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Privatisation of British Airways: Its Management and Politics 1982-1987

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KYOHEI SHIBATA**

Introduction

This paper aims at describing the course of events concerning British Airways plc from 1982 to February 1987. The period was chosen to provide a picture of how a state-owned air transportation company, envisaging privatisation and increase of competition, was reshuffled, managed, and prepared for flotation.

In 1993, European air transportation was, at least nominally, liberalised. Airlines are now allowed to set fares as they wish and to start or cease service on routes as they prefer. As is well known, airline deregulation originated in the Airline Deregulation Act of 1978 in the United States. The next year, Congress adopted the International Air Transportation Competition Act of 1979, and the U.S. government set out a policy of international deregulation, especially in regard to the Western industrialised countries. This policy has caused and still is causing deep repercussions among the nations but response differs from one to another. In the Far East, for example, Japan responded with a multi-airline policy which ended the monopoly of Japan Air Lines in the international scheduled service, although a tight regulation on aviation persists to date.

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Europe reacted differently. We find here three characteristics. First, the American deregulation was largely taken as a model to be followed. While the Treaty of Rome called for competition in the single market to occur, Europe had no country with liberal domestic air transportation. The only precedent was the U.S. Thus the American experience was taken in Europe (or at least in Britain) as a model showing how fares can be low if left to market forces.[1]

Secondly, as a result of this, lower fares were much more emphasised than deregulation itself. One result of this was anticipation of lower fares prior to deregulation in several instances.

Thirdly, international deregulation was promoted without in association with domestic deregulation, or rather, it was advocated by the countries that were liberalising domestic aviation. In the EC, deregulation of air transportation did not only mean domestic laissez-faire within each member country but international deregulation involving more than ten countries. In this aspect the European experience stands unique. Some member countries were prepared for deregulation while others were not. The British government under Prime Minister Thatcher was one of the most deregulation-oriented within the EC. In the Council of Ministers in charge of transportation, successive British ministers continuously advocated deregulation of air transport services. The privatisation of BA was pursued in parallel with this policy.

One question, then, is why the British were eager to promote it? The answer is, arguably, multi-fold. One explanation is that this suited the British traditional inclination toward free trade and mercantilism. In the field of aviation, Laker Airways had already shown that independent international operation at cut-prices was in the interest of the consumers and, therefore, feasible.

Another explanation is that the British were in a position to feel the wind of the American deregulation the most. The traffic between UK and the U.S. was the largest in transatlantic aviation (it has been, and is, the largest in international aviation too), which made the British public recognise and lament the comparatively expensive prices of European air travel. This derived also from the fact that Britain is an island situated between the U.S. and the European continent, which makes it far more natural for people to fly when going abroad, either for business or for holiday, than their European neighbours.

[1] In a spate of literature on the topic, air fares in Europe, both domestic and international, were always put in comparison with American domestic fares or transatlantic fares. See for example: Sean D. Barrett, *Flying High: Airline Prices and European Regulation*, Adam Smith Institute, published by Avebury, 1987.

However, these historico-geographical factors would not have wrought changes unless a particular government found it advantageous for it to pursue a particular policy. And this policy was part of a wider set of policies. To put it otherwise, the course of privatisation of BA should be analysed in the broader context of the then government's ideological, financial, political, and diplomatic concerns.

The set of policies of the British government, so far as the aviation was concerned, consisted of several ingredients. One was privatisation. A wide range of state organisations related to aviation were transferred to the private sector. In the field of manufacturing, British Aerospace (air-frame), Rolls-Royce (engine), and Royal Ordnance Factories (weaponry) became candidates of privatisation. In air transport, not only BA but also the British Airport Authority, an airport operator, were put up for sale. Very roughly speaking, the ideological concern here was, as in the other industries; promotion of competition and efficiency. The financial concern was to cut government expenditure. And the political concern was, as argued later, to win elections.

The second ingredient was to develop local economies. The British policy of air transport liberalisation was closely related to this policy. Its domestic deregulation, as well as expansion of destinations especially to Europe, was mostly concerned with local airports such as, for example, Manchester and Birmingham. No doubt political concern was central here.

The third was to enlarge the country's overall capacity and competitiveness in the field of aviation. The constructions of new terminals at Heathrow, London Dockland Airport (Stolport), and, later, Stansted, were aimed at maintaining the position of London as the biggest gateway to Europe. Also, the British government welcomed the rise of smaller independent carriers prepared to offer lower fares.

These three ingredients, then, provided the British government with confidence that the country would benefit, probably the most, from the air transport deregulation in Europe. Thus the UK voiced opposition against the tight regulation of air transport in Europe. This attitude was bound to be welcomed by the people but, more importantly, air transportation was one subject of negotiation at the EC level on which the British government could adopt a more liberal stance than its fellow members, and allowed it to bargain or offset some other issues UK held on defense, such as road haulage.

The above observation, however superficial, raises yet another question. That is, whether a country can promote liberalisation of international air transport without deregulating its domestic market. The cases of the U.S. and UK seem to suggest a negative answer. Essentially, regulation of air transportation consists of dictating who serves where with how much capacity, at how much costs, and for which price. A complete deregulation aims to leave operators to decide all these factors.

Apparently, however, such a policy reversal cannot take place without being associated with radical change in the domestic regulation. This suggests, in turn, that countries with large domestic air transport networks may find the change more formidable than those without. It is no coincidence that the member countries of the EC with relatively large domestic air transport networks, such as France, Italy, Germany; and Scandinavian nations, adopted protective attitudes. By the same token, it is also no wonder that such countries as Belgium, the Netherlands, Ireland, and, although not a member, Switzerland, each having relatively small domestic networks but airlines with extensive international networks, the so-called "merchant airlines", were prepared to meet a deregulated environment although they would feel much less of a political need to take the initiative. In this regard, the UK was peculiar.

However, the privatisation of BA made it particularly difficult for the British government to maintain consistency. One reason lay in the discrepancy between ideological logic and political needs. On the one hand, state intervention, including state ownership, was deemed to hinder competition and efficiency. Privatisation was thought necessary because state-owned companies, including BA, were inefficient. In order to force them to gain or regain efficiency, they should be thrown into competition. Competition would be secured by deregulation. Hence privatisation and deregulation were, at least in thought, to be pursued at the same time.

On the other hand, disposal of state assets should be gainful both financially and politically. To put it otherwise, companies to be privatised had to be a good investment. Thus the state-owned companies were required to be already attractive (competitive in some way), when going public. This was the essential task for the management of BA.

The importance of BA in the British aviation industry caused other dilemmas. First, privatisation of BA would, it was argued, result in quick elimination of the smaller operators. Second, the British government could not maintain consistency in advocating international air transport deregulation. Its attitude toward the U.S. and the Far East countries was different from that toward domestic and European areas. The policy in regard to the U.S. was further complicated by a diplomatic dispute over territorial coverage of jurisdiction, which is essential to sovereignty. The underlying fact of this inconsistency was that the British government had no airline able to substitute for BA.

Due to these dilemmas and contradictions inherent in the government's policy or set of policies, and also ad-hoc incidents, the privatisation of BA followed a tremendous zig-zag course. The following pages aim to recount what difficulties the management of the company found and how it strived to overcome them.

I. 1982: Slimdown

British Airways underwent a considerable change in 1982. In February 1981, Sir John King (later Lord King of Wartnaby) was appointed to chair the board of BA. He was born in 1917, became managing director of Whitehouse Industries Ltd. in 1945, and, from 1972, chairman of Babcock International plc, an engineering firm. As his career shows, he had been mostly in the engineering business,[1] and once was offered the chairmanship of British Steel. It is also reported that he is one of the close friends of the then Prime Minister, Mrs Thatcher (later Lady Thatcher). His task was to privatise the airline, which was wholly state-owned since its formation in April 1974, as the result of merger between BOAC and BEA.

1. King's Caution Toward Privatisation Date

Many decisions made in the course of the privatisation of BA were closely related to the privatisation policy pursued by the Thatcher administration. Of course, as Civil Aviation Authority argued in its report, "the avowed aim of privatisation was the promotion of competition".[2] Although the objectives of this policy are beyond the scope of this paper, an article by Vickers & Yarrow could be mentioned, since it deals with political advantages implied in the British privatisation policy.[3] According to Vickers & Yarrow, firstly, proceeds from government-owned asset sales are not classed as borrowings in the national accounts, thus in fact reducing the PSBR (Public Sector Borrowing Requirement), and secondly, asset disposals are treated as negative government spending in the British national accounting system, therefore reducing, by a corresponding sum,

[1] Cf. *WHO'S WHO, European Business and Industry 1988-1989*, vol. 1, Munich, p. 615. As for his profile, cf. *Times* 15 July 1983, p. 12 and *FT* 7 May 1983, p. 19.

[2] Quoted in Robert Baldwin, "Privatisation and Regulation: The Case of British Airways", in J.J. Richardson (ed.), *Privatisation and Deregulation in Canada and Britain*, Dartmouth Publishing Co. Ltd., 1990, p. 97.

[3] Cf. John Vickers and George Yarrow, "Privatisation in Britain" as chapter 4 of, MaCavoy et al., *Privatisation and State-Owned Enterprises: Lessons from the United States*, Great Britain and Canada, Rochester Studies in Economics and Policy Issues, Kluwer Academic Publishers, 1989, pp. 209-245. For broader implications, David Marquand, *The Unprincipled Society: New Demands and Old Politics*, Fontana Press, 1988, chap. 3.

government expenditure.[4] These remarks may not wholly explain BA's decisions and actions in 1982, but give a view of what the government was tempted to avoid in course of its privatisation policy.

As for the date of privatisation, Iain Sproat, the then Under Secretary of State for Trade in charge of aviation, stated on various occasions that BA was to be privatised "before the next general election". Although this outright combination of political advantage and business was deemed to be his private ambition, Sproat's incessant confirmation on this matter helped greatly King's implementation of radical reforms in BA, while King himself cautiously avoided to refer to the date of privatisation. At the beginning of October 1982, it was reported that King had said in Hong Kong that the privatisation would be achieved during the then government's lifetime. On returning to Britain, he quickly denied the news.[5] Although it is likely that he did talk as reported, King clearly wanted to keep himself away from this very political issue, with an intention to act, presumably, as a middleman under irresistible and arbitrary constraint.

2. Slimdown of the Company

The measures he took during 1982 can be divided in two categories. First was a radical slimdown of the overall size of the company, both in terms of manpower and flight operation. Second was the setting up of profit consciousness, through organisational reshuffling, from top to bottom.

The slimdown scheme was first introduced in September 1981, under an appellation "survival plan", and journalists often described it as a "retrenchment program". According to this plan, the number of personnel was to be brought down from 52,300 to 43,000 by March 1983. A special severance scheme was introduced, offering extra payments to those who applied for voluntary redundancy.[6] Some 12,800 applied, and the number of employees decreased to 44,500 as of February 1982. After a major organisational restructuring in May, the management announced a plan to further cut, i.e., down to 35,000, and officially notified this intention to union leaders in September. It does not seem that further cutting was successful: as of March 1983, the company still had 37,500.

That nearly one quarter of manpower declared their willingness to leave the company was said to be reflecting the critical state of employee morale. Yet there are some counter proofs. First, when 2,000 ramp workers

[4] Vickers and Yarrow, op. cit., p. 218.

[5] Cf. *Times* 2 Oct., p. 2; *FT* 2 Oct., p. 4.

[6] Cf. *FT* 10 Feb., p. 8.

abstained from work at Terminal One of Heathrow Airport in February 10 to 11 in a dispute over longer work time and work rule changes, a number of pilots and office staff took over the job of baggage loading, allowing more than 50% of flights to take place.[7] The second counter proof may be found in the turning around of the company's Highland service, a case where simple delegation of authority resulted in higher motivation, voluntary cross-subsidisation of jobs and substantial improvement in accountability.[8] Another proof is that BA's on-time performance was improving.[9] From a business administration point of view, it must be of particular interest to know how the severance scheme was operated and what category of employees (age, job, union affiliation, experience, etc.) left the company in this period.

Annual reports of BA show the breakdown of manpower. Yet grouping differs from one year to another between the periods 1981-82, 1982-83, so that precise and direct comparison is impossible. However, it is almost certain that the most affected were those who were not directly engaged in flight and maintenance operations.[10]

As for flight operations, unprofitable routes were being abandoned and capacity would be reviewed and altered, in accordance with setting up of profit-centre structure at the beginning of May. An implication is that the Civil Aviation Authority (CAA) allowed BA to drop certain destinations, while it was allowing other airlines to compete with BA in important domestic markets.[11] The most hit were shuttle routes between London and Glasgow/Edinburgh. British Midland Airways snatched one third of BA's business within a year.

As well, uneconomical planes were retired and put up for sale. By October, 22 aircraft had been sold off, bringing its fleet to 156 aircraft from 181 two years earlier. The sale included three Boeing 747s, one Boeing

[7] Cf. *FT* 10 Feb., p. 6 , 11 Feb., p. 10. This strike, led by the Transport and General Workers Union, lasted for six weeks, and blew up again in September of the next year. Cf. *Times* 12 Sept. 1983, p. 2.

[8] Cf. *ST* 25 Apr., p. 56; British Airways, *Report and Accounts 1982-83*, p. 12. For description of posterior situation, see *FT* 6 July 1985, p. 5.

[9] Cf. *Air Transport World*, June 1981, pp. 65-67; loc. cit., Mar. 1982, p. 66.

[10] Cf. *Air Transport World*, Nov. 1981, p. 23.

[11] Cf. Kenneth Button and Denis Swann, "Aviation policy in Europe", chap. 4 of Kenneth Button (ed.), *Airline Deregulation. International Experience*, David Fulton Publishers, 1991, p. 96 below. Also, Kenneth Button and Denis Swann, "European Community Airlines – Deregulation Problems", *Journal of Common Market Studies*, vol. XXVII, no. 3, p. 261.

747F,[12] three Boeing 707s, one VC10, seven Viscounts, and seven Tridents. In addition, the Royal Air Force decided to buy six Lockheed-1011-500 TriStars from BA for conversion to airborne tankers.[13] In the course, Trident fleet was cut from 39 aircraft in March 1982 to 25 in two years; all Viscounts were sold.

In parallel, a major program of aircraft purchase was taking place. In October 1978, BA ordered nineteen Boeing 757s, with eighteen more optional. The price was estimated to be £400 million. B757s were powered by Rolls-Royce RB211-535C engines, with 189-seat capacity, and aimed to replace 139/146-seat Trident Threes (BA had 25 of them) for short-haul routes. The first two 757s were to be delivered by March 1983, but due to financial constraints, BA had to arrange a lease-back agreement with Air Europe.[14]

As BA had already completed its purchase of twenty-eight Boeing 737-200s, there was certainly a fleet-standardisation taking course. As is well known, British state-owned airlines have often been submitted to a "buy British" policy.[15] But it would be premature to regard this period as a departure from this constraint, since more than half of its jumbo jets, as well as its L-1011s, and, as stated above, B757s were equipped with Rolls-Royce engines.

3. Profit Centre Structure

Organisational reshuffling which took place during 1982 was twofold. The first was a series of departure from the board, and the second setting up of profit centre structure.

The board of BA was a two level structure. The main board had six full-time executives and nine part-timers as of late 1981. Of them, one left at the end of 1981, and two in February 1982, before submission of a report

[12] Although this was the only Jumbo freighter of BA, the company continued its North-Atlantic cargo operation. Cf. *FT* 3 Mar. 1983, p. 19, 8 Jan. 1985, p. 15.

[13] The deal included hard competitive selling utilising DC10s. In fact the chairman of British Caledonian bitterly criticized the decision taken by RAF, which he regarded as an indirect and unfair injection of public money to its rival. Cf. *FT* 16 Dec., p. 8.

[14] For the purchase, see *Air Transport World*, Apr. 1983, pp. 65-66.

[15] Cf. Robert L. Thornton, *International Airlines and Politics*, Michigan International Studies no.13, reprinted by University Microfilm International, 1978, p. 103, and Richard Pryke, *The Nationalised Industries: Policies and Performance since 1968*, Martin Robertson, 1981, p. 132. The operating costs of Trident Three were 6% higher than B727-200, and those of BAC1-11, 8% higher than B737-200. Ibid.

by Price Waterhouse.[16] On the other hand, Gordon Dunlop was appointed as chief financial officer in June, a post hitherto nonexistent in the main board. The lower one, the executive management board, was composed of eleven directors. The chief executive officer (Group Managing Director) was Roy Watts, who was also a deputy chairman of the company. Of this board, at least four left in that year. The first to go was Roger Moss, finance director since 1974, who was virtually fired by King the day before the Price Waterhouse report was submitted to the company. In June, Alan Ponsford, director of public affairs retired; in the next month, chief of Intercontinental Services Division, Gerry Draper, left the post, which he had assumed less than three months earlier. A month later, Stephen Wheatcroft, director of economic development and also chairman of a subsidiary, British Airways Helicopter, announced retirement. As these departures often coincide with the period when the company's financial results were being announced, it would be of particular interest to know how King, chairman of the board, used the bad financial performance of the company as an opportunity to put pressure onto long-sitting board members.

The second reshuffling took place at the end of April, when King announced a decentralisation plan, of which primary feature was setting up profit centre structure. Under the plan, main divisions were established, each being provided with their own budget and fleet, and expected to make profit. Under the three main divisions were sub-divisions, with similar means and aims at a smaller scale.[17] To avoid unnecessary duplication,

[16] Price Waterhouse is an accounting company in the City, which was commissioned to make a report on BA in September of 1981. Although the report was to be solely prepared for, and submitted to, the main board of BA and the government, newspapers began to report that there would be a major reorganisation in the board. King might have profited from these rumours in order to reshuffle the board. Members of the main board were selected by the government.

[17] "Each division will ... produce a five-year plan for using the aircraft allotted to it and will have its own annual budget and profit and loss account. The divisions will have subsidiary profit centres designed to ensure that virtually every route makes money." *FT* 29 Apr., p. 44. Main divisions were: Intercontinental Services Division, which would deal with long-haul international flights, European Services Division, which included domestic services, and Gatwick Services Division, which would control charter operations. As of 1 May, Intercontinental Services Division was composed of Concorde, African, Caribbean, North Africa, South Asia & Australasian, and North Atlantic. Later in the year, African and Caribbean subdivisions were integrated to form Southern Routes subdivision, and North Africa and South Asia & Australasian subdivisions to form Orient Routes subdivision. European Services Division was, after some modifications, came to have six subdivisions under it at the end of 1982, namely, Shuttle subdivision (London-based domestic shuttles), Birmingham subdivision, Manchester subdivision, Scottish Highlands & Islands subdivision, Internal German Services subdivision, and

such common functions as coordinating of flight operation, computer services, and maintenance work were to be provided by central Departments.

Each general manager of subdivision was responsible for profit objectives. Although it is not clear whether they conceived these figures either as imposed norms or their own declared engagement (which is a critical factor in view of motivation), one can say that this profit centre structure aimed at an implementation of Management By Objectives, associated with delegation of authorities to a large extent. Given that BA made a turnaround that year, this MBO worked well. This suggests also that the employee morale was not necessarily bad, but rather responsive to a system which opened the way for participation and achievement. It is worthwhile to note that the management, on the other hand, was careful not to hamper the remaining employees' motivation, and extended them as much as a 14% payhike in August.[18] This idea of profit centre structure originated, apparently, from King's business experience in the private sector. As King has said: "if you take Marks and Spencer or Boots, they have a profit and loss account for every shop."[19] This statement might imply a departure from, or non-adherence to, the traditional concept of "internal subsidy" for public service routes.[20] A small step forward would lead to a concept of "yield management", which aims at making every flight profitable.[21]

4. An Overview of BA's Finance and Market Position

There is no doubt that BA was in a financially difficult period. Publication of its annual report for the year 1981-82 was unusually delayed, and when it was published in October, it revealed that the company's long-term debt was more than £1 billion and that its equity capital had negative worth. Since this translates into absolute insolvency, from the private sector's

London Provinces & Irish Routes subdivision.

[18] Cf. *ST* 15 Aug., p. 37.

[19] Quoted in *ST* 2 May, p. 60.

[20] Thornton, op. cit., pp. 41-42.

[21] Nawal K. Taneja, *The International Airline Industry: Trends, Issues & Challenges*, D.C.Heath, 1988, tr. into Japanese by Kunio Yoshida, pub. by Seizando, Tokyo, in 1989. p. 75 note; or Avishai Gil, "Air Transport Deregulation and its Implications for Flight Attendants", *International Labour Review*, vol. 129, no. 3, 1990, p. 320.

viewpoint, BA was a bankrupt company.[22] However, the company had been allowed to be in such a situation, precisely because the government, its powerful owner and sponsor, had been taking care of its balance sheet matters, in stumping capital and guaranteeing debts. Although no dividend had been paid on the state shareholding since 1979-80 period, the government had been injecting £10 million to BA in each of the preceding six financial years.[23]

Once privatised, such consistent and generous sponsorship could not be expected from any private shareholders. On the other hand, the British capital market was not familiar with airline stocks. Privatising BA was not a question of adding another airline stock to investors' portfolio, but creating a new field of investment. Therefore, BA's financial statements should appear decent and competitively attractive in regard to other industries. Furthermore, the fact that the initial subscribers would make money was not only a politically desirable outcome,[24] but also, the government would have been tempted to assure that privatised companies stood on their own feet.[25] Thus, it became almost imperative that BA be, if not a blue-chip, a healthy stock at the time of going public. The implicit fact that British government would never allow the country's largest international air carrier to liquidate, regardless of whether it was private or not, was not enough for successful privatisation.

