

B  
Adam Thomson's  
position

(B)

PRIME MINISTER

Sir Adam Thomson asked me to go and see him today. His Managing Director was at the same time seeing officials in the Department of Transport.

Sir Adam said that he wanted you to know how unhappy he was with the proposals being put to him by the Secretary of State as the best that were acceptable to Lord King. Sir Adam said that he could not give up some of his North American routes, <sup>(except St. Louis)</sup> since the North American business was inter-dependent. He would be content to give up the mid-Atlantic routes, and also be willing to throw in the South American routes which were more valuable to British Airways than to him; but he understood that Lord King would not accept a deal on this basis. \*

\* But pl.  
see postscript.

Sir Adam said that if Mr. Ridley put this deal to him on a 'take it or leave it' basis, he would leave it. He would put his business into 'survival mode', closing down routes and making redundancies, hoping for a better deal under a future government. He would make an immediate demand for transfer to Heathrow, although he understood that the Secretary of State would not agree to this. While he was not in the business of dealing in threats, he would look for any legal means of protecting his business by delaying BA's privatisation. He handed to me the two attached pieces of paper, about British Caledonian's case, one in technical terms and one in more popular language; ~~but~~ he said that he did not propose to publish the latter immediately but this would be the terms in which British Caledonian would go to the press in due course.

My impression was that, while Sir Adam may mean what he says about rejecting the present deal at the end of the day, his immediate purpose was to apply all the pressure he could in the hope of getting an improvement in what BA could be

induced to accept. The main difference which he was suggesting from the present proposal was that British Caledonian should accept South American destinations in place of those in North America.

F.R.B.

\*The latest letter from Lord King shows that he has moved some way further in BCAL's direction and is now asking for one destination in North America - Atlanta - and would accept the South American routes in place of the other destinations in North America. Sir Adam does not yet know this.

26 September, 1984

P.S. Does Adam Thomson want to go down in history as the man who turned down £18 million a year (profit) offered to him as a plate?

AT 26/9

File cc Transport.

## AIRLINE COMPETITION REVIEW

### A PLAN FOR MONOPOLY?

The Secretary of State for Transport shows every sign that he is submitting to new, monopolistic demands from British Airways.

He is in danger of abdicating his vested responsibility for Britain's aviation industry, as a whole, and betraying his Government's policies for competition and against monopoly.

Nicholas Ridley, who, less than a year ago, promised Parliament a thorough review of airlines in the interests of competition and the industry's sound development, now harbours plans from British Airways to actually increase its monopoly hold.

By accepting these proposals as a bargaining position, the Secretary of State places this Government in the centre of plans which would wreck any reasonable hope of a stable, competitive airline industry and a structured airports policy in the future.

The opportunity for creative, political strategy has apparently been given up.

What might have begun as a responsible consideration of the recommendations of the Civil Aviation Authority has - after three months of prevarication - been dissipated to the ideological values of the auction room.

The CAA recommended adjustments to a few air routes to achieve better balance in the industry and to create the climate and structure for the competitive strength of the industry in the long term.

The key proposal was the transfer of two destinations in Saudi Arabia from British Airways to British Caledonian.

If that is to be accepted by BA, Mr. Ridley says that the airline would require:

- \* The take over of three B.CAL destinations in the USA;
- \* The take over of three destinations in the Caribbean and South America;
- \* B.CAL to give up plans for new services to Florida;
- \* The ability to withdraw three of its scheduled services from Gatwick.

There would be no transfer of the route to Harare. There would be no development of proposals for competitive route sharing.

The net effect of this proposal is that British Airways' share of the British airline business would increase from the current 80.5 per cent to 82.2 per cent. B.CAL's share would decrease from 17.3 per cent to 15.6 per cent.

The other independent airlines would have, between them, a share of 2.2 per cent.

British Airways is flexing the muscle of monopoly - and is being allowed to do so - even before the State has relinquished control.

What value the promise of the Conservative Party to "take steps to ensure that these new firms (privatised companies) do not exploit their powerful positions to the detriment of consumers or their competitors?"

The situation mocks the legitimate ambitions of the existing private sector and its supporters.

