

PRIME MINISTER

LORD KING'S MEETING WITH THE PRIME MINISTER
WEDNESDAY, 22 FEBRUARY 1984

Lord King will want to argue that British Airways should not be restructured or reduced in size in the run up to privatisation. He will point to his undoubted success in turning round the Corporation from loss to profit, and in the better performance that is being recorded across the board.

We suggest that you should congratulate him on the substantial progress made, but should be impartial concerning the resolution of the British Airways debt problem and over the route licensing questions.

The Secretary of State for Transport is thinking of a deal which would entail British Airways surrendering some of its routes in return for payments which could correct the balance sheet deficit. It is a difficult hand to play, as the routes are not the property of British Airways but are the result of a grant of licence by the CAA. The Secretary of State cannot be seen to be meddling with BA's commercial decisions. However, it would be unfortunate if you said anything which made it more difficult for Nicholas Ridley to use the debt problem if necessary to persuade BA to sell some assets and make its own contribution to a better balance sheet.

The question of route licences is under review at the moment by the CAA. Until they report the matter is sub judice, and it would be dangerous to comment on the likely outcome of the CAA review. B.Cal. and some of the other independents have made submissions, as have British Airways.

An ideal political outcome in the end would be:

- a. | some modest reduction in the number of British Airways domestic routes and associated assets;
- b. | some cash from their sale which could offset part of the costs of repairing BA's damaged balance sheet (which their trading cash flow should also help);

c. greater competition on the UK domestic routes. Experience to date has been encouraging in that where routes have been opened up to competition, the response of BA and the other airlines has been good, with fares coming down and services improving.

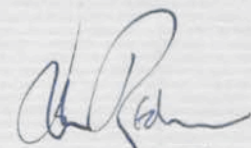
You could agree with Lord King if he pours doubt on Sir Adam Thompson's motives in wishing to reduce British Airways' dominance. It is not based on the principles of competitive free enterprise. B.Cal wishes to gain UK rights over certain international BA routes. B.Cal is in some difficulty with its South American and Nigerian routes, and is therefore looking for help rather than new competition.

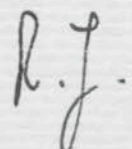
There is no chance that the vexed question of airports can be resolved before the privatisation of BA. Nicholas Ridley is right to make the easy moves first and to consider airports policy more generally in connection with their privatisation.

Lord King was right to dismiss the B.Cal initiative some months ago as a smash and grab raid. However, he has a PR problem. BA have allowed B.Cal to play David against BA's Goliath. BA should now set to work on recapturing the lost initiative to help the Government on the presentation ready for privatisation.

Our own back-benchers and the press do not fully understand that BA's principal competitors are not the UK independent airlines, but the international airlines, many of which receive hefty state subsidy. The privatisation of BA is light years away from the substitution of a private for a public monopoly. Where anti-competitive practices exist, they are the result of route licensing activity by governments, not the result of the present aviation industry configuration.

It would be unwise for you to concede that privatisation necessitates the maintenance of all BA's current routes, or prevents more competition on domestic routes in due course.


JOHN REDWOOD


ROBERT YOUNG



10 DOWNING STREET

Prime Minister

Attached is the DoT briefing for the meeting for Lord King. Also attached is a Policy Unit note which is distinctly less sympathetic to the B Cal case than Mr Ridley is urging you to be. I would take this line if the dominance of B.A. had been the result of its past commercial success - but it hasn't. It has been the result of past licensing decisions in favour of the state carrier. If we had always had two main private airlines, the distribution would not be as it is now

AT

21/2



DEPARTMENT OF TRANSPORT
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21 February 1984

Private Secretary
10 Downing Street
LONDON SW1

Dear Private Secretary

Lord King is coming to see the Prime Minister tomorrow. I enclose a brief on aspects of the preparation for privatisation.