The biggest obstacle was the company's long-term debt. All such measures to put the company into profitability as the fleet-modernisation, the massive redundancy scheme and the reorganisation of in-house structure, required further capital injections. In total, £1.5 billion was estimated to be needed. BA set out to sell its assets. In addition to the aircraft sale which was mentioned above, the properties and facilities put for sale included College of Air Training, a major training school for pilots in commercial aviation, Victoria Air-terminal, computer software, and International Aeradio plc (IAL).

IAL was involved in air timetables and maps, weather forecasting and hospital management. It was consistently profitable since its establishment in 1947, and earned £6.3m on revenues of £63.8m in 1980-81, and £9.3m on £91.6m in 1981-82. It employed about 4,500 people in more than 30 countries. BA held 99% of its shares, the remaining being in the hands of

[22] BA's financial performance for the period of 1972 to 1982 is graphically shown in *The Economist*, 23 Oct. 1982.

[23] BA paid as the dividend to the government £0.36 million in 1985-86 period, and £29.6 million in 1986-87. Cf. BA, *Report and Accounts, 1985-86, 1986-87.*

[24] Cf. Vickers and Yarrow, op. cit., p. 221.

[25] Cf. Dieter Boes, *Privatization: A Theoretical Treatment*, Oxford UP., 1992, p. 25.

various foreign airlines. As early as May, this very profitable subsidiary was put for sale through a method of tender-offer. Although the sale took place in the next year, we could already notice two fundamental factors of BA's privatisation.

First, BA had a number of "crown jewels", i.e., salable assets, which were underestimated in bookvalue but contained a potential value of sizeable gain once sold off.[26] Indeed, the book value of IAL and its related companies was slightly more than £3m. Standard Telephone and Cables plc acquired them for £60m at the end of March 1983. College of Air Training (Properties) Ltd., another subsidiary spin off, was valued at £0.8m but sold for £5m in June 1982. In this regard, compared with some cases in the American airline industry, BA was fortunate to be shielded from the danger of corporate raiding.

Secondly, although it was estimated by the Price Waterhouse report that deduction in long-term debt to the tune of £500m to £750m would be necessary to make BA viable for sale, the British government was not willing to wipe out BA's debt with public money. The reason for this reluctance was certainly political. Injection of public money would mean more expenditure, therefore risking an increase in the PSBR, an effect contradictory to the aims of the privatisation policy. Furthermore, it was doubtful whether the sale of BA shares, however successful, could be still rewarding after spending a lot to clean up the company's balance-sheet.[27] On the political level, repayment of debt with public money would immediately cause criticism about unfair and unjustifiable subsidy in an industry which the government was pushing toward increased competition.

Another fundamental factor is that, while the government did promote increase of competition, it would never hamper BA's basic competitive advantages in the marketplace, principally because it was anxious to assure a successful flotation. This contradictory policy would be a characteristic of the British government's air transportation policy toward 1987. On the other hand, since each profit centre meant to be profitable, BA would fiercely resist every threat that was likely to endanger the profitability of its routes. For example, in September 1982, BA threatened to withdraw from

[26] At the end of March, 1982, the company had 19 subsidiaries, among which 13 were operating, and 28 associated companies. Cf. British Airways, *Report and Accounts 1981/82*, notes 11, 12. As for sale of its real estates, cf. *FT* 10 Aug. 1984, p. 7.

[27] The gross proceeds for the government was £900m when privatisation finally took place in February 1987. Cf. Vickers & Yarrow, op. cit., p. 223 Table 4.5.

internal German services when the West German Finance Minister proposed to phase out the subsidy for Berlin flights.[28]

It must be mentioned that the overall profit and loss aspect of BA was not as critical as the press argued, despite the record loss for 1981-82 period to the tune of £544m. There are a number of reasons. First, the company's market share was extraordinarily high. After all, "in 1982 BA alone accounted for 65% of total UK airline output and 81% of output on scheduled services."[29] In addition to this overwhelming share in transport capacity, BA enjoyed the privileged position of the sole British scheduled carrier that flew to overseas destinations from Heathrow until 1985.[30]

Secondly, its workforce had already been slimmed down, a critical task which its American rivals would find terribly difficult to achieve. Indeed the proportion of payroll in the total operating expenditure on airline operation had already been brought down from 33.2% in 1980-81 to 31.7% in 1981-82. It continued to decrease: 29.2% in 1982-83 and 24.8% in 1983-84, a figure comparable to American "upstarts", which operated on "no-union, no-frills" basis.[31] Furthermore the 1981-82 period did record a small operating profit, i.e., £0.9m for BA Board, and £5.9m on a consolidated basis. It was largely due to the accounting policy by which the costs of the redundancy scheme for 1982-83, which was some £199m, and already included in account, that 1981-82 appeared a disastrous year.[32]

Thirdly, its fleet was being modernised, together with shortening of depreciation period for obsolescent aircraft. The writing down amounted to £208m.

[28] Cf. FT 16 Aug., p. 3, 1 Sept., p. 5. Subsequently, the new government under Helmut Kohl reversed the proposal. Cf. *FT* 19 Oct., p. 6.

[29] Baldwin, op. cit., p. 95. The share is measured by ATK, available-tonne-kilometers. In terms of passengers carried, as of 1983, BA accounted for 31%, the foreign carriers 32%, and the others 37%, still showing BA's supremacy. Cf. *FT* 20 Aug. 1984, p. 3.

[30] This privilege was considered as equivalent to a subsidy of £50 million per year. Cf. Mark Ashworth and Peter Forsyth, "British Airways: Privatisation and Airline Regulatory Policy", as chap. 8 of John Kay, Colin Mayer, and David Thompson, *Privatisation and Regulation: The UK Experience*, Clarendon Press, 1986, p. 165. In June 1985, British Midland Airways was allowed as the second British airline to launch international scheduled services out of Heathrow.

[31] For international comparison, see Rigas Doganis, *Flying Off Course: The Economics of International Airlines*, George Allen & Unwin, 1985, pp. 90-91.

[32] For a detailed analysis on BA's accounting policy in this period, see Mark Ashworth and Peter Forsyth, *Civil Aviation Policy and the Privatisation of British Airways*, IFS Report Series no. 2, The Institute for Fiscal Studies, 1984, pp. 108-112.

Finally, it was virtually guaranteed that its creditors would not resort to take forcible measures that would have been put into force had BA been a private enterprise. BA often claimed that most of its capital borrowings were contracted on commercial terms. Probably the interests were different from the Treasury's direct borrowing. But the Treasury guaranteed for a large part of its long-term debt as to principal and interest payment, as well as against exchange risk. Obviously banks extended loans to BA because it was a government-guaranteed borrower. It is doubtful whether BA could have raised capital in various currencies in 1981-82 period, as it did, if it had not been a nationalised company.[33]

It should also be borne in mind that BA covered a very wide – almost comprehensive – range of air travelling segments. As already noted, business travellers ranked BA high. For the highest layer of the market segment, BA had the unique asset of the Concorde. Budget travellers were offered a variety of discount fares that were competitively set (Apex, Saver fares, Super Savers). The holiday tour segment was covered by British Airtours Ltd., whole-plane charter subsidiary, as well as by such package tour subsidiaries as British Airways Tour Operations Ltd. and Martin Rooks & Co.Ltd., under brands of Enterprise, Sovereign, Flair and Martin Rooks. It even had a helicopter operation subsidiary, British Airways Helicopter Ltd., which flew to the North Sea oilfields.[34] Its computer reservation system, Travel Automation Services, known as *Travicom* and now as *Galileo*, was dominant in the travel booking industry in the UK. In this regard, one could even simplify the picture to say that BA was the civil aviation industry itself in the UK, not a fraction of it, and that all the independents, including charter operators, were but marginal derivatives. Its supremacy is well illustrated by its fleet; as of 1985, the airlines based in Britain had 31 B747s on service, of which 28 were operated by BA, 2 by BCal, and 1 by Virgin Atlantic Airways. No other domestic rival could afford to engage in a full-scale struggle with this empire. In conclusion, it is difficult to find any critical competitive disadvantage.

[33] BA, *Report and Accounts 1981-82*, p. 31 note 18.a. See also Ashworth and Forsyth, loc. cit., pp. 97-101.

[34] British Airways Helicopter Ltd. was sold to Robert Maxwell for £13.5m in 1986.

II. 1983: Toward Marketing-oriented Structure

1983 for BA could be regarded as a year when further steps were taken in the course King had set. Here we find six topics. First, further organizational restructuring took place under a new chief executive. Second, a series of fare adjustments was attempted in both domestic and international markets. Third, BA returned to profitability. Fourth, BA tried to protect its domestic market through court action. Fifth, a decision was taken to lease Boeing 737s. And lastly, the date and process of privatisation was contested.

1. Marketing-oriented Structure

In mid-January, it was announced that Colin Marshall was to assume the post of chief executive from the next month. Marshall, 49 years old, had spent much of his life in the international car-rental and retail-chain business (at Hertz from 1959 to 1964, at Avis from 1964 to 1981, and since 1981, at Sears Holdings). He, like King, seemed to be concerned with efficiency and competitiveness. As a result of his business experience in the U.S., he was even more marketing-oriented, saying: "I learned a lot across an enormous spectrum of US business – from Norton Simon's concept of a holding company to IT&T's approach of having a powerful head office staff."[1]

With his appointment, Roy Watts' double function as group managing director and deputy chairman was reduced to the latter. Hereafter, the day-to-day management was to be run by Marshall, and King seemed to concentrate himself on the privatisation issue, although he continued to keep tight control on the two-tier boards of BA.

Marshall was quick. As early as mid-February, he set up a top-level marketing team of five members. The team was responsible for marketing services, cargo marketing, distribution and passenger services, and research and development in marketing. Essentially, this was a staff section to devise global marketing policies, but which "the rest of the airline will be required to follow".[2] Obviously, the basic idea was a product manager system (or sometimes referred to as total marketing system), in which each product manager is responsible for budget and objective figures, plans the product,

[1] Quoted in *ST* 16 Jan., p. 53. Norton Simon and IT&T were both holders of Avis.

[2] *FT* 19 Feb., p. 3.

and coordinates the production line and sales section. It is well known that in order to run this system, organisations must have a marketing-centred structure.

On 11 July, King announced that 70 top managers were to be made redundant. Among them were three general managers of the main divisions and the head of industry affairs, also a board member. The main divisions established in the previous May were abolished and a single "Marketing Division" was established. Ten former subdivisions were reshuffled and centralised into eight "market centres" under the Marketing Division.[3] Cargo, charters and tours operations were established as "business centres", which were also under the Marketing Division, and as market centres, were separately accountable for profitability. Along with the Marketing Division was established "Operations Division" which "sold" such supporting services directly related to flight operation as cockpit and cabin crew, engineering, catering and ground works. Overhead activities such as safety, finance, human resources, etc. were charged to staff sections.[4]

Therefore, a crew who worked on a jumbo jet on the Tokyo-London route did not belong any more to Far East subdivision. They were, at least conceptually, dispatched from, or procured by, the Operations Division to Far East market centre of the Marketing Division. Thus market centres were intended to be like autonomous retail chain shops, whose function was to plan, acquire and sell the product of BA. This is a radical departure from the former structure which, after all, had been based on a traditional concept of regional division of flight personnel. More importantly, the move was associated with a stress on the product of BA being service, not merely seats. Offering service to the satisfaction of customers requires marketing-oriented attitude. Needless to say, it also requires another form of organisation. Very roughly speaking, a distinction was introduced between front stores and production line. The product manager system was built into the company.

The organisation being reconstructed as such, it is no wonder that BA proceeded to launch a major advertising campaign in April. The catch-phrase "The World's Favourite Airline" and a computer-graphical TV commercial film were works of Saatchi & Saatchi, which had been

[3] They were United Kingdom, North Europe (comprising the former Internal German subdivision), South Europe, Americas (covering the U.S., Canada and Caribbean regions as well as Concorde flights), Africa, Middle East & Indian Subcontinent, Far East, and Australia & New Zealand.

[4] Cf. BA, *Report and Accounts 1983-84*, pp. 8-9.

commissioned a year earlier. The campaign was intended to cover more than thirty countries, at a cost of £25m.[5] This marketing drive would go further toward a Corporate Image (CI) campaign in the next year, with aircraft colouring and livery changed. All these moves were not only to boost revenues but, more importantly, closely associated with the internal organisational restructuring. As is well known, a corporate image campaign requires a thorough analysis and re-positioning of the company in the industry arena, and aims at refreshing loyalty and motivation of employees while promoting a renewed image toward the outside. Although it is difficult to know whether these steps had already been programmed and put into the time-table, BA's moves could be regarded as, if not theoretical, coherent.[6]

2. Fare Adjustments

Fare adjustments took place both on international and domestic routes, although the implications for each are different.

The first implication was a temporary, promotional price-reduction to give impetus to the travel market during winter to early-summer. For example, fares for flights to Spain were reduced by 20 to 40% for the period of 1st April to 19 May.[7] Weekend flights on Irish routes were also

[5] As for the details of this campaign, cf. *FT* 14 Apr., p. 20.

[6] Saatchi & Saatchi was commissioned in place of Foote Cone and Belding, an American-owned agency, which had been in charge of advertising activities for British state-owned airline ever since the end of the Second World War. It may be worthwhile to note that we find a series of alterations in subcontractors during 1983. A catering equipment consortium set up by British companies won a contract to supply BA with disposable and reusable items in March. Cf. *FT* 15 Mar., p. 9. In the same month Bowring Group, a part of the U.S. insurance broking giant Marsh & McLennan Companies, lost the account (estimated to be £6.6m) after 60 years of service, to be replaced by the Sedgwick Group, the biggest independent British group. Cf. *FT* 17 Mar., p. 8. In August, a five-year contract was awarded to United Linen Services for overalls for BA's industrial staff. Cf. *FT* 27 Aug., p. 17. In autumn, the galley systems in to-be-leased B737s were to be supplied by C.F. Taylor Metalworkers. Cf. *FT* 12 Nov., p. 17. And S.G.Warburg, the merchant bank in charge of the sale of IAL, was switched to Lazard Brothers & Co., Ltd. cf. ST 13 Nov., p. 53, *FT* 14 Nov., p. 32. These changes in subcontractors certainly reflect the general review on BA's business relations, but also give an impression of a "contract British" policy, which Howard Phelps, the operations director of the company, confirmed later. Cf. *FT* 10 Apr. 1984, p. 9.

[7] Cf. *FT* 19 Jan., p. 8, 4 Mar., p. 7.

made cheaper during 5 February to 13 March.[8] Those who travelled to Canada in the period of 1st March to 30 April, or to the U.S. before March, could also benefit from Super Apex (Advanced Purchase Excursion) fares.[9] Despite some fares being deeply cut, these reductions were made in concert with the foreign carriers concerned, such as Iberia and Air Lingus. Indeed, the fares to the U.S. were often discussed with the other transatlantic IATA member carriers. In January, they agreed to reduce Apex fares on London-U.S. routes from £386 in the last summer to £329, and in August, to £249 after British Atlantic Airways (later Virgin Atlantic Airways) and People Express Inc. proposed to fly even more cheaply.[10]

On the other hand, BA increased prices for its first and business class by 5% in January.[11] According to a previous study jointly conducted by BA and CAA, it was suspected that there was a cross-subsidisation between fare-types.[12] The study, based on 1976-77 accounts, showed that BA lost money on its first class but earned more on normal and Ipex (Instant purchase excursion) tickets, which, from a certain viewpoint, could be judged as a discriminatory practice. Therefore this rise, however modest, might be regarded as an attempt to redress the situation.

If the fare adjustments on these international routes were set in co-ordination with the other carriers, domestic fares were not. At issue was shuttle services provided by BA on Heathrow-Glasgow/Edinburgh, Heathrow-Manchester, and Heathrow-Belfast routes. In February, BA proposed to the CAA to increase its fares from April. Heathrow-Glasgow's return would be raised to £116 from the previous £110, Manchester £88 from £81, and Belfast £116 from £106. The rivals also applied for increases.[13] British Midland Airways, which had started to compete with BA on the Glasgow route in October 1982, and on the Edinburgh route since the beginning of 1983, proposed to set its fares for both at £105, slightly higher than the previous £99.[14] BCal, which flew Gatwick-

[8] Cf. *FT* 21 Jan., p. 21. It was already agreed with Air France to reduce fares from London to French provincial destinations for winter. Cf. *FT* 16 Oct. 1982, p. 3.

[9] Cf. *FT* 31 Jan., p. 16; 11 Feb., p. 5. As for Apex and other types of cheap fares, cf. Pryke, op. cit., pp. 139-143.

[10] Cf. *FT* 14 Jan., p. 5, 18 May, p. 7, 26 Aug., p. 10.

[11] Cf. *FT* 25 Jan., p. 32.

[12] Pryke, op. cit., pp. 141-143; *The Economist* 24 Nov. 1984, p. 71 chart.

[13] Cf. *FT* 5 Feb., p. 4.

[14] Cf. *FT* 9 Mar., p. 6.

Glasgow/Edinburgh proposed £118 instead of £110.[15] CAA held a public hearing on 21 and 22 February, and announced on 8 March that it had acquiesced to all proposals but one. BA's request for Belfast return fare at £116 was refused, but CAA permitted the airline to raise it to £112.[16] Probably the reason of refusal was that it represented the highest percentage of increase (9.4%) compared with the other proposals. However, this authoritative action was not only far from deregulation, but also suggested a threat of deep disturbance within BA's internal profit system.

3. Return to Profitability

BA reported the first-half profit for 1982-83 period in October 1982. On 4 May 1983, the annual results were made public, stating the company had posted a net profit of £77.2m on consolidated basis. At the same time King had his appointment extended to another term. Despite Sproat's promises, the airline was still government-owned, and King was still reluctant to commit himself to a privatisation date, saying: "We want, above all, to see [the company] succeed. If we make it profitable, it's for the proprietor to decide whether to sell it."[17]

He insisted only that the profit should attain £250 million before BA went public. This figure, although referred to on various occasions, is not clear in origin. King might have been performing a traditional leadership role of setting a goal, or regarding this level necessary for successful privatisation. In any case, it was a very high figure, which represented around 10% of the total revenue or turnover of BA. Probably the Price Waterhouse report mentioned the figure, but it does not mean the figure was set without King's involvement, because, after all, a business consultant's job largely consists of stating what its client wants him to say with authority.

As for BA's long-term debts, the sum increased by 4.2%, from £1,010.6m to £1,053.2m. This was mainly due to an increase of the dollar-denominated portion that was not covered against exchange risk by the Treasury. This portion was calculated with actual exchange rates, so that the sum in 1981-82 report, £214.4m for $392.2m ($=£0.55), became in 1982-83 £299.1m for $444.7m ($=£0.67). In other words, this portion increased by

[15] Ibid.

[16] Ibid.

[17] Quoted in *FT* 7 May, p. 19.

slightly more than 13% in dollar-term, but measured in sterling, by nearly 40%.[18]

On the other hand, the biggest chunk of debt was comfortably covered by the Treasury against exchange risk. This portion accounted for about a half of the company's long-term debt. But the value of the dollar was fixed at approximately £0.46. Had it not been so, the amount of this portion would have been £623m instead of £523.4m in 1981-82, and £770m instead of £519.6m in 1982-83.[19]

This simple calculation suggests two facts. First, BA's financial performance was largely subject to exchange rate fluctuation, both in terms of its balance sheet as well as profit and loss account. International services divisions accounted for more than 80% of revenue, of which a substantial part was paid in US dollars. Fuel and oil, the second-largest item after payroll representing 26% of total airline operating expenditures, was also acquired in dollars.[20] Earning and spending US dollars is an indispensable element of its business. As shown in the summer of 1984, the strong dollar, and therefore weak pound, contributes to its business.[21]

Secondly, the British government was indirectly subsidising the company. The decrease in the guaranteed debt portion means that the government lost the value of foreign exchange reserve at least by £0.8m during the 1982-83 period. Moreover, all the loans and lease finances in dollar were guaranteed by The Treasury. These guarantees not only privileged BA to raise funds despite its technical insolvency, but also shielded the company to a

[18] BA, *Reports and Accounts 1982-83*, p. 45 note 18. See also, Ashworth and Forsyth, op. cit., pp. 97-99.