It is probably too late to hope for any serious re-consideration of the CAA's Airline Competition Policy Report. Time remains, however, to salvage commercial justice, political integrity and plain commonsense.

Reluctantly, B.CAL would be prepared to accept the transfer of just two routes (those to Saudi Arabia) for operation from Gatwick. British Airways was, after all, largely responsible for blocking the introduction of B.CAL's own services to Riyadh. BA admits to the Secretary of State that the re-allocation of these routes would not significantly affect staff or resources though profit from Jeddah and Dhahran would be lost.

B.CAL would in turn, offer to BA five destinations in North, Central and South America.

It would not, under any circumstances, contemplate the carve up of its hard-won US network.

This solution would be short of that which B.CAL and the CAA believes necessary to re-balance the industry and provide a base for rapid development of competition on shared routes.

If nothing is done, it will signify the beginning of a combative survival strategy by B.CAL which could involve a programme of significant cutback and demolish prospects for the development of Gatwick.

B.CAL would immediately:

- \* Place formal applications to transfer its scheduled service base from Gatwick to Heathrow, to be able to compete in the prime aviation market place. B.CAL would not be discouraged by talk of capacity 'ceilings,' but would seek every recourse to be allowed lawfully to follow its own free market destiny.
- \* Place formal applications to be allowed to compete alongside and share equal capacity with British Airways on a range of scheduled routes emanating from the UK.

B.CAL would pursue these plans through their full regulatory/legal course, taking no account whatever of political requirements to fulfil the British Airways privatisation programme.

In the circumstances, B.CAL would neither be responsible for the effect on Gatwick Airport nor for the possible demands from foreign scheduled airlines to abandon Gatwick in favour of Heathrow.

It would be the Government which had rejected the historic opportunity for planned development of Britain's airlines and airports.

\* \* \* \* \*

*File*

**AIRLINE COMPETITION REVIEW**

**British Caledonian Analysis of British Airways Proposal**

**1. The British Airways Proposal**

The Secretary of State for Transport outlined the following package as BA's requirement. For BA agreeing to surrender the right to serve the two Saudi Arabian points of Dhahran and Jeddah, BCAL would vacate:-

- i. Routes to Dallas/Fort Worth, St. Louis and Atlanta.
- ii. The Mid Atlantic route to Caracas, Bogota and San Juan.
- iii. BCAL to forgo the opportunity of service to Orlando and Tampa.
- iv. The return of three Iberian services from Gatwick to Heathrow.

From this list, BCAL has accepted that it would vacate only the Mid Atlantic and St. Louis routes, together with accepting the return of Iberian routes to Heathrow but in exchange for Harare as well as Saudi Arabia.

**2. Analysis**

**i. The Saudi Arabian Benefit**

There is no denying the benefit to BCAL of serving Saudi Arabia. Saudi Arabia will produce an important, immediate improvement in BCAL's profitability. An undiluted stream of profits from Saudi Arabia is essential to the development of competitive services by BCAL on both long-haul and short-haul routes.

Loss of Harare would be damaging, particularly for the future of Lusaka but it is not so critical as Saudi Arabia.

**ii. Imbalance Increased**

The results of a route exchange in the terms envisaged by British Airways will do nothing to reduce concentration in the UK air transport industry. BA's share of scheduled air transport production will rise by 2% to 82% (from 80.5%) BCAL's share of output will decline to 15.6% from its present 17.3%. There would be an overall reduction of 1800 in the annual number of scheduled movements operated at Gatwick and a loss of passenger throughput of about 60,000 passengers per year.

**iii. BA in the United States**

In the United States BA will acquire substantial additional strength which will be damaging to BCAL at its remaining gateways. BA already serves 12 gateway cities in the US out of 17 available to UK carriers. The addition of St. Louis, Atlanta, Dallas, Orlando, Tampa and Pittsburgh will give BA 19 out of 20 gateways. Of the 19 points served, 15 will be served in competition with only one US competitor or none at all, this sharply increasing the British airline imbalance in the US. (Attachment 1)

**iv. BCAL in the United States**

Development of BCAL's US network, which has been and remains a key corporate strategy for the airline, will be circumscribed. BCAL's North American routes operate in support of each other; significant volumes of traffic are not tied to a single gateway. Instead of five US gateways, BCAL would now serve only three, two of them in direct competition with BA. Projected results on a New York service would be worsened and, with fewer gateways in support, the viability of starting service in 1985 would be reduced. Deprived of access to traffic flows from Florida, S.E. USA, the Caribbean and northern countries of South America, BCAL would not want designation as a second carrier to Miami.