As you know, my Secretary of State saw Lord King and his Managing Director Colin Marshall yesterday evening. Mr Ridley impressed on Lord King, who appeared to take the point, that in the light of the figures now beginning to appear, he felt increasingly that there would be no case for the Government to authorise an approach to the court for a write-down of British Airways capital as a preliminary to privatisation. Such an approach would be bound to be criticised in Parliament. It is still premature to decide whether (and if so, how much) the flotation should be carried out in a way that would enable part of the proceeds of sale to improve the debt:equity ratio in British Airways balance sheet, but Mr Ridley re-emphasised that he looked to the airline to do everything feasible to improve their balance sheet by their own efforts including revaluation of assets, and sale of profitable assets. It would be helpful if the Prime Minister could endorse this message.

On the pressure by BCal and other independent airlines for routes to be taken away from British Airways before privatisation, the Prime Minister will recall that Mr Ridley has asked the Civil Aviation Authority to assess the implications for competition and the sound development of the British airline industry of the privatisation of British Airways. Their report is not due until July, so

the issue is for the time being in suspense. Lord King may urge on the Prime Minister, as he did on Mr Ridley, that British Airways should not suffer any loss of routes. Mr Ridley took the line that the remaining issues over privatisation, including both the question of a financial reconstruction and of fair competition, had overall to be acceptable to Parliament. British Airways should not dig themselves into an entrenched position in advance of the CAA's report and recommendations. The Government would need to look at the position as a whole when these recommendations were received. The Prime Minister may like to endorse what Mr Ridley said, and certainly not to give any commitments on routes before the CAA report has been received.

Yours sincerely

Andrew Melville

for

MISS DINAH NICHOLS
Private Secretary



BRIEF FOR THE PRIME MINISTER'S MEETING WITH LORD KING, CHAIRMAN OF BRITISH AIRWAYS, 22 FEBRUARY 1984

1 A note on the main issues follows the "line to take".

Line to take

2 The Prime Minister might like to take the following line with Lord King:-

(a) Recent results

BA are to be congratulated on their dramatic return to profitability.

(b) Routes (paragraphs 5-8)

BA must recognise the political pressure on the Government to reduce BA's dominance before privatisation. The Government will have to give full weight to the Civil Aviation Authority's recommendations when they complete their review in July.

(if raised) (c) London-Riyadh service (paragraph 9)

This is a new route and does not prejudice the CAA's or the Government's decisions over route transfers. As there is likely to be an appeal the Riyadh decision must be treated as sub judice.

(d) Balance sheet (paragraphs 10 and 11)

BA must do all they can (including revaluation of assets, profitable disposals, maximising bottom line profit and repayment of borrowings) to restore their balance sheet to viability: they should not rely on a capital reconstruction facilitated by the Government.

(if raised) (e) Pay

BA were right to aim for a two-year pay deal, but their offer was on the high side. We are glad BA are determined not to increase the offer and to withstand current strike threats from engineers and cabin crew.

(if raised) (f) Pensions

BA are to be congratulated on their ingenious proposals for closing the present fully index-linked pension scheme to new entrants and for inducing its members to transfer to the new, less costly scheme.



Background

3 Following E(DL)'s decision on 24 November 1983, Mr Ridley told Parliament on 12 December that the Government would vest the British Airways Board's business in British Airways Plc on 1 April 1984 with a view to a flotation of the airline, based on results for the half-year to 30 September 1984, in early 1985, soon after BT. Preparations for vesting are now well advanced; and work is also proceeding, in co-operation with BA, on preparations for the flotation.

The main issues

4 There are two main areas of difficulty that may arise at the meeting:-

- (a) BA's routes; and
- (b) BA's balance sheet.

Routes

and

5 This is a difficult/controversial subject. The independent airlines, notably British Caledonian (B Cal), have argued that BA is too dominant and that more competition should be introduced into the airline industry before BA is privatised. B Cal have pressed publicly for the transfer of some of BA's routes together with the related assets (for which they have said they will pay). The independent airlines' case has attracted considerable support, not least among Government backbenchers.

