

4 British Caledonian Group plc

4.1. British Caledonian Group plc (BCG) is the holding company for a group of which British Caledonian Airways Ltd (BCAL) is the principal subsidiary. The structure of the Group is shown at Appendix 4.1.

History and development

4.2. The Group Chairman, Sir Adam Thomson, is a qualified pilot, and flew for the Fleet Air Arm, BEA, West African Airways and Britavia. In 1961 he and four colleagues registered a new airline, Caledonian Airways (Prestwick) Ltd. Caledonia was the Roman name for part of Northern Britain and has become a poetic name for Scotland; it was thought to be an appropriate name for an airline founded by a Scot with the help of Scottish finance, with a base in Prestwick as well as Gatwick, and aimed at serving Scottish immigrants in the United States and Canada. Its inaugural flight, on St Andrew's Day 1961, was from Gatwick and the airline has been closely involved with Gatwick's development ever since.

4.3. Caledonian began operations with a single aircraft leased from Sabena. It concentrated on long-haul 'affinity group' charters to Canada and the United States, and also operated group charters to southern Africa and inclusive tour charters to the Mediterranean. At that time operations to the United States were restricted by US Government regulation. However, in 1963 Caledonian was the first non-American charter airline to obtain an unrestricted permit. Subsequently it won the first ever transatlantic inclusive tour licence. By the late 1960s Caledonian was the largest British charter airline. During its early years it relied on aircraft leased or purchased from other airlines, but as the 1960s progressed it began to buy new aircraft.

4.4. Caledonian made several unsuccessful attempts to obtain licences for scheduled services, to the Mediterranean from Glasgow, and to the United States and Canada from Gatwick, Birmingham and Prestwick. In May 1969 the Edwards Report, in recommending the creation of a second-force scheduled airline (see paragraph 2.2), suggested that it should be formed from Caledonian and British United Airways, which was the largest independent operator of scheduled services in the United Kingdom at that time. The recommendation was put into effect in 1970 when, with Government support, Caledonian mounted a successful bid to take over British United Airways. In 1971 the merged airline also acquired the Ghana, Nigeria and Libya scheduled routes transferred from BOAC, and Paris-Le Bourget from BEA. It took the name British Caledonian Airways in September 1971.

4.5. By the end of 1971 BCAL operated services to Europe, North and South America and Africa. It carried 2.6 million passengers in that year (compared with 617,000 in 1969 and 8,000 in 1961), of whom about a third were on scheduled flights. It also operated several domestic services, and these were developed during the 1970s to create intraline connections with its own international flights and interline connections with services from Amsterdam. At this time it also introduced several innovative fare schemes; these included Britain's first 'walk-on' air service (at night) at half the normal fare.

4.6. In 1972 BCAL was for the first time licensed to operate scheduled services to the United States, and it began flights to New York and Los Angeles the following year. It was forced to suspend them in 1974, and to cut back several other services, because of the oil crisis and the worldwide recession which followed. The number of passengers carried fell and profitability suffered. Nevertheless during the 1970s and early 1980s BCAL introduced services to points

in South and later North America, Africa and the East; and it profited from Britain's developing oil industry by operating passenger/cargo and whole-plane cargo services to Houston. By the early 1980s virtually all its services were scheduled. In 1982 it re-entered the charter market following the collapse of Laker Airways, and formed a subsidiary operating with two ex-Laker aircraft. At the end of the year half of the subsidiary's equity was sold to The Rank Organisation PLC, and it was later re-named Cal Air International Ltd. BCAL has, however, occasionally operated charter services since.

BCG's activities

4.7. Through BCAL, BCG operates domestic services from Gatwick to five other airports, and flies to 32 destinations in Africa, Europe, North America, the Middle East, and the Far East; all its international flights leave from Gatwick, where it is the largest airline. It carried 2.4 million scheduled passengers in 1986, which made it the 56th largest scheduled carrier in the world, and the 15th largest in Europe. Cal Air carried about a million passengers, and to a limited extent part-charter passengers were also carried by BCAL on scheduled aircraft.

4.8. In 1986 BCAL carried 76,563 tonnes of cargo (including mail) in the holds of scheduled aircraft. It has a cargo centre at Gatwick, and maintains cargo-handling facilities at Heathrow and in Europe to truck freight to Gatwick for onward dispatch.

