly, by providing additional airport capacity, as the traffic develops, based on the existing airports in the south east, particularly Heathrow, Gatwick and Stansted. The Government support the provision of air services which enable passengers in the regions to fly from their local airport but reject a policy of seeking to divert passengers with origins and destinations in the south east of England to other parts of the country.' (Hansard, 13th May 1981, WA col 273)

Heathrow handles 16% of the nation's trade and is used by 70 airlines flying direct scheduled services to over 200 destinations. Its capacity will rise next year to 38 million passengers per annum following the opening of the £200 million Terminal Four. While the environmental impact of Heathrow has been reduced in recent years the Government has indicated that on the opening of Terminal Four there will be a ceiling of 275,000 air traffic movements. The present level is already around 260,000 and rising rapidly.

Gatwick has grown from $\frac{1}{2}$ million passengers in 1960/1 to 11 million in 1981/2. Its capacity will be increased once the North terminal is opened but further expansion is precluded by an agreement between the BAA and West Sussex County Council that another runway will not be built in the next forty years. The new half hour rail shuttle from Victoria has made Gatwick more accessible to London.

Stansted which presently handles some 300,000 passengers a year has been selected by the BAA as the most appropriate site to develop the necessary extra airport capacity in the south east. A planning Inquiry has heard evidence on the BAA's plans for an airport handling 15 million passengers a year and linked to London by rail and on the neighbouring district councils' counter-application for a fifth terminal at Heathrow on the Thames Water Authority's Perry Oaks sewage treatment plant.

In Scotland, Aberdeen is one of Europe's fastest growing airports and, due to the North Sea oil trade, the world's busiest heliport. In the lowlands, Prestwick is the designated international airport while Glasgow and Edinburgh are expected to handle shorter haul traffic. Following the Secretary of State's upholding of an appeal against a British Midland Airways route licence from Glasgow to New York a review has been announced of Scottish lowland airport policy, in particular, whether it continues to offer the best means of meeting the area's civil aviation requirements with an assessment of the financial, environmental and social consequences of any changes.

In the docklands area of London an application to build a short take-off and

landing airport (Stolport) to take 50 seater Dash 7 commuter aircraft has gone to public inquiry. The proposal, causing negligible environmental impact, involves building a runway on a pier in the Royal Docks within 6 miles of the City of London. The CAA operates a number of airports in the highlands and islands of Scotland as vital links for these communities with the outside world. All except Sumburgh with its oil trade are loss making: the 1982-83 loss of £3.6 million was recouped from the Scottish Office.

In addition to the Government's 1979 approvals of the new terminals at Heathrow and Gatwick and of expansion of the West Midlands airport, substantial investment has been approved in regional airports. Expenditure of £32.5 million has been allowed for twelve airports in 1984-85.

British Airports Authority

The BAA which runs the airports of Heathrow, Gatwick, Stansted, Edinburgh, Glasgow, Aberdeen and Prestwick handles 75% of air passenger traffic and 85% of air cargo. It is a nationalised industry which has a consistent record of profits and in 1982/3 earned a current cost trading profit of £30.3 million. Employing some 7000 staff it derives half its income from aircraft landing and parking charges and the other half from commercial activities including duty free, catering, car parking and a wide range of concessions. It has financed almost all its considerable programme of capital investment from internal sources.

It is due for privatisation and the Government is currently resolving the best means to do this. In the south east the dominance and attractiveness of Heathrow is so strong (its traffic income is twice that of all the other UK airports and five times that of Gatwick) that on its own it would need severe regulation. Nicholas Ridley has said to the Select Committee on Transport that it is likely that the south eastern airports will be privatised as a block.

JM/SM

INTERNATIONAL AIR FARES 1984:

Economy Single Fares

<u>WORLD</u>				<u>EUROPE</u>			
<u>Route</u>	<u>Distance</u> <u>(miles)</u>	<u>£ per</u> <u>mile</u>		<u>Route</u>	<u>Distance</u> <u>(miles)</u>	<u>£ per</u> <u>mile</u>	
<u>200 miles</u>							
New York - Boston	191	14.6p		London - Brussels	203	40	p
- Washington	203	13.8p		- Paris	209	32	p
Denpasar - Surabaya (Indonesia)	200	16	p				
Sydney - Wagga-Wagga	227	22	p				
<u>300 miles</u>							
New York - Buffalo	292	9.8p		London - Dusseldorf	307	27.3p	
London - Glasgow	349	16.6p					
<u>600 miles</u>							
Pittsburgh - St. Louis	566	21	p	London - Milan	585	28.6p	
Jakarta - Singapore	564	20	p	London - Copenhagen	611	26	p
Brisbane - Canberra	591	18	p				
<u>900-1200 miles</u>							
Brisbane - Hobart	1109	11	p	London - Rome	892	22.8p	
Los Angeles - Oklahoma	1183	7	p	Amsterdam - Bucharest	1108	24	p
Hong Kong - Peking	1212	11	p				
Newark - Houston (People Express)	1415	5	p				

Sources:

Financial Times 12/5/84
 Sunday Times 29/4/84