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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

13 July 1987

Dear Roy,

BRITISH CALEDONIAN AIRWAYS

The Prime Minister has seen your Secretary of State's minute of 10 July about the latest position on the discussions between British Caledonian and British Airways. She has commented that the Secretary of State for Trade and Industry will no doubt satisfy himself that the proposed lines to take do not prejudice his own position.

I am copying this letter to Alex Allan (HM Treasury) and Timothy Walker (Department of Trade and Industry).

Yours,
David

(DAVID NORGROVE)

Roy Griffins, Esq.,
Department of Transport.

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Prime Minister

BRITISH CALEDONIAN AIRWAYS

- ...1. I attach a note by my officials (prepared after consultation with officials in DTI and Treasury) about the courses of action open to us in this matter.
2. I understand from Lord King that negotiations with BCal are continuing, and that they may well reach agreement. A policy of allowing BA to become the one British intercontinental airline will have supporters. But it will fly in the face of the policy we announced in the 1984 White Paper. Even if we wanted to change the policy, we should have to await the outcome of the statutory procedures governing mergers, which may include an MMC report on whether or not the creation of such an airline would be in the public interest.
3. I am sure that we should not take the initiative in looking for other buyers for BCal. Once the news is out, others can easily come forward of their own accord. Sir Adam Thomson has said that another group is already in discussion with BCal's major shareholders.
4. Sir Adam Thomson argues strongly that an MMC reference is unacceptable because of the effect the delay would have on confidence in his airline (though he maintains that it is financially sound and will end the year in the black). I have advised him to put his views to Sir Gordon Borrie; and I understand they are meeting this morning.
5. Inevitably news of the interairline discussions is spreading daily. Already several of our backbenchers know what is going on, and it will not be long before it breaks in the press. My officials have therefore agreed with DTI the following defensive line:-

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"This proposal falls within the merger control provisions of the Fair Trading Act 1973. In the first instance it will therefore be the duty of the Director General of Fair Trading to advise the Secretary of State for Trade and Industry whether the merger should be referred to the Monopolies and Mergers Commission. It would not be appropriate to comment until that advice has been received."

6. This line would also hold good if the proposal was for a substantial foreign shareholding in BCal.
7. If I am asked for an immediate Department of Transport reaction to a BA - BCal merger I am proposing to say -

"British Airways and British Caledonian have informed me of their discussions. They are now both private sector companies and they do not need my approval. If the merger were to go through, it would obviously necessitate a review of the Government's airline competition policy. But it would be premature to embark on this until the procedures under the Fair Trading Act have run their course."

8. I am sending copies to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry.

P.C.

PAUL CHANNON

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BRITISH CALEDONIAN AIRWAYS

Introduction

The Secretary of State for Transport's minutes of 7 and 8 July to the Prime Minister described BCal's attempts, first to interest a foreign airline in buying a substantial shareholding, and then to negotiate a takeover by British Airways. Officials of the Department of Transport, Department of Trade and Industry, and Treasury have now met to consider what options are open to the Government in this situation (which may become known at any time, stimulating keen interest and concern in Parliament and outside). Officials of the other two Departments are broadly content with the views expressed below.

Present policy

2. The Government's present policy on the airline industry is set out in the White Paper on Airline Competition Policy (Cmnd 9366) published in October 1984. The White Paper came out firmly in favour of a "competitive multi-airline industry" in the UK.

3. BCal's proposals go against this policy. A foreign airline shareholding in BCal would extinguish whatever competition they had previously been between the two airlines; and it would expose BCal's international services to challenge by third countries on the grounds that the airline was no longer under effective British control.

4. A merger of BCal with BA would also reduce competition by putting 92% of UK scheduled service capacity in the hands of a single airline, BA. BA argue that the real competition they face is from abroad and that there is no need for competition from other UK airlines; indeed they point to the emerging megacarriers of the US and claim that the UK's interest is in having one large airline strong enough to compete with the US giants. But BA have not yet convinced either the Department of Transport or public opinion at large that they are not already big enough to compete effectively with US airlines and that there is not room for two major competing carriers in the UK. Acceptance of BA's view would amount to repudiation of the 1984 White Paper policy; and such a volte-face would be very difficult to defend in Parliament and outside - at least unless it was backed by the findings of an independent, well-informed and well-respected body.

