p.c.

PRIME MINISTER 5 August 1987

PROPOSED BA/BCAL MERGER

Lord Young's office not aware of this.

It is possible that the subject of the proposed BA/BCal merger will come up when you see Lord Young on Thursday.

At yesterday's OFT Panel Sir Gordon Borrie sought the views of Government departments and the CAA on the case for referring the proposed BA/BCal merger to the MMC. Sir Gordon concluded by indicating his firm intention rapidly to recommend an MMC reference to Lord Young. A deadline of either 3 or 4 months would be set for completion of the MMC investigation.

Sir Gordon Borrie outlined his conclusions as follows:

1. There is a compelling prima facie case to investigate the implications of the proposed BA/BCal merger for airline competition. Indeed, it is difficult to envisage a case where reference to the MMC would be more warranted. There is no doubt that BA/BCal would have the potential to use in a predatory way their dominant position as regards runway slots, scheduling and support facilities at Heathrow and Gatwick - the world's two busiest international airports.

Even if the merger was allowed to go through without an MMC reference, it is highly likely that the European Commission would want to investigate it on competition grounds.

2. BA/BCal's contention that British consumers would benefit from the two airlines' greater capability to compete against US "mega-carriers" is unconvincing; likewise the claimed benefits of BA/BCal's combined purchasing power. With international deregulation still a distant prospect, the

mega-carrier argument is confined essentially to US domestic air services. In this regard the proposed merger will contribute nothing to BA/BCal's competitiveness. BA is already the world's largest international airline.

3. Having initially talked up the soundness of BCal's business prospects to justify the £237 million price offered by BA, Sir Adam Thomson has subsequently been giving increasingly dire warnings about the precarious nature of BCal's financial position in order to pressurise the Government into allowing the merger to go through without an MMC reference.

4. It is difficult to judge whether the delay and uncertainty caused by an MMC reference would lead - as alleged - to a rapid loss of confidence in B Cal's business and thence possible bankruptcy. Certainly Sir Adam Thomson was unwise to expose BCal to such risks when BCal could readily have obtained confidential guidance on the likelihood of an MMC reference. If Lord Young now approves the reference, BA's current generous offer will lapse. Thereafter Sir Adam and his shareholders (indirectly including the Bank of England) will have a strong vested interest in again talking up the soundness of BCal's business prospects to attract alternative bidders or partners.

Whatever the outcome of BA/BCal's proposed merger, change and restructuring of some sort is inevitable for BCal. But there are few grounds for serious concern that this will weaken the British aviation industry; on the contrary. BCal has valuable assets in the form of aircraft, established routes and its strong position at Gatwick. The British economy is enterprising and there is plenty of capital looking for attractive investment opportunities. Apart from BA there are a number of enterprising and capable airline operators running operations considerably more efficient than BCal's.

5. Thus, there is no case on grounds of wider national interest for not proceeding with an urgent MMC reference to examine the potentially far-reaching implications of the proposed BA/BCal merger for airline competition.

We strongly support Sir Gordon Borrie's conclusions and recommendation. An unconditional BA/BCal merger of the sort proposed poses much more of a threat to British consumers and other successful enterprising British airlines than the US mega-carriers.

JOHN WYBREW