

CONFIDENTIAL



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

CR7

Andrew Turnbull Esq
Private Secretary
10 Downing Street
LONDON SW1

26 September 1984

Prime Minister

Lord King's position
at Annex A and Adam
Thomson's at Annex B

Dear Andrew,

PRIME MINISTER'S MEETING WITH LORD KING
THURSDAY, 27 SEPTEMBER

AT
26/9

I enclose a brief setting out the
bones of a possible response to the CAA's
review of airline competition policy which
the Prime Minister will wish to see before
her meeting with Lord King tomorrow.
My Secretary of State is grateful for the
opportunity of a prior discussion at
9.15 am.

Arranged

Yours,

Dinah

MISS D A NICHOLS
Private Secretary

CONFIDENTIAL

Outline of possible Government response to
the Civil Aviation Authority's
review of airline competition policy

Objective

1. Our objective is, without postponing the privatisation of British Airways, to settle the issues raised by the Civil Aviation Authority's report (CAP 500) in such a way as to promote a British airline industry both competitive within itself and strong internationally.

2. The key elements of our policies should be
 - (a) to remove barriers to competition in domestic air services;

 - (b) to seek the designation, wherever possible, of two or more British airlines to operate in competition on international routes ("dual designation");

 - (c) to encourage new services, especially by the smaller independent airlines, between regional airports and overseas (especially continental Europe);

 - (d) to strengthen British Caledonian as a credible competitor and potential substitute for BA on overseas routes both long and short-haul;

 - (e) to ensure adequate safeguards against predatory pricing and other anticompetitive practices by any airline;

 - (f) to avoid the need for legislation or for excessive interference with BA's present operations such as would delay privatisation.

Proposals

(a) Domestic air services

3. Here I propose to endorse the CAA's proposals -

(i) that British airlines be enabled to operate scheduled services between any two points in the United Kingdom, other than Heathrow or Gatwick (excluded for capacity reasons) and any others specifically excluded (eg "lifeline" routes, where isolated communities are dependent on a vulnerable air link); and

(ii) to cease regulating domestic air fares (except insofar as is necessary to prevent predatory pricing).

The CAA can implement both these proposals under their present powers.

(b) Dual designation

4. I propose to welcome the CAA's proposals that "additional competition by British airlines on inter-continental routes should be licensed wherever possible" and that it "will seek to increase the range and market penetration of European scheduled services from Gatwick" (that will be operated largely in competition with British Airways' services out of Heathrow); and I shall use my powers as appellate authority, so far as I properly can, to support the CAA in this. I shall also instruct the traffic rights negotiators in my Department to make every effort to secure the right to dual designation from foreign governments.

(c) International services from regional airports

5. The CAA recommended that "BA's European routes from provincial airports should be taken over by other British airlines". This proposal is contested by regional interests

CONFIDENTIAL

and a number of our supporters there. And it would require legislation to make BA give up any of their regional air services, which would delay privatisation. BA have now made a counter proposal for modest assistance to other British airlines ready to operate new services between regional airports and the rest of Europe:

(i) to pay any airline licensed by the CAA up to £450,000 over three years ^{per route} as a contribution to their start-up costs in launching international services from the regions either in competition with themselves or on new routes; and

(ii) to provide them with back-up services (booking, ground-handling, timetabling etc) at the six regional airports BA serve, at cost.

BA's offer would be limited to a maximum of 15 new services, at a total cost of £6½m over three years.

6. This offer is well below the expectations of the airlines concerned, but I believe there would be takers. I understand that Mr Michael Bishop is discussing other arrangements with Lord King. I believe it is the most we could expect BA to do, short of legislation.

(d) British Caledonian

7. I have followed up colleagues' suggestion, at the meeting on 11 September, of a route swap between BA and BCal, instead of the route transfers, to which BA were opposed. It has been extremely hard to persuade either airline to contemplate a satisfactory swap (ie one that gives BCal sufficiently enhanced profits, without disruption to BA's operations, on a scale which would threaten privatisation and be unacceptable to Lord King). With the greatest difficulty I have prevailed upon BA to agree to the offer set out in Annex A, which (on BA's figures) would give BCal about £17m-£18m of extra profit while reducing BA's profit by about £20m in the

short run. BCal have not yet accepted this, and I shall tell Sir Adam Thomson that he must either take it or leave it. If he leaves it, I shall either (i) have to award his new licence to fly to Riyadh to BA, because the Saudis will not accept two UK carriers, and implement minor parts of the CAA's recommendations, or (ii) legislate to impose some route transfers.