[19] This portion steadily decreased: £445m in 1983-84, £196m in 1984-85, £113m in 1985-86, and £89m in 1986-87. Cf. BA, *Report and Accounts, 1983-84, 1984-85, 1985-86, 1986-87.*

[20] The portion of the UK marketing centre in regard to the total airline revenue was 16.3% in 1982-83, 16.0% in 1983-84, while that of the Americas, 28.8% and 26.6% respectively. Cf. BA, *Reports and Accounts 1983-84*, p. 50 note 1b. In 1983, BA carried around 1.5m passengers between UK and USA, i.e., slightly less than 10% of all the passengers BA carried for 1983-84 period. Although "the Americas" includes the Caribbean, no doubt the U.S. was the lucrative area. Needless to say, aircraft purchases, which is the largest capital expenditure item for airlines, are made by dollar as well. BA's forward foreign exchange purchase commitments amounted to $104m at the end of Mar. 1983, and $54 at the end of Mar. 1984.

[21] Cf. Ashworth and Forsyth (1986), op. cit., p. 165.

substantial degree from a liquidity crisis arising from exchange rate fluctuations, which triggered the fall of Laker Airways.[22]

Yet, BA's profitable results were certainly a political success for the Thatcher administration, especially at the time when the general election was imminent. In this election Sproat lost his seat. Afterward, the ministerial responsibility for BA's privatisation was handed over to a newly-appointed Secretary of State for Transport, Nicholas Ridley.

4. Domestic Competition

Domestic competition became noticeable in this year and we find some effects that deregulation-oriented policy-makers would like to regard as positive.

BA was losing market share on its Highland service. The main competitor was British Midland Airways (BMA), which offered £99-return rate against BA's £110 and snatched about 30% of the market. This price differential did not change at the price increase in 1983 because BA's fare was to become £116 and that of BMA £105. One outright response would have been to reduce the fare to the same level, but it was not feasible for BA because of a particular feature of its shuttles. BA guaranteed a seat to full-fare passengers who checked in up to ten minutes before scheduled departure time, an operation requiring backup aircraft. In addition to this, in-flight payment was accepted. Even so, the flight was "no-frills", i.e., meals or drinks were not served. On the other hand, BMA flew cheaper with more amenities on board, but no backup flight was available.[23]

In many regards, these differences are strikingly similar to the fierce competition between Eastern Air Lines' shuttle service and New York Airways (NYA) in the Boston-New York-Washington area in early 1981. Eastern offered seat guarantees with backups, but no amenities. NYA, a new entrant, required prior reservation but provided more amenities at cheaper rates ($29 or $49, against $59). Seeing its market share quickly eroded, Eastern brought down the fares of some of its shuttle flights to the same level of its competitor, and distributed coupons to its passengers

[22] As for the demise of Laker Airways, see Howard Banks, *The Rise and Fall of Freddie Laker*, Faber and Faber, 1982, esp. chap. 13. Laker Airways was also subsidised in the loan related to its Airbus order. Ibid., pp. 129-130.

[23] Cf. Peter Johnson, *Airline Deregulation and New Entry: A Case Study of the London-Glasgow Route*, Working Paper no. 82, Department of Economics, University of Durham, 1987, p. 2.

which offered 50% discount on its transcontinental route. NYA responded by buying them for $15 from its passengers on board, and inviting Eastern's passengers to pick up refreshments at NYA's counter.[24]

Given the international character of the air transportation industry, the management of BA must have been knowledgeable of this precedent, which was welcomed by American administrators and consumers, but a horrifying situation for airlines. Moreover, BA's main concern was profitability of each marketing centre rather than market-share. Its decision was to introduce "frills".[25] In this "Super Shuttle", which was also introduced on the Manchester and Belfast routes, passengers were offered free breakfast, free drinks on all flights, free newspapers and seat selection. An extensive advertising campaign was launched: on 30 August, the first three inaugurating flights to Glasgow were performed by Concorde. In devising these marketing tactics, the marketing team that Marshall had set up in February played a major role.[26] As early as October, BA claimed the operation was successful and the market was recaptured.

Another domestic market worth noting is the Heathrow-Belfast route. Seemingly BA had been the sole carrier operating scheduled flights on this route. In early 1983 BMA, its main rival in Highland service, applied for the route to be serviced from autumn. The planned frequency, seven flights every weekday and four on weekends, was competitively dense and the fare was to be £105 return against BA's £112. In a CAA hearing BA said it might close the shuttle service if BMA was permitted.[27] Despite this threat CAA granted a license to BMA. Then BA skipped the usual procedure of appealing to the transport secretary (Tom King) in order to have CAA overruled, and applied directly on 25 August to the High Court for a ruling.[28] The legal challenge failed, and criticism was levelled at BA's action, which appeared as anti-competitive.[29]

[24] Cf. Kyohei Shibata, "Koku kisei kanwa ka no keiei kadai [Managerial tasks under the era of air transport deregulation]", *Journal of Economic Review* no.26, Faculty of Economics, Shinshu University, Matsumoto, Japan, 1988, p. 104; *Business Week*, 22 Sept. 1980, "A plucky challenge to Eastern's shuttle", pp. 42-44; loc. cit., 26 Jan. 1981, "Deregulation breeds an East Coast air war", p. 22.

[25] The market, largely composed of business travellers, was price-inelastic. Cf. Johnson, op. cit., pp. 1-2.

[26] Cf. *FT* 15 Apr. p. 9; BA, *Report and Accounts 1983-84*, p. 21.

[27] Cf. *Times* 24 June, p. 1.

[28] *FT* 26 Aug., pp. 5 and 10.

[29] See, for example, *FT* 26 Sept., p. 30, or *ST* 21 Aug., p. 14.

However, to promote competition was not BA's task. Its main task was to be successfully privatised, and to this end, the company should be profitable. Therefore it had reorganised itself, principally with a view to making every marketing centre profitable. Consequently, it had become profitable in the 1982-83 period, but not enough. The Belfast route was important, where BA deployed its newly-delivered B757s. BMA was undoubtedly a strong rival. It had already proved to be highly competitive in Highland markets, and applied for several routes other than Belfast.[30]

On the other hand, there had been symptoms indicating that BA could not expect favour from the administrative bodies. First, as stated above, CAA had denied to raise the fare as much as BA wished, which had certainly caused a re-planning on the profitability of the service. Second, BMA's Scottish flights had been allowed the previous year despite the fact that BA opposed and CAA rejected the application, because the then secretary of state for trade, Lord Cockfield, overruled the CAA decision.[31]

It was clear that the government was reluctant to use its power to shield BA from increased competition, though they were anxious to see BA successfully privatised. The British government continued its subsidisation to the Concorde operation until March 1984, guaranteed the company's debt, and acted on behalf of BA in the litigation of Laker Airways International. Nevertheless, when the issue became more directly related to the consumers' purse, no help could be expected. After all, from the political viewpoint, "deregulation" should mean lower fares.

5. Fleet Decisions

UK aircraft-noise laws coming into force by 1986 were rendering BA's 24 Trident Threes obsolescent. Consequently, BA needed to replace the 146 seaters.[32] Boeing and McDonnell Douglas were asked to submit proposals. Airbus Industrie, in which British Aerospace had a 20% stake, was at first neglected. As soon as the news was aired, a political argument flared up. The Labour Party argued that the government should take measures to help get the A320 (150 seats) project launched. The voices urging BA to opt for

[30] Cf. *FT* 3 Oct., p. 4.

[31] *FT* 26 Aug., p. 10.

[32] The UK noise regulation was in accordance with a ruling by International Civil Aviation Organisation. The programme of fleet modernisation was initiated under Sir Frank McFadzean's chairmanship. Cf. *Air Transport World*, February 1979, pp. 54-59.

Airbus were industry-wide.[33] Yet A320 had a serious disadvantage in that it would not be delivered until 1988. Furthermore, it was not certain whether the aircraft would be powered with Rolls-Royce engines. Various proposals and discounts, as well as pressures, were made during the summer.

Finally in early September, Boeing came out as the winner. BA would take a short-term lease on 14 B737-200, powered by Pratt & Whitney engines, with an option on a further 17. The aircraft, worth £166m, were to be bought by an Anglo-American financial consortium and then leased to BA. The decision seems consistent with BA's situation, therefore, a sound one from the viewpoint of business management. As King put it, A320 might be a good plane to be decisively turned down. McDonnell Douglas' aircraft would require new parts and probably more staff. A leasing deal was fit to the company's financial needs since it did not increase long-term debt. Indeed, the following words of King, announcing the decision on 15 August, make a sharp contrast to Pan Am's paternalistic (and proved-to-be fatal) arrogance.[34]

> [A320] remains a paper aeroplane and I am not in the business of launching new aeroplanes....We have worked too hard to get this airline right to be able to afford to take a gamble on a new aircraft now.[35]

[33] *ST* 24 July, p. 45; *FT* 15 Aug., p. 7; *Times* 9 Sept., p. 4. As for the techno-nationalist attitude in the field of aviation peculiar to Britain and its origin, see David Edgerton, *England and Aeroplane: An Essay on a Militant and Technological Nation*, McMillan Academic and Professional Ltd., 1991, especially chap. 5. BAe itself was owned by the government by slightly less than 50% until May, 1985. For BAe's privatisation and its acquisition of Royal Ordnance Factories, see Keith Howard, *The British Aircraft Industry*, Manchester UP, 1989, pp. 173-177.

[34] When Pan Am decided to purchase Tristars, one executive said that the order would "make Lockheed", which was desperate to get into commercial airliner business again. Cf. *Business Week*, 17 Apr. 1978, "Lockheed's high hopes", p. 44. Pan Am's manoeuvre in obtaining a favourable financial package is vividly presented in John Newhouse, *The Sporty Game*, Alfred A. Knopf, 1982, pp. 56-57, 61-73.

[35] Quoted in *FT* 16 Aug., p. 5. It should also be noted that Sir Frank McFadzean, the predecessor of King, had already made the decision to update BA's fleet with American airplanes. Cf. *Air Transport World*, June 1979, pp. 34-35.

6. Privatisation Date and Process

The new government formed after the election was determined to continue a "deregulation" and privatisation policy, but less clear with respect to how and when. So far as BA was concerned, the question was multifold since the government's interests and those of the company were not always the same. For example, the government wanted to attract British individual investors as BA's shareholders, while King preferred institutional ones, presumably in hope of having faithful stockholders. Their views on how to make BA attractive to investors were also different. From BA's point of view, the simplest solution was an injection of public money, either to have the debt equity ratio lessened or to have the debt repaid outright. Yet the government was naturally reluctant to take either choice. Another difference arose when British Telecom, another candidate for privatisation due the following year, met resistance from its trade union.[36] Seemingly King profited from this and committed himself, very probably for the first time, to the date of privatisation, in saying that BA would be ready to go public by the autumn of 1984.[37]

Obviously, he was sure that the "Super Shuttle" would be successful, and the company would have attained its profit goal of £250m by next March, or at least would be very near to it by the first half of the 1984-85 period. But in any case, it remained that BA should wipe off its debts, and the government was not prepared to spend public money for that. On the contrary, the proceeds of the sale of IAL was decided to be repaid to the government in the form of a decrease in BA's external finance limit.[38] A possibility of a "bridging loan" was discussed between the government and City institutions,[39] while Ridley confirmed the government's intention to privatise BA.

Sir Adam Thomson, chairman of BCal, was alert to these developments. On 3 November, the day before BA's half-year results were announced, he submitted to the government a proposal for a massive transfer of routes, including some flight equipment, from BA to his company at a price of £200m.[40] Thomson added that if BA was privatised with its financial burden lightened, BCal would be forced to move its operations from

[36] Cf. *Times* 25 Oct., p. 2.

[37] Cf. *Times* 15 Aug., p. 1.

[38] Cf. *FT* 25 Oct., p. 8.

[39] Cf. *Times* 25 Oct., p. 2.

[40] Cf. *Times* 4 Nov., p. 2; *FT* 4 Nov., p. 6.

Gatwick to Heathrow. This was in fact a threat to the government's scheme of airport decentralisation for the London area. Yet the idea of route transfer itself did look like a step to further competition, and gained support of some members in the parliament. Furthermore, BA's refusal to commit itself to the A320 project had already angered some MPs. A series of crises in the American air transportation industry, which was high-lighted on 24 September by Continental Air Lines' filing for Chapter Eleven of the Federal Bankruptcy Law might have been taken as warning against "laissez faire".[41] In UK, demise of airline, or more broadly demise of aviation-related organisation, is not a simple failure of business; as that of Laker Airways, and later BA's acquisition of BCal show, bankruptcy of airline is more felt as a damage to her national interests.

BCal's proposal was a genuine surprise to King, who described it as "smash and grab raid" when he announced a £162m half-year profit as well as a profit sharing scheme.[42] He also stressed that BA was ready to compete on any route it would deem profitable. The management of BA became so desperate to have the government's word on its privatisation date that Dunlop, the financial director, said: "the October slot for floating British Telecom is dead."[43] The announcements of freezing all domestic fares on 23 November, and the introduction of "saver" fares on 1st December, which would cut up to 40% in some domestic routes from the next April, should be interpreted in this context.[44]

BCal's proposal, later to be known as "blue book of BCal", made explicit the government's dilemma between deregulation and successful privatisation. At first Ridley, the transport minister, tried to evade it by saying in the parliament that transfer of routes were to be done only by agreement between BA and BCal.[45] Yet, while the plan to convert BA from a government agency to public limited company from April of the next year was approved, Ridley had to commission CAA to urgently review civil aviation policy.[46] The question of route transfer became a central issue in the next year.

[41] As for Continental's filing, see Shibata, op. cit., pp. 112-113.

[42] Cf. *FT* 5 Nov., pp. 1, 5. His words quoted in this article show well his anger. On the other hand, BA submit to the government an ESOP, employee stock ownership plan, and an MBO, management buyout, as possible choices to be made. Cf. *FT* 7 Nov., p. 32; *ST* 6 Nov., p. 53; *Times* 30 Apr. 1984, p. 1.

[43] Quoted in *ST* 6 Nov., p. 53.

[44] Cf. *Times* 24 Nov., p. 3; *FT* 24 Nov., p. 8; *Times* 2 Dec., p. 3.

[45] Cf. *FT* 15 Nov., p. 15; *Times* 15 Nov., p. 4.

[46] Cf. *Times* 13 Dec., p. 28.

III. 1984: Opposition to Route Transfer

1983 was a good year for the international air transportation industry. The growth of traffic continued to 1984. As BA had already succeeded in cost reduction, the company posted a series of record profits. However, the more it became profitable, the bigger the concerns of other British air carriers, who were afraid of being overwhelmed by a privatised BA. They argued that BA, if privatised without some trimming, would be too formidable a rival to compete with, and that the government should transfer a part of its routes to independent carriers to secure a competitive environment. Their argument was strengthened by CAA, who proposed route transfer and wanted, as its own preparation for an era of deregulation, more power in economic regulation of airlines' behaviour. Led by King and Marshall, BA fiercely fought against these proposals, and carried the day. Indeed many decisions and actions taken in 1984 by BA, other carriers, and the government, were more or less related to the issue of route transfer, and therefore, to the issue of privatisation. This chapter deals with, first, preparatory steps taken by BA toward privatisation, then the controversy on route transfer, and lastly, fare alterations for domestic, European, and transatlantic destinations.

1. Preparatory Steps Toward Privatisation

As stated in the previous chapter, King was in favour of flotation in autumn 1984, but the government decided to privatise British Telecom first. There was no question that BA was next in line, but guesses as to the date ranged from February to March 1985. As the government never specified the date,[1] the reasons why this period of the year was chosen remain uncertain. Generally the capital markets are not very buoyant in these months, when institutional investors tend to be on selling side, in preparation of making reports on their investment performance. Probably the government, the sole shareholder of BA since April, needed to report gains for itself. The timing also would suit BA, having adopted an April-March fiscal regime. Or the capital market, it might have been thought, would be ready to digest BA shares half a year beyond BT flotation.

[1] It was only referred to as "early in 1985". Cf. Department of Transport, *Airline Competition Policy*, Cmnd. 9366, HMSO, 1984, p. 5.

The management tried to introduce cost controls in two aspects: labour costs and the pension scheme. The pay deal the management offered was to cover two years, worth 4% in the first year with a minimum rise of £6 and 5% in the second. On the other hand, King had already announced in the previous November a profit sharing scheme, under which the employees would be rewarded a bonus equal to a week's pay for each £50m of operating surplus made by the company over £150m.

There were several bargaining bodies in BA on behalf of employees: technical engineering staff, engineering and maintenance staff (6,700), engineering and technical supervisors (1,750), clerical and administrative staff (10,000), pilots (2,400), ground service staff (4,800), flight attendants (430), and cabin crew (4,500), which was composed of long-haul cabin crew (2,800) and short-haul branch (1,700). All employees were proposed the same offer.

On 9 January, engineering and maintenance staff rejected the offer and demanded a higher one-year offer, and went on strike for two hours on 16 January, again for twenty-four hours on 31 January, which caused cancellation of nine long-haul flights from Heathrow. The cabin crew, who were all members of the Transport and General Workers Union, a national labour organisation, also turned down the offer on 17 February, on the grounds that their pay was among the lowest in the industry. A week later, they went on strike for twenty-four hours, grounding more than 90% of flights from Heathrow. Engineering and technical supervisors also rejected the offer at first, but did not take any serious action. The remaining groups accepted.

The management took a hard stance. For example, Howard Phelps, director of operations division, warned cabin crews of suspension of payment up to a month, withdrawal for twelve months of travel concessions (90% discount) and loss of shop stewards' rights. In March, both groups lifted the threat of strike and accepted the original offer.

Obviously, the aim of the two-year deal was to leave no uncertainty about labour cost for the coming period of privatisation. A further step was taken in June when the management withdrew a management directive, known as Group Instruction 64, that no engineering work should be put out on subcontract without the engineering and maintenance staff union's approval. At first the union protested with a threat to black any planes or parts sub-contracted without their consent, but agreed to it once their consultative role was reaffirmed.[2] The management also tried, though

[2] The dispute arose when an order for refurbishment for BA's twenty-eight B747s was reported to go overseas. After the settlement, a £10m order for new galley units was given to Sell, a German company, and another £3m order for interior decor, to

failed, to introduce part-time cabin staff and short-time contract for some full-timers.

The pension scheme of BA had been frequently referred to as a major hurdle, alongside its debt, to be cleared before privatisation, since it was fully indexed to the inflation rate. The latest actuarial valuation of the funds at 30 September 1982 was £2,371m for current, deferred and prospective liabilities, representing an average annual increase rate of 6.2% from three years earlier. The employees' rates of contribution, which were different from one job category to another, and by sex, ranged between 7.0% to 8.5% of their salaries.[3] Contributions made by the company averaged 2.3 times employees' contributions as of 1983-84 period. Reflecting the decrease in manpower, the company's contributions were in downward trend: £72.4m in 1981-82, £66.9m in 1982-83, and £59.9m in 1983-84.[4]

However, once privatised, BA would be obliged to fill any deficits in case the current asset of the fund was over-estimated. This meant, from the government's point of view, the proceeds of the sale would be reduced by an uncertain amount. From prospective investors' point of view, it meant an equally uncertain portion of their investment would be transferred to an account that contributed nothing to the company's finance. Finally, from the management's point of view, an arrangement that was linked to the Retail Price Index bound the company to honour an un-negotiable bill of inflation every three years.

Dunlop, the financial director, who started reviewing the scheme in 1982, gave new pension proposals on 25 January to the company's sixteen unions and to the twelve trustees of the pension fund. Under the new scheme, pensions were to be protected against inflation only up to a 5% rise, and benefits would include the basic state pension instead of being in addition to it.[5] On the other hand, the new scheme offered a two per cent reduction in contribution levels and, if opted, longer pensionable service. The employees were offered three choices: either to remain with the old scheme, to switch to the new scheme, or to take a lump sum cash in switching to the new scheme but without longer periods of service.

HongKong Aircraft Engineering Co. Cf. *FT* 10 Apr., p. 9, 21 June, p. 14, 2 Aug., p. 4, 3 Aug., p. 7.

[3] The scheme did not apply to local staff overseas, and covered some 32,000 UK staff, including those of some subsidiaries. BA had 19,000 pensioners. Cf. *FT* 23 Jan., p. 4.

[4] The figures are for the BA group, including overseas staff. Afterward, they increased to £62m in 1984-85, £67 in 1985-86, and £73m in 1986-87. Cf. BA, *Reports and Accounts, 1981-82, 1982-83, 1983-84, 1984-85, 1985-86, 1986-87*.

[5] Basis of calculation also changed. Cf. *Times* 4 Feb. 1984, p. 20.

