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P.01381

PRIME MINISTER

Civil Aviation Authority Review

BACKGROUND

The Civil Aviation Authority (CAA) was invited by the Secretary of State for Transport to review the implications of the privatisation of British Airways (BA) for competition and the sound development of the British airline industry. The report of the CAA in response to that invitation was published on 16 July. Among its main recommendations were the following.

(i) Relinquishment by BA of scheduled service routes out of Manchester and Birmingham to a wide variety of destinations in Western Europe; between Glasgow and Paris; between Heathrow and Saudi Arabia and between Heathrow and Harare; and between Gatwick and points in Spain, Portugal, Gibraltar, Italy and Scandinavia. Apart from the Manchester and Birmingham routes, which would pass to smaller airlines, the routes concerned would be likely to be awarded by the CAA to British Caledonian (BCal).

(ii) A number of measures to increase competition in the British airline industry.

(iii) A strengthening of the CAA's own powers, notably to give the CAA a direct statutory duty to secure the sound development of the British airline industry, for example by suitable use of its licensing powers.

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2. Ministers collectively have considered these recommendations on several occasions, both in E(A)(E(A)(84)19th Meeting, Item 3) and in Cabinet (CC(84)27th, 28th and 29th Conclusions). It has been common ground that the recommendations summarised at (ii) above should be accepted and those at (iii) rejected. There has, however, been a sharp difference of view on the recommendations concerning route transfers. At their meeting on 2 August (CC(84)29th Conclusions, Minute 5) the Cabinet invited the Secretary of State for Transport to prepare a further paper discussing the issues. You said that you would arrange for a small group of Ministers under your chairmanship to give preliminary consideration to those issues before the Cabinet resumed their discussion.

3. This preliminary consideration is to take place tomorrow, 11 September, on the basis of a memorandum by the Secretary of State for Transport (C(84)22). This argues that it is necessary to maintain an effective British competitor to BA (in practice, this means BCal) on international scheduled routes; and that both for this reason and because it seems likely that the privatisation of BA will have to be conducted in a way which will be open to criticism as a subvention to BA from public funds, route transfers from BA to BCal are needed. The memorandum is not altogether explicit on which routes should be transferred; but it mentions the following possibilities.

	<u>Effect on BA turnover</u>		<u>Effect on BA operating profit</u>	
	£million	%	£million	%
1. Saudi Arabia	77	3.3	22-25	7.8-8.9
2. Harare plus certain Gatwick services	32	1.4	7	2.5
3. Caribbean	50	2.1	5-10	1.8-3.6

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Mr Ridley also suggests that some of BA's business routes to Europe out of regional airports should be transferred to other independent carriers, with the following effects.

	<u>Effect on BA turnover</u>		<u>Effect on BA operating Profit</u>	
	£million	%	£million	%
4. 50% of capacity on European routes from regional airports.	27	1.1	2	0.7

4. In paragraph 10 of C(84)22 Mr Ridley outlines the latest counter-proposal from BA: that BCal should be designated as second British carrier on a number of routes. However, many of these dual designations would need the agreement of overseas' governments (who would demand difficult concessions in return); and it would not sufficiently strengthen BCal's currently inadequate financial base. Mr Ridley therefore rejects it.

5. It seems clear that Lord King and his Board would strongly oppose route transfers. Mr Ridley discusses a number of ways of overcoming these objections: in view of the risks of legal challenge and challenge on grounds of financial propriety, he concludes in favour of primary legislation early in the next Session of Parliament.

6. Finally, C(84)22 discusses the litigation in train in the United States courts. The relevance of this is that BA (and, for that matter, BCal) faces claims for very large sums, of the order of \$2 billion in damages. In previous discussions some Ministers have suggested that the uncertainties created by these claims could lead to a lengthy deferment of privatisation, so that it would be wrong to let the wish to privatise BA influence decisions on the CAA recommendations. The analysis in C(84)22 suggests that the uncertainties

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are likely to last for a long time; but it does not seem to suggest that they will necessarily be a bar to privatisation.

