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PRIME MINISTER

31 July 1984

BA, BCal AND THE CAA

① The Annex is specifically related to your meeting with Sir Adam Thomson. Mr Ridley is coming five minutes early to report on his meeting with Sir Adam.

The issues are simple, well aired and nicely summarised in Mr Ridley's paper C(84) 21.

We fully support Mr Ridley in wanting to adopt the CAA's proposals to promote domestic competition (his paragraph 2) and to reject the CAA's desire to acquire even more power to restructure the airline industry (his paragraph 3).

The key issue is whether or not to transfer routes from BA to BCal. We have advised you strenuously against this hitherto, and we still do so now.

The key considerations seem to us as follows:

1. Route transfers do nothing for competition in the sense that the consumer gains. They simply re-allocate monopoly rights from one beneficiary to another.
2. Route transfers to BCal will be seen as a Government attempt to underwrite BCal's future. Government should not attempt that, because it is the start of a long slippery slope.
3. The BA Board (not just Lord King) will fight route transfers all the way, and compel Government to enact primary legislation. There will be a deplorable spectacle all round. It will delay and damage the privatisation of BA. It will antagonise BA employees who (unlike many nationalised industry employees) actually want privatisation. There could be fall-out damage to the rest of the privatisation programme.
4. Whatever you do, you will gain the approval of some MPs and Lords and the censure of others. There is no way of having everybody on your side, and not much certainty about the numbers. As Mr Ridley points out, BA have been late in getting back-benchers on their side, but have apparently been successful in balancing up what was supposed to be a pro-BCal lobby.
5. BCal's case for route transfers is weak. It began as an apparently altruistic harangue in favour of 'competitive balance' as between big BA and the little independents (although notably the little

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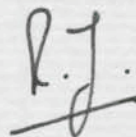
independents other than BCal did not join in the campaign). By last week, Sir Adam Thompson of BCal was quite openly saying to Mr Ridley that he needed some monopoly profits in order to stay in the air. This is an astonishing shift. We believe the truth is that BCal are already in serious difficulty and that Sir Adam is desperate for help - not for competition.

Since you are seeing Sir Adam Thompson on Wednesday, we have annexed a note on BCal for your meeting.

6. The general theory behind route transfers is to create a sizeable second force UK airline. The nearest we have been to this is with the old BEA and BOAC, but they did not compete directly with each other anyway. BCal is not a reincarnation of either.

Conclusion

The costs of embarking on enforced route transfers are open ended and of very dubious benefit. We recommend you to reject route transfers outright. If you feel (and we do not) that a gesture should be made to BCal, you could pursue BA's suggestion to give BCal dual designation (out of Gatwick) on routes which BA serve from Heathrow. BCal will almost certainly turn it down, but you will have called BCal's bluff on competition.



ROBERT YOUNG

31 July 1984

BRITISH CALEDONIAN
(based on Company Accounts to October 1983)

The company has sales of £428 million, a (historic) profit before tax of £3.3 million, and a balance sheet value of £69 million. It employs just under 8,000 people and has a fleet of 25 aircraft and 7 helicopters.

BCal's main scheduled routes are to the USA (Los Angeles, Dallas, Houston, Atlanta); to Brazil, Venezuela and Colombia; to Nigeria, Zambia and the West African coast; to Hong Kong; to Libya and Tunisia; and, within Europe, to Paris, Brussels, Geneva, Frankfurt and Genoa.

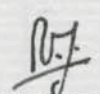
Its headquarters and route structure are based at Gatwick.

BCal's balance sheet is, on any objective assessment, weak. The key features are:

- i. Of £69 million cash reserves, £67 million are held overseas. No provision has been made for non-remittance.
- ii. It has £93 million of dollar borrowings, which at present exchange rates must feel uncomfortable.
- iii. At 31.10.83, it had total borrowings of £160 million against shareholders funds of £69 million - a dreadful gearing.
- iv. At 31.10.83 the company had entered into future commitments valued at £216 million.

For your meeting with Sir Adam Thompson, we suggest it would be prudent to listen to his case rather than to present one of your own. But you could ask:

- i. How solid BCal now feels its own balance sheet to be.
- ii. How BCal would fund any expansion, with gearing at over 200%.
- iii. Whether BCal is seeking competition, or help over the short term.
- iv. What the benefits of a merger with any other airline (not just BA) might be.
- v. Do the subsidiary businesses of BCal (holidays, hotels, aircraft engine overhaul and helicopters) offer good development opportunities? Hotels made a pretax profit of £1 million on a turnover of £8 million compared with profits of £3.2 million on £363 million of airline turnover. Helicopters lost £1½ million - why stay in?


ROBERT YOUNG