PREM 19/875

MT

PART 3

TOP SECRET.

Confidential Filing

Future of Post Office : Finances
Industrial Relations
Postal Monopoly
Telecommunications monopoly

POST AND TELECOMMUNICATIONS

PART 1 : May 1979

PART 3 : March 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~19.3.81~~		~~7.8.81~~					
~~30-3-81~~		[illegible]					
~~31.3.81~~		~~1-9-81~~					
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~~9.7.81~~							
~~20.7.81~~							
~~30.7.81~~							

PART 3 ends:-

8/5 Ind to Home Sec 16.3.82

PART 4 begins:-

RTA to PM A07865 22.3.82

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(82) 9th Meeting, item 1	16/03/1982
E(82) 29	11/03/1982
E(82) 26	09/03/1982
E(82) 23	04/03/1982
CC(82) 14th Meeting, item 1	02/04/1981
IT(81) 25	06/03/1981
IT(81) 29	05/03/1981
IT(81) 31	05/03/1981
IT(81) 28	05/03/1981
IT(81) 27	05/03/1981
IT(81) 24	05/03/1981
IT(81) 23	05/03/1981
IT(81) 22	04/03/1981

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed J. Gray Date 19/4/2013

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

Liberalisation of the use of British Telecommunications Network by Michael E Beesley – Report to the Secretary of State for Industry January 1981, published by HMSO 1981 - ISBN 0 11 513249 X

Signed J. Gray Date 19/4/2013

PREM Records Team

JH 378

CONFIDENTIAL

(2)

Prime Minister

Mr Jenkin tries to keep up the pressure.

MCS 18/3

AW
JV

Posts of Tel

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

16 March 1982

The Rt Hon W Whitelaw CH MC MP
Secretary of State for the
Home Department
Home Office
50 Queen Anne's Gate
London SW1H 9AT

Dear Willie,

'E' Committee decided this morning to remit the issues raised in my paper on Future Telecommunications Policy for further consideration by a small Ministerial Committee. I hope that we can keep the delays resulting from this to a minimum. Meanwhile, publication of the ITAP report on Cable Systems next Monday provides an opportunity for the debate on DBS, cable and related broadcasting issues foreshadowed in your recent and well received statement on DBS. I recognise that you will want to precede the debate with a statement on cable and your intention to appoint the Three Wise Men, together with their terms of reference. I hope that you will be in a position to do this sufficiently soon to permit the debate to take place before Easter. And I should like to urge Francis Pym to provide the necessary Parliamentary time for this.

I am sending copies of this letter to the Prime Minister, Francis Pym, Michael Jopling, Kenneth Baker and Sir Robert Armstrong.

Yours ever

Patrick

Post Office 18
Telecomms

P.0680

cc JU

PRIME MINISTER

Future Policy on Telecommunications
(E(82)23, 26 and 29)

BACKGROUND

In E(82)23 the Secretary of State for Industry invites approval in principle to changes in telecommunications policy which would be given effect in legislation in the 1982-83 Session; he has commented further on these proposals in his letter of 12 March to the Chief Secretary. The Chief Secretary has given his views in E(82)26 and the Central Policy Review Staff have commented in E(82)29.

2. QL Committee has provisionally decided to recommend to Cabinet the inclusion of a Telecommunications Bill in the 1982-83 programme. As the Home Secretary has already advised you, QL is acutely concerned that the Bills to be included in the programme should be ready for introduction at the beginning of the Session, or, exceptionally, by the end of November at the very latest. Since the Telecommunications Bill will be highly controversial and since the drafting will be difficult, QL Committee regard it as essential that instructions should be sent to Parliamentary Counsel much earlier than the end of July (as DoI have been forecasting) so as to give him a reasonable chance to make substantial progress with the drafting before the summer holidays. A principal aim of E Committee's discussion tomorrow must, therefore, be to ensure that detailed proposals are brought forward as quickly as possible so that the timetable requirements for the legislative programme can be met. On the evidence so far about the amount of inter-departmental work which needs to be done on some very important issues, and about the outside consultation which is envisaged, it is going to be very difficult to have a Telecommunications Bill ready in good time.

3.

MAIN ISSUES

4. The Secretary of State for Industry's proposals in E(82)23 can best be discussed under four main headings and in the following order:

i. Powers to enable British Telecom to be converted into a Companies Act company and the sale of shares in the company.

ii. Amendments to the BT Act 1981 and to the Telegraph Acts, primarily to break up further BT's monopoly and to put the private sector on an equal footing with them.

iii. Powers to define the regulatory regime applying to telecommunications and, possibly, to radio frequencies.

iv. Powers relating to the participation of the private sector and of BT in broadband cable systems.

5. Although none of these proposals is described in any detail in his memorandum, the Secretary of State for Industry hopes that the Committee will agree in principle to the drafting of the necessary legislation now so that the Bill, which would be substantial, could be introduced early in the next Session. Although the aim of the meeting must be to give a broad steer, and, where possible, provisional blessing, to the proposals, a good deal more work needs to be

completed before the Committee will be in a position to give policy approval to precise proposals. Parliamentary Counsel will want precise and detailed instructions on all parts of the Bill as soon as possible.

The privatisation of BT

6. There are already powers to require the creation and disposal of BT subsidiary companies. The Secretary of State for Industry now proposes, in paragraphs 4 and 5 of E(82)23, legislation to enable the conversion of BT as a whole into a Companies Act company and to enable the sale of new shares in that company.

7. He judges that initially the market might bear the raising of new capital equivalent to 20-25 per cent of the total equity of the company. He sees this sum as providing a necessary additional source of finance for BT and also as signalling the "partnership" between the private and public sectors which he judges to be important in carrying BT, the Post Office Engineering Union and wider public opinion with the Government in developing these proposals.

8. The Chief Secretary, Treasury is willing to support enabling legislation as proposed but he takes a different view of its objective. He sees the exercise not in terms of providing a new source of finance for BT but of passing control of BT from the Government to the private sector - that is, of achieving full and genuine privatisation. The main points in his memorandum E(82)26 are:

i. A situation in which the private sector held 25 per cent of the equity of BT would leave the Government with overall responsibility for the company, whose total borrowing would remain a charge on the PSBR, and could well add to the present difficulties of maintaining effective control.

ii. It is questionable whether in the next two years the market could absorb £1-1½ billion BT equity in one go and, in any event, the proceeds should accrue to the Government and not to BT.

iii. As the CPRS also argue in E(82)29, moves towards privatisation must keep in step with solution of monopoly and regulatory problems.

E(82)26

9. As the Secretary of State for Industry's letter of 9 March suggests, there may be some room for compromise between his position and that of the Chief Secretary. There might, for example, be some agreed timetable for ensuring that, in stages, a majority of the shares in the new BT company and not just 20 to 25 per cent were sold to the private sector. There might also be agreement that, in order to assist acceptance of privatisation by BT's management and workforce, the various stages of privatisation should be accompanied by some extra finance for investment for BT. But before the Committee can take final decisions they will need to have a more fully worked out plan for privatisation, preferably agreed between the Department of Industry and the Treasury. In preparing this plan officials will need some expert advice from a merchant bank on the feasibility of disposing of various amounts of equity in BT over a given timetable, bearing in mind also the need to keep in step with changes in the monopoly and regulatory arrangements and the considerations that the legislation cannot be enacted before mid-1983 and that there will have to be a General Election by the spring of 1984.

10. The Committee may therefore wish to confine itself at this meeting to expressing a broad provisional view on the desirability of legislation to turn BT into a Companies Act company with private sector equity participation. The Secretary of State for Industry, in consultation with the Chief Secretary and other Ministers concerned, might be invited to bring forward as soon as possible and in any even not later than, say, the end of April a plan for the privatisation of BT. Minister could then take policy decisions which would form the basis of drafting instructions for legislation and further detailed work.

Amendments to BT Act 1981 and to the Telegraph Acts

11. As explained in paragraph 9 of E(82)23, the Secretary of State for Industry proposes amending legislation principally aimed at:

i. Putting BT, where appropriate, on an equal footing with its new private sector competitors.

ii. Making moves towards possible privatisation of Giro.

15. At this stage the Committee can do little more than take note that the legislation would need to cover regulatory questions and invite the Secretary of State for Industry to put clear proposals, and any draft consultative paper, as soon as possible on the basis of recommendations from the Departments concerned which should take account of the points made by the CPRS in paragraph 4 of E(82)29. Again, you will wish to be satisfied that a consultative paper is necessary and to consider what are the implications of consultations for the legislative timetable.

16. The Home Secretary and the Secretary of State for Industry are already discussing the question of departmental responsibility for regulation of radio frequencies, which in turn bears on broadcasting considerations which are the responsibility of the Home Secretary. When they have concluded these discussions they will put recommendations to you for consideration.

Broadband cable

17. In paragraphs 6 and 8 of E(82)23 the Secretary of State for Industry seeks policy approval for the introduction of legislation providing for the licensing of local cable systems run by the private sector in parternship with BT and carrying both telecommunications and television services. This recommendation is premature and does not take adequate account of the further studies commissioned when the Committee discussed the development of cable systems on 25 February (E(82)6th meeting).