7. Mr Ridley proposes that he should communicate the Government's decisions to Lord King and then publish them in the form of a well-argued White Paper.

MAIN ISSUES

8. The issues before Ministers are as follows.

- (i) Should routes be transferred from BA to other airlines?
- (ii) If so, which routes?
- (iii) How should any transfers be effected?
- (iv) How should the Government's decisions be announced?

In practice the first three of these issues are likely to be inter-dependent.

Should routes be transferred?

9. The main points which Ministers will wish to consider are as follows.

- (a) The effects on competition. It is unlikely to be disputed that it would be desirable to have two, or more, strong British airlines freely competing on all international routes. Unfortunately, because competition in air transport is so heavily restricted by international agreements, it is not a possibility for the foreseeable future. The argument therefore has to turn on the less direct benefits


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of strengthening BCal's financial position by allowing it to enjoy monopoly-type profits on certain additional routes so that it can compete more effectively on those routes, both domestic and international, where genuine competition is a possibility. It is this argument which is the fundamental reason for Mr Ridley's rejection of the BA counter-proposal reported in paragraph 10 of his memorandum. However, it may not be altogether easy to put across in public discussion. Moreover, there are some other uncomfortable implications not far below the surface of C(84)22: that an efficient BA is dangerous; that a privatised BA might be either predatory (paragraph 4) or tempted to slip back into 'cosy arrangements' with other airlines (paragraph 5(a)); and that financially weak airlines should be shored up by reallocation of routes.

(b) The implications for privatisation. Hill Samuel have advised that if route transfers reduced BA's forecast profits by more than about 10 per cent the risks to privatisation would be unacceptable. It seems inevitable that any package of transfers involving the Saudi Arabian routes will reduce profits by at least that figure. (The minimum estimates in C(84)22, summarised in paragraph 3 above, suggest that even without the transfer of Caribbean routes, the reduction in operating profit would be 11 per cent.) Moreover, there must be a risk that Lord King and his Board would resign if any substantial route transfers were forced through: if they did, there could be no privatisation of BA for a considerable time. Mr Ridley's assessment before the Recess was that the risk of resignation was small. But since then much has happened, including public statements of attitude. His colleagues will wish to ask him for his current view.

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(c) The implications for future policy. C(84)22 discusses the route transfers under consideration explicitly as a one-off operation. But it may well be suggested in public debate that if it is the Government's fundamental policy to maintain at least two British airlines operating international scheduled routes, that could well entail further route transfers at some later date, for example if the finances of the second airline deteriorated. This risk would be increased by the line of reasoning outlined in paragraph 25 of C(84)22 to justify apparent departure from past pledges by Government spokesmen.

Which routes?

10. As noted earlier, C(84)22 is not entirely explicit about which routes should be transferred. The most important question is whether the Saudi routes should be transferred. On the one hand, transfers including them seem very likely to have serious implications for the privatisation timetable; on the other, transfers not including those routes are unlikely to be of enough benefit to BCal's finances to be worthwhile.

11. As for the other routes, there is one general point which Ministers will wish to bear in mind. All decisions on transfers, whether for or against, will be strongly criticised by someone. It would be possible to make a case for the rejection of all the CAA recommendations on the grounds that they would in reality do nothing to promote effective competition. But if Ministers decide that some transfers are justified there will be strong arguments for sticking as closely as possible to the specific transfers recommended by the CAA. Otherwise it would be asked what purpose was served by asking the CAA to conduct the review at all. If this argument is accepted, it creates a presumption:

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(a) against the transfer of Caribbean routes discussed in paragraph 11(c) of C(84)22; and

(b) for the full transfer to the other independent airlines of BA's European services from regional airports, despite the arguments in paragraph 14 of C(84)22 for a transfer of only half the capacity. (It is also relevant that the finances of the other independent airlines are, to say the least, no stronger than those of BCal; and that there will be considerable criticism if the whole exercise appears to be designed to favour BCal rather than to help the independent airlines more generally).