BA appointed Hogg Robinson Benefit Consultants as advisor to employees, who promoted an extensive campaign of presentations. When the deadline came at the end of June, BA announced that 17,000 out of 32,000 had opted to change. The cash payment, a strong inducement, to those who had opted was estimated to be around £80m. Seemingly no union took serious action against the new scheme. This sum can very well be regarded, together with lost revenues caused by strikes over the pay matters, as a cost to reduce uncertainty in payroll.[6]

In parallel, a number of agents were appointed for flotation preparations. One noticeable feature of these appointments is that BA and the Department of Transportation (DoT) chose their own teams quite independently. Already, Lazard Brothers had been appointed as merchant bank advisor. In March, BA named Rowe & Pitman and Phillips & Drew as stockbrokers. They made no secret about their intention to look for institutional investors.[7] On the other hand, the DoT had appointed Hill Samuel as its own merchant bank advisor for BA's flotation. In February Hill Samuel started formal procedures to select stockbrokers, which led to the appointment by DoT of Wood Mackenzie and Cazenove two months later.[8] In June, DoT appointed Valin Pollen to handle public relations for the privatisation, while BA had its own PR subcontractor, Shandwick.[9] Obviously King wanted his own advisors and agents.[10] During the controversy over route transfer, he often cited Lazard as the City's opinion that the implementation of CAA proposal would seriously hamper and delay the privatisation.

[6] "As a commercial enterprise, British Airways has to earn sufficient profits to service its debt and capital. Cost control is therefore important and the elimination of uncertain costs such as those relating to pensions is essential." *FT* 26 Jan., p. 44.

[7] Cf. *FT* 9 Mar., p. 8.

[8] Cf. *FT* 5 May, p. 6.

[9] Cf. *Times* 2 June, p. 21.

[10] It might be worthwhile to note that the sale of IAM, handled by S.G.Warburg, was decided in order to take tender process on the government's instructions. Cf. *FT* 11 Mar. 1983, p. 1.

2. Controversy over Route Transfer

In reviewing civil aviation policy, CAA invited any interested parties to submit suggestions and comments. More than one hundred airlines, travel and consumer groups addressed various proposals.[11]

Roy Watts, who left the company the previous year, claimed the national interest of Britain would best be served by a single strong international carrier, rather a minority opinion and to which the Federation of Air Transport User Representatives in the European Community objected.[12] The Air Transport Users Committee, a statutory body, urged a slimming down of BA.[13] Britannia Airways, the country's biggest charter holiday airline and a part of the Thomson Travel Group, argued that BA should withdraw from the whole-plane charter business and should spin off British Airtours before privatisation.[14] Orion Airways of Horizon Travel and Air Europe of Intasun Leisure Group, who were also charter airlines, joined this view.[15] BCal itself sought flotation, declared itself ready to spend £250m for route transfer, and then urged delay of BA's privatisation.[16] The routes BCal wanted to take over were revealed at the end of June.[17] Air UK and BMA argued that BA should withdraw from all its domestic routes except shuttle services between Heathrow and Glasgow, Edinburgh, Manchester

[11] Cf. CAA, *Civil Aviation Policy Review*, CAP500, 1984, Appendix 2, pp. 28-29. It is no wonder that few supported the idea to privatise BA untouched. Colin Marshall regarded the rivals' attitude "like vultures waiting to swoop." Cf. *FT* 12 Mar., p. 5.

[12] Cf. *DT* 31 Jan., p. 7.

[13] Cf. *FT* 10 Feb., p. 6.

[14] Cf. *FT* 20 Feb., p. 5.

[15] The three airlines formed a joint body, the Airport Users' Study Group, which in turn claimed BA subsidiaries were conducting dumping, and urged that CAA should be given power against monopolistic exercise. British Airtours was the second largest charter operator in UK and, perhaps owing to lower equipment purchase costs, was highly profitable and able to undercut rivals' prices. In August, Air Europe was forced to slim down operations because its parent gave a contract to British Airtours. Cf. *Times* 9 Mar., p. 3, 31 May, p. 21, 11 July, p. 21, 12 July, p. 23; *FT* 24 May, p. 10, 31 May, p. 10; *ST* 19 Aug., p. 45.

[16] Cf. *Times* 20 Mar., p. 3; *FT* 12 Apr., p. 11; *Times* 1 May, p. 19; *FT* 1 May, p. 44.

[17] They were from Heathrow to the Caribbean, Japan, China, Seoul, Kuwait, Abu Dhabi, Istanbul, Cyprus, Athens, Malta, Vienna and Helsinki, and from Gatwick to the Iberian peninsula. Cf. *ST* 1 July, p. 53.

and Belfast.[18] BA submitted its own comment on February 1st, stressing, among other things, that route transfer would not promote competition but seriously hamper its privatisation scheme,[19] all the while posting a net profit of £214m for 1983-84 and becoming one of the most profitable airlines in the world.

On 16 July, CAA published its view and sent it to the government. The report, *Civil Aviation Policy Review* (CAP500), was composed of five main recommendations.[20] First, it recommended to transfer to the independents BA's routes between continental Europe and domestic regional airports (Gatwick, Aberdeen, Belfast, Birmingham, Edinburgh, Glasgow and Manchester). Second, transfer BA's routes between Heathrow to Hahare (Zimbabwe), Dhahran and Jeddah to BCal. Third, increase the proposed limit of slots at Heathrow that had been set in connection to the construction of Terminal Four. Fourth, increase of direct competition on domestic routes through abolition of licensing about fares and entry, except in the case of Heathrow and Gatwick. Fifth, increase CAA's own regulatory powers to prevent BA from abusing its strength in charter markets, while rejecting the idea of hiving off British Airtours. Concerning the first and second points, CAA urged the government to take legislative measures.

Of course, CAA was acutely aware that transfer of international routes did not lead to an increase of competition. Competition, especially price competition, can only take place in the same market. In air transportation economics, a market means a pair of cities, i.e., a route. If BCal took over an international route from BA, it simply meant a replacement of a player by another in a duopoly game, in which the foreign airline, the counterpart, most usually operated based on a pooling agreement. If BCal wanted a new fare that was unacceptable to its counterpart, the foreign government would simply reject the proposal. In this regard, BA's argument was legitimate that route transfer would not increase competition and that it would welcome competition under dual (or multiple) designations. However, CAA's main intention was to create the "second force" airline that the Edwards Committee proposed in 1969 before the merger of BOAC and BEA.[21] The Authority maintained that the transfer would have an effect

[18] Cf. *FT* 23 May, p. 7.

[19] Cf. *FT* 2 Feb., p. 7.

[20] CAA, op. cit., p. 21.

[21] *British Air Transport in the Seventies*, Cmnd. 4018. Cf. *FT* 28 Feb., p. 18; *ST* 8 July, p. 53. As for a brief review of the Edwards report and subsequent CAA policy, cf. *ST* 19 Aug., p. 51.

to reduce BA's scheduled service revenue by around 7% and thus would not hamper its privatisation.

BA countered CAA in announcing its own estimate that a full implementation of CAA proposals would result in a loss of £300m in annual revenue (more than double the CAA estimate), £76m in profits, and a further redundancy of 3,600 employees. Then BA would, King stressed, need to create a new track record of profitability, and added: "Any privatisation would be put back by four years or more – beyond the life of this Government."[22]

Indeed this was his most powerful weapon during the ensuing months of intensive lobbying. When John Dent, CAA chairman, criticised BA's over-reaction, the company responded vehemently that "any postponement of privatisation or reduction in the price that may be obtained would arise only from the threat to BA contained in the CAA review."[23] On the other hand, Jim Harris, BA's director of marketing, suggested an entire withdrawal from Manchester airport if BA's European routes from the airport were transferred, threatening a loss of 1,000 local jobs.[24]

Of course the independents also launched an extensive campaign as well as lobbying. Eight of them appealed directly to the prime minister.[25]

The government was split. Ridley and George Younger, Scottish secretary, supported CAA proposals, while Norman Tebbit, Secretary of State for Trade and Industry, a former BOAC pilot and a friend of Roy Watts, and Nigel Lawson, Chancellor of the Exchequer, supported the idea of privatising BA unhampered. The government was not able to produce its own view in response to the last rise of the Commons before summer recess, and set up a cabinet committee.[26] The next cabinet meeting was to be held on 13 September. Then, a hot summer started.

BCal had already applied for a wide range of new routes immediately after the CAA review was published.[27] BMA and Air UK followed suit for

[22] Quoted in *FT* 20 July, p. 5.

[23] *Times* 25 July, p. 2; *FT* 25 July, p. 5.

[24] Cf. *FT* 27 July, p. 7.

[25] Namely BCal, BMA, Air UK, Dan Air, Air Europe, Britannia, Monarch and Orion. Cf. *Times* 2 Aug., p. 3; *FT* 2 Aug., p. 4.

[26] For the debates in the Commons on 30 July, cf. *FT* 31 July, p. 12; *Times* 31 July, p. 4. As for the composition of the cabinet committee, cf. *ST* 12 Aug., p. 14; *FT* 3 Aug., p. 6.

[27] Cf. *FT* 18 July, p. 8. Overall, twenty-eight routes were applied for.

fifteen European routes from Birmingham and Manchester.[28] Air Europe proposed to take over BA's Iberian services from Gatwick.[29] BMA wanted to establish a hub at Birmingham and applied for domestic and European routes serviced by BA from the airport.[30]

BA, while lobbying aggressively, declared it would not object to BCal's applications to CAA and would welcome the competition.[31] On 5 September, Marshall, at the occasion of announcing a record operating profit for the first quarter, proposed to share twelve international routes with BCal on a fixed capacity ratio (80% to 90% for BA).[32]

On the other hand, the management made it clear that if ordered a route transfer, it would not obey the government, so that the government would be obliged to dismiss the board members.[33] Furthermore King reminded everyone that the government had given promises of "no arbitrary transfer" before privatisation.[34]

The cabinet deferred decision, primarily due to failure to find a compromise. While Ridley tried to work out one behind the scene, a new limit was set for 5 October, the last cabinet meeting before the Conservative Party conference. The final result was a surprisingly self-contradictory statement of policy, published on 5 October.[35]

In this white paper, the objectives of airline policy were "to encourage a sound and competitive multi-airline industry...strong enough to compete aggressively against foreign airlines...; to promote competition in all markets...; to ensure adequate safeguards against anti-competitive or

[28] Cf. *Times* 8 Aug., p. 3; *FT* 8 Aug., p. 6.

[29] Cf. *Times* 13 Aug., p. 3; *FT* 14 Aug., p. 6.

[30] Cf. *FT* 22 Aug., p. 8.

[31] Cf. *ST* 5 Aug., p. 45, 12 Aug., p. 2; *Times* 13 Aug., p. 3; *FT* 13 Aug., p. 3.

[32] BCal rejected the proposal. Cf. *FT* 6 Sept., p. 44; *Times* 6 Sept., p. 2, 10 Sept., p. 1.

[33] Cf. *Times* 10 Sept., p. 1.

[34] Cf. *Times* 10 Sept., p. 12. It is also likely that he himself had promised the employees no further redundancy. Cf. *ST* 16 Sept., p. 57; Ashworth and Forsyth, op. cit., p. 109.

[35] Department of Transport, *Airline Competition Policy*, Cmnd. 9366, HMSO, 1984. For a brief appraisal, see John Vickers and George Yarrow, *Privatization: An Economic Analysis*, MIT Press Series on the Regulation of Economic Activity, MIT Press, 1988, pp. 349-350.

predatory behaviour...; to put the ownership of British Airways into the hands of private investors..."[36] But the decisions stood in sharp contrast.

First, "[t]he Government has decided that there will be no forced reduction in British Airways' size relative to the rest of the industry"[37] because "[u]ncertainty affecting the privatisation of British Airways must be resolved"[38] and, after all, "the independents have grown despite British Airways and should continue to be able to grow given fair competition".[39] On the other hand, BA was to help the independents other than BCal in providing up to £450,000 for each of 15 new route developments undertaken by them from regional airports, which was a de facto subsidy to its rivals.[40] BA's route transfer would not take place. "The Government has received strong representations from local authorities and other interests that British Airways should retain its regional presence"[41] and admitted "a risk that without the major airline operating from Manchester and Birmingham both airports would become less attractive."[42]

Second, the competition must be cautiously promoted because "on some routes for example, both domestic and international, demand is probably too low at present to support more than one British carrier."[43] And "the best prospects for introducing extra competition lie in the short haul routes to continental Europe..."[44] since "[t]raffic on many of the short haul routes is sufficient to support competing British airlines."[45] Clearly the text omits the possibility of an increase in traffic to be generated by price-competition. Under competition, airlines struggle to maintain, or increase, their profitability out of lower yield (revenue per passenger distance carried)

[36] Ibid., para. 4.

[37] Ibid., para. 15.

[38] Ibid., para. 14.

[39] Ibid., para. 15.

[40] Ibid., para. 20. CAA held hearings from October to November 1985, and allocated routes by January 1986. The assistance by BA did not necessarily take the form of money, as technical co-operation substituted for it. Cf. *FT* 23 Sept. 1985, p. 8, 23 Jan. 1986, p. 8.

[41] Ibid., para. 19.

[42] Ibid., para. 20.

[43] Ibid., para. 8.

[44] Ibid., para. 16.

[45] Ibid.

through cost-cutting and larger traffic volume. If deregulation means where, when and how to generate traffic or to snatch rivals' share are largely or completely at operators' discretion and risk, the above argument is, to say least, very paternalistic.

Third, the government "strongly endorses the Authority's proposal to introduce an area licensing facility...between any two points in the UK [excluding Heathrow and Gatwick],...also welcomes the Authority's proposal that domestic fares should no longer require specific approval",[46] while refusing to give CAA powers against anti-competitive or predatory behaviour on the grounds that "the Authority can attach appropriate conditions to an air transport license...and refuse lower prices".[47] Instead, the Office of Fair Trading and Monopolies and Mergers Commissions were endorsed to handle anti-competitive behaviour.

Probably the whole affair was an inter-ministerial power struggle between CAA and DoT over air transportation policy, judging from a bold statement that "[a]fter very careful consideration the Government has concluded it is unnecessary for the Authority to be given a duty to promote the sound development of a competitive British airline industry."[48]

If CAA was the loser, BA was undoubtedly the winner. Route transfer was wholly rejected. Instead, a deal of swapping some routes between BA and BCal was forged. BA would hand over Jeddah and Dhahran in exchange with BCal's routes to South America. In addition, BCal would surrender licenses to Denver and Morocco, and would not oppose BA's application for Orlando and Tampa.[49] BA was allowed to move its Iberian services from Gatwick to Heathrow.[50] It is no wonder, for example, that Dan Air's chairman fiercely criticised the white paper.[51] It is also curious why BCal did not show discontent. Probably Thomson was glad to take over the routes to Saudi Arabia, so lucrative as to be nicknamed the "bankers' route", in exchange for the South American network that had been severely damaged due to the Falklands War.

[46] Ibid., para. 26.

[47] Ibid., para. 28.

[48] Ibid., para. 31. See also *ST* 7 Oct., p. 57. In this regard, Ridley's position must have been a delicate one. He described the paper a result of "practical politics". Cf. *FT* 6 Oct., p. 1.

[49] Cf. ibid., para. 23.

[50] Ibid., para. 18. One should note that Iberia and Air Portugal were operating from Heathrow and BA had been complaining about it. Cf. *FT* 4 Mar. 1983, p. 7.

[51] Cf. *FT* 11 Oct., p. 7.

The talk between BA and BCal began five days after the White Paper was published, and two weeks later agreement was reached to take over each other's routes from March 31 of the next year.[52]

The tactics employed by the BA management throughout this crucial controversy were widely ranged, from persuasion, appeasement to open threat. Apart from lobbying and persuading ministers and MPs, it threatened an entire withdrawal from regional airports and secured their support against route transfer; it made clear the intention to defy an order for route transfer with a threat of industrial action by its unions, together with a threat to blow up the prospect of privatisation if management changed. Also, it was, as we shall see in the following sections of this chapter, active in promoting lower fares, or at least, cautious not to appear as opposed to lower fares, both domestically and internationally. Furthermore, decisions and declarations on purchase of aircraft seem to have been politically steered.

As early as January, BA showed a renewed interest in the A320. King met Bernard Lathière in London, president of Airbus Industrie, and paid a visit to the constructor's headquarters at Toulouse in March.[53] Besides Airbus, BA ordered three BAe (British Aerospace) Super 748s for £9m on 10 May.[54] Then on 14 September, the day after the cabinet deferred its decision over the air transfer row, BA formally declared its interest in the A320.[55] Three days later, King gave a personal endorsement to another British-made aircraft, BAe 146, but did not forget to add that the aircraft would be used on its European routes so that route transfer would affect the final decision adversely.[56] No doubt all these aircraft were economical, quiet, and advanced; but it is equally true that these announcements were carefully timed.

As the White Paper admits, regional interests were strongly against route transfer. Manchester International airport opposed the replacement.[57] The British Chamber of Commerce and Industry stood on the side of the regional airports.[58] West Midlands Council, the owner of Birmingham

[52] Cf. ibid., 2 Nov., p. 9; *Times* 31 Oct., p. 3.

[53] Cf. *Times* 12 Jan., p. 1, 26 Mar., p. 17.

[54] Cf. *Times* 11 May, p. 2.

[55] Cf. *Times* 15 Sept., p. 1. BA currently possesses ten A320s, originally ordered by BCal.

[56] Cf. *FT* 18 Sept., p. 7; *Times* 18 Sept., p. 3.

[57] Cf. *FT* 12 Sept., p. 10.

[58] Cf. *Times* 12 Sept., p. 2.

airport, opposed the transfer of BA's services from the airport and stated typically: "...British Airways as the national flag carrier does carry a major prestige factor for the airport, and we strongly believe that as in other European countries, the flag carrier should be operating from major regional airports."[59]

In addition to practical concern about loss of jobs resulting from withdrawal by BA, we find here reflection of two particular assumptions. The first is that status of an airport or the region is affected by having or losing the national flag carrier's service. This is rooted in the second assumption of national flag carrier. Certainly it is wrong to think that BA was not Britain's national flag carrier. But it would also be an obsolescent belief that a country should possess a national flag carrier. If international air transportation deregulation means lower fares and intensive competition through dual or multiple designation (or through no designation process at all), any government who wishes to obtain political gains out of its implementation should necessarily be prepared to have as many competent airlines as possible.

If so, this also suggests an explanation as to why the deregulation of international air transportation has been particularly upheld by such countries as the U.S. and UK. Deregulation of domestic air transport gives rise to venture-minded operators, who, as new entrants, are necessarily prepared to offer cheaper fares. On the other hand, the highly standardised operational procedures and technical requirements in the field of aviation make them, almost from the outset, able to operate on international routes, especially to nearby destinations. Needless to say, possession of this new breed of airlines is a prerequisite for a government that wishes to gain some possibly political advantages in pursuing the policy of international deregulation. In Europe, the UK and the Netherlands were the earliest to develop multi-airline industries, out of which they could afford to become "liberal".[60]

To put it otherwise, "the" national flag carrier in the sense of "chosen instrument" was being outmoded, at least for the industrialised countries where consumers cried out for cheaper air transport.[61] The Civil

[59] Quoted in *FT* 23 Aug., p. 5.

[60] In the late 1980s, Europe saw about one hundred airlines newly created. A large part of them were in the "liberal" countries. Cf. International Civil Aviation Organisation, *The Economic Situation of Air Transport, Review and Outlook: 1978 to the Year 2000*, 1989, p. 6 Table 2-2, as quoted in Gil, op. cit., p. 322 note 8.

[61] Marvin Cohen, chairman of CAB and faithful successor of Alfred Kahn, admits that the U.S. would adopt a flexible attitude toward third world nations. Cf. Marvin Cohen,

Aeronautics Board, if not the US government, was clearly aware of this implication of deregulation, when it refused Pan Am permission to take over bankrupt Braniff's Latin American routes in 1982. The other governments were slow to realise the change. Also, the government of the People's Republic of China still regarded Pan Am as the national flag carrier of the U.S., and protested to Washington as Pan Am resumed its Taipei service in June 1983, while allowing Northwest Airlines to serve both countries across the Taiwan Strait.[62] As the posterior course of events showed, the U.S. could do without Pan Am, essentially because it had many other pawns in hand that became competitive out of fierce domestic struggles. In fact, the U.S. had, and still has, more competent airlines than any other country. Therefore, the need for a "second force" airline arose not only from the concern for consumers, but also from the sheer necessity of, say, national interest.

3. Domestic Competition

London-Edinburgh and London-Belfast routes were the main field of competition that year. Also, BA announced an expansion plan from Manchester to foreign destinations. In all cases, BA at first responded selectively to BMA's challenges, and then used its muscles.

In December 1983, BCal announced a weekend return fare of £60, instead of the normal £118, for Gatwick-Edinburgh flights. BMA brought down its Heathrow-Edinburgh return fare to £74, effective from 1st April. BA responded by introducing a £58 return for a two-month trial from 6 February on off-peak flights on weekdays and all weekend flights, bookable fourteen days in advance, and valid up to a month. The competition was limited to off-peak discounts, aiming at the holiday traveller segment.[63] The idea was later extended to other shuttle services for the summer season.[64]

Can Airline Deregulation Work in International Air Transportation?, Flight Transportation Laboratory Report M80-1, Department of Aeronautics & Astronautics, MIT, 1980, p. 37.

