

PRIME MINISTER

BRITISH CALEDONIAN

I had an hour with Sir Adam Thompson, at his request, earlier this evening. He was particularly anxious to follow through the balance sheet queries you directed at him this morning.

We tackled first the three specific points you raised:

- (i) Blocked overseas balances.
The £67 million shown in BCal's latest accounts have now been almost completely cleared. Since BCal had borrowed against the balances, the remittances have been applied to reduce borrowings rather than to increase liquidity.
- (ii) Dollar borrowings.
As we thought, BCal do feel uncomfortable.
- (iii) Gearing.
Yes, it is high and will not come down much, even in the medium term. But gearing of over 200% is commonplace in airlines, and BCal gave me a table for Europe and the USA to confirm the point.

BCal's comments should make us feel a little easier about its short term future; but they admitted that they would have to strengthen their balance sheet soon, regardless of Government's response to the CAA's recommendation.

As background to improving the balance sheet, Adam Thompson took me through BCal's recent earnings - and its projected earnings on the assumption (unwarranted in his

view) that BA would not behave in predatory fashion once privatized. The figures are in Annex A. They exhibit great volatility in the past and great growth in the future. Adam Thompson was very confident of earnings of £14 million this year (versus £3.3 million last).

If we were to believe these figures, there would be no case for Government support to BCal.

BCal's plan (they said) was to raise new equity of £30 million late this year, mainly from existing shareholders. But the prospect of BA's being privatized, intact with its routes, kills off that possibility. So the only way forward for BCal is to press for the reallocation of profitable routes from BA and to raise much larger sums to service them. BCal's own proposals for route transfers would have required a further £150 million of equity capital and £250 million of loans. The CAA's smaller package of proposals requires some £75 million of equity and £120 million of loans. Even that is a large addition to their present £69 million of shareholders' funds and £160 million loans.

BCal have given me copy letters of comfort from their financial advisers that they could raise the funds to finance BCal's own proposed route transfers. The CAA are satisfied that BCal can raise the necessary to service Saudi Arabia and Harare. We do not have evidence that the CAA package in full can be financed. BCal mentioned that they would want "a close look" at the Gatwick/Iberian routes before taking them on.

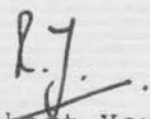
So long as route transfers could be phased, BCal do not see the likelihood of service interruptions on handover. They would offer to take on BA's dispossessed staff in the UK and overseas, but would not necessarily want the aircraft which BA might declare surplus. They do not feel that the reallocation of routes from BA to BCal poses serious

difficulties for the construction of a BA prospectus: why is it harder for BA to forecast the reductions than for BCal to forecast the gains?

We discussed other minor matters, and I was given a copy of their Five Year Plan for background information.

My conclusions are:

- (i) if BCal's £14 million profit prediction for this year is accurate, the company is not about to go bust;
- (ii) BCal's plans to expand its capital base seem to me immodest. If you believe that route transfers to BCal are, de facto, the start of Government's underwriting the future of BCal, beware the scale of ambition to be underwritten;
- (iii) the competition issues do not look different by virtue of Sir Adam Thompson's presentation to you or his discussion with me;
- (iv) the behaviour of BA post privatization is important. You could ask Mr. Ridley to explore further what restraints can be applied. He could respond to the CAA's recommendations in principle (accepting domestic deregulation and competition but rejecting the immediate transfer of routes) while announcing his intent to investigate and head off the possible abuse of dominance.


Robert Young
Policy Unit
1 August 1984

ANNEX A

BCal's Profit Record and Forecasts

	<u>Turnover</u>	<u>Profit before Tax</u>
	<u>(£m)</u>	<u>(£m)</u>
1973/74	77	(5.7)
1974/75	86	(0.3)
1975/76	117	5.6
1976/77	159	7.9
1977/78	177	12.2
1978/79	200	6.6
1979/80	252	9.7
1980/81	323	(6.2)
1981/82	401	1.5
1982/83	428	3.3

1983/84 Estimate	495	14.0

1984/85 Forecasts*	c.590	31.0
1985/86	c.640	28.0
1986/87	c.720	55.0
1987/88	c.800	81.0

* excluding route transfers