6 In response to this pressure Mr Ridley announced during his statement in December on British Airways' privatisation that he was asking the CAA to advise him on the implications of ^{BA}privatisation for competition and the sound development of the British airline industry. The CAA decided the best way of responding was to initiate a review of its licensing policy and to that end has begun a process of consultation with the industry and other interests. The Authority is being asked to give advice and recommendations to the Secretary of State well before BA is privatised. He has been set a target date of 16 July. It is too early to forecast the outcome.

7 BA's counter-arguments - and they have recently put these to the CAA in their contribution to the review - are -

- (a) that privatisation is irrelevant to the question of competition: the independent airlines' concern springs not from privatisation but from their recognition, in the new efficient and profitable BA, of a formidable competitor;
- (b) that it would be very unfair to BA and their staff to penalise them for their turnaround by docking their routes;



- (c) that giving up routes will damage the prospects for privatisation;
- (d) that BA already faces sufficient competition, both on domestic services and, from foreign airlines, on international routes; and
- (e) that to substitute B Cal for BA on various international routes, as B Cal wish, will not increase competition at all.

8 Mr Ridley discussed all this with Lord King on Monday evening 20 February, reiterating the political case for doing something to meet the criticism of BA's dominant position and urging Lord King again to consider offering some voluntary route transfers to B Cal.

9 Lord King is particularly incensed at the CAA's recent decision to license B Cal, rather than BA, to fly the new route between London and Riyadh in Saudi Arabia. The decision is subject to appeal to Mr Ridley, and BA are also believed to be considering taking the issue to the courts on the grounds that the CAA have exceeded their statutory powers.

Balance sheet

10 Hitherto it has seemed that BA's large negative reserves and massive debt will make it difficult to privatise them in the near future without some sort of capital reconstruction, if only by letting them retain some of the proceeds of sale in order to restore their debt:equity ratio to viability. Obviously, however, a capital reconstruction facilitated by the Government will only aggravate the independent airlines' criticisms of BA's unfair dominance of the market.

11 Lately BA have made good profits (estimated by them at some £280m before tax and interest for 1983/84) and have thereby begun to improve their balance sheet themselves. But if there is to be hope of avoiding the need for Government help completely, they will have to do a lot more - eg revaluation of assets, profitable disposals, avoiding unnecessary capital expenditure, maximising repayments of borrowings. As a first step, Mr Ridley has told Lord King that he considers that an approach to the Court by British Airways Plc for a write-down of capital (which E(DL) thought would be criticised in Parliament as a device) must and can now be avoided. Lord King appeared to accept this.

CAP1
Department of Transport

21 February 1984

Michael Donne looks at the main issues raised in submissions for
the Civil Aviation Authority Policy Review.

BA opposes route-shedding to independents on privatisation

ANY TRANSFER of routes from British Airways to British Caledonian Airways and other independent airlines would seriously jeopardise the successful privatisation of BA, probably driving would-be investors away.

This point is made strongly by BA in its detailed submission to the Civil Aviation Authority's review of civil aviation policy, published yesterday. The review is being conducted urgently by the authority at the request of Mr Nicholas Ridley, Secretary for Transport.

B-Cal is asking for a substantial transfer of routes and aircraft from BA to the independents (in return for cash payment which would be in excess of £200m), so as to improve the independents' competitive position vis-a-vis the state airline.

BA, in reply, believes that this would be disastrous to potential investors on privatisation of the airline, and would in effect be useless, since it would dilute the overall UK air transport effort, which should be directed to meeting foreign airline competition.

The emphasis that both BA and B-Cal put in their submissions on the routes transfer issue mean that it now becomes one of the central issues, if not the dominant one, in the policy review, and is bound to

influence the CAA's own attitudes in settling future route licensing policy.

Routes transfers are also bound to become a significant political issue over the coming months.

BCAL Reorganisation of routes urged

"ONLY A substantial re-organisation of routes to strengthen the networks of Britain's private sector airlines will improve competition" in the UK civil aviation industry, according to the independent British Caledonian, Britain's second largest scheduled airline.

In its submission B-Cal claims that reorganisation would ensure that the independents, together with British Airways, could compete with foreign airlines as effectively and profitably as possible.