18. It was agreed that the Home Secretary should arrange for an urgent inquiry into the broadcasting issues which was to be completed in time for legislation to be ready for introduction at the beginning of the 1982-83 Session. In their
Flag 6 — minutes of 7 March and 11 March, the Home Secretary and the Secretary of State
Flag H — for Industry have discussed the timescale for the inquiry and the implications of this for legislation in the next Session. You have agreed that the inquiry should be given until the end of September to complete its work. Meanwhile officials in MISC 73 will be looking at the wide range of issues arising out of the development of cable systems and will take into account the conclusions of the inquiry into the broadcasting aspects as soon as they are available. Every effort will be made to ensure that any necessary legislation can be ready for the next

Session but the timetable will inevitably be very tight if the legislation has to be incorporated in the Telecommunications Bill and that Bill has to be introduced early in the next Session.

19. At this stage the Committee need to do more than note the work already in hand, while acknowledging the difficulties about legislation on cable in the next Session which cannot be finally assessed at this stage.

HANDLING

20. After the Secretary of State for Industry has introduced his paper you might suggest that, subject to any general points which the Chief Secretary, the Home Secretary, the Lord President and Mr Ibbs might wish to make, the Committee might discuss the proposals under the four main headings listed in paragraph 4 above, ie

- privatisation of BT
- amendments to the BT and Telegraph Acts concerned with monopoly
- regulatory arrangements
- cable.

CONCLUSIONS

21. The Cabinet has yet to decide on the legislative programme for the 1982-83 Session, in the light of the recommendations of QL. Subject to that,

and in the light of the discussion, you will wish to reach conclusions on the following points:

i. whether, if the broad objective of turning BT into a Companies Act company with private sector equity participation is endorsed, the Secretary of State for Industry should be invited, in consultation with the Chief Secretary, Treasury, and other Ministers mainly concerned to bring forward as soon as possible (perhaps by end-April) a plan for achieving that objective so that the Committee could take policy decisions which could form the basis of drafting instructions for legislation and further detailed work (paragraph 10 above);

ii. whether the Secretary of State for Industry should be invited to reach agreement as soon as possible with the other Ministers concerned on the proposed amendments to the BT Act 1981 and the Telegraph Acts, on the priorities to be given to them in the event of constraints on the legislative timetable, and on the terms of any consultative document which may need to be issued (paragraph 13);

iii. whether the Secretary of State for Industry should be invited to reach agreement as soon as possible, on the basis of recommendations by his Department in consultation with the Home Office, Treasury, MPO and CPRS, on the regulatory aspects, other than the questions concerning the Home Office's Radio Regulatory Department which is being considered separately (paragraphs 15 and 16);

iv. whether, on cable, the Committee should merely note that work has already been put in hand to have an inquiry into the broadcasting aspects which will report by end-September and to have a report by officials in MISC 73 on all aspects of the development of cable; that every effort will be made to have legislation ready for the next session; but that the precise timing of the legislation on cable cannot be settled at this stage.

v. whether in addition the Secretary of State for Industry, in close consultation with the Home Secretary and with the Chief Secretary and other Ministers as necessary, should be invited to work out an overall timetable and strategic approach relating to legislation on telecommunications and to ensure that particular proposals should each be progressed and presented as quickly as possible, not necessarily at the same time but in the context of the overall framework.

PG

P L GREGSON

15 March 1982

SECRETARY OF STATE FOR NORTHERN IRELAND

c.c. Regional Policy file: Urban Development Corp. Pt. 3. (re para 3)

Prime Minister

I regret that because of unavoidable commitments in Northern Ireland on Tuesday 16 March I shall not be able to attend our meeting of 'E' Committee. I am therefore writing to let you know my comments on the two items for discussion.

2. On the question of Future Policy on Telecommunications, I agree with the proposals made by the Secretary of State for Industry with regard to the conversion of BT into a Companies Act company (BT Ltd) and for the sale of new shares as a step towards privatisation; the licensing of local cable systems run by the private sector in partnership with BT carrying both telecommunications and television services; and the associated proposals relating to Giro. I do, however, feel that careful consideration needs to be given to the CPRS argument on the best way to achieve full and fair competition. In general, therefore, I agree with the CPRS recommendations although I am anxious that the procedure put forward by CPRS should not be allowed to become too protracted. It seems to me absolutely vital that over the next year or so, we should keep up the momentum which we have now established as a Government clearly committed to encouraging actively the introduction and application of new information technology. Necessary legislation should be drafted.

3. On the question of the Medway Towns and Chatham Dockyard Closure, I agree with the the Secretary of State for the Environment that the establishment of an Urban Development Corporation would be the best way to proceed. I share his scepticism about the effectiveness of a joint committee of the local authorities. The CPRS emphasise the seriousness of the economic problems in the West Midlands and other assisted areas where we do not propose that UDCs should be established, and also point out the severe and intractable problems over many decades of the two

/...

existing UDC areas, the London and Liverpool docklands. But I do not believe that we should underestimate the problems of the Medway Towns and the key fact that these will now be exacerbated as a direct result of a decision by the Government. In considering how best we can help the Medway Towns in an effective way, we need to bear in mind our responsibility as a major employer and also clearly recognise the very important role which the naval dockyard has played in the local economy of the area for generations. Both on grounds of effectiveness and also as a clear recognition of our special responsibility in this area, I therefore feel that the establishment of a new UDC is warranted.

4. I am copying this minute to other members of 'E' Committee and to Sir Robert Armstrong.

pp J P

15 March 1982

(Signed on behalf of of the Secretary of State in his absence)

BB

JH 357

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DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
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Secretary of State for Industry

12 March 1982

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Parliament Street
London SW1

Prime Minister

MCS 12/3

Dear Leon,

FUTURE POLICY ON TELECOMMUNICATIONS

Given the importance I attach to the proposals circulated in E(82)23 and their central position to our industrial and economic policies, it might help if I set out some of the thinking behind them ahead of our meeting on 16 March.

2 The enabling Bill I have in mind is intended to complete the regulatory revolution we started in July 1980. The first part will promote the conversion of BT into a Companies Act company. This is an essential first stage to selling shares and rolling back the public sector as you say in para 5 of E(82)26. We do, however, have to carry BT, the POEU and wider public opinion with us if our proposals are to take firm root and not to become an item of political controversy; hence my preference to call this process one of partnership and my stress on the need for additional funds for BT. I see no difficulty, however, about the Treasury obtaining the greater share of the proceeds of any sale of shares, nor about a firm commitment to further sales of shares as soon as the market will permit.

3 The second part of my Bill would amend the general power in the BT Act 1981 to licence and control enterprises to run telecommunications systems, so as to put the private sector and BT on an equal footing. The third part would bring about the long overdue reform of the Telegraph Acts, including the extensions of some of the rights to wayleaves to licensed undertakings other than BT. A fourth element may be needed to establish any new regulatory authority we may decide to create in the light of the Consultative document I am seeking to circulate.

4 I agree with you that we need a good deal more work on the preceise details of how we are to implement the powers I seek. This falls to the working groups in MISC 73, and to the group of

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officials already at work on the Telegraph Acts and regulatory matters, and to any other groups you or others may suggest to carry out the remit in para 6 of E(82)26 and to explore any other issues colleagues may wish to raise - but I trust you and other colleagues will accept that we must agree in principle to the drafting of the necessary legislation now if we are to introduce this substantial Bill early in the next session.

5 I believe that this Bill will prove to be the most lasting legacy of Information Technology Year. We cannot afford to permit legitimate differences of opinion on means to detract or delay us from deciding conclusively on our common end on 16 March.

6 I am copying this to the Prime Minister, the other members of E Committee, and to Francis Pym and Sir Robert Armstrong.

Yours ever

Patrick

File Place

attach

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cc Mr. Walters
Mr. Scholar

MR. HOSKYNS

E: Telecommunications Policy

I think you and Alan will want to take a careful look at E(82)23, attached, Patrick Jenkin's paper on future telecommunications policy. It contains a far reaching recommendation, for the conversion of BT into a Companies Act company with up to 25% private equity; it has already led to a number of raised eyebrows in Whitehall, and Michael Scholar may wish to note that there will be papers, of a partially dissenting nature, from the Chief Secretary and probably the CPRS.

The issue for Ministers is whether it would be in keeping with their general approach to telecommunications policy - characterised so far by the establishment of limited competition, together with a certain amount of liberalisation - to "privatise" BT by sending it (as Patrick Jenkins puts it in paragraph 7) down the AT & T route, rather than through an extension of liberalisation and the selling off of certain functions.

As background to this, you should know that preliminary work in MISC 69 casts some doubt on the suggestion in paragraph 2 that Sir George Jefferson is in fact prepared to make the major management changes necessary to turn what used to be part of the Post Office into something approaching a modern, technological and competitive company. You will recall that the genesis of MISC 69 was the assertion by the Chancellor that Jefferson was prepared to move so fast that there might be industrial action; it now seems that it would be fairer to say that Jefferson would like to move fast, but his willingness to do so is strictly limited by his belief that he cannot progress faster than the unions will allow. So, however successful the work of MISC 69, the chances of BT turning into AT & T are pretty remote, even if Ministers really thought it desirable to substitute a private sector monopoly for a public sector one.

The balance of doctrinal argument seems therefore to me to be against Patrick Jenkin's proposal, which will tend to reinforce BT's monopoly on the basis of private sector finance. And the Treasury

/have

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have other objections as well. They say that Patrick Jenkin is wrong to assume that broad-banding (paragraph 3) will be done by BT rather than the private sector: and that it is rather unlikely that BT will in fact need more investment funds than are already available to them. They may not even need to sell the new BT bond. The Treasury also object to the absence of discussion in this paper - which was circulated without clearance with them - of the method of control of BT if it were a Companies Act company. They point out that it is hard enough to control it as a nationalised industry; and if the minority private equity stake is supposed to be the first part of a phased progression to complete disposal of Government control, the paper ought to acknowledge that the process will take many years, certainly longer than the outstanding lifetime of this Parliament.

