

(I feel we have been bounced. How can we charge that? By left? What public subsidies would a

Prime Minister? I must need? ...



CONFIDENTIAL

From the Secretary of State

The Rt Hon Leon Brittan MP
Chief Secretary to the Treasury
Treasury Chambers
London SW1

We are top priority on ...
remain a note on ...
and we must ...
write ...
in ...
for the ...
debate ...
riposte ...
Agree to Lord Cockfield's
(and Sir J King's) conclusions,
October 1982 in particular that
it is now too late to do
anything about the pay
and redundancy payments

Dear Leon,

1 Thank you for your letter of 10 September about how we handle BA's accounts for 1981/82. This letter also takes up the Prime Minister's request in the letter from her office of 6 September for more information about British Airways' redundancy payments and pension liabilities.

offers?
MUS 8/10

2 I have made no secret of the fact that I regard BA's past performance as appalling. But it does not help to make statements, as your letter of 10 September does, which are patently wrong: nor to denigrate what Sir John King has in fact achieved. You say that Sir John King should take "early and radical measures" and you claim that "overmanning [is] not now going to be forcibly attacked." The truth of the matter is that it has been. The staff has been reduced from 58,000 in August 1979 to 42,000; and Sir John King plans a further reduction to 35,000 by the year end. This is a total reduction of 40% in a very brief period of time. If you can quote me examples of similar cuts undertaken over a similar period of time by other organisations in the public sector, including the Civil Service, I should be interested to hear of them.

3 Your references to a "capital reconstruction (at the expense of the taxpayer)" and "fresh injections of capital" show a considerable misunderstanding of the position. Much of the money in question was effectively lost years ago (although the events of 1981/82 also brought heavy losses): what we are now facing is the moment of truth when the books have to agree with the facts. That this apparently requires a large injection of capital is due to the way that BA, no doubt with Treasury approval, as well as that of my Department, borrowed money from third parties with a Government guarantee. Much of this

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money has now effectively been lost. Had the Government followed the straight-forward course of enabling BA to meet the losses as and when they were incurred no injection of capital on the present scale would have been required. That it is needed on this scale is not a reflection of current losses or future needs but simply of the method of finance adopted in the past.

4 So far as John King's stewardship is concerned, in 1980/81, BA made an operating loss of £95m. In what was effectively his first year this was translated into an operating profit of £13m: and he is on course this year to achieving his target of £180m. There are few if any nationalised industries which have achieved a turnaround of this magnitude in so short a period of time.

5 The whole of the present trouble arises from interest payments and exceptional provisions. The interest payments are essentially on loans in respect of losses - either revenue losses or losses of capital. A loss is not an asset and it does not earn an income. You cannot therefore judge the current performance of a business on whether it can service the cost of debt representing past losses whatever the nature of those losses might be.

6 Nor can you judge present performance by exceptional write offs rectifying past errors and also external factors, such as Lockheed's withdrawal from civil aircraft manufacture. This is no more than recognition of what has happened. I have doubts about the treatment of some of the items - for example the method adopted for depreciating the fleet. However the treatment adopted by BA's accountants and accepted by their auditors is in accordance with standard accounting practice - or at least one interpretation of it - and we are in no position to demand that BA should be less "prudent" in their accounting than their auditors have agreed. The same is true of the massive redundancy payments - I refer later to the calculation of the amounts - as these represent the cost of putting right excessive overmanning inherited from the past. Again I personally think it is wrong to charge the whole amount in the 1981/82 accounts although many of the redundancies do not occur until 1982/83. But once again - and for the same reasons - it is difficult to be more royalist than the auditors.

But it should not have occurred

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7 What BA needed - right from the beginning - was a full time executive Chairman. However good John King is, a part time nominally non-executive Chairman was not what BA needed. Most of the present management difficulties spring just from that. The right answer was for John King to go full time as executive Chairman abandoning his other commitments. I asked him; he refused. He has however already taken steps to strengthen the senior management by the appointment of a new Chief Finance Officer and I expect him to discuss with me before long certain other senior management appointments.

