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POSSIBLE ECONOMIC IMPACT ON UK INTERNATIONAL TRANSPORT OPERATORS OF ACTION AGAINST IRAQ

SUMMARY

- **There would be some commercial impact on UK airlines, particularly BA and Virgin, but any disruption to services would be directly attributable to the hostilities, not a secondary result of financial difficulties.**
- **The airlines are making contingency plans, including making financial provision.**
- **DfT is not proposing to intervene, and will encourage the European Commission to take a similar position.**
- **On shipping, the main non-oil trade issue is protection of the Red Sea/Suez route, as war insurance rates could rise quickly unless the insurance market can be calmed by briefing.**
- **Even if Suez were blocked, most trades could divert to other routes at some additional cost. But shipping costs are not a significant determinant of end product or service costs**
- **Government intervention in case of market failure on war insurance is being prepared, with HMT consent, for both shipping and aviation. Additionally in aviation, HMT has indicated it would re-activate arrangements for covering war-related third party risk if necessary.**

AVIATION

Airlines

1. We would not expect hostilities against Iraq to disrupt airline services for economic reasons, although some individual companies, notably BA and Virgin, would suffer adverse commercial effects.

2. Some airlines (probably only BA and Virgin) would need to re-route certain services, resulting in extended travel time, increased fuel consumption, disruption to operational and staffing schedules, and possible difficulties in maintaining workable arrival and departure slots at congested airports.

3. Military action would reduce passenger demand on certain routes, not only to and from directly affected areas but also, and on past evidence more significantly, on transatlantic routes. BA and Virgin would be substantially

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affected by a downturn on routes into and out of the US, whilst bmi British Midland and some others would suffer loss of feed traffic. Short haul demand would be less affected - the major no-frills operators seemed to go from strength to strength in the aftermath of 11 September.

4. The major airlines are well aware of the possible commercial implications of hostilities against Iraq - according to BA, advance bookings on some routes are already significantly down. They are preparing themselves by building up cash reserves - BA says it has a reserve of some plus further drawdown facilities. They are not asking for government support, but are anxious that we should do what we can to ensure equal treatment for their main EU competitors. They complain at every opportunity, with some justification, about the assistance US carriers are receiving post-11 September.

5. This matter is on the agenda at a meeting on Friday 15 November between the Director of Aviation in DG TREN and EU Directors-General of Aviation. Our line will be that the Commission should maintain a firm stance against state aid, in the hope that our non-interventionist stance would be mirrored elsewhere.

6. On the special case of war-related insurance cover, the UK and most other EU governments provided emergency support for third party risks following 11 September because the market had failed. The Commission approved such support under the Community's state aid rules. The UK scheme ("Troika") was closed down on 31 October 2002, except for continuing support for two security screening firms, but Treasury has indicated that it would step in again should there be another market failure. Arrangements for activating existing legislation to provide geographically-zoned hull insurance cover at short notice are in hand.

Airports

7. We would not expect UK airports to experience any problems unless we were to start closing airspace on a significant scale and prevent access over a long period. Post-11 September experience suggests that we could expose ourselves to claims for compensation were we to close airspace without due consultation and/or good reason.

Air Traffic Management

8. Although a drop in traffic would adversely affect NATS' finances, air traffic services would not come to a halt. As is well known, NATS faced problems following 11 September. The composite solution proposed by its Regulator (CAA) and supported by the Government is designed not only to remedy existing problems but also to protect NATS from any further severe downturn in business. If all else fails, the Transport Act 2000 makes provision for NATS to go into administration. The Act prevents a wind-up of the company, in order to ensure that service provision continues.

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SHIPPING

9. Direct effects on shipping services depend on type of trade and extent of warzone disruption. Indirect effects, such as on insurance markets, would depend on speed and credibility of calming countermeasures. Effects on UK non-oil trade are likely to be minor; effects on oil supply are covered in DTI advice and there is only a minor shipping issue. A Gulf warzone, greater disruption for example into the Red Sea-Suez corridor and potential retaliation on shipping elsewhere need separate consideration.

10. For **passenger shipping**, there is no UK Gulf interest and only slight UK passenger participation in Middle East cruises on foreign vessels, which would divert from the area. Guidance to the industry on security protection elsewhere is kept under review, in the light of threat assessment.

11. **Manufactures** are mainly carried in the container trade, using multinational alliances of companies with large fast containerships on the mainline routes, and feeder services from regional hubs. There are some specialised trades such as carcarriers. The Gulf is a dead end, partly served by feeders from regional hubs such as Oman on the mainline through the Red and Arabian Seas. The main issue is protection or blockage of the Red Sea route; war risk insurance rates may rise quickly unless the insurance market can be briefed authoritatively on protection.

12. Blockage of the Red Sea or Suez would affect different trades in different ways; North Europe-Australasia could divert via Panama with little extra mileage, while North Europe-East Asia transit could increase by 6 or 7 days via the Cape, and the proportionate increase on Europe-India traffic would be greater. The container trade has excess capacity and low rates at present and post-Christmas is its quiet period; so the immediate effects of blockage on shipping could be damped and the first strain would appear in hub port congestion as ships' reassignment of routes changed regional and feeder patterns.

13. **The oil trade** risks are covered by DTI. The only additional shipping point to note is that the largest crude carriers can call, fully laden, only at a limited number of alternative loading ports, so reducing the efficiency of substitution of other supply sources. This would have little effect on the pump price. Large crude carriers are judged relatively attractive terrorist or retaliatory targets, but as the Limburg incident showed are comparatively difficult to destroy; advice has already been issued to the industry on precautions, without being specific to the Middle East.

14. **Non-oil primary products** are mainly carried in bulk carriers, few under UK or western flags and so potential targets. Little of significance to the UK economy originates in the Gulf or Red Sea area, and other traffics such as ore or coal from more distant locations like Australia can divert easily.

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15. **Indirect effects:** continued shipping services at higher rates could actually benefit UK (and other) shipowners in the short run, depending on the trade and the insurance market's reaction. But shipping costs are not a significant determinant of end-costs or profitability, even though shippers and exporters might suffer some short-term delays as traffic patterns reassign.

16. Prolonged economic uncertainty could however reduce world trade, with downside effects on shipping and ports. But the shipping trade is generally phlegmatic and thanks to competition among routes would take regional disruption in its stride. **Insurance** markets are more fragile, both in sentiment and substance. There could be short-term panics in the event of direct or retaliatory destruction of ships, hence the desirability of calming strategies thought out in advance.

17. **Some scale**. An average 40 ships (all flags) a day (or 15,000 a year) pass through Suez, of which 20% are oil tankers. Canal tolls yield $2 bn a year, whose avoidance through closure would partly offset costs of diversion. UK imports using the Red Sea route amount (2001 figures, in tonnes) to 3.3m liquid bulks, 14.0m dry bulks, 8.7m containerised cargo.

Department for Transport

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