This paper is at present down for discussion at 1030 on 16 March.

J. M. M. VEREKER

8 March 1982

Post & Telecoms

AD
AW
JU.

FROM THE
MINISTER OF STATE
FOR INDUSTRY AND
INFORMATION TECHNOLOGY

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 6401
SWITCHBOARD 01-212 7676

KENNETH BAKER'S OFFICE

(2)

Terry Matthews Esq
Private Secretary to the
Rt Hon Leon Brittan QC MP
Chief Secretary,
HM Treasury
Parliament Street, SW1

Prime Minister

Announced today.

MCS 9/11

9 November 1981

Dear Terry

POSTAL TARIFFS

I told you on the telephone on Friday that Mr Baker had seen the Chairman of the Post Office, Mr Dearing, to discuss his response to the report of the Post Office Users' National Council (POUNC) on the proposed increases in postal tariffs. The report is due to be published today.

The report calls upon the Post Office either to defer the increases from 4 January to 1 April or to take ½p off the proposed increase for Second Class Mail. Mr Dearing told Mr Baker that he proposed to reject both these courses - the first would result in a failure by the Post Office to meet its EFL and financial target by around £40m in 1981/82 and the second would cost £30m in 1982/83.

Mr Baker pressed upon Mr Dearing the importance of making a positive response to the POUNC report, and Mr Dearing has agreed to defer implementation of the increases until 1 February. This will cost the Post Office some £12m in 1981/82. Given that the Post Office's tariff proposals already require significant improvements in efficiency,Mr Baker considers that this is the most we can expect from the Post Office.

M17/M17ABV

The Post Office has said that even with the deferment it still intends to make every effort to achieve its financial target and keep within its external financing limit for 1981/82. The Post Office propose to announce this today.

I am copying this letter to the Private Secretaries to the Prime Minister, Members of E Committee, and Sir Robert Armstrong.

Yours sincerely

L Riley

MRS E A RILEY
PRIVATE SECRETARY

M17/M17ABV

NE/09

Ce w/ papers Duguid Post Telecoms

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
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Secretary of State for Industry

NBPM

MLS

2 October 1981

The Rt Hon Leon Brittan QC MP
Chief Secretary
Treasury Chambers
Gt George Street
London
SW1A 2ER

Prime Minister
Foreign Secretary
E Committee
Sir Rbt Armstrong
Mr Ibbs, CPRS

Dear Leon,

POSTAL TARIFFS

Thank you for your letter of 30 September.

I have written to Mr Dearing giving our approval for him to proceed with his tariff proposals, subject first to a slight alteration in the overseas rates to maintain the differential between inland rates and those to EEC countries and second to formal acceptance of a new performance aim on the lines you have suggested. A copy of my letter is attached. – overleaf

I propose to announce the new aim shortly after Parliament reassembles.

Yours ever

Keith

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

2 October 1981

R E Dearing Esq CB
Chairman Posts and National Girobank
Postal Headquarters
St Martins le Grand
London
EC1A 1HQ

Dear Ron,

POSTAL TARIFFS

You wrote to Kenneth Baker on 28 July seeking agreement to an approach by the Post Office to POUNC with tariff proposals involving increases of 1½p and 1p on the basic inland letter rates.

This is to let you know that Government is content for you to put your proposals to POUNC on the understanding:

i that the package will be modified slightly so as to maintain at 4p the differential between the inland first class rate and the basic rate to EEC countries;

ii that the Post Office accepts a new performance aim of a reduction of real unit costs by 5% over the period 1982/83 to 1984/85 including a reduction of 2% in 1982/83 on the lines you have already indicated to Kenneth Baker.

I would be grateful for your acceptance of these conditions before you make a formal approach to the Users' Council.

Yours ever

Patrick Jenkin

cc A Duguid
J Vereker
A Walters.

Foreign and Commonwealth Office

London WC1

2 October 1981

NBPM

Dear Patrick,

POSTAL TARIFFS

I have seen your letter of 24 September to Leon Brittan which proposed that under the new tariff structure the rate to Community countries should be adjusted so as to maintain the present differential with the first class domestic tariff. Ian Gilmour wrote to Kenneth Baker about this on 13 August.

I am glad that Mr Dearing has recognised the force of the arguments over the Community rates and am grateful for his readiness to keep the differential constant. However, I still hope that we can gradually decrease this difference so that we eventually apply our internal postage rates to intra-EC mail in the basic weight steps.

Copies of this letter go to members of E Committee and Sir Robert Armstrong.

Yours ever

Humphrey

The Rt Hon Patrick Jenkin
Secretary of State for Industry
Ashdown House
123 Victoria Street
London SW1E 6RB

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MAP Post + Tel

CHIEF SECRETARY TO THE TREASURY

cc Mr Duguid
Mr Wolfson

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Patrick Jenkin MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1E 6RB

30 September 1981

Dear Patrick.

POSTAL TARIFFS

Thank you for your letter of 24 September.

I think we all recognise that Mr Dearing has made a good start at the Post Office but, as I am sure he would be the first to agree, a great deal remains to be done even so.

There are two aspects of your proposals that caused me concern. The first was that, while scrapping the present real unit costs performance aim as unattainable, you were being offered in return only a promise of a 2% reduction in real unit costs in 1982-83 and nothing definite thereafter. Accordingly my officials have been pursuing this point with yours and I now understand that Mr Dearing is prepared to commit the Post Office to reducing its real unit costs by 5% over the period 1982-83 to 1984-85. I see that as a very significant advance on anything yet achieved, with important implications for the improved postal productivity we all want to see.

Given that undertaking and the way that it will add to the pressures that your proposals will already put on the Post Office to conclude a pay settlement in low single figures in the current round and mount a sustained attack on their current costs, I am prepared to accept your proposal that the Post Office should be allowed to put forward its $1\frac{1}{2}$p/1p tariff increases as set out in paragraph 9 of your letter.

However I remain extremely concerned about the Post Office's proposed EFL for 1982-83. An EFL of zero as you propose still falls far short of the levels which we agreed at E Committee the Post Office should be aiming for. While I am willing (as I say) to accept the tariff increases, I must press for the Post Office, whether by larger reductions in current costs or, if need be, by further reducing investment, to take whatever steps are needed to achieve the target we have set them.

My agreement is of course also conditional on the Post Office's being formally set an aim to reduce real unit costs by 5%, and I should be grateful for your confirmation that you intend to do this.

I am sending copies of this letter to the Prime Minister and to other recipients of yours, and also to Robin Ibbs.

Leon

LEON BRITTAN

CONFIDENTIAL

cc D/N DOT HL
CSO LPO
CO
MOD
DOE
HO
FCO
HMT
D/EMP
MAFF

Post + Telecom

10 DOWNING STREET

From the Private Secretary

25 September 1981

Postal tariffs

The Prime Minister has read your Secretary of State's letter of 24 September to the Chief Secretary. She has noted Mr. Jenkin' would be prepared, albeit reluctantly, to pursue with the Post Office Chairman the idea of a 1p/1p tariff increase; but only if this were coupled with an EFL of £27 million; but that he would prefer to accept their original 1½p/1p tariff package and an EFL of zero.

The Prime Minister has not reached a view as between these two alternatives, and she is content for the matter to be settled between your Secretary of State and the Chief Secretary.

I am sending copies of this letter to the Private Secretaries to the members of E and to David Wright (Cabinet Office).

T. P. LANKESTER

Ian Ellison, Esq.,
Department of Industry.

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DEPARTMENT OF INDUSTRY
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Secretary of State for Industry

Mr Duguid
cc Mr Robertson

24 September 1981

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Whitehall
London SW1P 3AG

Prime Minister
Mr Jenkin is reluctantly prepared to press the P.O. to confine their tariff rise to 1p/1p, rather than 1½p/1p - but only on condition that their EFL is £27m higher. He would prefer to back their original proposal. Shall we leave this to Leon Brittan?
Yes mt
JC
24/9

Dear Leon,

POSTAL TARIFFS

Nigel Lawson wrote to Kenneth Baker on 18 August asking for a reasssessment of the Post Office's proposals for tariff increases. The Prime Minister endorsed Nigel's view as recorded by her Private Secretary's letter of 20 August.

2 Kenneth Baker has held further discussions with Mr Dearing and put strongly to him the Government's concern about the Post Office's shortfall from its performance objective. Kenneth suggested that, had the postal business kept on course to meet its performance objective instead of being about 6% adrift by the end of the current financial year, it should theoretically have been possible to avoid the proposed tariff increases altogether.

3 Mr Dearing is, of course, as concerned as we are about the history of rising costs in the postal business. He has, however, pointed out that its performance has been affected by the rising wage rates needed to correct the effects of the previous Administration's pay policies and by the need to incur additional man hours to restore the quality of service, which had sunk to an unacceptably low level in the first half of 1979.