The reduction in scale and spread of BCAL's North America operation will damage the airline's ability to offset \$-related costs, which are already a net outflow, leaving BCAL exposed to exchange rate movement of the US \$.

The airline's residual US network will not be large enough, compared with other competitive transatlantic airlines, to give BCAL strength in travel retailing and wholesaling in the United States.

For these reasons, the loss of a single major US point would inflict serious damage upon BCAL and its US market. Losing either Atlanta or Dallas to BA would give BA a disproportionate capacity to undermine BCAL's position in the United States

**v. Dilution of Benefit**

Surrendering points on BCAL's existing network will dilute the benefits expected from Saudi Arabia and reduce the airline's capacity to develop competitive service.

The dilution results from:-

- loss of current and future profits expected on existing routes. (Attachment 2)
- loss of interline earnings. (Attachment 2)
- loss of system synergy, especially on US routes.
- redundancy and other payments.
- increased exposure to BA predation.
- increased expenditure/risks associated with route development.

**vi. Impact on BCAL**

Awareness, identity and marketing strength in the USA would be seriously impaired and the £30M which has been invested in the Dallas/Fort Worth, Atlanta and St. Louis routes to bring them into profitability would be lost. In the Southern states, BCAL would be forced back to metropolitan Houston.



BCAL will operate in a small way in many markets but, with the exception of West Africa, not be sufficiently strong in any. Saudi Arabia is a self-contained market and, as a result of bilateral restrictions, is not of itself a spring-board to further Middle or Far East expansion for the airline. The reduction of intra-line passenger transfers from long-haul to short-haul services at Gatwick will weaken the airline's efforts to develop a European network.

While the earnings from Saudi Arabia will be of great benefit to BCAL, the price that has to be paid to BA in the form of a truncated network and loss of opportunity in the United States will undermine BCAL's long-term future as a major British intercontinental carrier.

#### **vii. Corporate Risks**

BCAL's corporate strategy in developing the United States and Far East routes has been one of matching the political and economic risks of Africa and South America with the competitive risk in facing BA and strong foreign carriers. BCAL accepts competitive risks but exchanging major routes in the United States for Saudi Arabia again increases BCAL's exposure to political and economic risks again. Events of the recent past show how unpredictable and volatile such risks are and why an airline should not carry excessive risks of this kind in its portfolio.

BCAL's portfolio, as a result of this exchange, would be unbalanced in terms of political and economic risk although it would immediately improve BCAL's profitability.

In contrast, BA would be reducing its political and economic risks, already at a significantly lower level than BCAL's. The increase in BA's competitive risk would be marginal since BCAL, as a competitor to BA in the United States, would be diminished.

#### **viii. Acceptability**

Staff will regard the loss of hard-won and highly competitive US routes as a defeat for the airline. There will be redundancy of up to 400 staff. Industrial disruption and motivation problems may result.

There will be a loss of confidence in BCAL among the travel trade if the package was accepted. BA would be seen as largely preserving its strength and ubiquity at BCAL's expense. The Press are likely to react unfavourably to such a proposal bearing in mind their general support for CAP 500. This is likely to present problems funding development in the immediate term.

BCAL is required to make a profit for its shareholders. However, while there would be immediate profit gains in acceptance of the BA package, the long-term consequences would be damaging to the airline's profitability and future.

**ix. Future BCAL action**

If the package were accepted, it is likely that BCAL would not wish to embark upon any substantial development of competitive service for a number of years. The future of the Lusaka route would be in question as would the domestic points which currently make large losses. In short, BCAL would retrench.

**x. BA Predation**

Although losing profit from Jeddah and Dhahran, British Airways would not be much weakened by the changes. It would be extending its network to important areas and hence its capacity to meet most travel demands. Corporate risk would be reduced. In these circumstances BCAL is more likely to face BA predation on its residual network. While the Saudi profits will better equip the airline to resist predation from BA, the extension of BA's international network and reinforcement of its Heathrow hub will make predation that much more effective.