4.9. BCAL also provides service to other airlines. It is one of three agents currently providing passenger and ground-handling services at Gatwick, and is a shareholder in a company providing passenger-handling services at Manchester Airport. It carries out maintenance work at Gatwick on its own aircraft and those of other airlines. Until 1986 BCG also carried on an aero-engine overhaul business through Caledonian Airmotive Ltd, a wholly-owned subsidiary of BCG, which was sold on 4 March 1987. BCAL owns 50 per cent of British Caledonian Flight Training Ltd, which trains aircrew for BCAL and other airlines.

4.10. British Caledonian Helicopters Ltd specialises in contract work for companies engaged in oil production and exploration in the North Sea.

4.11. Through another wholly-owned subsidiary, Caledonian Hotel Holdings Ltd, BCG operates 11 hotels in the United Kingdom and abroad.¹ Other hotels were sold in 1986, as were three inclusive tour companies operated by Caledonian Leisure Holdings Ltd.

Employment

4.12. At 31 July 1987 BCG had 8,207 staff, of whom 7,692 were employed by BCAL (1,148 overseas). BCAL is a member of the National Joint Council for Civil Air Transport, under whose auspices terms and conditions of employment are negotiated with individual trade unions. Most of its staff belong to trade unions. In 1983 it began to implement 'The Way Ahead', a strategy aimed at changing labour relations in BCAL. In exchange for a higher basic rate of pay and greater involvement in the business, staff agreed to forego overtime pay and adopt more flexible working practices. BCG told us that BCAL's industrial relations record is good; it has never lost a full day's operation because of industrial disputes and staff turnover is low.

Financial information

4.13. BCG makes up its accounts to 31 October each year using the historical cost convention as modified by the revaluation of certain tangible fixed assets.

4.14. Table 4.1 sets out summaries of BCG's restated balance sheets, together with its capital commitments, at 31 October in each of the years 1982 to 1986 inclusive.

¹ Shortly before our inquiry was completed BCG announced the sale of Caledonian Hotel Holdings to a subsidiary of Aer Lingus for an undisclosed sum.

TABLE 4.1. BCG: summarised balance sheets and capital commitments

	£ million				
	31 October				
	1982	1983	1984	1985	1986
Tangible fixed assets	228.4	243.2	338.9	417.6	337.9
Investments	0.4	3.1	1.7	2.0	3.1
Stocks, debtors and overseas cash less liabilities (other than borrowings)	13.1	33.1	18.3	31.3	78.7
Capital employed	241.9	279.4	358.9	450.9	419.7
Borrowings less United Kingdom cash	(187.7)	(211.2)	(279.4)	(357.0)	(319.9)
Net tangible assets	54.2	68.2	79.5	93.9	99.8
Share capital and reserves	56.0	68.4	81.5	99.7	97.2
Intangible assets	(3.8)	(2.3)	(4.2)	(7.9)	(4.3)
	52.2	66.1	77.3	91.8	92.9
Deferred income	2.0	2.1	2.2	2.1	6.9
	54.2	68.2	79.5	93.9	99.8
Capital commitments:					
Contracted for	73.3	216.6	183.4	131.6	344.4
Authorised but not contracted for	4.7	6.6	4.2	12.1	4.0
	78.0	223.2	187.6	143.7	348.4
Gearing (borrowing net of UK cash: capital and reserves less intangible assets) (%)	360	320	361	389	344

Source: MMC from BCG.

We make four comments on the summarised balance sheets in Table 4.1. First, cash held overseas has not been deducted from borrowings in calculating capital gearing, as is the Commission's usual practice, because of doubts about the remittability of certain balances. Secondly, although BCG is highly geared by conventional standards, the position has not worsened over the last five years. Thirdly, there has been a significant increase in capital commitments, from £78 million in 1982 to £348 million in 1986. Finally, despite the retained loss of £14.4 million in 1985-86 (see Table 4.3), share capital and reserves fell by only £2.5 million, mainly because of property revaluation surpluses of £11.5 million.

4.15. Details of BCG's tangible fixed assets at 31 October 1986 are set out in Table 4.2.

TABLE 4.2 BCG: tangible fixed assets at 31 October 1986

	At cost or valuation	Depreciation or amortisation	£ million Net book amount
Aircraft fleet			
—owned	16.2	2.2	14.0
—leased	235.5	37.7	197.8
Aircraft support equipment			
—owned	27.2	9.0	18.2
—leased	7.8	1.2	6.6
Freehold hotels and related equipment	14.2	—	14.2
Other land and buildings:			
Freehold	9.0	1.3	55.8
Leasehold	0.6		
—over 50 years unexpired	47.5		
—50 years or less unexpired			
Other plant and fixtures			
—owned	36.2	16.7	19.5
—leased	17.1	5.3	11.8
	411.3	73.4	337.9

Source: BCG.