4 Since his appointment in May last year Mr Dearing has begun to turn the business round. Tariff increases have been held within the rise in RPI and the last increase, in January 1981, was 5 percentage points less than forecast when he took over. Quality of service has been restored, overtime has been cut and the downward trend in labour productivity has been reversed, with a reduction in 1980/81 of 6 million (2%) in the hours worked compared with the previous year. This has been done against a background of tough management action to remove deeply embedded restrictive labour practices, which has meant standing firm in disputes with the workforce in major city centres, including a

SECRETARY OF STATE FOR INDUSTRY

lockout in early August in the London Western District Office. Mr Dearing's objectives for the business entail further reductions in manhours (by 3¾% in the current year with more to come in 1982/83), improvement in the quality of service, and progress in the introduction of new services, involving cooperation with the private sector. He is ready to commit himself to achieving a reduction in real unit costs of 2% in 1982/83.

5 I accept Mr Dearing's view that it is not realistic to expect him to recover all the ground lost before he took over in the time left for the present performance aim to run. I believe that we must assess his tariff package in the light of what it is practicable to achieve.

6 Since the Post Office prepared its Medium Term Plan earlier this year it has had a further hard look at cutting current costs and has identified savings for 1982/83 amounting to some £166m, rather more than 6%. The tariff proposal of 9.3% has been made on the basis of these revised forecasts. The Board believes - and I accept - that there is very little room for going further and that the 9.3% tariff package plus an investment programme involving an EFL of £27m is about as much as can be achieved. My Department has already secured the Post Office's agreement to a substantial reduction in its capital programme notwithstanding the need for large scale renewal of rundown assets. If the package were not otherwise substantially changed, however, Mr Dearing would be prepared to reduce certain overseas rates to meet the point concerning the differential between inland and overseas rates in Europe raised in Ian Gilmour's letter of 13 August.

7 Kenneth Baker has explored the scope for some downward revision in the tariff package following the Government's recent announcement of a 4% cash limit on pay in the public services. If it were possible to foresee a slightly lower Post Office settlement than the 5% now assumed in the forecast, the effect on current costs might be £20m, which would make it possible for the Post Office to get by with either a 1p/1p increase or to cut its EFL requirement by about £20m.

8 I have no statutory powers over tariffs but it would be possible for me to press for the £20m saving to be used by way of a reduction in tariff of ½p on the first class. However, I must record that, following last year's cuts in Mr Dearing's original tariff proposals, he and his Board are convinced that if the Government were to insist on a second reduction there would be a crisis of authority in the business, thus putting at risk the very real progress he has begun to make. Certainly I would only feel able to press for a reduction in the tariff package if I were able to give Mr Dearing a firm assurance that the Government

would not subsequently insist on a further cutback in his proposed EFL of £27m.

9 Against this backgrond I would be prepared, reluctantly, to pursue with Mr Dearing the idea of a 1p/1p tariff increase but only if this were coupled with an EFL of £27m. An EFL of this size must cause you concern and I would prefer to seek a lower EFL and to accept the Post Office's original bid for a 1½p/1p tariff package. It will take at least three months to submit the tariff package to the Post Office Users Council and to implement the increases within the Post Office. Time is therefore running short if the Post Office is not to run into EFL difficulties in the current year through a failure to implement its tariff package on time. I would therefore welcome your early agreement to my accepting the original 1½p/1p tariff package (with the adjustment to the overseas rates) and an EFL of zero.

10 Copies go to Members of E Committee and to Sir Robert Armstrong.

Yours ever

Patrick

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 6401
SWITCHBOARD 01-212 7676

From the
Parliamentary Under Secretary of State

/ September 1981

Kenneth Baker MP

NBPM.
MW
3/x

Mrs Sally Oppenheim MP
Minister of State for Consumer Affairs
Department of Trade
1 Victoria Street
London SW1H OET

Dear Minister of State,

Thank you for your letter of 24 August about POUNC's comments on BT's recent proposals for price increases.

For myself, I think that POUNC's allegations about the misleading way that BT presented its price increases were somewhat overstated, and indeed did not always fit easily with the detail of their comments. With such a multiplicity of tariffs it is inevitable that the overall tariff package should be presented in terms of changes to the average residential bill and I notice that POUNC made no criticisms of BT's calculations on that score.

Nevertheless I share your concern about the tariff increases and the effect they will have on the consumer. I pressed Sir George Jefferson hard to try and find some way of moderating the increase on local call charges, possibly by avoiding any increase in the off-peak rate. I am afraid that he regards this as impractical for technical reasons concerned with metering procedures. I am not satisfied about this and we will be pursuing this with him.

BT has now responded to POUNC's comments. They have agreed to adopt the alternative tariff package recommended by POUNC, with the smaller rise in rentals and consequent benefit to the smaller user, whether residential or business, and to adopt some phasing for the connection charges for leased circuits. Both these changes are in the right direction, and you may like to see the enclosed letter from Sir George to John Morgan which gives this undertaking and also responds to POUNC's comments on the presentation of the tariff proposals.

Given BT's reaction to POUNC's comments, I do not feel that the time is yet right for a Section 11 reference of BT under the Competition Act. BT will only come into existence next month and already faces very considerable changes stemming from the liberalisation of telecommunications attachments and the greater freedom for private firms to use its network. A reference to the MMC could well divert management resources from handling the adjustment to their new more competitive environment. However, I regard your concern as a most useful means of maintaining pressure on BT to behave in a commercial manner and I shall ensure that it is brought to Sir George's attention.

I am copying this letter to the Prime Minister.

Yours sincerely,

J Ath

for
KENNETH BAKER
(Approved by the Minister and signed in his absence)

British
TELECOM

from the Chairman
Sir George Jefferson CBE

British Telecom

2-12 Gresham Street
LONDON
EC2V 7AG

Telephone
National 01-357 3773
International +44 1 357 3773

Telex 883051

Prestel Page 383

Mr Nieduszynski
for info.

cc PS/SOS.
PS/MM.
PS/SEC.
Mr [illegible].
Mr Solomon.
Miss Marshall.

27 August 1981

PERSONAL

Mr Kenneth Baker
Department of Industry
Ashdown House
123 Victoria Street
LONDON
SW1E 6RB

RECEIVED IN
28 AUG 1981
OFFICE OF THE
MINISTER OF STATE
KENNETH BAKER

Dear Kenneth,

When we met earlier this week, you mentioned to me that it would be very helpful, in presentational terms, if we could do something to moderate the impact on residential customers of the increase in local call tariffs. In particular, you had in mind avoiding any increase in the off-peak rate.

Let me say at once that I was very sympathetic to your views, because I was myself aware of the presentational advantages that such a modification could bring.

However, I regret to say that I have now been convinced that, largely for technical reasons concerned with the way our metering system works, such a modification would not be practical without either, on the one hand, a radical change to other aspects of our proposals or, on the other, a substantial loss of revenue.

I have, therefore, responded to POUNC in the terms of the attached letter. Presentationally, we will be concentrating on our decision to go ahead with the alternative proposals, preferred by POUNC, and on the decision to phase the introduction of the connection charges for private circuits.

It is, of course, the case that both our positions have been made rather more difficult by the terms of some of POUNC's public comments, which have contrasted quite sharply with the detailed content of their commentary.

/This is

PERSONAL

Mr Kenneth Baker

This is very unfortunate, in that it has left the impression that some bills might go up by as much as 115%, which is, of course, simply untrue. In our public response, we are seeking to correct that impression, without provoking a quarrel with POUNC.

Yours sincerely

G K Jefferson

SIR GEORGE JEFFERSON

British
TELECOM

from the Chairman
Sir George Jefferson CBE

British Telecom

2-12 Gresham Street
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National 01-357 3773
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Telex 883051

Prestel Page 383

27 August 1981

Mr John Morgan
Chairman
Post Office Users' National Council
Waterloo Bridge House
Waterloo Road
LONDON SE1 8UA

Dear John,

TELECOM PRICES

Thank you for your prompt response to our proposals for price increases. I am pleased to note that, with the exception of private circuit connection charges, you have not recommended rejection of our proposals. As you know, these proposals, averaged across all our customers, represent an increase of 9½% on bills, some 1½% less than the expected increase in the price of goods and services generally over the same period, as measured by the RPI.

In those circumstances, I must confess, that I was a little disappointed that the careful weighting of points in your detailed comments was not fully reflected in the POUNC Press and Broadcast Notice and subsequent comments. We now have a situation where some customers believe that their bills are likely to be more than doubled. In fact, there is no way in which these proposals are likely to lead to such an increase even under the most unfavourable circumstances. Indeed, in the case of the much-quoted locall calls, it is perhaps worth noting that the cost to the customer of some 60% of all such calls made at the standard and peak rates will increase by only 7½%.

We do, however, fully agree with you that these are complex changes, and difficult to present to our customers in a readily comprehensible way. We felt - and still feel - that to quote the average effect was the most relevant way of getting the message across to the majority of our customers, while making clear that there could be considerable variations from those averages. However, to assist our customers, I have asked for urgent consideration to be given to the most informative ways in which these new rates can be presented in our further literature.

/Turning

Mr John Morgan

Turning to the more general aspects of our performance, you are, I believe, aware of my continuing concern to improve efficiency and productivity. However, although much still needs to be done, the record is by no means unimpressive. Between 1975 and today the size of the telephone network has increased by approximately 40%, while today's manning levels are, if anything, slightly lower than they were in 1975.

Moreover, prices have been held to about three-quarters of the levels they were ten years ago, in real terms. At the same time, the extent to which capital requirements have been financed from our own resources has increased from around 50% in 1970 to 85% in 1980-81. The fact that we have been able to do this while reducing the real cost of our services to the customer is due largely to the improvements in productivity and utilisation of resources that we have achieved in this period. This will bear favourable comparison with the performance of most companies in the private sector.

