Prime Minister[2]

You may like to see.

(The DTp conclusions are at the end of their paper.)

pro

MR NORGROVE

29 July 1987

DLN 29/7.

BRITISH AIRWAYS BID FOR BRITISH CALEDONIAN

I attach a copy of the basic submission on the BA/B Cal merger which the Department of Transport has today sent to the Office of Fair Trading. This is the only submission directly from the Government. The CAA has commented separately.

I support Transport's case for a reference to the MMC. Quite apart from the merits of the proposed merger, it would be politically damaging for a Government which is the champion of competition and the consumer to be bounced at short notice into reversing an airline competition policy robustly reiterated as recently as the spring.

As regards the merit of the case, I would be more sympathetic to Lord King's argument that BA needs to emulate the US "mega-carriers" in order to compete successfully in the world's first division, if we were facing the prospect of deregulated international air services. In spite of our efforts, this prospect still seems a long way off. Meanwhile the crude interpretation of the proposed deal is that BA is prepared to pay substantially more than anyone else for B Cal (which excites B Cal's shareholders) because it is buying out its most effective (although not most efficient) competitor; and gaining a fistful of valuable air services licences specifically conferred on B Cal because it was a competitor to BA.

In today's world of regulated international air services, Lord King's arguments are specious. "Little BA" may rank seventh in size behind the major US carriers, but the bulk of their business is domestic. In the international market for scheduled air services BA is the world leader - a bull point in the privatisation publicity. Moreover, if through the merger, BA acquires a stronghold at Gatwick as well as Heathrow, it will be sitting as the dominant airline at the busiest and second busiest international airports in the world.

If, as may well be the case, B Cal cannot be financially restructured and put under new management as a going concern, we should not be unduly worried about the break-up and disposal of its assets. This course may not be ideal for B Cal's shareholders (B Cal is not publicly quoted) but it could well lead to the best outcome from the point of view of competition and the consumer.

3i own over 40% of the shares.

JM

JOHN WYBREW

BA/BCAL PROPOSED MERGER

Note for Director General of Fair Trading

by the Department of Transport

Introduction

Now that British Airways (BA) has announced its proposal to take over British Caledonian Airways (BCal), the Director General of Fair Trading has to decide whether to advise the Secretary of State for Trade and Industry for or against referring the merger to the Monopolies and Mergers Commission. This paper gives the Department of Transport's view on the advice the Director General should give.

Airline Competition Policy

2. The Government's airline competition policy is set out in the White Paper of 1984 (Cmnd 9366). More recently the Department's view of airline competition was described in more detail in the evidence the Department put to the Select Committee on Transport for the investigation they commenced in the last Parliament (copy of paper of 21 November 1986 attached at Annex A). More recently still the Government's policy was summarized in the prospectus for the sale of British Airways published in January this year (extract at Annex B). The then Minister for Aviation once again confirmed Government policy on this subject in a Written Parliamentary Answer on 22 April this year (copy at Annex C).

3. The policy is perhaps best summarised in paragraph 32 of the 1984 White Paper, as follows:-

> "......the Government agrees with the [Civil Aviation] Authority it is in the consumer's interest to ensure there are a number of efficient and profitable British airlines strong enough to compete with each other directly or indirectly where the opportunity occurs, irrespective of whether there is a competing foreign airline. It will not be possible to secure direct competition between British airlines on every route. Even then, the Government considers the existence of a British airline indirectly competing on other routes, and able to take over a particular route if the airline operating it should withdraw or fail to maintain an adequate standard of service, is a spur to efficient service and a market-orientated approach by the incumbent airline......."

Recent developments

4. Progress has been made with implementing the White Paper's policies. More liberal bilateral regimes have been negotiated with foreign governments - for example, Japan, the Netherlands, Belguim and West Germany - to allow more airlines to compete, and in some cases to relax control on capacity and fares. BCal has gained new opportunities as a result. However, the world has not stood still since 1984, and the competitive environment in which our airlines operate is changing. BA and BCal in their joint submission to DGFT point to the concentration of the US airline industry into a half a dozen "mega-carriers", enjoying considerable economies of scale and with large domestic markets based on operating hubs which enable them, for example through the working of computer reservations systems, to keep traffic to themselves that might otherwise have flown on foreign competitors. It is also argued that in the longer term there is an unresolved conflict between the

Government's airline competition policy and the growing pressure on scarce airport capacity in the London area. There is certainly a case for reappraising the 1984 policy in the light of these and other changes.