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Objectives

5. It is undeniable that BCal has long shown poor financial results and is now in a weak position with many of its assets mortgaged. But arguably this weakness is due largely to poor management aggravated by poor trading conditions over the last few years. Certainly in other parts of the UK civil aviation industry BCal is widely regarded as a poorly managed enterprise. That being so, our objective should not be to have BCal cosseted by a close association with a foreign airline or to let it be eliminated through merger with BA. Rather we should aim for an airline that remains British, but independent of BA, rejuvenated under new management, so that the opportunities and assets that BCal at present puts to poor use are employed more efficiently and more profitably. This is the solution that would strengthen the UK airline industry by enhancing competition.

6. Sir Adam Thomson is not at present motivated to pursue such a solution. BCal today is not worth much as an independent airline, but its route rights would be a valuable prize for another airline. As a substantial shareholder, now over 60, Sir Adam's motivation is to find a buyer willing to pay a premium for control of BCal, such as another airline wanting to limit competition. But Sir Adam's interests here are not those of the UK which on the prevailing policy view are best furthered by continuing competition between British airlines. Our immediate objective, then, should be to encourage Sir Adam (and BCal's other proprietors) to make renewed efforts to make a success of BCal as it is (eg by bringing in better management) or to sell the airline to other British proprietors capable of turning the airline round.

Options

7. Even if we do nothing, as soon as BCal's merger proposals become known certain processes will take place automatically. This will be so whether BCal wish to accept a substantial foreign shareholding or a takeover from BA. Under the Fair Trading Act 1973 the Director-General of Fair Trading (DGFT) has the duty to advise the Secretary of State for Trade and Industry on whether a merger should be referred to the Monopolies and Mergers Commission (MMC). The Secretary of State for Trade and Industry must then decide whether or not to make the reference. If he does so, the MMC will then consider whether the merger is in the public interest and report back.

8. One option would be for the Secretary of State for Trade and Industry to refuse to refer a BCal merger to the MMC, thus allowing it to go ahead. But such a decision would fail to achieve the objectives identified in paragraphs 5 and 6 above, and would be hard to justify. If it was argued that the merger was urgent because BCal were a failing company, that would not, even if true, be a conclusive argument against a reference. Even if the airline went into liquidation, the airline business is thriving this year, and there is a good chance that most of BCal's opportunities and assets would be taken up by another owner or owners.

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9. A second option is simply to accept the desirability of a reference and to let the statutory processes take their course. If the MMC, in confirmation of our present view, concluded that a merger of BCal with a foreign airline or with BA was against the public interest, then those courses could be closed off. BCal's proprietors would then be left with the choice of soldiering on under present ownership (there is no evidence that BCal are close to insolvency) or of finding another, preferably British, buyer.

10. In the event that the MMC found in favour of a merger between BCal and a foreign airline or BA, then the Government would have no power to stop the merger, but at least the change of policy that this would imply would have the endorsement of an independent and respected body and have a better chance of acceptance in the House and by public opinion.

11. A further option might be to attempt to hasten the process by trying now to identify a suitable alternative British buyer and interest him in taking BCal over. But another British buyer, particularly one outside the airline industry, would be unlikely to offer as much as BA or a foreign airline competitor; so BCal would have no interest in entertaining such an offer while the option of a sale to BA or a foreign airline was still open. Moreover, if the Government showed anxiety by trying to actively to find an alternative purchaser, the purchaser might be tempted to seek a contribution from the Government, for which there could be no justification. Fortunately, this problem has arisen at a time when the airline industry is doing well. Thus there is a good chance that interest in taking over BCal should arise spontaneously from the market, and this should be allowed to happen.

Conclusions

12. We therefore draw the following conclusions:-

(i) It is in the first instance for DGFT to advise the Secretary of State for Trade and Industry on whether he should make a merger reference to the MMC; it is then for the Secretary of State for Trade and Industry personally to make his decision.

(ii) There are no grounds at present for the Government to take the initiative to find an alternative British buyer of BCal (though it would be welcome if one emerged spontaneously) (paragraph 11).

CAP
Department of Transport
10 July 1987

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