I appreciate that customers do not easily reconcile our apparently large 'profits' with the overall financing situation and the need for price increases. However, the facts are that the recently announced profits are both small in relation to the size of the business and fall short of Government profit targets. Moreover, customers should recognise that these profits are fully retained in the business to assist the financing of the investment programme. Our profits are therefore contributing to the improvement of the facilities we shall be able to offer.

Of course, it would be easier for all of us in the current circumstances where there exists a major backlog of investment necessary in the improvement of the scale and quality of our plant, if a greater part of the investment programme could be financed by money that British Telecom borrowed from Government or other sources. But this should not be taken to excess, and in arriving at these proposals, we have increased our borrowing to around 20% of capital requirements in 1981-82 compared with the fully self-financing rates of a few years go. However, we, too, look forward to the time when capital financing may be eased by scope for recourse to the commercial market, and I welcome your continued strong support in this respect.

The current degree of cross-subsidisation between services has, as you say, been criticised by yourself over the past two years and more recently in Professor Beesley's Report. The extent to which we are moving towards a rebalancing of the tariff structure is, in our view, well justified in the light of your previous comments and the Government decision in relation to liberalisation of the network. The proposals still fall a long way short of total rebalance. We have no wish to raise the cost of telephones to our domestic

/customers

Mr John Morgan

customers excessively, and we very much hope that any further development of liberalisation by the Government will be phased in a way that maximises our opportunity to protect the interests of all our customers. It was in that latter context that we put to you our alternative proposals. We are grateful for your advice and concur in your recommendation that we should proceed with smaller increases in rentals on this occasion, at the expense of some reductions contemplated on other services.

The Government's intentions on value added network services certainly lend urgency to the need to set connection charges for leased circuits at levels that reflect current costs. However, in view of your comments, and the comments we have received from other representative bodies, we judge that it would be right for the increases to be staged. We are accordingly arranging to implement only half the proposed increase on orders received from 1st August; the full increase will be implemented on orders received from 1st February 1982. At the same time, we have reduced the charges for some short-distance circuits by £50. The charges will be reviewed during 1982 as part of our continued work to align costs and prices. The associated schedule shows the revised figures and the staged implementation.

During 1980-81 you will have seen that we have secured a significant improvement in the quality and provision of service to customers, compared with the unacceptable level of performance in the late 1970s. For example, currently:

- the proportions of calls on which plant was satisfactory and adequate, at 98.7% on local calls, 97.3% on STD calls, and 98.0% on IDD calls, show a marked reduction in failure rates over the past two years;

- with $1\frac{3}{4}$ million new lines supplied during 1980-81, the 300,000 orders now waiting for service, are approximately half the number two years ago;

- 160 electronic exchanges were brought into service in 1980-81, serving more than half a million customers.

The results of our modernisation programme can also be seen in the introduction of the microprocessor controlled Monarch and Herald call connect systems, new public telephones, an extended range of special range telephones, and improved facilities for telex, datel and mobile telephone services. International services, supported by a wide range of modern developments, have continued to grow at substantial rates. Such service improvements depend on adequate finance for our investment programmes.

/I am

Mr John Morgan

I am glad that you have found your regular discussions with us to have been helpful in coming to a conclusion on our proposals. We will now proceed to implement these on the basis of the alternative smaller exchange line rental increases and associated call price changes, with the staging of private circuit connection charges outlined in this letter.

We will be releasing the main points of my letter in the associated Press and Broadcast statement, which is embargoed until 12 noon on 28 August.

Yours sincerely

SIR GEORGE JEFFERSON

STAGING OF INCREASES ON PRIVATE CIRCUITS CONNECTION CHARGES

Type of Circuit:		Connection Charge (£) for Chargeable length of circuit (Kms)				
		0-0.8	0.8-16	16-80	80-160	160 and over
S1	before 1.8.81	60	100	120	140	160
O	from 1.8.81	130	175	210	270	300
	from 1.2.82	200 *	250 *	300 *	400	450
S2	before 1.8.81	60	100	120	140	160
H	from 1.8.81	150	200	230	270	300
J	from 1.2.82	250	300	350	400	450
S3	before 1.8.81	60	100	140	160	180
	from 1.8.81	180	250	290	330	360
	from 1.2.82	300 *	400	450	500	550
T	before 1.8.81	80	120	140	160	180
	from 1.8.81	210	260	290	330	360
	from 1.2.82	350	400	450	500	550
Y1	before 1.8.81	19	30	80	90	100
	from 1.8.81	160	190	240	270	300
	from 1.2.82	300	350	400	450	500
Y2	before 1.8.81	19	30	80	90	100
	from 1.8.81	180	210	260	290	320
	from 1.2.82	350	400	450	500	550

The proposed increases on miscellaneous facilities and wideband circuit connection charges will be maintained except where the increases exceed 100% (on miscellaneous facilities) where these will also be staged.

*Charge £50 less than originally proposed.

OIO

DEPARTMENT OF TRADE
1 Victoria Street
London SW1H OET

Tel Direct Line 01-215 5626
Switchboard 01-215 7877

Await DoI
response.

MAP 26/viii

With the Compliments of

the Minister of State
for Consumer Affairs Office

CS 178

RESTRICTED

From the
Minister of State
for Consumer Affairs

DEPARTMENT OF TRADE
1 VICTORIA STREET
LONDON SW1H OET

TELEPHONE DIRECT LINE 01 215
SWITCHBOARD 01 215 7877

Kenneth Baker Esq MP
Minister of State
Department of Industry

24 August 1981

Dear Ken

You will have read with some concern the allegations made by POUNC about the misleading nature of the British Telecom announcement of its price increases. If the POUNC allegations are correct, then I believe that the way in which this announcement was made by British Telecom is quite disgraceful and will cause widespread and unnecessary public resentment.

As Minister for Consumer Affairs, I must express my concern, both at the amount of the increase and the way in which it was announced. Naturally, I have no way of knowing whether the claims made by POUNC that the large increase is due to inefficiency and overmanning are correct, but it does strike me that this would provide an ideal time and a necessary circumstance for a Section 11 reference under the Competition Act, and would be grateful to learn your views.

All too often the Government's financial targets are blamed for price increases when the real reason is costs incurred by the above.

I am copying this letter to the Prime Minister.

Yours ever
Sally

SALLY OPPENHEIM

RESTRICTED

Post-Telecomms

CONFIDENTIAL

10 DOWNING STREET

cc HO MOD
FCO DOE
HMT
LPO
DM
maff
DOT
DN
CS,HMT
CO

From the Private Secretary

20 August 1981

Dear Jonathan

The Prime Minister has seen a copy of Mr. Baker's letter of 7 August to the Chief Secretary about postal tariff increases. She has also seen the Lord Privy Seal's letter of 13 August and the Financial Secretary's letter of 18 August commenting on the Post Office's proposals.

The Prime Minister shares the Financial Secretary's concern about the way these proposals seem to have evolved. She would like to see them re-appraised on the basis suggested by the Financial Secretary.

I am sending copies of this letter to Private Secretaries to members of E Committee and to David Wright (Cabinet Office).

Yours ever

Mike Pattison

J.C. Hudson, Esq.,
Department of Industry.

CONFIDENTIAL

1.

PRIME MINISTER

Kenneth Baker has written round to 'E' members (Flag A) reporting a Post Office request for approval to refer further price increases to POUNC. These would be 1½p on a first-class letter and 1p on a second-class letter, with broadly corresponding increases on other major services. They could, say Industry, be expected to add well under 0.1% to the RPI. The effective date would be 4 January next. ?

The Lord Privy Seal (Flag B) sees an objection in EC terms. Mr. Lawson (Flag C) is wholly dissatisfied with the basis of the proposed increases, and asks that the Post Office be instructed to re-appraise the whole thing. It seems that there are a few weeks in hand.

Do you wish to endorse Mr. Lawson's request that the Post Office be asked to do their homework properly before coming forward with proposals?

Yes please MT

MAP

19 August 1981

CONFIDENTIAL

cc J Vereker
A Walker
A Drysdale

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Mr Kenneth Baker MP
Minister of State
Department of Industry
Ashdown House
123 Victoria Street
LONDON
SW1

18 August 1981

Dear Minister,

POSTAL TARIFF INCREASES

I am replying on behalf of Leon Brittan to your letter of 7 August.

The $1\frac{1}{2}$p/1p tariff increases you propose may well be less than at the last round, and within the expected movement of the RPI. But that is little consolation after the massive increases in July 1980 and January of this year.

Moreover I am less than happy at the way these proposals seem to have evolved, and so less than convinced that anything like the full extent of these increases is in fact needed. The starting point seems to have been the expected movement of the RPI, and, geared to that, an 8% pay assumption; thus we find that the increases proposed would not only, as you say, leave the Post Office £85m short of its financial target in 1982-83, but also - to the best of my knowledge - leave it nearly 7% off course for meeting the performance aim we have set it, to hold real unit costs steady over the five-year period to 1982-83. This is a quite unacceptable position which we should find most difficult to defend.