Method of effecting transfer

12. The arguments in favour of effecting any transfer of routes by primary legislation seems strong. Other approaches seem likely to attract legal challenge (which would be embarrassing even if ultimately unsuccessful), or to create objections of Parliamentary propriety. Any such legislation would certainly be opposed strongly by the Labour Party. Ministers will wish to assess the risks of opposition among their own supporters.

Announcements

13. Mr Ridley proposes that the Government's decisions should be announced in a White Paper. Given the public interest that the subject has aroused, and the certainty of objections from interested parties, it is clear that the text of any announcement will need to be very carefully drafted. However, Ministers will wish to consider the possibility that it might look odd to issue a White Paper on a set of specific decisions rather than a general policy. Indeed, the publication of a White Paper could well strengthen suggestions, which are likely to be made in any event, that the Government should declare its

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general attitude to competition among British airlines and whether it might contemplate further route transfers in certain circumstances.

HANDLING

14. You will wish to invite the Secretary of State for Transport to open the discussion. The Chancellor of the Exchequer will have views on the implications for the privatisation programme and for competition. The Secretary of State for Trade and Industry will also have views on competition aspects; and, as you know, he feels strongly that the proposals in C(84)22 would be inconsistent with assurances which have been given to BA and Parliament in the past. The Lord Privy Seal and the Chief Whip can advise on the implications of any legislation for the Parliamentary timetable and the likely attitudes of Government supporters. The Solicitor General can deal with any legal questions.

CONCLUSIONS

15. The conclusions of the meeting must, of course, be subject to the views of the Cabinet on 13 September. However, you will wish to reach as great a measure of agreement as possible on the following.

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- (i) Whether any routes should be transferred from BA to other independent airlines.
 - (ii) If so, which routes should be transferred?
 - (iii) If there are to be route transfers, should they be effected by legislation?
 - (iv) Announcements.

PLG
P L GREGSON
Cabinet Office.
10 September 1984



10 DOWNING STREET

From the Private Secretary

Prime Minister ①

These papers will be discussed on Tuesday
and again at Cabinet on Thursday.
A Cabinet Office brief will be available
on Monday.

In my view the Redley's proposals
are more consistent with the Government's
philosophy on competition and enterprise
than the Chancellor / Tebbit view. But
you may feel that the course of legislation
is politically too dangerous.

AT
7/9

B.A. - Riyadh

B. Cal. -

B. Cal.

Lower flights
Health

1) Mrs Ryder: please invite x

2) MR. TURNBULL - On return

CAA Review

We have provisionally arranged a small meeting of Ministers to discuss the CAA Review on Tuesday 11 September, prior to the Cabinet meeting that week. There are, however, some problems over attendance to which you will wish to give thought.

First, the Foreign Office have put in a bid. The Foreign Secretary is away, and if the Prime Minister agrees that they should be represented, Mr. Whitney would come. Could you please let Colin Budd know.

Secondly, Mr. Tebbit is unavailable and will be represented by Mr. Fletcher.

Thirdly, I see from the LCA that the initial discussion paper is to be circulated to the Attorney General. He will be in the US on 11 September, but I have provisionally arranged for the Solicitor General to attend the meeting.

So the line-up is:

Chancellor of the Exchequer

Lord Privy Seal

Secretary of State for Transport

Chief Whip

~~Mr. Fletcher~~ S/Trade

Solicitor General

?Mr. Whitney, and

~~Cabinet Office.~~ Peter Gregson a possible RTA.

End
20 August 1984

CAROLINE RYDER (on return)

Civil Aviation Policy

The Cabinet will be returning to the subject of Civil Aviation policy on 13 September. Before then, we need a meeting of a smaller group of ministers, as follows:

Chancellor of the Exchequer

Lord Privy Seal

Secretary of State for Trade and Industry

Secretary of State for Transport

Chief Whip

Mr Gregson or Mr Buckley

The only opportunities I can see in the diary are Monday 3 September or Tuesday 4 September. Could you please press the appropriate offices hard for a meeting on one of these days, to last about one hour.

DBS

David Barclay

16 August 1984