B-Cal believes that the opportunity for such changes offered by the impending privatisation of British Airways is unique. "Privatisation is a watershed, because it will result in important changes to the dominant organisation in the industry, and will affect all others."

B-Cal argues that the civil aviation structure in the UK is out of balance—in terms of air-

line strengths and airports.

Since 1971, 14 airlines have failed in Britain, B-Cal is the sole survivor of independents which sought to operate long-haul scheduled services.

The imbalance between the size of BA and the smaller independents cannot be altered by market forces alone, and it requires Government action to achieve a realignment.

The airports problem stems from the fact that Heathrow handles 27.1m scheduled passengers a year, while Gatwick handles only 5.1m (the rest of Gatwick's 12.5m annual traffic is mainly non-scheduled and charter traffic).

"There is a clear need to reinforce the Gatwick policy and enhance its development for scheduled services. The target should be to develop Gatwick to the point where there is indifference among foreign operators as to the London airport they serve," says B-Cal.

To achieve this, airline restructuring through route transfers from BA to B-Cal and the other independents should start soon. "It is clear that airline restructuring cannot be divorced from issues of airport policy and capacity."

B-Cal says the absence of competition is not in the interests of users or of sound development. In a thinly-disguised attack on BA, B-Cal goes on: "Among the risks of over-concentration of international scheduled services in one large-scale enterprise is the likelihood, unless continuously challenged, of periods of management inertia, lack of innovation of new products, absence of vigour in development of new services and an ability to mask inefficiency."

"All this is compounded by a complacency implicit in the knowledge of being irreplaceable. However capable management is, it works better when effectively challenged."

B-Cal claims that it is the only airline able to compete with BA comprehensively. "If the object of policy is to enhance competition among UK airlines, there must be a reallocation of existing route opportunities from BA to B-Cal. Privatisation accentuates the long-standing need for a re-structure."

It warns that privatisation will strengthen BA "because it will be born again on a very healthy financial base with regard to debt capacity, exchange rate guarantees and repayment of state investment."

BCal has also submitted a detailed assessment of BA routes that ought to be transferred to it, and an analysis of the likely effects on both airlines. Because of the highly sensitive nature of this information, BCal has requested secrecy.

BCal is believed to be suggesting that up to one-third of BA's routes, covering well over 3m passengers a year, ought to be transferred to BCal and other independent airlines and that most of the new traffic ought to be flown in and out of Gatwick rather than Heathrow.

This puts the transfer of routes onto a much higher level than a "dash and grab raid," as it was originally described by Lord King, chairman of BA, and makes it seem more like dismemberment of BA.

BRITISH AIRWAYS Cuts in market share rejected

CUTS IN British Airways' route structure, with transfers of routes and aircraft to the independent airlines, would cast doubt on the airline's future among potential investors, and impede progress towards a successful privatisation of the state airline.

This is one of the key points in BA's counter-attack to the BCal bid for some of its routes, contained in BA's submission.

BA declares that it is convinced there is no case for reducing its present share of international or domestic air markets.

The truth, it claims, is that there is no international market of any significance in which BA has a dominant share.

Fares, capacity and service standards, says BA, are dictated by competition from other international airlines.

"There is a major fallacy in the argument that to transfer routes from one British airline to another would create more competition."

The competition, it stresses, comes from the foreign airlines, which the UK airline industry should be aimed at beating.

"A prime requirement for any airline is that the route network for which, having been designated and licensed, it plans its resources (aircraft, staff, ground equipment, buildings) is and remains, as far as possible, the route network it is allowed to fly.

"Without reasonable security of tenure, investment by an airline, and hence investment in an airline, would involve great risk.

"Investors, would, therefore, require a higher level of return, and the cost burden on the airline would be increased. This would have to be passed to passengers in the form of higher fares and/or in the case of international services, would put UK airlines in a very unfavourable position against

foreign competitors, thus making profits impossible and continuing investment capital unavailable."

BA says there are "overwhelming economic and practical arguments against any transfer of British Airways international routes to another airline."