Should we not approach all this the other way round? The starting point must surely be a requirement that the Post Office should meet the financial and performance targets which the Government have set them; in a monopoly industry tariff proposals will be a derivative of that requirement. This year we have also to take account of our general approach to nationalised industries' pay, as set out in the paper circulated by the Chancellor on 4 August, and to be further discussed at No.10 on 7 September - our object being to look for increases substantially below the last round. On that basis, we should still be looking for substantially larger productivity improvements from the Post Office in both this year and next, than those you speak of. The case for these remains very strong in their own right given the MMC's findings. And the tariff increases derived from the process I have described should be considerably lower than those the Post Office have now put forward.

If there are good reasons why it is impracticable to expect the Post Office to meet the targets we have set them, then I think we need to know what those reasons are and to consider carefully whether we can accept them. My officials recall being told by the Post Office management a year ago, of their resolve to get back on course for the performance aim, difficult though that task would be; since then, mail volume has held up better than expected in the recession (it is in any case not very GDP-sensitive), and productivity deals with the unions have gone through generating useful improvements in costs; so it is not at all clear why the management's resolve now seems to be failing and why we should not look to continue or, perhaps, accelerate the process. You acknowledge, when speaking of the financial target, that further economies will anyway be necessary.

May I, then, ask you and the Post Office to look at the tariff proposals again, on the basis I have suggested? I realise that, in doing so, I am saying that Mr Dearing cannot now expect to put his proposals to POUNC on 26 August. But I understand that there is scope for something like a month's slippage in the Post Office timetable before their datelin for introduction of the new tariffs, 4 January 1982, is in danger. In any case, what matters is to get this right.

I am sending copies of this letter to the Prime Minister and other recipients of yours.

Yours sincerely,

D. L. Willetts

pp NIGEL LAWSON
(approved by the Financial Secretary & signed in his absence)

Pat Telecomms

NOPM yet MAD 14/viii

cc A. Walton
A. Duguid
J. Vereker

LORD PRIVY SEAL

Foreign and Commonwealth Office
London SW1

13 August 1981

Dear Kenneth,

POSTAL TARIFF INCREASES

I have one comment on the tariff charges outlined in your letter of 7 August 1981 to Leon Brittan.

I understand that the proposed increase of 1.5p in the domestic first class rate is to be accompanied by a larger increase of 2p in the rate to other Member States less Ireland. Their effect will be to increase to 4.5p the differential between the internal first class rate and that to the EC Nine less Ireland. This comes after the changes on 1 January 1981 which widened the then differential of 1.5p to 4p. This is occurring at a time when the Commission have recommended that Member States charge the same internal postage rate for intra-Community mail in the basic weight step. Adoption of this recommendation would be a small but useful step in demonstrating that the Community is one market to which we are firmly committed. The financial difficulties of the Post Office notwithstanding, I believe it is an error at this stage of our Community membership to move further away from this laudable objective. If 19.5p is considered a difficult rate for Community destinations, could not the Post Office be encouraged to set a 19p rate, thus reversing the recent unfortunate trend?

Copies of this letter go to the recipients of yours.

Yours ever
Ian

Kenneth Baker Esq MP
Department of Industry
Ashdown House

cc Mr Vereker
Mr Walters
Mr Duguid

Post + Tels

FROM THE
MINISTER OF STATE
FOR INDUSTRY AND
INFORMATION TECHNOLOGY
Kenneth Baker

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212
SWITCHBOARD 01-212 7676

NBPM yet –
wait for
Tsy comments
RF 14/8

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Whitehall
London
SW1P 3AG

7 August 1981

Dear Leon,

POSTAL TARIFF INCREASES

The Post Office has sought our approval to put forward to the Post Office Users' National Council proposals for price increases averaging 9.3%. They would take effect from 4 January 1982. The increases would entail 1½p on a 1st class letter, 1p on a 2nd class letter, bringing the cost of the stamps to 15½p and 12½p, and broadly corresponding rates of increase on other major services. They could be expected to add well under 0.1% to the RPI.

Even allowing for the fact that the last increases were implemented on 26 January 1981, the current proposals at 9.3% would appear to be well within the likely increase in the RPI (some 10-11%) between January 81 and January 82. The additional income arising from the increase in 81/82 (£40m) would enable the Post Office to meet its financial target. It would not on unchanged assumptions meet its External Financing Limit, but my officials have discussed this with the Corporation, and have been assured that measures will be taken to ensure that the EFL is met.

The package is not without its risks. It requires successive productivity improvements of 2.2% in 1981/82 and of 3.0% in 1982/83 respectively, and assumes that the Post Office's marketing ability can maintain business volume at the 1981/82 level; and a pay increase of 8% on basic rates. The momentum of introduction of productivity schemes (which now cover a third of rank and file staff) will need to be maintained. But, even on these assumptions, in 82/83 the increases would still leave Posts with a shortfall of some £85m from its financial objectives, and further economies would be necessary so that any further increase needed in January 1983 could be held to reasonable levels.

The proposed tariff changes seem acceptable, and the Post Office's achievement in confining them to just over 9% reflects the success of the measures which it has taken this year both to improve productivity and working methods, and to stabilise a potentially declining business volume. I am therefore minded to tell the Chairman that he is free to put the proposals to the Post Office Users' National Council.

Mr Dearing would like very much to announce submission of his proposals to the Council at the time of publication of the Post Office's Annual Report and Accounts - planned for 26 August. It would therefore be helpful if you and those to whom this letter is copied could give as early a response as possible.

Copies go to the Prime Minister, to Members of 'E' Committee, and to Sir Robert Armstrong.

Tommen

KENNETH BAKER

Kenneth

-1 AUG 1981

CONFIDENTIAL

File

Pol. Telecom

10 DOWNING STREET

From the Private Secretary

30 July 1981

Thank you for your letter of 28 July about telecommunications liberalisation.

As I told you on the telephone, the Prime Minister is content with the proposed statement, subject to any detailed drafting points suggested by colleagues. I understand that Sir Robert Armstrong has made one such suggestion.

The Prime Minister is aware that, following consultations through the usual channels this morning, this will now be an oral statement.

I am sending copies of this letter to John Halliday (Home Office), Brian Fall (Foreign and Commonwealth Office), Peter Jenkins (H.M. Treasury), David Hayhoe (Chancellor of the Duchy of Lancaster's Office), Murdo Maclean (Chief Whip's Office) and David Wright (Cabinet Office).

M.A. PATTISON

Ian Ellison, Esq.,
Department of Industry.

CONFIDENTIAL

2

PRIME MINISTER c. Mr. Gow

MS

I attach the text of Mr. Baker's statement on telecommunications liberalisation.

He was attacked from the Opposition benches on predictable lines. But a number of Government supporters shared their unease about the future position on domestic tariffs, particularly in rural areas regardless of whether the problems were related to liberalisation or to existing factors.

Leading for the Opposition, Stan Orme said that they would have liked to have had a debate. They suspected that the proposals would take substantial traffic, including the most lucrative, from BT, thus undermining BT investment. They believe that telecommunications equipment manufacturers in this country were nervous about the effect. And they were worried about the effects on the cost of telecommunications services to the consumer, especially in rural areas. Mr. Baker replied that BT would lose some traffic, but liberalisation experience in the US showed an overall increase. He had had no recent representations from manufacturers who were concerned about the risks of liberalisation. Liberalisation itself would not lead to dramatic tariff increases, but the tariff structure was already under review because of the imbalance between the return on local domestic traffic and trunk traffic. From the Government side, many backbenchers welcomed the proposals, but some of them introduced a note of caution. Peter Mills was particularly concerned about the rural areas, Nigel Forman was concerned about domestic tariffs in general, and Kenneth Lewis declared that the phrase "restructuring of tariffs" always meant across the board increases. Peter Emery was concerned about the needs of the elderly, but congratulated Mr. Baker on the speedy reaction to the Beesley Report.

Peter Hordern and Tim Renton were disappointed that the new share/bond arrangement proposed by Warburgs would not be taken out of the EFL: Mr. Baker undertook to report their views to the Treasury. Gerry Neale wanted the scope of the remaining monopoly, and its pricing practices, kept under review: Ian Lloyd

/saw the Post Office

saw the Post Office licensing system as a restricting factor and Neil Thorne wanted reassurance that Ministers had power to terminate the licences if they were misused by overseas interests. From the thinly attended Opposition benches, John Golding suggested that the industry had been given three years to adapt precisely because they were nervous of the change. John McWilliam drew attention to research commissioned from Logica by the Post Office Engineering Union which suggested that the Beesley proposals would involve a 15% loss of trunk revenue which would require a 25% increase on the rest of the network. Ioan Evans and Bob Cryer dismissed the proposals as a further dogmatic attack on the successful public enterprise whilst Dennis Skinner simply wanted to know (and got no answer) on how many jobs would be created.

In his replies Mr. Baker made great play of the US experience in liberalisation. There had been an increase in jobs both within AT&T and in the private sector. The Bell network had actually paid money to some of those offering added facilities in view of the extra revenue created for the network as a whole. In respect of the Logica research, he pointed out that their analysis had been based on the assumption that the full package would be introduced from the start. In discussion of the Warburg proposal for a preference share or bond, he did little to avoid giving the impression that the Treasury were being unreasonably obstructive.

In the final round, Stan Orme claimed that Mr. Beesley had failed to reassure the House and his own backbenchers on the reasons for rural areas and for the elderly. Mr. Baker acknowledged the anxiety but cautioned against the scaremongers. In the Department's recent seminar on the proposals, the consumer interests had taken a positive view of the ideas. The real costs of telecommunications were falling, and it should therefore be possible to readjust tariffs without significantly increasing the real charges for any group.