**xi. BA at Gatwick**

BA has a poor record of service at Gatwick. It has failed twice in operating US points from the airport. It wants to transfer Iberian services to Heathrow and to operate certain new US points there. While these experiences raise doubts about the benefit to the UK of BA operating long-haul scheduled services from Gatwick, they also indicate an additional risk to BCAL of BA ultimately transferring such points to Heathrow along with the reciprocal US operator. This would damage BCAL's hub at Gatwick as well as its remaining US routes.

**xii. Ability to Rebuild BCAL's Network**

Because of interline and synergistic benefits BCAL will wish to strengthen its network against the risks and threats outlined above.

However, the demands of British Airways in the United States will deny BCAL opportunities in that market. The US has been the major source of expansion for BCAL because of its liberal and expansionist air transport regime. It was that regime that allowed BCAL to translate its perception of a Southern tier of US gateway points into reality and generate benefits for the UK and Gatwick not identified by BA.

BCAL's expansion opportunities would be constrained by agreement with BA, by very limited bilateral opportunity and by a truncated network.

**xiii. Double Designation**

The arrangements for double designation opportunities for BCAL so far outlined by the Department do not constitute a sufficiently firm basis, either in terms of profit potential or availability, on which BCAL might build to replace lost routes. S.E. Asia has been ruled

out as has Scandinavia, both key markets in BCAL's strategic thinking for itself and Gatwick. It is only in Europe that some hope exists for securing double designation for a Gatwick operator but constraints on marketing and pricing policy remain.

**xiv. UK Air Transport Policy**

A route exchange between BA and BCAL would be far removed from the objectives consistently sought by BCAL. The resultant structure of the UK industry would not meet the principles set out by the CAA in its review and subsequent report. The development of Gatwick would not be advanced.

**xv. Conclusion**

Securing Saudi Arabia is an important objective for BCAL. The BA package, which offers the prospect of Saudi Arabian routes, is therefore attractive. However, the price demanded is excessive and BA grows more dominant in the process. This dilutes the benefits from a Saudi exchange. It will undermine company and public confidence. There are likely to be redundancies among BCAL employees. Above all, the BA requirements expose BCAL to major risks which jeopardise its future survival too severely to enable the package to be accepted. Loss of US gateways in order to secure Saudi Arabia is simply not acceptable to BCAL, and is not in the interest of Gatwick, the industry or the consumer.

25.09.84

## CIVIL AVIATION REVIEW

## Effect of British Airways Proposals on UK-USA Services

1. Present Position at September 1984

UK Airline Services:-

	Competing with One or Less Direct Carrier	Competing with Two or More Direct Carriers	Total
<u>British Airways</u>			
Anchorage	1		
Baltimore	1		
Boston		1	
Chicago	1		
Detroit	1		
Los Angeles		1	
Miami	1		
New York (Kennedy)		1	
Philadelphia	1		
San Francisco	1		
Seattle	1		
Washington	<u>1</u>		
	<u>9</u>	<u>3</u>	<u>12</u>
<u>British Caledonian Airways</u>			
Atlanta	1		
Dallas/Ft. Worth	1		
Houston	1		
Los Angeles		1	
St. Louis	1		
San Juan	<u>1</u>		
	<u>5</u>	<u>1</u>	<u>6</u>
<u>Virgin Atlantic Airways</u>			
New York (Newark)		1	1
<u>Total Gateways (Unduplicated)</u>	<u>14</u>	<u>3</u>	<u>17</u>