8 There are three specific points I need to deal with. First the pay settlement. I have no interest in defending this. I did not agree: I was not asked. I was not even told. The way it was done was a psychological error. It was dressed up to look like a 11% pay rise. In fact it is less than 5½% on an annual basis. It is considerably less than has been given on a two year basis to other loss making industries such as the miners and the railwaymen. It is comparable to the increases given to the Civil Service. The Health Service workers are now also being offered a very similar figure also over 2 years. Of course it is all wrong. But we cannot pick out BA to impose a pay freeze which we are not prepared to impose elsewhere. The offer has in any case already been made to nearly all employees in BA and has been accepted by nearly all of them. The only group where the offer has not yet been made formally is to the pilots; but there is a clear expectation that they will receive a similar offer. John King's judgement is that to try to go back on the offer would lead to an immediate and across the board strike. The cost would rapidly exceed any hoped-for savings. If this happened the only sensible course would be to close the airline down completely and finally. This would require legislation. And British Airways accounts for some 60-65% of British airline operations. It is no good threatening to do this unless we are prepared to carry out the threat. You need to ask yourself whether you are.

9 Second, the redundancy payments. Again, I was not asked. Of course the easiest way to eliminate these is not to make the redundancies. But if you want

why not
when they
are being
we have lost
so much?

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to proceed with the redundancies you have to ask yourself what are the minimum terms which will be acceptable - that is without provoking a major strike.

The terms of the special redundancy scheme, introduced in September 1981 with the object of reducing staff numbers to 43,000 by March 1982 were as follows:-

for those with less than 3 years service, a lump sum payment of 6 months salary;

for those with 3-10 years service, a lump sum payment of a year's salary;

for those with 10 years service and over, a lump sum on a sliding scale up to a maximum of 18 months salary for those with 15 years service and over.

5,000 staff left under this scheme between September 1981 and March 1982. The same terms are being offered for the latest tranche of redundancies which aim to bring numbers down to 35,000 by March 1983. If this target is achieved some 13,000 staff will have left under the special scheme at a total estimated cost of some £200 million; an average cost per head of some £15,500. (A further £25m was spent on redundancies under the old severance scheme in the early part of 1981.) This average of course disguises large variations in payments to individuals. Low-paid staff with only a short period of service - who were among the first to go under the scheme - will actually have received comparatively little. The key point in all of this to my mind is that it is a very good investment: the payback period for this latest scheme is estimated at less than 1½ years.

✓ 10 My own view is that these terms are nonetheless too generous (though some other public sector bodies - especially dockworkers and the civil service - appear to have schemes which are just as generous, and less generous payments could well make it harder to reduce BA's manpower numbers within the ambitious timescale BA have set themselves). But whether what has been done was

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right or wrong is not in issue. The question is whether we can do something different now. We have discussed this with John King. His assessment of the situation is that we could not - at least not without provoking serious industrial action which itself would frustrate the attempt to bring the airline back into profit.

11 The third point relates to pensions. Pensions for British Airways' staff are provided predominantly through the Airways Pension Scheme (APS), which began in 1948 but which dates in its present form from 1973. This is financed (in the usual way) by employer's and employees' contributions and through the scheme's investments. BA's employer contributions in 1981/82 amounted to about £70m.

12 Actuarial valuations of the scheme are carried out at intervals of not more than three years. Any deficiency revealed by these valuations is financed either through setting contributions - in practice this means employer's contributions, as the maximum rate of employees' contributions is fixed by the Trust Deed - at a level higher than would otherwise be necessary or through special deficiency payments. As a result of the 1979 valuation BA are at present paying deficiency payments of an extra £2.16m a year over twenty years. BA are proposing in addition to charge to their 1981/82 accounts a sum of about £50m for the adverse effect on the fund that they expect the next valuation of the scheme to show as a result of their large staff reductions last year and this year. The next triennial valuation is about to commence and its results should be known early next year.