BA argues that:
● To transfer routes from Heathrow to Gatwick reduces the UK market share of the premier airport generally and thus the entire UK competitive position.

● Permitting foreign airlines to fly from Heathrow, while the UK airline flies from Gatwick or Stansted, would be of disadvantage to the UK and would reduce its market share.

● Even if the foreign airline could be persuaded to transfer its parallel service to Gatwick, the range of points served from Heathrow would be reduced and interline (connecting) traffic lost.

● Gatwick's single runway is saturated at peak commercial times on some days of the week.

● Resources would be wasted or not used to their optimum advantage.

BA claims that it would be ironic, "not to say unfair, if BA were now to be penalised for its increased efficiency."

"Why should a privatised British Airways be in a better position to act in an anti-competitive manner than a state-owned British Airways with the backing of the Treasury?"

"The real reason why BA is now a greater force to be reckoned with, is that pressures of the market place have already forced it to achieve cost and performance efficiency that puts it very high in the international league.

"It would be a poor reward for BA and its staff if the consequence of its efforts were to be the arbitrary removal of a share of its business."

It is also BA's belief that there are no valid reasons for structural changes in the British air transport industry.

BRITISH ATLANTIC 'Competition absent'

BRITISH Atlantic Airways, the newly created airline which wants to operate a UK-New York service, argues in its submission that "effective competition is conspicuous by its absence on the UK's international air services."

It says the authority should stress to the Secretary of State the urgent need for a revision of the UK's international air services agreements with the U.S. and other countries.

BCal seeks more of BA's routes

BY MICHAEL DONNE, AEROSPACE CORRESPONDENT

BRITISH CALEDONIAN, the independent airline, is believed to be suggesting to the Government that up to a third of British Airways' routes should be transferred to the independent sector on privatisation of the state airline.

This goes much further than the original £200m plan for a transfer of routes and equipment originally proposed by BCal months ago.

It is bound to generate a fight between the two airlines and effectively makes the BCal plan a political factor in the aviation policy review.

This is being conducted urgently by the Civil Aviation

Authority at the request of Mr Nicholas Ridley, Transport Secretary. Submissions by more than a score of airlines and other bodies had been received by the authority by late last night, including those from BA and BCal.

Both BA and BCal have made route transfers a major item in their submissions. BCal has asked for details of the proposed route transfers to be kept secret at this stage but it is understood it has gone much further than originally thought likely.

Its overall objective would be to transfer up to about a third of BA's routes to the independents. Of these about a

half in turn would go to BCal itself and a half to other independents.

The details remain confidential within the authority. The rest of the BCal submission, however, is likely to be published today with BA's own submission. Late yesterday neither side knew what the other was proposing.

BA, however, is expected to argue that though such transfers might strengthen BCal they would weaken BA and do nothing to improve the overall competitive capability of the UK air transport industry.

In BA's view the main task is to strengthen the entire UK airline industry to meet foreign

competition and that any route licensing review should aim to achieve that. To carve bits and pieces out of one UK airline to favour another would be disastrously damaging and achieve nothing.

From the authority's point of view the fact that the two airlines have chosen the arena of the policy review to battle over route transfers does little to help a calm appraisal of overall civil aviation needs.

While many other ideas are advanced in the two airlines' submissions, including views on airports policy and route licensing, the entire review is bound to be clouded by the route transfers issue.

CONFIDENTIAL

Copy
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From the Group Director
Economic Regulation

Mr H M G Stevens
Department of Transport
1 Marsham Street
London SW1

13 February 1984

Dear Handley,

LONDON - RIYADH ETC

The Authority has now concluded its hearing of the applications from British Airways to serve Riyadh and from British Caledonian to serve Riyadh and certain points in the Gulf. Both applicants stressed the importance of avoiding delay in the start of a Riyadh service by a British airline and I am therefore writing now in confidence to tell you and the parties to the case that the Authority has decided to grant British Caledonian's application, with one modification to which I shall return later, so that you can put in hand the necessary steps to secure access for British Caledonian to Riyadh at an adequate frequency.