8. Such a swap would involve costs to the Exchequer:-

(i) BA's loss of expected profits would mean a reduction in proceeds from the sale (if we sell 100% of the shares) of perhaps £80m-£100m;

(ii) BA would incur about £50m of additional capital expenditure this year on aircraft to operate their new routes; and

(iii) as a result of (ii) BA's debt: equity ratio at the time of privatisation would be worsened; and it would therefore be necessary to allow them to retain a greater part of the proceeds of sale.

I believe this to be a defensible compromise between forcing a larger transfer on BA, which would need legislation and doing nothing to strengthen BCal. But it cannot be effected without agreement of both.

(e) Predatory pricing and anti-competitive practices

9. We must have in place effective means of acting against predatory prices and other forms of uncompetitive behaviour, so as to protect the smaller airlines against BA's dominant position. The CAA accept that they can and must act effectively within their present powers. I propose to reject their request for new legislation, which would create unnecessary uncertainties for a successful privatisation of BA.

Specifically

(a) in the charter market, where anxiety is strongest, now, the CAA would undertake to monitor prices, and act to limit capacity if any airline was growing too fast through predatory competition. If the Secretary of State for Trade and Industry agrees, I propose a new back-up role for the Office of Fair Trading (OFT) here;

(b) even after we have freed scheduled domestic services, the CAA would be able to consider charges of predatory behaviour and could if necessary raise unrealistic fares or cut the schedules of any airline found dumping capacity. The OFT already has a back-up role here;

(c) in international services, the CAA can and does consider charges of predation wherever our international agreements allow.

(f) BA privatisation

10. Time is now short if we are to hit the target of privatisation early in 1985. We need very soon to begin positive action with the City to get investors used to an unfamiliar stock. The present uncertainty must first be dispelled. If colleagues can agree at Cabinet on 4 October, and we can announce decisions in a White Paper immediately thereafter I believe that, unless there are unforeseen developments - and subject to the Laker problem, on which I shall be putting advice to colleagues later - we can still meet the timetable.

CAP

26 September 1984

Proposed route swap between

BA and BCal

BA would give up to BCal its routes to Jeddah and Dhahran in Saudi Arabia (12 services a week)

BCal would give up the following route rights to BA:-

- Atlanta (USA) (7 services a week)
- their south Atlantic route - ie Brazil and, when once more available, Buenos Aires and Santiago de Chile (2 services a week)
- their mid-Atlantic route - ie San Juan (Puerto Rico), Caracas (Venezuela) and Bogotá (Columbia) (one service a week)
- Morocco (not at present operated)

BCal would also undertake not to object to BA's applications to the CAA for licences to serve Orlando and Tampa (Florida).

BA would also be allowed to transfer back to Heathrow from Gatwick its services to Madrid, Barcelona and Lisbon, on condition that it ensured (by transfers of other services from Heathrow to Gatwick, as necessary) that the total package did not bring about any increase of movements at Heathrow.

CONFIDENTIAL

NDS/5

AF 26/9

UNA



DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

David Peretz Esq
Private Secretary to
the Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

26 September 1984

Dear David

CIVIL AVIATION AUTHORITY REVIEW OF AIRLINE COMPETITION POLICY

The Prime Minister is seeing Lord King tomorrow morning at 9.45am to discuss the Government response to the CAA review.

My Secretary of State feels the Chancellor, and the Secretary of State for Trade and Industry, should see the attached paper provided for the Prime Minister as briefing for that meeting.

I am copying this letter with the paper to Callum McCarthy in Mr Tebbit's office and, without the paper, to Andrew Turnbull at No.10.

yours sincerely,

Henry Derwent

H C S DERWENT
Private Secretary

CONFIDENTIAL

26 SEP 1984

11 12 1
1 -
E
7 6 5 4
10 2