MP

30 July 1981

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DRAFT STATEMENT

TELECOMMUNICATIONS LIBERALISATION

On 15 April, my Rt Hon Friend published Professor Beesley's report on the use of British Telecommunications' (BT) network. This recommended complete freedom for anyone to use the national network to provide telecommunications services to third parties. Comments have now been received on the report from BT, its unions, from British industry - both manufacturers and suppliers - and, of course, from user groups. The Department also held a seminar to allow a full discussion of the issues involved.

When he introduced Professor Beesley's report, my Rt Hon Friend said that the Government were attracted by his free market please-the-customer approach. The comments received, often thoughtful and detailed, have done nothing to change this view; indeed many of them have endorsed it. There now appears to be general acceptance that use of the BT network to supply services to third parties, particularly when there is an enhancement of existing facilities, stimulates additional use of the network and thereby increases BT's revenue. My Rt Hon Friend, therefore, proposes to use the powers in the British Telecommunications Act to allow the private sector much greater freedom to use BT's inland network, subject in every case to technical compatibility with the network and compliance with the appropriate national and international standards.

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This is a large step forward which will help to transform telecommunications in this country from being dominated by a monopoly to being market-led and more genuinely responsive to user demand. It will bring benefits, not only to business and industry - and hence jobs - but to all sections of the community. Such a transformation cannot, however, be achieved overnight and my Rt Hon Friend proposes that, as has been done for attachments to the network, liberalisation of use of the network should be introduced on a step by step basis. BT and UK industry will thus have time to prepare for the new regime.

The first step will involve licencing private operators to use BT circuits to supply any value added network services which BT will not be supplying before 1 April 1982 and will take effect when BT takes over from the Post Office probably on 1 October. The second step commencing at the beginning of 1982 will involve freedom for the private sector to use BT circuits to compete with BT in the supply of all kinds of services, provided these services involve substantial elements additional to the basic network facilities. This freedom will not apply to simple resale to third parties of capacity on circuits leased from BT. During these two stages liberalisation will be effected by general licences for categories of service or by specific licences where that is more appropriate. Organisations wishing to provide such services should in the first instance apply for licences to BT who will licence them in conjuction with the Department of Industry. Services already licensed by BT will, of course, be allowed to continue in operation

A possible third stage might involve allowing the private sector complete freedom to use the BT network to supply services to third parties, including simple resale. This raises wider issues and my Rt Hon Friend will examine the consequences further in consultation with BT and other interested parties.

Professor Beesley also drew attention to the implications of his recommendations for international services and for competing public networks. No liberalisation in the area of international services is proposed at the present time, but the implication of this will be explored further with BT.

In his statement on 15 April, my Rt Hon Friend restated his intention to consider the scope for allowing the provision of additional transmission services. A number of organisations have been investigating the market possibilities and a detailed application has been received from Cable and Wireless, BP and Barclays for a licence to provide a business transmission system (project Mercury). The Government are giving active consideration to this proposal and are in principle in favour of such a development. A technical examination of the project is under way and a decision will be announced as soon as that has been completed. Meanwhile BT is being encouraged to respond sympathetically to requests to remove some anomalies affecting private networks, a number of which are already licensed.

The diversity of uses to which the network can and will be put increases the importance of having a modern dynamic terminal equipment market in the UK. The arrangements for liberalisation of the supply of terminal equipment for attachment to the BT network are in hand and there have been extensive discussions with industry and other interests about the order of priorities for this phased introduction of full competition. New technical committees of the British Standards Institution (BSI) have already begun work on the writing of the necessary standards. A working party of the British Electro-Technical Approvals Board (BEAB), which has been invited to act as the authentication body under the new arrangements, is discussing the detailed procedures that it will follow. A report on progress will be laid before the House as soon as possible.

In the context of greater competition, Professor Beesley also stressed the need for removal of constraints on BT's capital investment. The Government share BT's belief in the benefits flowing from a modern and efficient telecommunications network and have allowed BT to increase its investment substantially over the last two years. BT is currently investing some £5 million per day and already has the largest investment programme in the country. In the interests of its customers, BT would like to invest more.

[Mr. Baker]

of the Office of Fair Trading. Any private operator who feels that he is being restricted and has not received his licence may appeal to the Office of Fair Trading.

My hon. Friend asked whether the unions would co-operate. During the passage of the British Telecommunications Act I spoke several times to Mr. Bryan Stanley, general secretary of the Post Office Engineering Union, and I spoke to him earlier today. I do not expect the union to be obstructionist to the proposals that I have outlined.

Mr. Dennis Skinner (Bolsover): While the exercise is being completed, how many jobs will be created? The Minister has a duty to tell the House. What is all this about the new word being constantly used today, "liberalisation"? Is it what I would call a Warrington word?

Mr. Baker: I assure the hon. Gentleman that more jobs will be created as a result of my statement today than if I had not made it.

Mr. Skinner: How many?

Mr. Baker: I ask the hon. Gentleman to consider what has happened in America in the past four or five years of liberalisation. Employment has increased in the main provider of the network, AT and T, and the number of jobs has increased among the private operators. I expect the same to happen in the United Kingdom.

Mr. Richard Page (Hertfordshire, South-West): I welcome my hon. Friend's statement. It will be a major step forward in the promotion of information technology in this country. As Japan has stated that it believes that information technology will be its major economic and employment sector in the 1990s, is my hon. Friend prepared to expand his awareness of information support programmes to take advantage of his statement today? To continue with the point made by my hon. Friend the Member for Horsham and Crawley (Mr. Hordern), surely if BT is a profitable sector of our economy, the public should be allowed to invest directly in its success through the City. If we are to have some sort of preference shares I cannot understand why such shares should count against our public sector borrowing requirement.

Mr. Baker: I shall draw the remarks of my hon. Friends the Members for Hertfordshire, South-West (Mr. Page) and Horsham and Crawley (Mr. Hordern) to the attention of my colleagues in the Treasury. The proposal from Warburgs is by far the most advanced proposal that we have had about the financing of nationalised industries by going to the private market. If one can consider floating a preference share based on profit and performance—we could do that only in a nationalised industry that is profitable, which BT is and will be in the future—one is creating a novel form of financing for the nationalised industries which will support the investment programme.

Mr. Kenneth Lewis (Rutland and Stamford): Is my hon. Friend aware that when people hear talk about the restructuring of tariffs they know that as a consequence all prices will rise across the board? I support what my hon. Friend is trying to do, but I hope that at the end of the day the proposal will lead to an expansion of telecommunications, because we need that to enlarge the market and bring down prices. If it does not bring down prices, the Government will be blamed.

Mr. Baker: I am grateful for my hon. Friend's comments because that is the other side of the equation. I reassure the House on what I have already said about residential and rural tariffs, but the fact that we are to have competitive services, both value added and the possibility of an additional network, will produce a choice for the consumer for the first time in British Telecommunications services. Over the years that is bound to improve quality of service and ensure service at competitive prices.

Mr. Gerry Neale (Cornwall, North): I join my hon. Friends in congratulating the Minister on his statement. Despite the sincere comments made from the Opposition about their opposite view, I reassure my hon. Friend that there is a strong view held by Conservative Members that where the private sector can provide alternative services it should be permitted to do so. We welcome that considerably. Will he reassure us that he intends to pay close attention to the pricing policies of elements of the monopoly that remain to ensure that there is no cross-subsidisation which could result in unfair competition?

Mr. Baker: My hon. Friend knows that there are powers in the British Telecommunications Act to ensure that we are kept fully informed of all the details and that there is not cross-subsidisation. The Secretary of State has powers to require some operations of BT to be hived off into separate companies that are separately accountable so that the true costs of such operations can be seen openly.

Mr. Nigel Forman (Carshalton): Is my hon. Friend aware that many of us welcome his announcement, but we should be happier about it if we could be reassured, first, that domestic telephone users will not suffer as a result, and, secondly, that the new borrowing instruments, which are called Warburg instruments, will be adopted by the Treasury?

Mr. Baker: I shall draw my hon. Friend's comments to the attention of my ministerial colleagues. As regards domestic and rural tariffs, I reinforce what I said earlier. There are within the arrangements, and consequent upon the tariff restructuring and liberalisation, substantial gains for the rural areas. One of the ways that we can ensure that BT remains competitive in those areas is to reinforce its investment programme, and we have done that. We inherited a dramatically declining investment programme from the Labour Government and in each of our years in office that programme has increased considerably, for example, from £1·6 billion to £1·9 billion this year.

Mr. Speaker: Order. As only two more hon. Members wish to question the Minister, I shall call both before calling the Opposition spokesman.

Mr. Tim Renton (Mid-Sussex): While I welcome the concept of the preferred shares, does my hon. Friend agree that such shares normally count as part of the share capital of a company and that if they end up in the hands of institutional investors it will mean that some part of the equity ownership of BT has moved from the Government to the institutions?

Secondly, is it not a paradox that all BT's borrowings count as part of the public sector borrowing requirement, but those of Cable and Wireless, which is 100 per cent. Government owned and is about to enter competition with BT, do not count as part of the PSBR?

Mr. Baker: I confirm what my hon. Friend said in the latter part of his question. The anomaly has existed for a

The hon. Gentleman also mentioned rural areas. I must emphasise that in any tariff restructuring in which trunk calls become relatively cheaper many rural areas will gain from cheaper trunk calls—[HON. MEMBERS: "How?"] Because they must communicate with other communications centres, and the costs will be cheaper. One significant application that I have already received comes from a company that wants to place its operation in a remote development area, with the result that employment for several hundred people will be created there.