[62] Cf. Kyohei Shibata, "Koku-kisei-kanwa-ka no Pan Am [Pan Am under Deregulation]", *Journal of Economic Review* no.25, Faculty of Economics, Shinshu University, Matsumoto, Japan, 1986, pp. 49-72.

[63] Cf. *Times* 5 Jan., p. 2.

[64] Cf. *FT* 4 Apr., p. 9; *Times* 5 Apr., p. 3.

The Heathrow-Belfast route became the theatre of full-scale price competition. BMA started the service on 25 March, with an introductory fare of £29 single for off-peak flights and £37 for peak ones, applicable until the end of April. As soon as these fares were announced, BA quickly matched them and set identical fares.[65] Dan Air, flying between Gatwick and Belfast, did the same.[66]

In August BMA introduced a £99 day return fare for its services from Heathrow to Belfast, Edinburgh and Glasgow, then initiated a frequent flier programme.[67] In October BA applied to CAA for an increase, effective from November, while keeping its excursion fare at £95, and later declared its intent to freeze domestic fares the following year.[68]

As for international services from regional airports, BMA applied to take over New York service from Manchester and Prestwick, of which BA and BCal had not used their licenses. Air Europe won a license to fly scheduled services between Gatwick and Palma (Majorca), while BA had ceased operation between Heathrow and Palma some time previously.[69] In defense, BA announced a "major expansion" plan from Manchester to overseas destinations in November.[70]

4. European Routes

The British government was eager to bring down European fares. It repeatedly advocated at various levels of the EC that "Fortress Europe", i.e., the European "air cartel", should be put to an end in light of the Treaty of Rome. In 1984, the first success was scored.

On 4 May, David Mitchell, Parliamentary Under Secretary of State for Transport, reached agreement with the Dutch government to end the pool system between BA and KLM. Six days later, BA announced a £49 return

[65] Cf. *Times* 13 Mar., p. 2; *FT* 15 Mar., p. 8.

[66] Cf. *Times* 26 Mar., p. 2.

[67] Cf. *Times* 21 Aug., p. 2; *FT* 21 Aug., p. 5.

[68] Cf. *FT* 18 Oct., p. 5, 6 Dec., p. 7.

[69] Cf. *FT* 9 July, p. 6.

[70] Cf. *FT* 2 Nov., p. 9. The planned destinations were New York, Munich, Larnaca (Cyprus), Malaga, Cork, Madrid, Lisbon, Oporto, Athens, Malta and Geneva.

fare from Heathrow to Schipol, effective from July.[71] BCal followed suit in bringing down its fare to the same level for Gatwick-Schipol, and Air UK for Stansted-Schipol. Virgin Atlantic, which was due to start transatlantic service from June, applied for the Gatwick-Maastricht route at £20 single.[72]

The news was much hailed by newspapers. Ridley declared triumphantly at the Council of Ministers that UK airlines were no longer bound to consult their opposite numbers on fare changes before asking the British government's approval.[73] If BA was not bound, it did consult KLM to set up the fare as well as its restrictive conditions. Tickets were to be purchased in advance, seats were to be requested only the day before departure, and ticket-holders were to spend a certain period of time before returning. The same fare proposed by BCal was available on one flight each way a day, but bookable.

The Dutch government refused the proposal by BCal on grounds of unfair competition, and requested a uniform package. After hasty negotiations for about three weeks, a new agreement was signed on 20 June, which liberalised fares, routes and capacity of air transportation between the two countries. The most notable feature of the agreement was the "sixth freedom", allowing airlines to carry passengers originating from the other country to a third country via the home country on a single

[71] The return fare for Club class, BA's brand for business class, was then £156, Eurobudget £132, and APEX, the cheapest, £87. The £49 fare was branded "Latesaver". Cf. *FT* 8 May, pp. 1, 36, 11 May, pp. 2,11; *Times* 11 May, p. 1.

[72] The service by Virgin Atlantic on this route started on 15 Nov. During the first three weeks the fare was £16, to be raised to £25 afterwards. Cf. *Times* 26 Oct., p. 1.

[73] Cf. *FT* 12 May, p. 17; *The Economist* 19 May, p. 16. However, it should be stressed here that the Dutch government was one of the first European governments, along with the Belgian, that had concluded a liberal air services agreement with the U.S. in the late 1970s. The British government found the Dutch attitude damaging to their negotiation for Bermuda II. Cf. Christer Joensson, *International Aviation and the Politics of Regime Change*, Frances Pinter, 1987, p. 124; Alan P. Dobson, *Peaceful Air Warfare: The United States, Britain, and the Politics of International Aviation*, Columbia Press, 1991, p. 263.

flight.[74] As this freedom was requested by the Dutch government, there was a fear in Britain of losing traffic.[75]

This freedom is, however, essential to develop international hub-and-spoke operations, especially in such a multi-national and comparatively small region as Europe. Deregulation in this regard would trigger competition not only between airlines, but also between airports to become important hubs, hence, between national governments to provide their airports with competitive capacity to handle traffic.[76] In this competition, geographical elements may play an important, perhaps decisive, role, itself an interesting topic but beyond the scope of the present paper.

BA continued to introduce lower fares for continental flights: German destinations, French provincial destinations, Swiss cities, Budapest, were all made accessible at cheaper rates. Yet, in every case BA worked closely with its counterpart airlines, namely Lufthansa, Air France, Swissair and Malev, in devising fares and restrictions.[77] In most cases, travellers were required to book a fortnight in advance and spend a weekend before returning. These restrictions were designed to be unattractive, or unpractical, to the business traveller segment, while BCal found it extremely difficult to set unrestricted fares. In Europe, lower fares were being introduced, but very much in a concerted way between the flag carriers, who were anxious to fill seats unsold to business travellers. The independents could not crack the cartel yet.

[74] Cf. ibid., p. 33. As for the consequence and evaluation of the Anglo-Dutch air service agreement, see Francis McGowan and Chris Trengove, *European Aviation: A Common Market?*, IFS Report Series no.23, The Institute for Fiscal Studies, 1986, pp. 138-150. For other bilateral agreements liberalised by UK, see Button and Swann in Button (ed.), op. cit., pp. 94-95, also Paul Stephen Dempsey, "Aerial Dogfights over Europe: The Liberalization of EEC Air Transport", *Journal of Air Law and Commerce*, vol. 53, no. 3, 1988, pp. 630-634.

[75] Cf. *Times* 8 June, p. 2; *FT* 22 June, p. 8; *The Economist* 30 June, p. 18. Cooperation between the Dutch government and KLM, "the flying Dutchman", is often close and effective. For another example, see Thornton, op. cit., pp. 98-99.

[76] For hub-and-spoke operation, see, for example, Donald Pickrell, "The Regulation and Deregulation of US Airlines", as chap. 2 of Button (ed.), op. cit., pp. 21-23.

[77] For German flights and the difficulties encountered by BCal, cf. *ST* 29 July, p. 1; *Times* 4 Aug., p. 3, 19 Sept., p. 3; *FT* 27 Sept., p. 6, 9 Oct., p. 9. For French ones, cf. *Times* 31 Aug., p. 3; *FT* 31 Aug., p. 5. For Swiss, cf. *Times* 7 Sept., p. 3; *FT* 7 Sept., p. 8. For Budapest, cf. *FT* 6 Oct., p. 4.

5. Transatlantic Routes

Transatlantic traffic boomed this year, thanks primarily to the strong dollar. In 1983, 15 to 16 million people flew between Europe and the U.S.; one third of this traffic was between the U.K. and U.S., by far the largest volume. BA was the biggest operator, carrying 1.5 million or 10% of the North Atlantic traffic, followed by TWA with 1.0 million. As on the European routes, BA collaborated with TWA and Pan Am, its American counterparts, in devising lower fares and restrictions. Virgin Atlantic, a new entrant, branded them as "predatory".

In mid-February, British Atlantic Airways applied for the Gatwick-Newark route at £99 single, effective from June. While BCal proposed to resume service on the route for £50 single from the following April, the Virgin Records Group purchased 75% of British Atlantic's parent company and changed the airline's name to Virgin Atlantic Airways. Virgin Atlantic proposed the same £99 fare for an introductory period, £119 from July until September 15 with £10 weekend surcharge, and then down again to £110. CAA granted the license and certificate. On 24 June the inaugural flight took off, and scheduled service began in July.

The main rival of Virgin Atlantic was supposed to be People Express, an American upstart which began transatlantic service in May 1983. Due to the weakness of sterling, People Express' fare in sterling went up: £99 at the outset, £102 in October 1983, £113 in May 1984, and £122 in August. Virgin's fare was also slated to go up to £129 in November.

On the other hand, BA and other predominant carriers' cheapest fares were on a steady downward trend. For example, BA's standby fare to New York, available only in last minutes before departure, was brought down to £170 in July 1984, from £175 a year earlier. In July, BA announced a series of deep cuts. The standby fare was further brought down to the level of £139.[78]

In addition to this, BA announced, with Pan Am and TWA, a Super Apex return fare for the winter season from November to March. Usual restrictions applied: tickets were available for those who booked in the last three days before departure, ticket-holders were required to spend a

[78] Apart from New York standby fares, Heathrow to Los Angeles or San Francisco was brought down to £199 from £230, Washington or Baltimore £159 from £190, Philadelphia £149 from £180, Chicago £189 from £210, Detroit £189 from £205, and Miami £189 from £195. Cf. *FT* 1 Aug., p. 1.

weekend before returning, and no refund was available. The return fare for Heathrow-JFK was £259 instead of £299 in the previous year.[79]

On 30 August, Richard Branson, president of Virgin Atlantic, asserted that the Super Apex fare to New York was "predatory" and suggested legal action in the U.S. The price differential was £1 for return. Given the deep cuts that BA was introducing on other American routes, it is difficult to judge the £259 fare as specifically designed to get Virgin Atlantic out of business. Despite the popularity it gained, it was then a tiny airline with only one leased B747. North Atlantic business was buoyant while the breakeven load factor for BA was merely 54.8% for 1983-84. Having posted a half-year net profit surpassing that of the whole previous year, BA had no express need to cut Virgin Atlantic's throat. It is more likely that BA's intention was to cover the budget traveller segment, which the "point-to-point" airlines were appealing to. As the restrictions suggest, it was for BA a question of filling unsold seats. But for Virgin Atlantic, which needed a 70% load factor to attain breakeven, a large enough price differential was essential.

This suggests that upstarts are easily pushed to the wall if big airlines introduce fares close enough to theirs.[80] Added to this, small scale airlines have a peculiar disadvantage. Their narrow margin is crucially at the mercy of exchange rate fluctuations. In fact, People Express did not change its fare in dollar terms ($149), but was forced to raise its price in Britain due to the weak pound. In contrast, BA could afford to shield itself through a large amount of forward transactions.[81]

Branson's claim hit a sensitive diplomatic nerve. In the previous June the U.S. Justice Department started a criminal anti-trust investigation on possible conspiracy to drive Laker out of business, which the liquidator of the bust airline alleged in US civil court. In this litigation BA, among others, was on defensive against a $1.05 billion claim. The official view of Britain was that the prices agreed upon among airlines and approved by the both governments under Bermuda II were exempt from US internal law.

[79] Other reductions were: Heathrow to Boston for £239 from £299, to Washington £284 from £340, and Philadelphia £274 from £334. Cf. *FT* 18 July, p. 9; *Times* 27 July, p. 3.

[80] This tactics also proved effective in US. In 1984 People Express started service to Florida, mainstay market for Eastern Air Lines. Eastern succeeded to keep its share with a few dollars on top of People's fares. Cf. Shibata (1988), op. cit., p. 124.

[81] Cf. note 20 of the previous chapter. Virgin Atlantic may be unique in this aspect, as a substantial portion of sales by its parent record company was in dollars.

DoT requested assurances from the American government that the fares proposed by BA and others would not be prosecuted under anti-trust law. Given the independence of Justice, Washington was reluctant to give such assurances. Then DoT refused to grant cheap fares on 18 October. A week later it announced its intention to charge the difference between the ongoing fares and the prices of Super Apex tickets already sold. As 70% of them were estimated to be bought in the U.S., some 70,000 travellers might be requested to pay at British airports in the most extreme case. Dan McKinnon, the last chairman of CAB, threatened retaliation. As the tickets were to be used shortly, tension mounted. On 30 October, DoT reversed its decision and allowed airlines to honour the tickets sold before they were banned.

In early November BA, TWA and Pan Am again applied for the same fare, only to be refused on 15 November. Four days later, President Reagan ordered the Justice Department to abandon its investigation on the Laker case. A month later, both governments agreed to approve lower winter fares and the Justice Department declared it would not bring anti-trust action against them. Simultaneously, the British government decided to reverse its ban. Virgin Atlantic did not resort to legal challenge.

It is obvious that the British government tried to obtain de facto guarantees that lower fares agreed upon among airlines and approved would not be prosecuted under American law. Although the assurance given by the American authorities was of temporary character, the score was clearly marked in favour of the British. In this regard, the lower fares proposed by BA and threat of court action by Branson were both used to gain a point in principle, which is a highly diplomatic issue. Perhaps Reagan was anxious to secure British support on strategic matters in Europe. His stoppage order to the Justice Department certainly displaced a major hurdle for the privatisation of BA, but it should not be regarded as the main aim of the British government.

The last topic that needs mentioning is Concorde. The British government and BA agreed to write down Concorde assets to nil in 1978-79, with an amount of £160m in public dividend capital. Surplus earned on Concorde operations were to be divided between them, the government receiving 80% and BA retaining 20%. Thanks to losses brought forward, such payment had never taken place, despite, for example, an operating profit of £11.5m made by Concorde operation for 1983-84.

Since 1983, BA began to employ this unique asset in a promotional fashion; inaugural flights of domestic Super shuttle service and its anniversary a year after were both commemorated by Concorde. In October 1983, Marshall declared his intention to extend its Washington service to Florida. One reason may have been the lower load factor compared to its

New York flights.[82] The next month, the Cunard Steam-Ship Company signed a £5.5m contract to charter 130 flights for its round trips to New York on Queen Elisabeth II and Concorde, with three nights at the Waldorf Astoria Hotel in Manhattan.[83]

In parallel to the changing status as a public limited company, the profit-sharing scheme between the government and BA was scrapped. On the other hand, BA bought all spare parts that were owned by the government in exchange of cash more than £9 million. Given the overall cost of more than £1.5 billion for R&D and construction, Concorde was hardly a remunerative project for the government.[84] However, it became finally a money-spinner for BA.

[82] Concorde service to Washington, three times weekly each way, carried 10,000 passengers per year (load factor around 30%), while New York flights, twice daily each way, carried 75,000 (load factor around 50%). The Miami service started in March, 1984. Cf. *Air Transport World*, June 1984, pp. 68-70.

[83] Afterward, this kind of fancy charter tour became a characteristic of Concorde's operation by BA; the trips by Cunard were enlarged, a flight to New Zealand to view Halley's Comet was undertaken, and a return flight was provided for executives visiting a computer exhibition in Hanover. Cf. *Times* 2 Mar. 1985, p. 3, 29 Oct. 1985, p. 3, 3 Dec. 1985, p. 18; *FT* 26 Oct. 1985, p. 1, 18 Jan. 1986, p. 4. Also, *Air Transport World*, Jan. 1986, "British Airways Concorde now considered flagship of the fleet", pp. 40-45.

[84] For the development and construction of Concorde, see Keith Hayward, *The British Aircraft Industry*, Manchester UP, 1989, pp. 100-108.

IV. 1985: Toward Expansion

In 1985 BA cleared the last hurdle for privatisation, or so it was thought. The litigation concerning the bankruptcy of Laker Airways was settled out of court. In the meantime it became increasingly clear that the government's policy differed from one area to another. In domestic air transportation, deregulation of air fares took place. In Europe, CAA employed its power selectively to promote cheaper fares. In the transatlantic arena, CAA actually refused a lower fare in fear of triggering another anti-trust civil suit in the U.S. And finally in the Far East, the government showed a clear intention to guard BA's interests.

1. Laker Litigation Settled out of Court

On 24 November 1982, Christopher Morris, senior partner at Touche Ross & Co., filed a suit at District Court of Columbia, U.S., alleging as the liquidator of Laker Airways Ltd. that a conspiracy by international airlines drove Laker Airways out of business. Morris argued that established carriers had collectively set low fares on North Atlantic routes during the 1980-81 winter season to drive Laker Airways bankrupt and, when a rescue plan was discussed, acted to make it fail. The amount sought was $1.05 billion as the federal anti-trust law tripled the damage.[1]

Although a civil case it was, the British government claimed that fare-setting practice, implied in Bermuda II, should be exempt from the domestic jurisdiction of the United States. Moreover, its was certainly not pleasant to see British companies, including a state-owned one, being sued by another British one in American court. From the viewpoint of the U.S., however, the Bermuda II was not a treaty ratified by Congress, and the British attitude did look like protecting a cartel club. The situation became tense in the autumn of 1984, until President Reagan's instigation to call off the Grand Jury investigation of possible criminal offence. Soon thereafter, BA began to seek an out-of-court settlement. Interestingly, it seems the move was urged by DoT on advice of its merchant bank advisor, Hill Samuel.[2]

[1] The defendants were BA, BCal, Pan Am, TWA, Lufthansa, Swissair, Sabena, KLM, UTA, SAS, McDonnell Douglas, and McDonnell Douglas Finance Corporation. For the analysis of Laker, see Banks, op. cit.

[2] Cf. *FT* 15 Dec. 1984, pp. 1, 30, 19 Dec. 1984 p. 5.

Seemingly there was still a considerable difference between the government and the board of BA as to when and how the company was to be sold. As late as November 1984, King wanted to float BA by February of the next year, with its debt lightened by the injection of public money, and offered the government a large portion of the proceeds. The government rejected the idea for financial reasons and, more deeply, for political reasons as well.[3]

To put it another way, the difference rested on whether the government was to inject money first to make BA attractive, sell it at a higher price, and to get money back out of proceeds, or BA would be left to get rid of the hurdles in the way to privatisation by its own efforts. Clearly the government opted for the latter; when BA became a public limited company in April 1984, the government made sure that the company would not commit to aircraft purchases without its consent, because, not only would it have decreased the proceeds of BA's sell-off but also increased the PSBR.

On the other hand, BA set out on a course of expansion that year and the management was not happy to see their hands tied in regard to fleet decisions. In March, King made his belief public that "government controls over such important aspects of business as pricing policy or investment decisions is inconsistent with the freedom of management to act".[4] In July, Marshall said that "[t]he Government has clearly indicated that they do not want us to place orders for substantial new equipment before privatisation",[5] presumably referring to the request made by the government to seek its approval for all aircraft investment except those acquired on short-term leases. Then in September he declared an intention to replace and expand BA's fleet at an annual cost of £550 million over the next ten years.[6] As B747 had no competing type of aircraft, he was in fact referring to a major aircraft order.

Nonetheless, an embarrassing note in the company's report stating that it had been sued for $1.05 billion needed to be addressed, especially if a portion of the stock was to be sold to American investors.[7]

[3] Cf. *FT* 3 Jan., p. 10.

[4] Quoted in *FT* 22 Mar., p. 12.

[5] Quoted in *Times* 23 July, p. 5. For the government's request, cf. *FT* 6 Aug., p. 6.

[6] Cf. *FT* 25 Sept., p. 11. As another step of expansion, BA acquired a stake in Brymon Airways, mainly to gain access to London Dockland Airport. Cf. *Times* 29 Nov., p. 21, 21 Dec., p. 4; *ST* 22 Dec., p. 19.

[7] It was reported that up to a quarter of the stock was likely to be sold to American investors. Cf. *Times* 2 Oct., p. 17.

A City law firm, Linklaters and Paines, was commissioned by BA for arranging the settlement package. Their task was three-fold: to obtain permission from the co-defendants to act as their representative toward the plaintiff, to negotiate with them and the creditors about sums they would provide or receive, and to make sure no legal action would be attempted concerning the failure of Laker Airways. Although the process of negotiation was dramatic, it is too detailed to fully describe. Commentary will be limited to two major points.

The first point is that BA, having taken the initiative, was paying the most. The final settlement was $48 million to the creditors, $8 million to Sir Freddie Laker (plus three free trips a year on BA flights over eight years), and $12.5 million to all the plaintiff's lawyers. Although the final amount BA actually paid is not clear, it was well over $20 million.[8] Added to this, BA agreed to pay an extra $12 million over nine years on its own borrowing from the U.S. Export-Import Bank, the largest creditor to Laker Airways. To the travellers affected by higher fares posterior to the collapse of Skytrain ("class action"), BA, TWA and Pan Am offered discount coupons for future transatlantic flights to the tune of $30 million.[9]

The second point is that the government was determined to finish the Laker saga for good. In June, Lonrho, an international trading firm and partner in ventures with Sir Freddie Laker, announced its intention to seek compensation for damages incurred by the failure of Laker Airways. Ridley, the Secretary of State for Transport, publicly criticised Lonrho with unusual vehemence.[10] When Sir Freddie refused the offer when it was first proposed in July, King and Marshall contacted Ridley to abandon a comprehensive settlement.[11] Both episodes indicate close communication between the government and BA throughout the settlement process. Moreover, publication of BA's annual report for 1984-85 was delayed until the end of the year, when all the claims concerning the Laker case had been

[8] In the course of negotiation, it was agreed that TWA and Pan Am would provide $10 million each, BCal $5m, and the other European airlines $20m as a group. BA was to bear the rest. McDonnell Douglas and its financial subsidiary were creditors to Laker Airways. Cf. *FT* 24 Aug., *weekend FT*, pp. I, XII. BA had made a provision of £33m for cash costs. Cf. BA, *Report and Account 1985-86*, p. 28 note 3.