## CIVIL AVIATION REVIEW

## Effect of British Airways Proposals on UK-USA Services

2. Position After British Airways' Requirements

UK Airline Services:-

	Competing with One or Less Direct Carrier	Competing with Two or More Direct Carriers	Total
<u>British Airways</u>			
Anchorage	1		
Atlanta	1		
Baltimore	1		
Boston		1	
Chicago	1		
Dallas/Ft. Worth	1		
Detroit	1		
Los Angeles		1	
Miami		1	
New York (Kennedy)		1	
Orlando	1		
Philadelphia	1		
Pittsburgh	1		
San Francisco	1		
St. Louis	1		
San Juan	1		
Seattle	1		
Tampa	1		
Washington	1		
	<u>15</u>	<u>4</u>	<u>19</u>
<u>British Caledonian Airways</u>			
Houston	1		
Los Angeles		1	
New York (Kennedy)		1	
	<u>1</u>	<u>2</u>	<u>3</u>
<u>Virgin Atlantic Airways</u>			
New York (Newark)		1	1
<u>Total Gateways (Unduplicated)</u>	<u>16</u>	<u>4</u>	<u>20</u>

## BRITISH CALEDONIAN NORTH AMERICAN OPERATIONS

Attachment 2

£ Millions	1979/80	1980/81 Actual	1981/82 Actual	1982/83	1983/84 Estimates	1984/85	1985/86 Forecast	1986/87 Forecast	1987/88
HOUSTON	2.7	5.6	6.0	9.8	14.1	15.8	11.2	15.1	19.6
ATLANTA (with St. Louis)					0.3	1.9	1.6	3.6	6.0
DALLAS (with St. Louis) -	(3.9)	(9.8)	(4.2)	0.9	(0.1)	(0.1)	(0.7)	1.7	4.6
LOS ANGELES			(3.9)	(3.6)	(1.5)	2.3	1.1	3.9	6.2
ALL ROUTES OPERATING PROFIT	(1.2)	(4.2)	(2.1)	7.0	12.9	19.9	13.2	24.3	36.4
FINANCING CHARGES	(3.5)	(5.2)	(5.9)	(7.3)	(7.2)	(7.1)	(6.0)	(4.9)	(3.8)
TRADING PROFIT	(4.7)	(9.4)	(8.0)	(0.3)	5.7	12.8	7.2	19.4	32.6
CUMULATIVE	(4.7)	(14.1)	(22.1)	(22.4)	(16.7)	(3.9)	3.3	22.7	55.3
INTERLINE REVENUES	N/A	N/A	N/A	N/A	12.0	13.2	13.7	15.7	17.7

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FILE

LANAETH

10 DOWNING STREET

*From the Principal Private Secretary*

26 September, 1984

CAA REVIEW

As you know, Sir Adam Thomson asked to see me this afternoon. (He did not betray any knowledge that Lord King was seeing the Prime Minister tomorrow, and I did not do so either). He handed me two documents - one a technical analysis of what is described as 'British Airways proposal' and the other written in more popular language, which he said that he did not propose to release to the press at this stage but which would act as a basis for what British Caledonian would say to the press in due course. Sir Adam said that he would ask Mr. Pugh to leave copies of these documents with Mr. Holmes.

Sir Adam Thomson's main message was that the Government would be wrong to try to impose the 'British Airways proposal' on British Caledonian. He said that British Caledonian could not accept the loss of some of its North American routes (except for St. Louis) because they were inter-dependent. The freight was also important to British Caledonian. He was willing to give up the mid-Atlantic routes and the South American routes to BA: these would be much more valuable to BA than they were to British Caledonian. But if the present proposals were put to him on a 'take it or leave it' basis, he would leave it. He would have to take his business into 'survival mode', which would involve closing down routes - and he referred particularly to South America - and redundancies. He would make an immediate demand for transfer to Heathrow, although he understood that the Secretary of State for Transport would not agree to this. He would then hope that a subsequent government would give him a better deal. He also said that, while he did not want to deal in threats, British Caledonian would seek any legal means open to them for protecting their business.

I made the point that the Government was seeking honestly to find the best solution which was consistent with a number of conflicting objectives. Sir Adam Thomson said

that he recognised that, but genuinely thought that the 'Nott undertakings' had been given in different circumstances before the implications of privatisation had been properly considered. He also claimed those serious commentators who had looked below the surface of the problem had supported British Caledonian's case, as had the CAA. He added that he believed that the other independents had been offered by BA some 'grace and favour' arrangements by which they would fly to BA destinations out of regional airports, and he understood that the other independents had no enthusiasm for such an arrangement.

I said that I would report his views to the Prime Minister and your Secretary of State.

RB

Miss D. Nicols,  
Department of Transport