It will be helpful to you if I give an outline of our reasoning. The full and definitive statement of our reasons will appear in our formal decision document in the usual way but since this letter may be held to constitute notification in writing of the Authority's decision of the case for purposes of Regulation 20(8)(a) of the Civil Aviation Authority Regulations 1982, it should specify the decision date. The formal decision document will be ready not later than 13 March 1984, and the decision date is hereby specified to be 16 March 1984. It is of course clearly understood that, if British Caledonian starts its service while the matter remains under appeal, it will be at their own risk. This letter also sets out our advice on certain bilateral matters.

The Authority considered the applications within the framework of its duties under the Civil Aviation Act 1982 and its own 1981 Statement of Policies. It concluded that both applicants were able and likely to provide the public with a high standard of service both in the air and on the ground and that both would be well fitted to compete effectively against other airlines, noting in this connection that Section 68(1) of the Act relates to British airlines in the plural and is of a general character not restricted to any individual route.

The Authority found that the reasonable interests of users would be furthered if more than one British airline operated

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services to Saudi Arabia. Although the fact that they would be serving different cities must limit the scope for direct competition between them, indirect competition was likely to be substantial and beneficial. In particular each airline will seek to maximise its traffic so as to justify the retention or expansion of frequencies, revenue and profit. Users will gain from the enhanced service and wider range of choice.

Users will benefit particularly from the introduction of non-stop services between Gatwick and Saudi Arabia; this will widen the choice of points of departure and interline connections, especially single airline services to oil-related gateways in the United States which are better served by British carriers from Gatwick than from Heathrow. From an airports policy point of view a service to Saudi Arabia will make a significant contribution to the standing and competitive attraction of Gatwick, going well beyond the simple benefit to Heathrow of a reduction in frequencies there, and there is no reason to suppose that the use of Gatwick will lead to a lower United Kingdom market share.

In considering the impact of its decision on British Airways' existing services the Authority had to consider under Section 68(2) the reduction in earnings that might result both from diversion of traffic and from an imposed reduction of frequencies on its routes to Jeddah and Dhahran; it did not have to consider in this context any loss of expectation with respect to Riyadh. The impact attributable to diversion will depend in some part on the competitive attraction of British Airways' services relative to British Caledonian's while any reduction in frequency will depend on the outcome of negotiations. Exact quantification is impossible while the underlying assumptions remain uncertain. One thing however is abundantly clear: whatever happens, British Airways' services will remain handsomely profitable in terms of both net operating revenue and operating ratio.

It is of course likely that the designation of British Caledonian to serve Riyadh will result in aggregate in higher costs and possibly in lower revenues than if all points in Saudi Arabia were served by one airline. Because of the uncertainties I refer to above, the actual cost to the United Kingdom of licensing a second carrier is difficult to estimate with precision but it is likely to be well within the limits that result from aggregating the separate projections of the two airlines. British Caledonian's projections of traffic, market share and profitability seem to be particularly conservative and we would expect them to do better. This "cost" however has to be seen as the price which the United Kingdom is willing to pay for the benefits of having more than one airline on international routes, with all that this implies in terms of a healthy and competitive industry and the maximisation of consumer benefit.

13 February 1984

An important element in the Authority's reasoning did indeed relate to the competitive structure and sound development of the industry. In my consultative letter of 19 December 1983 I observed that the Edwards Committee had recommended, and all subsequent Governments have accepted, that the country and the public are better served by having a number of profitable and keenly competitive airlines than by depending on a single monopoly carrier, and this must be true whether or not the airlines can compete directly with each other on long-haul scheduled services. I went on to say that the Authority believes that the national interest continues to be best served by this policy, which implies the continuation and, if necessary, the expansion of opportunities for other airlines. The present case relates to a city not previously served by a British airline and therefore does not raise questions of substitution or of direct competition on the same sector: the decision does not therefore prejudge specific issues that have been raised in the current policy review. Where a profitable new point does become available however - and this is a relatively rare occurrence - considerations of competitive balance must come into play and these must generally operate in favour of the smaller airline if the present imbalance is not to be intensified. If one were to favour British Airways in such a case for the sort of reasons that British Airways itself advanced - competitive strength, world-wide sales network, Heathrow base, knowledge of the country and the likelihood of smoother bilateral arrangements - one would really be saying that airlines other than British Airways could have little or no hope of gaining access to major international opportunities in the ordinary course of events. This is a proposition that the Authority is not ready to accept. In our view, where other conditions are satisfied, the sound development of the industry requires the licensing of an airline other than British Airways on at least a high proportion of the new routes that become available if the industry's competitive balance is to become healthier than it has been hitherto.

