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From: J B UNWIN
10 September 1986

MR NORGROVE - No 10

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BRITISH AIRWAYS PRIVATISATION

I understand from the Department of Transport that, subject to confirmation later this morning that the documents have actually been initialled, a satisfactory capacity agreement has been reached with the Americans in Washington. In essence, it amounts to a roll over for at least 3 years of the old capacity control mechanism (Annex 2 of the Bermuda Agreement) and, according to the Department, represents a better deal than the one the Americans rejected in August.

2. This means that, subject to the formal confirmation referred to above, the Transport Secretary will this afternoon recommend privatisation of British Airways next January.

J B UNWIN

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PRIME MINISTER

British Airways Privatisation

MISC 112(86)2, 3, 4 and 5

CONCLUSIONS

You will wish to decide:-

(i) whether to go ahead with privatisation of British Airways (BA) in January 1987 (for this to be possible requires a firm decision by the end of this month);

(ii) if not, whether to bring forward the privatisation of the British Airports Authority (BAA) from June 1987 to next January, and to defer the flotation of BA to next June (leaving Rolls Royce, as at present planned, to come forward next April.

BACKGROUND AND MAIN ISSUES

2. Because of difficulties first with anti-trust litigation in the US, and subsequently in the negotiation of new arrangements to regulate capacity on US/UK air services, there have been extensive delays in the Government's plans for the privatisation of BA. The latest position reached on UK/US air services negotiations, on BA's residual anti-trust liabilities, and on the financial aspects and timing of the flotation are covered in the Transport Secretary's separate papers MISC 112(86)3, 5 and 4.

Air Services Capacity

3. Annex 2 to the Bermuda 2 Agreement, which regulates capacity on US/UK air routes, expired on 23 July. It has not proved possible to reach agreement with the US on new principles for the regulation of air services capacity; the US would really prefer a situation in which there were no restraints, and their airlines were free to exploit to the maximum the competitive advantage they have through the exclusion of UK airlines from internal US routes. They have, however, eventually accepted that the resulting situation would not give UK airlines the 'fair and equal opportunity to compete' provided for in the main Bermuda 2 Agreement, and have offered to renew the previous capacity control arrangement for a further three years, subject to certain modifications. Negotiations on this are currently in progress in Washington, and the Transport Secretary will need to make an oral report on their progress; success is by no means guaranteed, but the prospects are a good deal better than they were a few weeks ago.

Residual Anti-Trust Liabilities

4. Last Summer the difficulty of making a sufficient disclosure in the flotation Prospectus without precipitating further litigation in the US which could have cost £100s of millions made it impossible to go ahead with privatisation. Since then the settlement at little cost of the 'class action' arising out of the Laker liquidation, together with the dismissal of two further suits mounted by Mr Beckman (Laker's erstwhile counsel) have reduced BA's potential further anti-trust liabilities to the point where the legal advisers can now recommend as sufficient a Prospectus text which effectively relies on the £25 million provision already published in BA's 1985 Accounts. The four-year statute of limitations together with progress with BA's anti-trust compliance programme, including their document control programme, provide further assurance that potential anti-trust liabilities have been reduced to manageable proportions.

Although there may be appeals in Beckman's two further cases, the Attorney General is now satisfied that it would be prudent and proper for the flotation to go ahead on the basis of the Prospectus text attached as Annex 1 to MISC 112(86)5. In view of this, there is no point in further consideration of devices - none of which overcome the Prospectus disclosure problem - to separate the residual anti-trust liabilities from the business to be privatised.

Financial Questions and Timing

5. The fall in the value of the dollar, combined with the perceived threat from international terrorism, led to a marked decline in transatlantic passenger numbers earlier this year. As a result, BA forecast pre-tax profits of only £125 million, for 1986-87 as against a budgeted profit of £205 million and last year's pre-tax profit of £183 million. More recently, however, traffic has shown substantial recovery, with revenue now running only 4-5 per cent below budget. Inevitably this means that the proceeds from the privatisation, currently estimated at £700-800 million, will be substantially less than had earlier been expected. Moreover a January flotation would have to be on the basis of forecast rather than actual results for the current financial year; the fact that a safety margin always has to be allowed to ensure that the actual results do not fall below the forecast tells in favour of a June rather than a January 1987 flotation, other things being equal. Furthermore a later flotation would give time for evidence to become available of renewed traffic growth in the first half of 1987 - if such growth actually materialised.

Present Privatisation Plans

6. Present privatisation plans provide for the two air transport nationalised industries (BA and the British Airports Authority (BAA)) to be floated in January and June 1987, with Rolls Royce coming forward in April. BAA's is a much steadier

business, not subject to the currency and other fluctuations which have affected BA this year. There is nothing in BAA's business which would lead to expectations of substantially higher proceeds in June than in January 1987. The market/political argument put by the Transport Secretary in paragraph 4 of MISC 112(86)2 in favour of going ahead with BA in January tells in principle equally in favour of BAA on that timescale. In favour of giving the earlier slot to BA are the considerations that the earlier delays have increased the political 'visibility' of this issue, and that further delay might lead to the loss of senior managers essential to the Company's continuing commercial success. You will recall the severe criticism of the Government when the previous Transport Secretary announced postponement in March, and the general scepticism about the reasons given for that postponement.

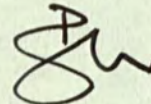
OVERALL BALANCE OF THE ARGUMENTS

7. City opinion is clear that privatisation of BA cannot go ahead until the question of air services capacity has been resolved. If negotiations cannot be completed successfully within the next few days, privatisation will have to be postponed at least until June 1987, subject to further consideration of the position in the light of continuing negotiations on air services capacity and BA's future financial performance. Unless the Trade and Industry Secretary takes the opportunity to argue that Rolls Royce should have precedence over BAA, BAA would then fill the January 1987 slot. Anti-trust is no longer a problem for BA. The only immediate question is the specific decision whether to allocate the January 1987 slot to BA or to BAA. Leaving aside questions about political timing and the overall evolution of the UK economy and UK financial markets, the strictly financial arguments would seem to favour waiting until June 1987 for BA: more time would be available for market preparations, the Prospectus would be based on actual rather than forecast 1986-87 results, and some credit could be secured from evidence of renewed traffic growth if it materialises. In the case of BAA,

by contrast, there are no reasons to expect higher proceeds in June than in January. But Ministers may nonetheless feel that political and managerial considerations in favour of privatising BA at the earliest possible date are overriding.

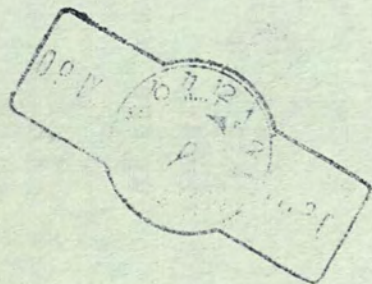
HANDLING

7. You will wish to invite the Secretary of State for Transport to introduce the discussion, and to report on progress in negotiations with the US on air services capacity. The Chancellor of the Exchequer will wish to contribute on the financial and timing aspects of the decision, while the Attorney General will need to advise on the legal considerations. The Secretary of State for Trade and Industry (not least from the standpoint of his responsibility for the privatisation of Rolls Royce), the Secretary of State for Foreign and Commonwealth Affairs and the Chancellor of the Duchy of Lancaster will all wish to contribute to the discussion.



J B UNWIN

Cabinet Office
9 September 1986



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