[9] Notice by the district court of Columbia can be found on *Times* 20 Nov., p. 8 and *ST* 1 Dec., p. 2. See also *Times* 27 Dec., p. 2. When it was settled in March 1986, the applications totaled 215,000, i.e., $18 for each. Cf. *FT* 21 Mar. 1986, p. 1.

[10] Cf. *FT* 17 June, p. 1; *Times* 17 June, p. 2. The claim by Lonrho was successfully blocked as Sir Freddie agreed to take the offer in August.

[11] Cf. *FT* 16 July, p. 6.

almost settled. The intention was clear: to proceed with a prospectus with no mention of litigation. Although the hurdle was successfully cleared, it is tempting to regard the move as a buy-off.[12] It may also be added that this willingness of BA to settle might have triggered later lawsuits concerning Laker.

2. Fleet and Accidents

As the new noise regulation was taking effect, the remaining Tridents were to be retired by the end of the year. To replace them, BA was receiving B757s but accelerated the move: in February three more B757s were purchased at more than £90 million for delivery during the next year, and in August, a leasing deal for another three at £98.5 million was announced. As a result, this type of aircraft in BA's fleet came to 23 at the end of the financial year. As for the South American routes swapped with BCal, two Tristar 500s were leased from Air Lanka of Sri Lanka in March.

BA also began to replace B747 engines, its main workhorses. Engines manufactured by Pratt & Whitney of BA's earliest 12 jumbos were to be replaced with RB211-524 D variant, a new type of Rolls-Royce. The replacement was estimated to cost £100 million, but the new engines would give a longer range (6,300 miles instead of 5,700 miles), enabling non-stop flights to the Far East with less fuel consumption. All these fleet developments were set back by the accident in August of that year.

The month of August 1985 saw a series of air disasters; on 2nd August, 133 people died in Dallas, and ten days later, a domestic flight of Japan Air Lines, from Tokyo to Osaka, lost control in mid-air and crashed into a mountain, causing 520 deaths. On 22 August, the day after BA announced the successful conclusion of the Laker litigation, 55 holiday-makers died as a Boeing 737-200 of British Airtours (130 seats, 137 on board including crew) erupted in flames on runway at Manchester International Airport. The cause was engine failure (type JT8D-15A by Pratt & Whitney) during take-off. After x-ray tests, BA withdrew 22 engines from service.

Although the cause of the Manchester accident was not attributable to the operator, there rose a world-wide concern about air travel safety. In the U.S., it took the form of allegations of negligence of safety measures by financially restrained airlines. In Britain, the dense configuration of seats became a central theme. As noted above, BA was rejuvenating its fleet of B747s. A part of the scheme consisted of reducing emergency exits from

[12] Indeed, Dunlop, BA's chief financial officer, reportedly said at an early stage that: "We're buying a signature [of Sir Freddie]." Cf. *FT* 14 Jan., p. 1.

ten to eight. The modification was criticised despite its conformity to the international security rule. Other than this, several minor incidents on BA flights were reported.[13]

On 8 November, an agreement of compensation between relatives of the victims and the concerned companies, i.e., British Airtours, Boeing Co., and Pratt & Whitney, was reached. As was true in the Laker litigation, it was an out-of-court settlement of a lawsuit, which was filed in the U.S. on 26 September. Although the amount of compensation was not revealed, it was believed to be "very substantial".[14] Compared with similar cases in Japan, this is a very quick settlement. If the lawsuit had proceeded, at least a mention would have been necessary in the annual report of the parent company.

3. Domestic Competition

Following the Civil Aviation Policy Review of the previous summer, CAA was liberalising the process of domestic fare approval. From September, airlines needed to publish intended fares for domestic routes only ten days in advance, which would be allowed automatically unless the CAA found them unfair. Ironically, the result of liberalisation was fare increases.

The first round of increases took place in April. Fares by BA rose less sharply than its rivals, so that the price differentials narrowed: BA's single fare for Heathrow-Glasgow/Edinburgh rose from £60 to £62, while that of BMA from £57 to £61; the Heathrow-Belfast fare of BA from £59 to £61, that of BMA from £57 to £60. They again widened when BA rose its fares from September. BCal's Scottish fares from Gatwick were consistently higher than corresponding fares of BA. BA still controlled around 40% of the domestic traffic. In autumn the fuel price increased in the UK, and airlines responded by raising their fares again.

An important fact is that, despite the liberalisation of the fare approval process, price competition did not occur immediately. Of course there were price differentials and there was a spate of discounts.[15] But the price differentials were merely widened or narrowed to the tune of a few pounds, not overturned. A series of undercutting and matching did not take place. Probably the reason was threefold. Firstly, the air traffic in the UK was on

[13] Cf. *Times* 8 Apr., p. 3; *FT* 14 Nov., p. 9, 22 Nov., p. 1, 17 Dec., p. 5.

[14] Quoted in *FT* 9 Nov., p. 4.

[15] Cf. *Times* 12 Oct., p. 33.

a comfortable upward trend. Secondly, the independents were looking for European routes, which would require financial resources for development. And lastly, no domestic trunk route saw a new entrant determined to snatch a share from existing carriers.

4. European Routes

Following the Anglo-Dutch air service agreement of the previous year, the British government continued to liberalise air transport between the European continent and Great Britain, or more precisely, the regional airports in Britain. In parallel, British airlines were rushing to announce cheaper fares throughout the year, but a fundamental behavioural characteristic persisted. The cheap fares introduced by the independents, especially those by BCal, were much less restricted in terms of reservation and minimum stay requirements than those by BA. BA continued to collaborate with its foreign counterparts, even in cases where new bilateral agreements no longer bound it to do so. It must also be noted that the bilateral agreements were designed so as to encourage international services to and from the regional airports in Britain, thus serving the British government's policy of regional airport development, while access to Heathrow and Gatwick were severely limited.

From January to February, BA announced deep cuts in fares effective from April. The destinations made cheaper were Austria, Belgium, Spain and Greece. As in the previous cases, the fares had been agreed upon with foreign counterparts, namely Austrian Airlines, Sabena, Iberia, and the usual restrictions applied for Apex fares: at the very least, booking was to be made two weeks in advance and ticket-holders were required to spend one Saturday night abroad. Despite the new Anglo-Dutch agreement signed on 19 June, the fares set by BA were identical with those of KLM and the cheapest fare, £55 for return to Amsterdam (normal economy was £162), was so restrictive as to be criticized as meaningless.

Compared to this, BCal offered flights from Gatwick at a higher price (£69 return) than the cheapest fares offered by BA and KLM but with no advance booking requirements.[16] Important to note is that this kind of challenge was limited to the countries which had a new liberal agreement with Britain. In this regard, however restrictive its terms were for cheap fares, BA sometimes preceded the government's effort to bring down fares. Later in the year, Britain concluded new air service agreements with

[16] It required one night stay minimum while abroad.

Belgium (signed on 10 October) and Switzerland (announced on 3 December). BCal immediately announced a £55 return fare for Brussels, effective from December, undercutting BA's Apex fare by £14.

When proposals for a modest rise (around 5%) on business class and economy fares for European destinations were applied by the concerned airlines, CAA turned down most of them while accepting all the cheaper fare proposals. The fares denied were concerned with Scandinavia, West Germany, France and Italy and others. Although CAA explained the reason for refusal as "excessive in relation to costs", it was evidently a political decision. If an important objective of the British government in regard to "Fortress Europe" was to introduce cheaper fares, BA performed the role of military messenger who would negotiate to open a lower window to the fortress, and the independents were to serve as water flooding through it. Thus BCal could denounce the Association of European Airlines and pull out of it in October, while BA retained membership.

Spain deserves a particular mention. The traffic between UK and Spain was 8.29 million passengers for 1983, reflecting its popularity among British holiday-makers. Consequently, charter traffic was far superior to scheduled ones on all Spanish destinations but Madrid.[17] The "Moneysaver" and "Freedom" fares, agreed between BA and Iberia in January, were specifically designed to attract this holiday segment.[18] When the British airlines applied to CAA for a number of European destinations, Iberian destinations were the most contested.[19] CAA policy was to allow smaller airlines, including charter operators, to serve the most popular holiday sites with scheduled flights. In February, Air Europe won license to start a Gatwick-Palma service starting from May, and announced in August a plan of launching scheduled service on the Gatwick-Gibraltar route from November.[20] In the same month, Britannia Airways won license for Manchester-Malaga from November despite BA's appeal to DoT.[21]

[17] McGowan and Trengove, op. cit., p. 63 Table 4.2. Compared to Europe, North Atlantic air traffic is largely dominated by scheduled carriers. Cf. ST 5 May, p. 64 chart.

[18] Moneysaver fare was valid for stays between six days and one month. Freedom fare offered a domestic flight in Spain for an extra £40, with minimum stay requirement over Saturday and valid for six months. Cf. *FT* 17 Jan., p. 7; *Times* 11 May, p. 13.

[19] Cf. *FT* 21 Mar., p. 8.

[20] Cf. *FT* 13 Feb., p. 8, 20 Aug., p. 6.

[21] Cf. *FT* 6 Aug., p. 6. On the other hand, DoT sought to reduce Iberia's flights on Heathrow-Madrid route by a quarter. Cf. *FT* 22 May, p. 9.

In general, governments involved in deregulation have a tendency to designate other than their traditional flag carrier for service to the nearest touristic countries. As noted above, CAB refused Pan Am's request to take over Braniff's Latin American network; another example is that All Nippon Airways expanded itself from charter operations for such proximate destinations as Korea, Taiwan and Hong Kong to the international scheduled services. This tendency could be explained by aeronautical technical reasons, but implies a necessity for traditional flag carriers to be prepared for, first, fierce competition (including designation process) in nearby areas and in the home market, and second, securing profitability of non-competitive long-haul routes.

5. Transatlantic Routes

The British government's policy in regard to transatlantic routes was to leave the existing competition in place. At the same time, however, it was anxious not to provoke anti-trust litigation against BA. For, despite the declaration by the U.S. Justice Department, Virgin Atlantic was well able to bring a civil suit in the U.S. Thus in January, CAA refused again BA's "Late-saver" fare proposal for £259 return on Heathrow-JFK route, while allowing "Early-saver" fare at the same fare on the same route.[22] BA had to make a new proposal at £282 return for this route.

The tactic employed by BA in the transatlantic area was to keep its cheap fares competitive for the new cut-rate carriers, while jacking up the fares for business travellers in line with its American counterparts. Thus it applied to CAA for summer fares after it had agreed with Pan Am and TWA, under the auspice of IATA, to raise fares from April. Apex fare for Heathrow-JFK was to rise to £362 in April, and again to £384 in July. Economy fare remained unchanged at £233 for single. Virgin Atlantic and People Express made similar applications, but given the low level of their previous fares, increases were sharper.

People Express was dropping out. Its management style, although much hailed, was fragile and its growth as well as employee motivation was exceedingly reliant on the company's stock price.[23] Reflecting critical

[22] "Late-saver" was bookable within three days of departure, whereas "Early-saver", an Apex fare, required booking three weeks in advance. The late-saver fares to all the other American destinations were admitted.

[23] Cf. Shibata (1988), op. cit., pp. 123-124. People Express was acquired by Texas Air Corp. in September 1986.

financial strain, its fare adjustment became very frequent. In January, its Gatwick-Newark single fare was intended to rise from £122 to £154. It went up to £181, down to £166 in July, to £147 in August, and then to £131 in November. People Express also launched a plan to serve Brussels. All these alterations reflect a desperate effort to preserve profitability and competitiveness in spite of exchange rate fluctuations.

Virgin Atlantic also changed fares, but less abruptly and frequently than People Express. It also made a successful joint fare promotions with Pan Am, TWA, and Northwest Orient. The domestic competition in the U.S. was so intensive that these American airlines agreed to provide a passenger arriving on Virgin Atlantic with an internal flight for a mere $22.[24]

In May, BCal resumed its Gatwick-JFK service after eleven years of disruption. In September, BA launched a series of stand-by fare decrease in regard to the American destinations, undercutting both Virgin Atlantic's standard fare and BCal's stand-by fare to New York. BCal matched immediately. On the other hand, BA announced its intention to start services to Argentina and Grenada in addition to other South American destinations, while adding Miami, Tampa and Orlando to its American destinations. No doubt it decided to develop its transatlantic network.

6. Challenge from the Far East

If the management of BA, as well as the British government, loudly advocated deregulation in Europe, they adopted a different attitude toward the Far East.

Since February 1983, Singapore Airlines (SIA) applied several times for service between Manchester and Singapore. Manchester International Airport Authority welcomed it, but DoT requested SIA to cut is daily flights to Heathrow as condition of approval. As the bilateral air service agreement between UK and Singapore did not lay down to preclude the capacity of service, the British government's attitude was criticised not only by Singaporians but also by several MPs representing the Manchester area.[25] In March 1985, the Singapore government formally applied for access to Manchester (three flights a week). Then BA suggested to the Manchester International Airport Authority that services by SIA, "an

[24] Cf. *Times* 24 Oct., p. 4.

[25] Cf. *Times* 25 Mar., p. 10.

aggressive airline that would cream off the best of the business", would jeopardise BA's expansion plan from the airport.[26]

Indeed SIA was the most favoured airline by bankers, and its Heathrow-Chiangi operation enjoyed an 89% load factor, an exceptionally high figure for international scheduled service, while BA operated at 61% on the route.

The Singapore government decided to put pressure by excluding British companies from tendering lists for the construction of the second terminal at Chiangi airport. The tactic proved to be effective; in May, Ridley gave SIA permission for two flights a week to Manchester despite DoT's advice. BA and SIA reached agreement in September: SIA would start Manchester service in April 1986, while BA continued to serve only Heathrow-Chiangi.

A similar attitude could be found in regard to Malaysia. In May 1984, Malaysian Airline Systems (MAS) was refused to increase the number of flights between Kuala Lumpur and London from four to five a week. MAS argued that the demand on the route justified the fifth flight, which BA contested. In October 1984, the Malaysian government ended tax exemption for people who receive air trips as part of their remuneration except in cases where they flew MAS, and halted talks with a British consortium working on a project of Malaysian railway development. In April 1985, Prime Minister Mrs Thatcher, on a visit to South East Asian nations, agreed to the fifth flight in principle. BA wanted in exchange the fifth freedom, i.e., right to pick up passengers in Malaysia to be transported to a third country, but seemingly failed to obtain it. After a series of talks, the final agreement was signed in September: weekly capacity for each carrier was enlarged from 1,240 to 1,550 passengers and BA and MAS would start a fifth flight in November 1985 and in July 1986, respectively.

The third example was the Philippines. In 1984 the bilateral air service agreement between UK and the Philippines terminated. The negotiation for a new agreement was broken in September 1985, over the question of the number of flights. Philippine Airlines flew three times a week, while BA flew twice. BA demanded Philippine Airlines either to drop down one, or to pay a royalty of £745,000. The latter agreed to pay the royalty but insisted on £500,000.[27] Apart from these ASEAN countries, BA strongly opposed BCal's application for Japan and Korea.

At first glance, all these instances make a sharp contrast with the British attitude vis-à-vis Europe. Of course one could explain that BA was fearful of these non-IATA, low-cost, and highly competitive carriers. They would undermine the profitability of BA's Far East market centre, and snatch

[26] Cf. *ST* 31 Mar., p. 57.

[27] Cf. *ST* 17 Feb., p. 57; *FT* 17 Sept., p. 8.

away passengers heading to/from Oceania, that of the Australia and New Zealand market centres as well.[28] Yet the anger of the Asian governments (and that of UK Department of Trade and Foreign Office) might not have been caused if BA had not acted as a governmental body at early stages. At least in the cases of Singapore and Malaysia, BA was allowed to act as a government department toward the foreign governments and airlines. This capacity was long inherited from its ancestors. In the days of Imperial Airways and, later, of BOAC, the state-owned airline could well be expected (and sometimes forced) to serve the interests of the empire or the Commonwealth as a whole. Due to historical changes and in the face of privatisation and competition, BA was no longer to serve these interests, but its own.

7. Labour Relations

The postponement of privatisation made an effect on internal labour management. The two-year pay deal of 1984 was expiring at the end of the year and the unions were eager to change some aspects. The management tried to simplify the pay and grades, but met resistance by disruption of operation.

On 30 January, many short-haul flights from Heathrow were grounded as cabin crews stopped work. The dispute was over in-flight catering duty on BAC1-11, which the contract did not cover. Unions of clerical and administrative staff were in dispute over reduction of grades (from eleven to six). Engineers and maintenance staff, also disputing job restructuring, resorted to an industrial action in August. However, it was essential for the management to keep payroll under control. It became all the more necessary as the need for fleet replacement arose. In addition, job restructuring was probably connected to the company's Corporate Identity movement as well.[29]

The negotiation over a new pay deal started in autumn. The unions sought, among other things, to replace the profit sharing scheme with an extra month's pay, which could be more easily accepted as collateral for

[28] In fact BA cut fares to Australia in the winter of 1986-87. Cf. *FT* 2 Aug., 1986, p. 4; *Times* 16 Aug., 1986, p. 3, 13 Sept. , 1986, p. 13.

[29] As stated above, a CI is intended to renew the employees' morale. As for BA's campaign in this respect, see *Times* 15 Oct., 1983, p. 5, 14 Feb., 1984, p. 20, 4 Dec., 1984, p. 22; *FT* 25 May 1984, p. 20, 5 Dec. 1984, p. 14, 10 May, p. 16.

bank loans, overdrafts or mortgages.[30] The second point was over the level of wage, which the unions claimed to be in the lowest category in the industry. Compared with the other European state-owned airlines and, especially with Americans, it seems true that BA employees were less well paid. This was partly the reason BA's payroll in operating costs was competitively low. For example, average annual earnings for members of ALPA (Air Line Pilots Association of the U.S.) in 1984 were $112,000 (approximately £77,700), while basic salary of BA's senior captain was £29,035 in 1985, although the latter does not include allowances.[31] The management stood firm and the negotiation dragged on.

[30] Thanks to the operating profits, the employees received a bonus equivalent to 6.5% of salary in the profit sharing scheme. The calculation method had changed over time: instead of a week's pay for each £50m of operating surplus over £150m, they received a bonus of one-fiftieth of a week's pay for every £1m of operating surplus over the same threshold. Cf. *FT* 2 Mar., p. 3. However, a part of bonuses was accumulated for the employee stock ownership plan.

[31] Cf. Shibata (1986), op. cit., p. 62 note 33; *FT* 16 Dec., p. 8. BA executives did not earn as much as those in the American airline industry; Marshall, the most highly paid, received £78,720. Cf. *Times* 31 Dec., p. 2. For international comparison as of 1982, see Doganis, op. cit., p. 97 Table 5.2.

V. 1986: Toward a New Environment

In 1986, the date of privatisation was fixed for the next spring. The decision was affected by various factors. A sharp downturn of American tourists in the first half showed the deep dependence of British carriers on the North Atlantic market. The British government tried to limit competition by setting up a capacity limitation regime within Bermuda II, which was one reason for postponement of privatisation. The management of BA became impatient to obtain independence of management, and seemingly clashed with the government. Meanwhile "Fortress Europe" was formally denounced by the European Court of Justice, giving further momentum to liberalisation of air transport in Europe. The member governments were obliged to cope with the new order of the day but found it extremely difficult. In many ways, this was the year that a new regime started to be formed.

1. Privatisation Date Fixed

At the beginning of the year, BA seemed to have no more inherent obstacles against privatisation. Although a series of lawsuits concerning the demise of Laker were filed, they were easier to surmount than the former case. One was brought by Ambassador International Travel, a travel agent in Los Angeles, claiming damage due to Laker's bankruptcy. Another was filed by former Laker employees. The class action for travellers was still to be settled. BA argued these lawsuits were not as embarrassing an obstacle as the one that had been settled the previous year.

On the other hand, BA's debt-equity ratio had been steadily improved. The outstanding debt of BA, £901 million at 30 March 1984, had been reduced to £464 million by 30 September 1985. Discussion between the government, financial institutions and BA started in February. Seemingly, the government was eager at the first stage, and planned even to send a prospectus for BA's share through the client lists of major banks in the City. Michael Spicer, Under Secretary responsible for aviation, noted:

> The sale of British Airways is central to the Government's wider share-ownership schemes, and the sale of shares in the airline is an important ingredient in the policy.[1]

[1] Quoted in *FT* 3 Feb., p. 8. See also *Times* 8 Feb., p. 23. This attitude would completely change. At the sell-off, the government made clear that BA stock was not fit for amateurs.