13 So much for the cost to BA of the APS while it continues in being. The Trust Deed governing the scheme provides, however, that if it is discontinued BA must pay over immediately any sums necessary "to restore the solvency of the Fund" The interpretation of this "solvency guarantee" is uncertain, and BA are considering whether to seek a declaratory judgement on it.

14 We understand that the BA Board have recently concluded that the present (fully indexed) pension scheme is too costly for the airline. The freedom to take corrective action is, however, circumscribed by a clause of the Trust Deed that precludes any change that "would operate in any way to diminish or prejudicially

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affect the present or future rights of any then existing Member or pensioner". The Board are therefore proposing to leave the present scheme in force for existing employees, to close it to new entrants, and to open for staff joining the airline in future a new scheme offering less generous benefits. BA hope that some members of the present scheme might be induced by the prospect of lower contributions to transfer voluntarily to the new scheme. This change will require careful presentation to BA's employees, and the Board will not be announcing it until they have worked out the full details in the next few months.

15 Meanwhile we need take no quick decisions here. BA have now accepted a rewording of their report and accounts that omits controversial or embarrassing references to previous liabilities; the new text has been agreed between your officials and mine. We shall need to revert to the subject before privatisation, and then we shall have to ensure that anything BA ask us to agree to is compatible with the decisions we have yet to take on civil service pensions: we shall therefore need to make clear to BA that the civil service solution, when it emerges, should limit our liability so far as BA is concerned.

16 On the subject of BA's corporate plan there is no disagreement between us that we need something more rigorous than GP10. John King has now just sent us a new financial plan covering the next five years, which reflects BA's latest decisions on route withdrawals and on manpower reductions. We have sent the plan over to your officials. We have also sent the plan to Hill Samuel to assist them in their assessment of BA's prospects for privatisation, which we have asked them to undertake urgently.

17 To sum up we face an inevitable dilemma. In the private sector British Airways would have gone bankrupt as did Rolls Royce and Laker. The problems of insolvency would then have been solved automatically. Redundancy payments would have been limited to the statutory amounts, the pension fund would have been dissolved, the Treasury would have had to pay off the banks whose loans it had guaranteed. The liquidator would have been able to sell off the business as a going concern, free of all obligations, as happened with Rolls Royce Motors. But if we want to keep the existing British Airways in business - and my legal advice is that it would require legislation to alter this position - then we are

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at the mercy of those in a position to exert pressure on us - the staff who demand their redundancy payments, and the maintenance of their entrenched pension rights and the unsecured creditors who demand payment of their debts. I doubt whether in political terms legislation to secure the insolvency solution is really a practicable option. If you have a different view I would be glad to know. But unless we do decide to go down that route, it is then a matter of commercial judgement what are the terms which enable you to buy off your problems. I do not always agree with John King but I believe that so far as this is concerned his judgement is broadly right.

18 I hope therefore, in conclusion, that you will now feel able to agree to the comfort letter which BA has asked for. If you can agree to this, I would propose to make the letter subject to the following conditions. First, the assurance should be, as you suggest, limited to one year only - though of course if we have not by next year done anything about a capital reconstruction we must be prepared for BA to ask for a further comfort letter then. Second, I should tell John King that he must make a determined effort to complete the necessary senior management changes at the earliest possible moment. Third, he should be told to press ahead with the planned staff redundancies to 35,000 with the aim of completing these by the March deadline he has set himself. Finally, he should be quite clear that our letter of comfort implies no Government commitment to any particular level of capital reconstruction.

19 We must also consider our public stance when the accounts reach the press. We should first, I suggest, point out that the content of the accounts is entirely a matter for the BA Board and their auditors. We can also point to the fact that, as I have explained at the beginning of this letter, the extraordinary items largely reflect past mismanagement and misfortunes, not present performance, on which we can point to John King's achievements over staff reductions and operating profits. If asked about a capital reconstruction we should say that the Government have not yet accepted any commitment in this regard and we shall take our decision in the light of all relevant factors. As for privatisation, we should maintain our line that we intend to privatise BA as soon as practicable.



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20 I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours,
Arthur

LORD COCKFIELD

6.OCT.1982

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