BCG capitalises and depreciates tangible fixed assets subject to finance leases¹ in the same manner as owned assets. It depreciates its wide-bodied aircraft over 18 years, allowing for a residual value of 10 per cent of cost, its narrow-bodied

¹ See footnote to paragraph 3.18.

aircraft so as to write them off by the end of 1992,¹ and its helicopters over their remaining commercial lives of 3 to 12 years. It does not, however, depreciate freehold hotel properties on the grounds that they are maintained to a high standard and have, in its view, a residual value at least equal to their net book value.

4.16. Table 4.3 summarises BCG's restated profit and loss accounts for the last five years.

TABLE 4.3 BCG: summarised profit and loss accounts

	1981-82	1982-83	1983-84	1984-85	1985-86
	<i>£ million</i>				
Revenue	400.1	428.5	526.2	602.0	567.0
Operating costs	(385.7)	(411.6)	(503.7)	(564.0)	(505.7)
Operating profit	14.4	16.9	22.5	38.0	61.3
Other income*	(0.1)	2.0	8.8	12.5	25.3
Exceptional items	2.4	—	5.0	(0.6)	(77.9)
Finance charges	(15.6)	(16.3)	(18.4)	(27.5)	(28.0)
Employee profit share	—	—	(0.8)	(1.0)	—
Profit/(loss) on ordinary activities before taxation	1.1	2.6	17.1	21.4	(19.3)
Taxation	(0.8)	(1.7)	(3.4)	(3.5)	7.9
Profit/(loss) on ordinary activities after taxation	0.3	0.9	13.7	17.9	(11.4)
Extraordinary items	—	(0.6)	(0.6)	(3.6)	(3.0)
Profit/(loss) attributable to ordinary shareholders	0.3	0.3	13.1	14.3	(14.4)
Dividends	—	—	(2.2)	(3.0)	—
Retained profit/(loss)	0.3	0.3	10.9	11.3	(14.4)

Source: BCG.

*Mainly profits on disposals of fixed assets and fixed asset investments.

4.17. BCG's 1985-86 revenue of £567 million can be analysed by activities and by geographical areas as shown in Table 4.4.

TABLE 4.4 BCG: analyses of revenue, 1985-86

	<i>£ million</i>
<i>By activities</i>	
Air transport:	
Airline operations	471.0
Helicopter operations	11.9
Overhaul of aero engines (now discontinued)	36.8
Inclusive tour holidays (now discontinued)	37.5
Hotel operations	13.4
	570.6
Intra-group sales	(3.6)
	567.0
<i>By geographical area</i>	
United Kingdom domestic	109.3
Europe	69.9
North Africa	9.3
West and Central Africa	99.5
South America	1.4
North America and Caribbean	174.0
Middle and Far East	107.2
	570.6
Intra-group sales	(3.6)
	567.0

Source: BCG.

¹ At around this date noise control requirements will necessitate the withdrawal of the aircraft from service in the United Kingdom.

4.18. Exceptional items in 1985–86 included the impact of terrorism (£35.5 million), Nigerian devaluations (£34.5 million), and BCAL's severance programme (£10.1 million), less a profit on aircraft refinancing of £2.2 million.

4.19. Table 4.5 summarises BCG's source and application of fund statements for the last five years. It shows that funds generated from operations and new loan finance have fallen well short of the amounts required to cover expenditure on fixed assets. The shortfall has largely been made up by fixed asset disposals, which amounted to £138 million in 1985–86.

TABLE 4.5 BCG: summarised source and application of funds statements

	1981–82	1982–83	1983–84	1984–85	1985–86	£ million 5-year total
<i>Source of funds</i>						
Profit on ordinary activities after taxation and extraordinary items	0.3	0.3	13.1	14.3	(14.4)	13.6
Depreciation and other items not involving the movement of funds	18.2	20.8	25.9	32.2	37.1	134.2
Funds generated from operations	18.5	21.1	39.0	46.5	22.7	147.8
Disposals of fixed assets*	1.2	2.4	3.5	16.3	138.1	161.5
Loans and lease finance received	25.1	62.7	105.0	134.7	96.1	423.6
Secured deposits released	3.8	4.8	8.3	14.8	33.2	64.9
Other items	(0.2)	—	0.1	0.7	5.8	6.4
	48.4	91.0	155.9	213.0	295.9	804.2
<i>Application of funds</i>						
Expenditure on fixed assets*	19.0	12.3	106.1	135.6	81.8	354.8
Acquisition of subsidiaries	—	3.7	0.3	—	—	4.0
Other applications	—	1.0	—	—	—	1.0
Loan and lease finance repayments	25.0	65.9	42.4	78.3	193.4	405.0
Secured deposits placed	—	—	5.5	—	—	5.5
Dividends paid	—	—	2.2	3.0	—	5.2
Increase/(decrease) in stocks and debtors, less creditors	(8.7)	3.3	(7.9)	20.6	59.6	66.9
	35.3	86.2	148.6	237.5	334.8	842.4
Increase/(decrease) in net liquid funds	13.1	4.8	7.3	(24.5)	(38.9)	(38.2)
<i>Source: BCG.</i>						