As the discussion was conducted behind the scenes, it is unknown why this optimism of the government changed by early March. It is clear, however, that the management of BA stressed its need of new aircraft and that the government was not keen with the idea. On 6 March, King commented in a private meeting of MPs:

> If the owner of any business stands as a barrier between that business and the funds it requires for investment, it is a bad owner....We do not want to be constrained by the Public Sector Borrowing Requirement from raising or sponsoring capital because of the need of the Government of the day to build a section of motorway or a hospital, or electrify a few miles of railway line.[2]

On 12 March, Ridley declared another postponement without specifying for how long. He cited as the reason uncertainties about the negotiation of Bermuda II. The Anglo-US negotiation started a month earlier. Reportedly, the British side sought two things: to prevent American carriers' overall capacity from swamping the market and to obtain guarantees against prosecution under the U.S. anti-trust law. The former point was already included in the Annex II of the Bermuda II agreement, to expire in July. Ironically, despite its advocacy of deregulation in Europe, the UK was seen by the U.S. as representing protectionist European countries, and scrapping Bermuda II was a prime objective of U.S. officials.[3]

It is probably true that British officials did not want to weaken their bargaining position vis-à-vis the Americans by setting a time-limit. As the expiration of Annex II would allow airlines to increase capacity without constraint, the U.S. had no particular need to renew it while Britain, if privatisation of BA had been definitely set, would have found herself in a weaker position. However, this concern is a matter of diplomatic bargaining tactics. Whether Annex II, a capacity limitation clause, was necessary for BA to be successfully privatised is a different question.

Of course Annex II was not only intended to protect BA but all the British air carriers serving the North Atlantic. BCal was suffering from decreases in Gulf business because of the falling oil price. The importance of North Atlantic for BCal was far greater than for BA.[4] The underlying thought here is that the British carriers, notably BA, would not be able to compete with their "powerful" American rivals. But were they really "powerful"?

[2] Quoted in *FT* 7 Mar., p. 9.

[3] Cf. Joensson, op. cit., pp. 124-125; Dobson, op. cit., pp. 267-268.

[4] Dobson, op. cit., pp. 274-275.

The American carriers in the North Atlantic were in bad financial shape. Pan Am was struggling to keep afloat, selling its Pacific network to United Airlines in 1985. Edward Acker, chairman of Pan Am since September 1981, pursued a strategy to concentrate on the Atlantic flank. The sell-off of the Pacific division was followed by a 30% increase in its capacity in the Atlantic in 1985. In 1986, Pan Am was planning another 30% increase.[5] However, having incurred huge losses in its domestic operations, Pan Am never launched a full-scale price war in the transatlantic market and substantially cut down the planned increase in May. TWA, another dominant American carrier in the North Atlantic, was spun off by its parent Trans World Corp in 1984 because of the airline's large losses in the domestic operation, and became the target of a fierce takeover battle between Carl Icahn and Frank Lorenzo in 1985. People Express was falling into the hands of Lorenzo, chairman of Texas Air Corp.

All these "powerful" American carriers suffered from huge losses due to cut-throat domestic competition. The North Atlantic was one of the rare profitable areas for Pan Am and TWA, but it means that they had to maintain profitability in this market.[6] Indeed this is one reason why they coordinated BA by setting fares. As the table below shows, their yields, i.e. revenue per passenger mile, remained fairly constant in the Atlantic market despite the challenge by such cut-rate carriers as People Express and Virgin Atlantic. It was quite unlikely they would launch a full-scale capacity war in the North Atlantic, or could afford to do so, either.

Yields of the major American carriers in the Atlantic market (annual average, US cents)

	Pan Am	TWA	People Express
1985.3.31	11.74	11.46	5.59
1986.3.31	11.85	11.40	6.15
1987.3.31	12.15	11.54	6.43

Source: DoT (US), *Air Carrier Traffic Statistics; Air Carrier Financial Statistics.*

[5] Cf. Shibata (1986), op. cit., pp. 64-65. Pan Am was the most hit by the downturn of transatlantic traffic; the load factor of its atlantic flights fell to 44.6% in April, and in May to a dismal 39.7%. Cf. Department of Transportation, *Air Carrier Traffic Statistics Monthly April 1986, May 1986.*

[6] For TWA and Pan Am in this period, as well as an American view on the transatlantic market after the U.S. deregulation, see Herbert R. Northrup, "The New Employee-Relations Climate in Airlines", *Industrial and Labor Relations Review*, vol. 36, no. 2, 1983, pp. 178-179.

Certainly, BA was in a fragile position. It had to maintain a good track record for a successful sell-off; intense competition in the North Atlantic, if it occurred, would have erased its profit.[7] Nevertheless, BA was in far better financial shape than most of its American rivals. Presumably, it would well have attracted investors regardless of whether Annex II was renewed or not.

Another possible reason, although as speculative as the above argument, was the privatisation scheme of the British government. As the next general election was to take place in the following year, the Thatcher government was in need of political gain. At the beginning of 1986, there still remained a number of state-owned organisations to be privatised. Among them were Trustee Savings Bank (TSB), British Gas, Rolls-Royce, British Airports Authority (BAA), Royal Ordnance Factories and the National Bus Company.

In hindsight, TSB and British Gas, both of which were privatised in 1986, were much more suited to political needs. Firstly, they were larger in terms of money they would raise: privatisation of TSB realised £1.36 billion (although the proceeds were retained by TSB), and that of British Gas brought the Treasury £5.6 billion, compared to BA's £0.9 billion.[8] They served also to widen share ownership: 5 million people applied for TSB shares, 7 million for British Gas, compared to slightly more than 1 million in case of BA. Comparison of minimum initial instalments illustrates the government's intention clearly: applicants for BA shares were required to pay £260 minimum (65p per share, 400 shares), while those for British Gas £50 (50p per share, 100 shares). These differences arose from the nature of each company and industry it operated. British Gas, like British Telecom, was a public utility monopoly while BA, though profitable, was in a highly competitive industry, which made it a less safe item for investment by those not familiar with the stock market. To put it otherwise, the above-cited statement by Spicer applied better to TSB and British Gas than to BA.

BA reacted angrily. Immediately after the announcement of postponement, the management took up an employee buyout plan and King brought it to the Prime Minister on 17 March, only to be rebuffed.[9] This is a curious move, since the management must have been keenly aware of the political gain that the government was seeking, however tacitly, out of its privatisation policy. Yet there were particular reasons for this impatience.

[7] A pact between the U.S. and some European countries, including UK, imposed certain limits on fare levels in the north Atlantic market. Cf. Dempsey, op. cit., pp. 623-626.

[8] Cf. Vickers & Yarrow (1989), op. cit., p. 223 Table 4.

[9] The plan is described in *ST* 16 Mar., p. 1.

First, the stock market was booming. In March KLM raised £200 million by selling in the international market new issues and a portion of the shares retained by the Dutch government. In May, Cathay Pacific Airlines went public in Hong Kong with a comfortable oversubscription at 55 times the shares offered. BA was missing the chance.

Second, the North Atlantic market was showing a sharp drop after a boom. It was increasingly clear that the summer booking would experience a heavy decrease. It was triggered by weakening of the dollar but later in the spring, the situation became all the more serious as American tourists, fearful of terrorist action in regard to Libyan bombing and fallout from the Chernobyl nuclear disaster, turned away.[10]

Third, as noted in the previous chapter, BA was planning a large re-equipment program. It was closely associated with an overall development of strategic facilities at Heathrow. The company already opened a large computer centre in July 1985, and in April 1986, the fourth Terminal started to function. As the plan foresaw replacement of its fleet at the rate of more than £500 million a year over a decade, BA was in need of access to capital markets. But the sum for the purchase, several billion pounds, would never be possible to raise as long as the company was kept under PSBR constraint. Another aspect of this action is that the management of BA came to prefer, by this time, to improve the company's balance sheet through an enlarged capital base, rather than decreasing debt on the basis of the current equity capital.

And fourthly, the delay of privatisation was bound to affect the company's morale adversely. The profit-sharing scheme was operated in relation to share options; a large number of employees deposited their bonuses to buy the company's shares at privatisation. The management team that King and Marshall had built was composed of the people who, after all, viewed privatisation as their primary task and objective. In June Derek Jewson, general manager for UK passenger sales, resigned. Later in the same month, Howard Phelps, head of Operations Department, announced his retirement.

During the summer BA tried hard to stimulate North Atlantic traffic and made certain progress. Meanwhile, the Anglo-US negotiation progressed. On 11 September the final agreement was reached.[11] In the revised Annex

[10] Cf. "Wooing punters as well as passengers", *The Economist* 23 Aug., pp. 56, 58.

[11] *Exchange of Notes between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America further amending the Agreement concerning Air Services, signed at Bermuda on 23 July 1977, as amended*, Treaty Series no. 41, Cm 792, HMSO, 1989.

II, the British secured a provision of consultative process to preclude capacity and to impose a certain limit on it.[12] Although unsuccessful to obtain a guarantee of exemption from the U.S. anti-trust law,[13] the British government no longer regarded it as a hurdle to be cleared.[14] On the same day, the privatisation of BA was formally announced to take place early in the next year. It was already decided that TSB and British Gas would be privatised during the current year. By this date, the litigations concerning Laker had been either settled or dismissed. As for pricing and decisions about method of share allotment, BA had to wait until the next year.

2. Transatlantic Market

As noted above, the transatlantic traffic between the U.S. and Europe declined sharply in that year. In April, the U.S. forces bombed Tripoli. As the British government supported the action, several retaliatory terrorist actions took place. The fear was aggravated by the Chernobyl nuclear disaster, which deterred Americans from visiting Europe. Consequently BA suffered a drop of 18% of traffic on its North Atlantic flights in the first six weeks of its financial year, and the load factor was down to 50%. To entice American travellers, BA announced a bold plan on 20 May; 5,600 free round trip tickets were offered to the Americans.[15] On the other hand, the company cancelled recruitment of 1,500 part-time cabin staff for the summer season and called upon employees to accept unpaid leave. The other airlines also tried to generate traffic by a series of deep cuts. To cite cheapest single fares to New York, Virgin Atlantic offered £56, People Express £66, TWA £115 for passengers aged between 12 and 24 (refused by CAA), and BCal and BA £149 for stand-by. But these price-cuttings did not overcome the difficulty. BA's transatlantic bookings dropped by 25%

[12] Ibid., pp. 4-5. The provision, which was called as "150% rule", guaranteed a 40% share in capacity to the both countries.

[13] Three years later, it was vaguely redefined in another exchange of notes. Cf. *Exchange of Notes between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America concerning the licensing of their respective airlines to operate International Air Services*, Treaty Series no. 42, Cm 793, HMSO, 1989, p. 3 above.

[14] John Moore, successor of Ridley from May, said: "I am ... satisfied that anti-trust issues need no longer delay the flotation [of BA]." Quoted in *FT* 12 Sept., p. 1.

[15] For details of these "Lift Off for Britain" and "Go for It, America" campaigns, see *Times* 21 May, p. 1; *FT* 21 May, p. 1, 19 Aug., p. 32.

in May and by 17% in June when compared to the same months of the previous year. It was not until August that the traffic began to recover. Consequently, the revenue of BA's airline operation in the first half was £1,559 million, down from £1,640 million a year earlier; the operating profit decreased more than a quarter, to £151 million from £205 million.[16]

Apart from the dependency of BA on the North Atlantic, the summer situation in 1986 also provides an instance of the general vulnerability of international aviation to political and/or environmental upheavals. With its global network, BA is apt to suffer from incidents in many parts of the world. The Falklands and Gulf wars are other instances.

3. European Routes

In March, an Anglo-Italian agreement on air services was signed in Florence, which opened Milan to some British independent airlines.[17] On the route between Dublin and London, Ryanair, an Irish independent airline, was challenging BA and Air Lingus.[18] In both cases, BA offered fares identical to those of its foreign counterparts. This practice was severely challenged that year.

On 30 April, the European Court of Justice ruled that fare-fixing practices by member countries and airlines were illegal in light of the article 85 of Treaty of Rome.[19] The ruling was made in regard to price-cutting practices by several French travel agencies, among them Nouvelles

[16] Cf. *ST* 23 Nov., p. 73. The operating profit in the first quarter to 30 June was £38 million compared to £90 million a year earlier. Ibid.

[17] By this agreement BCal was allowed to fly between Gatwick and Milan, Birmingham Executive Airways between Birmingham and Milan, Cathay Pacific between Hong Kong and Rome, and British Airways to connect Manchester-Milan-Rome. Cf. *FT* 13 Feb., p. 4, 14 Mar., p. 7.

[18] Ryanair started operating between Dublin and Luton on 23 May with four daily flights. One way fare was £59 and return £85, deeply undercutting the corresponding fares by BA and Air Lingus. Cf. *FT* 24 Apr., p. 3; *Times* 2 May, p. 3.

[19] This "landmark" ruling is reviewed and discussed in a large amount of literature. See Prodromos D. Dagtoglou, "Air Transport after the Nouvelles Frontières Judgement", in P.J. Slot and P.D. Dagtoglou (eds.), *Toward a Community Air Transport Policy: The Legal Dimension*, Kluwer, 1989, pp. 115-118; Carl Otto Lenz, "The Contribution of the European Court of Justice to the Common Air Transport Policy", in P.D. Dagtoglou (ed.), *Air Transport and the European Community: Recent Developments*, European Air Law Association Conference Papers no.1, Kluwer, 1990, pp. 19-34; McGowan & Trengove, op. cit., pp. 126-128; Button & Swann in Button, op. cit., pp. 112-118.

Frontières, which sold tickets issued by Air France at prices below the approved tariff. The Tribunal de Police de Paris had referred the matter to the Court for ruling a year earlier. Prompted by the ruling, the European Commission published proposals for liberalisation on 19 June, and warned the member governments of legal action if they failed to act.

Although the Commission's proposals still acquiesced to the governments' intervention to prevent their flag carrier's capacity share from falling below 25% on each route, the Council of Ministers in charge of transportation failed to discuss the matter because of the large differences of opinion between the members. In July Moore, the British minister, assumed the presidency of the Council, which was set for 10 November. On 10 July the Commission started sending warning letters to the airlines including BA and BCal, demanding explanation of fare-fixing arrangements between them before 20 September, though the period was extended by another two months by requests from the airlines.

On 11 and 12 November, the Council of Ministers was held in Brussels. The British proposal was rejected.[20] On 15 December, the Council met for the last time under Moore's presidency, only to reach deadlock once again. It was a year after that it reached agreement.[21]

One immediate effect of the ruling was a series of challenges by independents on the busiest metropolitan routes in Europe. In April, BCal anticipated the ruling by declaring fares to Paris undercutting those of BA and Air France, and was soon followed in May by Virgin Atlantic, which declared its intention to break into Paris-London market. In June fares for London-Amsterdam was deeply brought down by BMA, and new Dutch airlines were also entering into the fray.[22]

[20] As for the British proposal, Cf. "Skyway robbery", *The Economist* Nov. 15, p. 16, "Europe's air fares: unfair", loc. cit., pp. 49-50. Moore was heavily criticised for the moderate proposal. Although his attitude was attributed to the concern of successful privatisation of BA, it is hard to believe that the British government dared to appear protectionist in exchange for one billion pounds. Certainly Moore was anxious to obtain progress toward deregulation, essentially as a political success, but miscalculated the other countries' response.

[21] Community Regulations (EEC) 3975/87 and 3976/87. They were adopted on 14 December 1987. The texts are given in: Frere Cholmeley, *Air Law and the European Community*, Current EC Legal Development Series, Butterworth, 1990, pp. 128-147, and also in Dempsey, op. cit., pp. 687-709. It was the expiration of the Article 2 of the latter Regulation that liberalised international air transport in EC on 1st January 1993.

[22] For Paris-London market, see *FT* 1 May, pp. 1, 48; *ST* 4 May, p. 5, 15 June, p. 62. For Amsterdam and other Dutch destinations, see *Times* 16 May, p. 3, 1 July, p. 6; *FT* 28 Oct., p. 8, 7 Nov., p. 2.

The second effect was a shift of dimension. Since the ruling, the deregulation between the European countries became a subject of multilateral negotiation and bargaining at EC level rather than a matter of bilateral ones. As such, it requires additional and separate study from a different point of view to analyse the series of negotiations, regulations and decisions which ensued.[23] Here it suffices to point out that a new regime which the judgement started to shape in Europe was the one which BA and other British airlines were rather prepared to live with.

4. Engine Decision and its Financing

As the course of events shows, the privatisation of BA was, above all, a political matter. As such, the management of the company suffered from requirements imposed by the government's political needs. On the other hand, being a subject of politics enabled BA to make use of the concerns of politicians and the government to its own commercial interests. As described in Chapter Three, BA's threat to deprive a regional airport of its operation proved to be effective in securing political pressure against an unfavourable policy. Another example could be found in the decision it took in regard to engines. Here, political concerns resulted in more favourable terms of purchase and finance than there would have been otherwise.

In mid-June, it was reported that BA was considering General Electric's CF6-80C2 as a possible choice for the power plant for the B747-400s that the company was planning to order. Not only Labour MPs but some Conservative backbenchers took notice of the news, since the order in question, worth several million pounds, was considered to be vital for Rolls-Royce, and therefore, for the British aero-engine industry. Moreover, as Rolls-Royce was one of the candidates for privatisation, it needed a good financial performance for the same reasons as BA. Although Rolls-Royce had already secured the launching order for its RB211-524D4 engine from Cathay Pacific, BA's choice was bound to affect the prospect of its sales. On 10 June Neil Kinnock, leader of Labour Party, urged the government to take measures to ensure that the order went to Rolls-Royce. Thatcher refused and replied that the company should "win orders on merit".

At the end of the month, another American engine maker, Pratt & Whitney, joined the bidding with its PW-4000. BA requested the tenders to

[23] For a concise account of the European civil aviation policy, see Eugene Sochor, *The Politics of International Aviation*, University of Iowa Press, 1991, chaps. 11 and 12.

submit their final offers by 18 July. Meanwhile, it became clear that BA's inclination toward the GE engine was largely related to its financing proposal, arranged by GE's sister company, General Electric Credit Corporation.

Rolls-Royce then hastily assembled banks to set up a package. Importantly, in both cases the finance was to cover the aircraft as well as the engines. In other words, these engine manufacturers had to negotiate terms of finance with the bankers on behalf of BA. During the process, it was also made clear that the number of aircraft BA intended to acquire (B747-436) was 16, with an option of an additional 12. Goldman Sachs, Rolls-Royce's financial advisor, set up an international syndicate which would provide a $2.3 billion loan facility.

On 15 August, Rolls-Royce emerged as winner of the contract. Meanwhile the competition between the financial institutions became heated in the City; the group by Goldman Sachs fell apart. On 20 September, another group headed by National Westminster Bank won the deal.[24] In October, BA placed the aircraft order to Boeing.

At first glance, the episode provokes several questions: was there any political pressure on BA? or did BA use its choice as a lever to win privatisation? As for the first question, both Rolls-Royce and BA have denied it. As for the second, there is no examples which support the assumption that BA bargained its choice to secure its privatisation from the government.

On the other hand, however, BA gained a lot out of the development of events. Firstly, it secured the government's approval for its plan to purchase 16 B747-436s, the biggest order in the civil aviation industry to date if the option was exercised. As Rolls-Royce was involved, the approval for the whole plan was but an inevitable one for the government. Secondly, the competition between the banks demonstrated their eagerness to participate in the financing of BA, which, presumably, was an assuring sign for the company's sell-off. We must note that the contest in the City intensified before the announcement of the privatisation date. And lastly, thanks to the competition between the banks, the financing facility was enlarged and its term improved. It would not have occurred unless Rolls-Royce was convinced to draw its own package. To show that one has other fish to fry

[24] Besides NatWest, arrangers were Barclays Bank, Midland Bank, Citicorp Investment Bank, Mitsubishi Trust and Banking Corp. The deal was an operating lease. The tombstone was displayed, just after BA's privatisation, in *FT* 16 Feb., 1987, p. 23.

is quite a common and classical tactic in business.[25] Although who leaked the first news at the very early stage is not revealed, the outcome was satisfactory to BA, Rolls-Royce, and the government.

5. Labour Relations

As noted in the last chapter, the pay negotiation extended to 1986. Compared with the negotiations held in 1984, there were several differences. The first was that the pay rise was not unilateral. For example the pilots, who accepted the offer at an early stage, secured a 20% raise in wages for the next two years, whereas the engineering and maintenance staff, after a lengthy negotiation process, had to strike a deal of a 16% raise for the same period. The second difference was that the management insisted on productivity concessions and job flexibility (horizontal enlargement of job), including simplification of grades. The third difference lies in the circumstances of business overall; in 1984, the company was returning to profitability thanks partly to the boom in the North Atlantic traffic, while in 1986, this market was in a critical situation, threatening the company's profitability.