BA's proposed takeover of BCal

apparently

5. BA's proposed takeover of BCal would nonetheless mark the complete reversal of the 1984 policy. Annex D contains figures of the market shares of the two airlines, by various measures, showing the extent to which the merged airline would dominate the UK air transport industry. As BA themselves acknowledge, their view of international airline competition in future leaves room only for very large airlines (of which the UK could only have one) and small specialist airlines; the merged airline would therefore enjoy an unchallengable monopoly among UK airlines in the provision of worldwide air services for the indefinite future. A merger of this consequence should, in the Department's view, be contingent on the reappraisal of airline competition policy, it should not predetermine that policy. And the reappraisal needs to be a thorough and impartial one, the conclusions of which will command public support: it should entail public consultation; it should bring to bear the expertise and experience of the Civil Aviation Authority as the industry's regulator; and it should have regard to the public interest. A statutory reference of the proposed merger to the Monopolies and Mergers Commission would be one obvious way of initiating such a reappraisal. It would be necessary to be sure that the MMC would be able to address adequately the competition

issues raised in an industry operating in an international market created by bilateral agreements.

Consequences of an MMC reference

6. It is said that, if there is a reference, the merger might be abandoned. But it would not, in the Department's view, as explained above, be right that the merger should go ahead without a measured and impartial reappraisal of the 1984 policy first being undertaken.

7. So what would be the consequences of abandoning the merger without a reference?

(a) It is conceivable (though now unlikely) that BCal would resume its role as an independent British intercontinental airline in competition with British Airways. If so, this would be fully in accordance with the established airline competition policy; and it would provide an interval in which this policy could be reappraised by the Civil Aviation Authority and the Government in the light of the arguments recently adduced by BA.

(b) A merger, or some other link, might be negotiated between BCal and another British partner, whether within the British airline industry or outside. This would also be compatible with the present airline competition policy (any partner airline for BCal apart from BA could not have more than a small share of the market, and the linkage could not therefore constitute the challenge to the policy that the proposed BA/BCal merger constitutes). As with (a) above, this consequence, too, would provide an opportunity for a reappraisal of the present policy should this seem desirable.

(c) BCal might negotiate a link with a foreign airline. This could take many different forms. Since international civil aviation is regulated under bilateral agreements between governments, which have been negotiated in the mutual interests of each, the Department would not in principle wish a foreign airline (not even another EC airline, in the absence of an integrated internal market, or even any degree of reciprocity) to assume an interest in BCal which could enable it to influence BCal's policy. ~~The~~ statutory safeguards in the Civil Aviation Act 1982 against foreign control would not be sufficient to prevent an undesirable level of influence being exercised. However, the acquisition by a foreign company of material influence over BCal would again raise the question of a reference to the MMC under the Fair Trading Act 1973.

(d) Offers might be made for parts of the BCal operation (for example, the short distance services to Europe, or the intercontinental services) which would allow these to continue, though operated by different airlines.

(e) At worst, BCal might fail altogether. But if it did so it would be open to other British airlines, including BA, to apply to the CAA for the route licences relinquished by BCal and to resume BCal's services.

Conclusion

8. The Department of Transport's view therefore is that

(a) BA's proposed takeover of BCal would mark a reversal of the Government's airline competition policy, reaffirmed as recently as May;

(b) there is nonetheless now a case for reappraising that policy in the light of recent developments in the international environment for British airlines;

(c) if there were no reference to the MMC, the policy would be changed without any proper review;

(d) the dangers of a reference seem more tolerable than the dangers of letting the takeover go ahead immediately without a reference (or other reappraisal.)

CAP
Department of Transport
27 July 1987