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Another important element in our reasoning relates to the number of frequencies that should be operated. In our view the level of frequency to be operated by British airlines to each of the three Saudi Arabian gateways should be such as to cater adequately for demand and the evidence suggests that demand on Riyadh is likely to amount to about 30% of the total. There is thus a strong case for seeking four frequencies to Riyadh, the number which both applicants applied for and which not only matches Saudia's non-stop frequencies but also in British Caledonian's case is the more justified by the smaller size of the aircraft it proposes to use (although we shall not restrict BCAL's ability to use larger aircraft in its fleet should the need and opportunity arise). The choice of British Airways to serve Riyadh would effectively have denied the United Kingdom any further opportunity to press for adequate opportunities for a British airline properly to serve the market demand.

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13 February 1984

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British Airways' high-handed action in agreeing with Saudia to limit its frequencies to two a week makes your task more difficult and is to be deplored.

A large part of British Airways' objections to British Caledonian turned on bilateral matters. British Airways sought to persuade us that there was little likelihood of the Saudi authorities' agreeing to accept British Caledonian's designation but we saw no reason to reach any different conclusion to that implicit in the Department's advice, viz that the outcome cannot be a foregone conclusion and we shall only find out what the Saudi authorities will agree to by asking them.

The one respect in which we have not granted the application in the terms applied for relates to the fifth frequency in year three. We wish to see first how the market evolves and how the bilateral arrangements go.

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It seems to us that the addition of Riyadh to the route schedule suits the purposes of the Saudi authorities and is not something we should have to pay for but, insofar as we are asking them to suit us by accepting a second airline (although the agreement provides for it) and giving it combination rights beyond the new point to the Gulf, the opportunity will arise for a price to be asked. The United Kingdom should not be willing to pay through the nose or accept long delay. In the last analysis we should not settle for less than British Airways secured - two to Riyadh out of a total of twelve - and we should not trade away our place in the second tranche as originally described: but obviously we hope you will do better. If however the Saudi authorities say that in no circumstances whatever will they accept a second British airline or they demand too outrageous a price, the Authority would wish to be consulted as to the options that will then be available.

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As to the Gulf points, the Authority has decided to grant British Caledonian's application in the terms applied for. The effect on British Airways' services to Rawalpindi and Australia is likely to be marginal so far as traffic diversion is concerned. Much will of course depend upon your obtaining the necessary rights from Saudi Arabia and we do not suggest that a substantial price should be paid for them. There is everything to be said for British Caledonian's continuing to deal directly with the Gulf authorities as hitherto. If it seemed that the entry of British Caledonian to these markets was going to lead to the reopening of existing arrangements in a significant way, this too would no doubt become a matter for further consultation.

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13 February 1984

The Authority will announce its decision in a press statement tomorrow. The parts of this letter marked "confidential" will not of course be disclosed.

I am copying this letter to Colin Marshall and Alastair Pugh, whose attention I would draw to Section 18 of the Official Secrets Act 1982 so far as the information marked "confidential" in this letter is concerned; the wrongful communication of this information may result in prosecution under Section 2 of the Official Secrets Act 1911.

We wish you every success in any negotiations that may ensue. I am sure that your efforts will be assisted if, for the time being, our two airlines refrain from further dealings with Saudia or the Saudi authorities.

Yours sincerely

Ray Colegate

R Colegate

collected Power in our hands

Some more different industries

transfer of Profit & wealth

from BA. without further

compensation.

American

Foreign savings

to CAL. go to market & not BA