On 14 March, the engineering and maintenance staff rejected the offer, which was composed of an 8% raise for the year and another 8% for the next. The Transport and General Workers Union (TGWU) recommended to the ground service staff and cabin crew to accept the deal at 16%.[26] Ten days later, the negotiation with the engineering and maintenance staff was agreed to be reopened. By this time, the management had secured the acceptance of the aircraft engine maintenance staff at Treforest, South Wales, thus effectively split its counterpart. On the other hand, as the clause of job flexibility that the management sought to obtain along with the pay rise included transfer of certain jobs from blue-collar to white-collar staff, the latter, the engineering supervisors and technicians, also rejected the offer, and proceeded to ballot for industrial action.

On 7 May, the talks broke down again despite urging by Amalgamated Engineering Union (AEU) to accept the offer. In mid-May, the professional engineers and senior draughtsmen accepted an 18% offer. Increasingly, the militant elements of the unions found themselves alienated. AEU members

[25] In June, BA executive was reported to have said: "Rolls-Royce seemed to think they would get the order, and sent along their second eleven." Quoted in *ST* 29 June, p. 57.

[26] It was composed of a 6% raise retrospective to 1 January, a further 3% from 1 July, and 7% from 1 March 1987. Cf. *FT* 18 March, p. 15.

decided to accept the offer, while TGWU stood against. Toward the end of the month a ballot took place among the unions but the result was so slight (51.5% against industrial action) that the unions found themselves unable to act either way.[27] After TGWU members also accepted the offer on 9 June, the last acceptance was secured from the administrative and clerical staff in early August.[28]

In the process described above, we find some common features as well as particularities compared to the American situation. The first common feature is the plurality of unions. As the airline operation requires one of the highest standards of precision in various aspects, the workforce is composed of highly skilled, qualified and specialised personnel. The specialisation, coupled with the difference of career paths, leads to establishment of the unions corresponding to each specialised job field. However, it seems that the state-owned airlines tend to find within them more unions than the private ones. BA had sixteen, an unusual number in the U.S. case, but a figure corresponding to, for example, Japan Air Lines.

Secondly, the relative readiness of the pilots to compromise and the confrontational attitude of the blue-collar engineers are both common in the American cases. It is usually explained that pilots, the highest paid, tend to be compromising as their expertise is rewarded only in the civil aviation industry. We find many cases in the U.S. where the Air Line Pilots Association (ALPA) was the first to make concessions. In case of engineers (mechanics), the pay difference is relatively small between aviation and other industries. As aircraft is one of the most sophisticated and advanced kinds of equipment, airline mechanics are highly qualified engineers, and thus able to secure a high grade in other industries. The militant character of the International Association of Machinists (IAM) in the U.S. hardly needs mentioning.[29]

One should also note that the negotiations held in 1986 between the management and unions of BA, though complex and heated, were basically not antagonistic. BA could offer pay raises throughout the period that this

[27] Cf. *FT* 27 May, p. 12.

[28] The deal struck by TGWU members was composed of an 8% raise retroactively to 19 March, another 8% in 1987, with pay and grading review for January 1988. Cf. *FT* 10 June, p. 15. The deal with the administrative and clerical staff was the same as that of the ground service staff and cabin crew. Cf. *FT* 5 Aug., p. 8.

[29] For a brief review of the labour relations in the American airline industry, see Blumestock, James W., and Thomchick, Evelyn A., "Deregulation and Airline Labor Relations", *Logistics and Transportation Review*, vol. 22, no. 4, December 1986, pp. 389-403.

paper deals with. American cases in the corresponding period are full of pay-cuts, strikes and legal disputes. Deregulation is usually understood to lead to competition over products (price, routes and capacity). The other side of the coin, viewed from management, is that it forces the management to engage in a contest to bring or keep down the costs.[30] Thus airlines under deregulation are forced to set up as competitive a cost structure as possible. As the payroll is one of the controllable factors, the internal struggle between unions and management is bound to be fierce. Thanks primarily to the radical slimdown in 1982, and also thanks to the comparative wage advantage, BA was somewhat exempt from these fierce internal struggles.

[30] For the possible impact on the wage by the European deregulation, see Gil, op. cit., pp. 325-327.

VI. 1987: Privatisation

As this paper aims at describing events related to the privatisation of BA, this chapter only deals with the first months of 1987. The merger between BCal and BA, the negotiation between the British and Spanish governments in regard to Gibraltar, in connection to the British policy at the EC level, and the moves toward deregulation in Europe, are left undiscussed.[1]

The privatisation consisted of several steps, but the whole process was rather rushed. On 8 January, BA published a preliminary prospectus ("pathfinder") which stated that 720.2 million shares were being offered, and the minimum number of shares to be applied was 400. After eighteen days of speculation and comments on the possible share price, it was announced at 125p on 27 January. The payment was divided into two instalments: 65p was required for the initial payment, and the balance to be paid in August.[2] At the same time, the preliminary plan of allotment was revealed, according to which the City institutions would acquire through preplacement roughly 45% of the shares, the overseas investors (American, Canadian, Swiss and Japanese) roughly 20%, the employees of the company 10% on concessionary terms, and the British public around 25%. If the public offer was oversubscribed three times, the portion would be increased at the expense of the British and overseas investors. Six days later, Cleveland Securities launched the grey market by buying at 80p and selling at 85p.[3]

By the closing (10:00 a.m. on 6 February), a total of 1,145,068 applications were received with an oversubscription slightly less than ten times. Accordingly, the clawback mechanism was triggered. Meanwhile, the share price in the grey market went steadily up: 87p for buy and 92p for sell on 6 February. On 8 February the government announced the allocation. In view of the enthusiasm, it was decided to favour small investors.[4] The British public was allotted 35% while the allocations for the

[1] The merger of BCal by BA and its implications in regard to the competition policy are discussed in Vickers and Yarrow (1988), op. cit., pp. 352-354.

[2] The detail of the offer is in *ST* 1 Feb., p. 60. The nominal value was 25p per share.

[3] For a brief description of the grey market, see "Dealing in the grey market", *Accountancy* March 1987, p. 38.

[4] Those who applied for 400 to 1,500 shares were allotted 200 (50% to 13.3% of the shares applied); for 2,000 to 5,000 shares, 250 (12.5% to 5%); for 6,000 to 10,000 shares, 300 (5% to 3%); for 15,000 to 35,000 shares, 350 (2.3% to 1%); for 40,000 to 100,000 shares, 1% of the shares applied; for over 100,000, no shares.

City institutions and overseas ones were reduced to 36.1% and 16.5%, respectively. The balance was reserved for the employees of the company and loyalty bonuses. The letters of allotment were sent from 16 February.

Transactions of BA share at the Grey Market (2 February to 11 February 1987)

DATE	Buy (p)	Sell (p)
2 Feb.	80	85
4	82	86
6	84-87	89.5-92
9	94-98	99-103
10	100	105
11 before 14:30	107	112

Source: *Financial Times.*

On 11 February at 2:30 p.m., the official dealing started by quoting 119.5p for the first market price. There ensued massive selling and buying. By closing, 141.8 million shares were sold, which accounted for about 20% of the newly issued shares. As the table below shows, the price went down slightly until 17 February. Probably more cautious investors were waiting for letters of allotment before proceeding to selling. The next day the price popped up and remained around 108p to 109p until the 20th, when the massive sale apparently ended. In ten days, a total of more than 279.4 million shares changed hands, which represented nearly 40% of the outstanding shares. During the period, BA remained the most active stock at the London Stock Exchange, except on the 13th and the 20th.

One noticeable fact is that the share price did not collapse despite massive selling. This reflects a strong demand. Given that all the small investors received some portion of their applications, it was the institutional investors that were buying eagerly. Another fact is that BA stock was also active at the New York Stock Exchange (NYSE).[5] The price and the trading volume followed more or less the same trend as in London. Within the same period, an amount equivalent to 8% of the shares changed hands at NYSE. These two facts combined, a preliminary conclusion is that the

[5] One share in the U.S. and Canada was equivalent to ten shares. Cf. *FT* 24 Feb., p. 26, 26 Feb., p. 29. The number of shares allotted to the American institutions accounted for 8.6%, to the Canadian ones 3.9%, and to the Swiss ones 1.9%. See also *FT* 23 Mar., p. 24.

British public, as soon as (or even before) they received the allotted shares, sold them to the institutional investors, a substantial part of whom were American.[6]

Transactions of BA share at the Official Markets (11 February to 20 February 1987)

London Stock Exchange NYSE (for 10 shares equivalent)

DATE	Price (p)	Volume (millions)	Price ($)	Volume (100,000)
11 Feb. 14:30	119.5			
11 close	109	141.8	16.75	28.137
12 close	108.5	33.3445	16.375	9.329
13 close	107	n.a.	16.875	5.554
16 close	106	12.5	no trading	
17 close	105.5	32	16.5	5.283
18 close	109.5	39.25	16.75	5.421
19 close	108	13.5	16.5	2.723
20 close	109	7	16.875	0.913
Total		279.4		57.36

Source: *Financial Times, Wall Street Journal.*

The number of shareholders has been steadily decreasing. As of 15 May 1992, the total number of shareholders is 265,819, of whom 96% possess not more than 1,000 shares. These small shareholdings account for less than 10% of the outstanding shares. Viewed by another classification, individual shareholders, accounting for 98% in number, hold only 12% of the outstanding shares.[7] More importantly, 41% of the outstanding shares are in the hands of non-UK nationals at the end of March 1992.[8] To put it otherwise, BA is now a heavily institutionalised and internationalised company in terms of shareholding. Therefore, so far as the wider share ownership policy is concerned, BA is not a successful case.

However, it is doubtful if the British government wished to see this stock kept in the hands of the initial individual applicants. As argued in the previous chapter, the government took precautions at the outset so that

[6] Salomon Brothers, one of the lead managers for the American issue, said that more than 300 institutions were chasing the stock. Cf. *Times* 12 Feb., p. 19.

[7] BA, *Report and Accounts 1991-92*, p. 39.

[8] Ibid., p. 6.

small investors would be deterred from applying. Notwithstanding this, the government was also anxious not to exclude them from the allocation. On the other hand, airline stock is notoriously volatile. It must be noted that almost no one recommended the public to keep the stock, despite a rather high dividend and the loyalty bonus scheme for faithful holders. The individuals sold for a quick profit, but quite rightly. Also, it would not be wrong to assume that the immediate transfer from the individuals to the institutional investors was not an unwelcome outcome for the government.

This consideration leads to the conclusion that the key to the whole process lay in two ingredients: underpricing and allocation. The former secured that the stock would be priced at high premium. The second enforced, especially after the clawback mechanism took place, the strong demand by the institutional investors. Finally, the high premium was a success for BA, too. No doubt the robust price in UK and the U.S. assured the company to obtain credit for expansion.

In parallel to the privatisation, BA launched a campaign to recruit 100 pilots for the next decade; it was the first recruitment of pilots for the last ten years. Several plans for aircraft orders were successively announced.[9] Apart from the $2.3 billion facility, BA successfully raised £100 million in April.[10] The privatisation freed the company to pursue expansion.[11]

[9] Cf. *FT* 19 Feb., p. 5, 25 Mar., p. 6, 15 Apr., p. 14.

[10] Cf. *FT* 30 Apr., p. 3.

[11] In October 1986, a further organisational reshuffling took place "to enhance [the company's] selling ability worldwide." BA, *Report and Accounts 1986-87*, p. 7. BA was clearly geared up to boost revenues by expansion rather than to recover profitability by retrenchment.

Conclusion

For many people, to fly is a joyful experience. To manage an airline, hardly so. BA provides a rare case of turnaround. From the business management point of view, it is of particular interest to see how the success was achieved. However, excessive generalisation is dangerous; one should bear in mind the particular circumstance surrounding this case. It may also be necessary to define the "success". As argued in the last chapter, the privatisation of BA did not conform to the government's policy of wider share ownership. It could also be argued that its pricing was so low that the company was sold off at the expense of taxpayers. Yet these claims, regardless of their validity, are about the government's policy, and therefore, essentially political. If the privatisation of BA was unsuccessful, the flotation was successful. The business world welcomed the company's accession.

So far as a business organisation is concerned, profitability counts more than efficiency. Of course it is absurd to maintain that the efficiency of a company has nothing to do with its profitability; an unprofitable company cannot be thought efficient. Nevertheless, profitability and efficiency are different notions. Comparisons between airline competitiveness based on such measurements of efficiency as available seat kilometres per employee, revenue per employee, or more generally, output divided by input, are relevant only when unit cost is the same and when airlines compete in the same markets. BA may be inefficient compared with its American rivals. But it is profitable while many American airlines are not. The question should be, then, how its financial success has been achieved.

At first glance, one factor is the slimdown from 1981 to 1983. However, to slash payroll is an emergency measure and its effects, as shown in the American cases, are relatively short-lived. More importantly, the management introduced a series of organisational restructuring initiatives. The profit centre structure, and then the marketing-oriented structure, along with a corporate image campaign, incurred costs. Yet they were deemed necessary to eliminate "managerial discretionary behaviours"[1] and their consequences. At the same time they were to serve the purpose to establish commitment and loyalty among the employees. To put it otherwise, the reshufflings were attempted in line with motivation management. We find some explicit motivational factors related to pay; the pay rise in 1982, the

[1] Matthias-Wolfgang Stoetzer, "Efficiency and Prices in the European Air Transport Market: Some further Evidence", in Giandomenico Majone (ed.), *Deregulation or Reregulation? Regulatory Reform in Europe and the United States*, Frances Pinter, 1990, p. 127.

profit sharing scheme, and the employee share ownership plan should be understood in this context.

As "managerial discretionary behaviours" are accumulated over a long period of time and deeply rooted within the organisation concerned, it seems necessary to bring in new managers with strong character for radical reforms. In the case of BA, King, and later Marshall, proved to be extremely fit for the task. In the case of Pan Am, Edward Acker, though unsuccessful in the end, fought fiercely and managed to keep the company aloft for some time; in Japan, the Nippon Telephone and Telegraph (NTT) provides a similar case of successful privatisation under a chairman newly brought in. Very roughly speaking, the job of a manager consists of transforming a state of things in the firm or the section he or she is in charge of to another. In other words, the state of things a new manager finds is the material, out of which he or she creates a new and improved state of things, either in terms of physical settings or motivational factors, financial or numerical performances, or a combination of these elements. The real reward for the manager is probably this very creation. Presumably, to those who qualify themselves as businessmen, managerial discretionary behaviours are simply not acceptable.

One important fact is that King was chosen and brought into the company by a government that was selling off the airline to the public. BA did not become profitable (or efficient) out of competition. As argued in the introduction, it was required to become so, mainly in view of the privatisation policy.[2] Also, the government was anxious not to hamper the basic advantages of BA. The route transfer was blocked;[3] the company's debt was largely guaranteed by the Treasury; BA's fare setting in the North Atlantic with its counterparts was shielded from prosecution by the American authorities.

However, as the British government was also committed to competition, relations between the company and the government turned out to be tense when the inherent contradiction became apparent. The controversy over route transfer is the most explicit instance. Another confrontation occurred when BA wanted capital for expansion but the government, presumably, chose other state-owned organisations to be privatised before BA. In both cases, the management had to be political and, admittedly, its manoeuvre was remarkable.

On the other hand, the company's status as a state-owned flag carrier helped to accomplish the turnaround. BA's occasional threats to withdraw its service were based on the fact that it was the most privileged carrier in

[2] The process seems similar to some other privatisations. Rolls-Royce also tried to improve productivity before privatisation. Cf. Hayward, op. cit., p. 161 below.

[3] For an extensive discussion on this issue, see Ashworth and Forsyth (1986), op. cit.

UK. Being state-owned, the company was allowed to announce its results when it wished, a behaviour that would have led to a delisting if it had been a quoted company. BA also could be sure that its foreign counterparts would not undercut its prices. It must be added that the boom in the North Atlantic from 1983 to 1985 contributed substantially to improve its balance sheet and to displace major obstacles of flotation. The out-of-court settlement for Laker litigation and, to a lesser extent, the replacement of the pension scheme in exchange for lump sum payments would have been both much more difficult to achieve, if not impossible, unless BA earned its own way.

To put it briefly, BA exploited the circumstance. Yet any management unable to exploit circumstances, either political or economic, which surround the organisation shall be judged incompetent. To run a company is no candid business. Given the recovery to profitability, the consistency in decisions on fleet, finance and organisational restructuring, and shrewd exploitation of the circumstance, the management of BA under King and Marshall was competent. Despite threats, political tactics and buy-offs, it is fair to say that the management of BA was earnest in the bold sense of the word.

After the privatisation of BA, there followed a series of privatisations around the world. Japan Air Lines was wholly privatised later in the same year, followed by Air New Zealand and Air Canada in the next two years. Lufthansa, Air France and Alitalia also are lining up in the queue. In Latin America, a number of carriers either have been or are being privatised. In Asia, India and Pakistan are privatising their carriers. In Eastern Europe and ex-USSR, not less than a hundred carriers have been established and they are desperately looking for capital.

BA, now the most consistently profitable airline in the world, is spreading its wings over the world under Sir Colin Marshall, new chairman since early 1993: apart from the merger of BCal in 1987, the airline set up Air Russia, acquired the single largest share in TAT European (France), Deutsche BA (Germany), Qantas (Australia), and USAir (U.S.). It is yet to be seen whether this aggressive strategy to become a global carrier would prove correct. What is certain, however, is that BA's acquisitions are consistent with its own fleet decisions, i.e., Boeing aircraft (especially B737s) powered by Rolls-Royce engines, and that it could afford to be aggressive because of its profitability. Also certain is that its acquisition of BCal made it possible for the British government to act for the benefit of BA without being criticised as unfair. It is well illustrated in the course of bilateral negotiations during 1991 and 1992 between the U.S. and UK concerning the American carriers' landing rights to Heathrow and BA's acquisition of USAir.

Selected Financial Statistics

BA's airline turnover (1981-1987) (£ million)

	1st Quarter	1st Half	Year
1981-82	n.a.	n.a.	1,861
1982-83	n.a.	n.a.	2,043
1983-84	602	1,298	2,382
1984-85	682	1,491	2,797
1985-86	n.a.	1,640	2,981
1986-87	n.a.	1,559	3,054

Note: Including British Airtours.

BA's airline operating surplus (1981-1987) (£ million)

	1st Quarter	1st Half	Year
1981-82	n.a.	n.a.	5
1982-83	n.a.	n.a.	169
1983-84	70	198	274
1984-85	81	236	303
1985-86	90	205	205
1986-87	38	151	183

Note: Including British Airtours.

BA's airline gross operating margin by geographical area (1981-1987, %)

	Europe	The Americas	Africa	Middle East, Far East, Australasia
1981-82	0.4	-1.1	14.0	-2.8
1982-83	6.3	8.4	14.1	6.2
1983-84	9.5	12.9	13.8	10.0
1984-85	7.0	15.0	14.2	8.0
1985-86	4.4	8.4	7.8	7.0
1986-87	5.7	6.6	10.8	5.0

Note: Excluding discontinued activities.

BA's Group profit/loss before taxation & extraordinary items (1981-1987) (£ million)

	1st Quarter	1st Half	Year
1981-82	n.a.	n.a.	-144
1982-83	n.a.	n.a.	45
1983-84	47	150	185
1984-85	47	189	168
1985-86	n.a.	201	183
1986-87	n.a.	141	143

BA's outstanding capital debt (1981-1987) (£ million)

	1st Quarter	1st Half	Year
1981-82	n.a.	n.a.	1,011
1982-83	n.a.	n.a.	1,053
1983-84	n.a.	n.a.	901
1984-85	873	770	647
1985-86	n.a.	464	379
1986-87	n.a.	353	297

Share ownership of BA (1987-1991)

Date	Number of shareholders	Stake of small shareholdings (less than 1,001 shares)	Stake of large shareholdings (more than 1 million shares)
21 May 1987	420,526	13.65%	50.30%
18 May 1988	347,897	10.89%	58.87%
15 May 1989	338,350	10.26%	63.90%
15 May 1990	314,039	10.17%	69.94%
10 May 1991	295,970	9.59%	70.62%

Source: BA, *Report & Accounts*, advertisement of results in *Times* and *Financial Times*.

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2 Oct. p. 4 "Confusion over BA chairman's statement"
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1983

7
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5 Feb. p. 4 "Inquiry to hear plans for air fare rises"
11 Feb. p. 5 "BA offers end-of-winter transatlantic fares deal"
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2 Mar. p. 19 "Preparing for new growth"
4 Mar. p. 7 "BA 'losing out on flights to Spain'"
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15 Mar. p. 9 "Group wins £3m BA catering equipment order"
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14 Apr. p. 20 "How Saatchi aims to take British Airways up, up and away"
15 Apr. p. 9 "BA to consider ways of improving Shuttle"
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