*Tangible and intangible fixed assets, and fixed asset investments.

4.20. BCG is an unlisted public company. At 11 June 1987 its issued share capital consisted of some 20 million ordinary shares of £1 each. The principal shareholder was Investors in Industry plc (3i), whose initial holding of 14 per cent in Caledonian Airways (dating from 1967) has increased as a result of the merger with British United Airways and a subsequent rights issue until it now has a 41 per cent stake in the company. The rest of its shares are mainly in institutional hands, with no single shareholder holding more than 6 per cent of the total capital; most staff are also shareholders as a result of employee share schemes.

Recent events

4.21. The 1980s have dealt a number of blows to BCG. In 1982 BCAL's services to Argentina, Chile, Ecuador and Peru were curtailed because of the direct and indirect consequences of the Falklands War. BCAL had hoped that the CAA's review of airline competition policy (see paragraph 2.6) would enable it to be strengthened by the transfer of some of BA's routes, but the Government instead proposed a more limited route exchange. It was at last able to disembarrass itself of its South American routes in return for the profitable Saudi Arabian services; however these promptly began to make losses because of the collapse in the price

of oil. Services to Houston and Lagos suffered for the same reason; the profitability of the Lagos service was also affected by foreign exchange problems in Nigeria which meant there were delays in repatriating funds (which in the meantime had lost value). Flights to Tripoli were suspended because of the United States bombing of Libya; fear of reprisals by Libya, and of radioactive contamination following the Chernobyl explosion, reduced the number of American tourists flying to Europe. In 1986 its licence to operate the Gatwick-Heathrow helicopter airlink, which BCAL said gave it important interline benefits, was withdrawn on environmental grounds.

4.22. In 1985 BCG had considered flotation on the stock market. This plan was abandoned, and instead it disposed of some of its businesses and reduced the flight frequency on some of BCAL's routes. In May 1986 BCG announced that it would reduce its workforce by 1,000 by means of voluntary redundancy.

4.23. Meanwhile a number of airlines, British and foreign, had expressed interest in either a full merger or a minority shareholding. The International Leisure Group (which owns Air Europe) made an offer in May 1986 which BCG believed to be unacceptable; in the same year cursory discussions with British Midland came to nothing; and discussions with the French airline Union de Transports Aériens were shelved because of the difficulties an airline under foreign control could expect to encounter in obtaining United Kingdom air transport licences and designation under international ASAs. No discussions with other airlines have yet led to a firm proposal.

4.24. BCAL told us that during this period of contact with other airlines, which lasted until spring 1987, BCG did not receive an approach of any kind from BA. Nevertheless BCG told us that early in 1987 it began to accept that some form of association with BA was the best solution to its problems which, not unnaturally, had begun to concern its major shareholder. Thus an informal conversation on 2 June 1987 between two executives of the airlines rapidly led to formal negotiations. On 10 July representatives of BCG met the Director General of Fair Trading and explored the possibility of obtaining confidential guidance as to whether he would be likely to refer a merger. On 14 July he was told by BA that both parties had decided to proceed and confidential guidance would not be sought. Terms were agreed on 15 July, and on 16 July it was announced that BA had made an offer for the whole of BCG's issued share capital. The offer placed a value on BCG of some £237 million. At the time of the announcement undertakings to accept the offer had been received in respect of some 40 per cent of BCG's shares. When the offer document was posted on 28 July, shortly before the reference to the Commission, BA had received acceptances in respect of 60 per cent.

4.25. The offer lapsed on 6 August when, acting on the advice of the Director General of Fair Trading, the Secretary of State referred the proposed merger to the Commission. On 20 August the Secretary of State announced that BA had given undertakings not to acquire any part of BCG's share capital, or to enter into any agreement or arrangement which would result in its holding or having an interest in more than 15 per cent of BCG's shares, until the Commission had reported.