Several Hon. Members *rose*——

Mr. Speaker: Order. I remind the House that there is a time limit on questions. I therefore hope that we shall have brief questions and answers.

Mr. Peter Emery (Honiton): Will my hon. Friend accept the congratulations of the House on being a Minister who acts within two months of receiving a report in order to carry out its findings? He deserves a great deal of co-operation. Although hon. Members have asked about the loss of revenue, have estimates been made of the increase in revenue arising from the extra services that will be used as well as a greater use of the general circuit? As well as the rural costs, will he also consider the costs that will accrue to elderly people, particularly the single elderly, who rely on the telephone as the one method of staying in communication with the rest of the world?

Mr. Baker: I thank my hon. Friend for his initial remarks. Benefits will flow to BT because these proposals will increase its revenue. The American equivalent of BT, the Bell system, pays money to certain value added services for the business they generate for the Bell network. I wish that Labour Members would appreciate that fact and live in the real world.

Mr. Ioan Evans (Aberdare): Does not the hon. Gentleman realise that his statement will be seen as an attempt by the Government dogmatically to pursue a policy of privatisation without regard to the national interest? Surely the Government should distinguish between a public monopoly and a private monopoly, where the user is the nation and the benefit comes back to the nation. Does he not also realise that many people will see this as the thin end of the wedge and will feel that if the Government get away with this they will be able to hive off other national assets in the telecommunications sector?

Mr. Baker: The hon. Gentleman exagerrates. I am quite sure that the changes we are making will be to the benefit of the consumer, British manufacturing industry and eventually, through higher revenues, BT. In addition, they will create jobs. What is wrong with that package?

Mr. Bob Cryer (Keighley): That is not what will happen.

Mr. Peter Hordern (Horsham and Crawley): My hon. Friend said that BT would introduce a new form of borrowing instrument. He also said that that would count against the external financing limit. Therefore, what is the use of it? Is he not aware that our institutions are investing abroad at the rate of about £2,000 million a year, including companies such as AT and T? Surely the solution is to take that part of BT outside the public sector altogether and to allow the institutions to invest in it to produce the kind of telecommunications system that Britain should have.

Mr. Baker: I am very much aware of the interest that my hon. Friend has shown in the capital investment needs of the nationalised industries generally and British Telecommunications in particular. We have received a proposal from Warburgs to issue a form of preference share for BT relating to its profit performance, based on its revenue and the profit related to the revenue. We and the Treasury are considering that with sympathy. Of all the various proposals that have been put to us, that is by far the most optimistic of those that we have considered. Even if it were to be approved, it is still likely that it would probably count against the external financing limit and, therefore, part of the public sector borrowing requirement for British Telecommunications. The fact that BT can go to the market to appeal for funds from a sector of the market that is not the same as the gilt-edged market means that there is an element of additionality, because if the preference share were to be floated the EFL of BT would be higher than it would otherwise have been.

Mr. Bob Cryer (Keighley): Is not the reality that the proposal is part of a continuing vicious attack on a highly successful public enterprise which sticks in the craw of the Government? As that clearly will give access to the most profitable areas—while British Telecommunications will be required to maintain the rest of the services—can the Minister spell out in some detail, to satisfy both myself and the queries raised by Conservative Members that he has failed so far to answer, the safeguard for rural areas, small businesses, the elderly and the safety standards involved with the new equipment?

Mr. Baker: I specifically referred to safety standards in my statement. There is an elaborate system of ensuring that safety standards will be preserved. I have already answered questions on the restructuring of the tariffs of BT, but a tariff restructuring is taking place in BT, apart from the liberalisation. The proposals recently made by the board of BT were made long before the board knew the Government's policy and it has made some progress along that road. I expect the board to take into account the considerations that I have made. We are living in a period when the real cost of telecommunications is coming down. I shall not permit a regime by the board that will load one type of consumer, whether those in the rural areas or the elderly.

Mr. Ian Lloyd (Havant and Waterloo): Those of us who warmly support the general philosophy developed in the Beesley report will be enthusiastic about what my hon. Friend has said. As the effective liberalisation will depend to a considerable extent in the early stages on the attitude of the Post Office, which has licensing powers in its hands, what appeal will there be from the Post Office if the Government feel that the liberalisation is not being applied too generously? If that liberalisation is agreed by the Post Office but is strongly obstructed, as some of us fear and expect, by the trade unions who disapprove of the policy, what redress will we have?

Mr. Baker: My hon. Friend asked whether BT will exercise the regime fairly. There are two constraints. First, the licensing powers are ultimately vested in the Secretary of State and the Government. If the Secretary of State or any Minister in the Department feels that BT is being unduly obstructionist, he will be able to use his powers of licensing and issue a licence. There are also the activities

[Mr. Baker]

that liberalisation will of itself lead to substantial increases in residential telephone charges. As the right hon. Gentleman knows, a substantial exercise has been taking place in BT for the last two or three years on restructuring its tariffs, for the simple reason that the domestic network loses money while the cost network makes money. That has been happening not only in Britain but in telecommunications regimes throughout the world.

The right hon. Gentleman specifically mentioned rural areas, although I did not notice the Labour Government taking any specific measures to protect those areas. If trunk calls are cheaper, many residential users in rural areas will benefit. In any case, whole areas will benefit from cheaper rural trunk calls which will make communications with the centres much cheaper. I have already had notification of one applicant for a van service who intends to take advantage of this by locating his office in a remote development area. The right hon. Gentleman must therefore recognise that cheap trunk calls can bring jobs to remote areas.

Several Hon. Members *rose*——

Mr. Speaker: Order. In order to be as fair as I can to the House, I propose exceptionally to allow these questions to run until 4.30 and then to move on.

Mr. Peter Mills (Devon, West): I agree with much of what my hon. Friend has said, but I am deeply concerned about the effect of these proposals on rural areas. Will he bear in mind that BT has already cancelled a meeting with South-West Conservative Members to discuss the possible closure of telephone kiosks, about which there is a real fear? I hope that he will be more reassuring about this problem than he has been so far.

Mr. Baker: I entirely understand my hon. Friend's anxieties. I shall bring them to the attention of the chairman and board of BT. As I have explained, the restructuring of BT tariffs has now been in hand for about 18 months, and that will continue whether or not we have liberalisation. I am concerned that, when there is liberalisation, rural and residential tariffs should not be unfairly loaded, and at a time when the real cost of telecommunications is falling I look to BT and its board as far as possible to achieve this change without significantly increasing charges in real terms for any class of user.

Mr. John Golding (Newcastle-under-Lyme): Is the Minister aware that that is not possible, and that these proposals will increase telecommunications costs not only in the rural areas but also for small business men and the domestic user? Is he aware that by taking away £100 million turnover initially—potentially much more—these proposals will lead to restrictions on development and modernisation? If the hon. Gentleman does not think that these proposals will damage British industry and jobs, why has he given British industry three years in which to adjust? Is it not because he knows full well that this statement will create jobs in Japan, America and other countries with a resultant loss of jobs in Great Britain?

Mr. Baker: The hon. Gentleman should appreciate that, even by 1990, under these proposals and the proposals that we have made in the past, more than 90 per cent. of our telecommunications and services will still be provided by BT. That is a commanding share of the market. Most companies would not look upon that as a threat to their entire tariff structure. I do not accept the sort of scaremongering that I have heard today. In fact, that was refuted by consumer interests and by Dame Elizabeth Ackroyd at a recent seminar that we held.

I believe that these proposals will significantly increase the number of jobs in this area, and I shall tell the hon. Gentleman why. When liberalisation along these lines occurred in America from 1976 to 1978, jobs in AT and T, which is the equivalent of BT, went up by 6 per cent. and by 12 per cent. in the private sector. Therefore, there was an increase in jobs in both the private and public sectors. The hon. Gentleman should not let monopoly stand in the way of job creation.

Mr. Neil Thorne (Ilford, South): Is my hon. Friend satisfied that if there are cases of abuse in the granting of these licences, particularly by firms overseas, he has sufficient power to terminate the licence as a matter of urgency, especially if it is likely to lead to unfair competition with our home industry?

Mr. Baker: I can give my hon. Friend that assurance. As to the liberalisation of buying telephone equipment, an elaborate system has already been established through using the British Standards Institution and the BEAB. During my statement, the hon. Member for Bolsover (Mr. Skinner) commented that that was another quango. If he wants to enter these debates, he really must inform himself. It is a private sector test authority. That is the body that we shall use. It is well established in private industry and is supported by the unions. I therefore ask the hon. Gentleman to become informed.

Mr. John McWilliam (Blaydon): Is the hon. Gentleman aware that the Post Office Engineering Union, of which I am a member, asked Logica to carry out research into the effect of the Beesley report? It said that if cream skimming on the scale of the third proposal took place, 15 per cent. of the trunk call revenues to BT would be lost and that that would require a price increase of about 25 per cent. for remaining users. Is the hon. Gentleman aware that it is unlikely that users in the rural communities will benefit in any way whatever? How does he equate his statement on "Project Mercury"—which sounds more like a space shot—with the statement made by Lord Lyell who in his reply on behalf of the Government said——

Mr. Speaker: Order. If the noble Lord was speaking for the Government, the hon. Gentleman is free to quote him, but if he was speaking for himself that is another story.

Mr. McWilliam: Thank you, Mr. Speaker. I am quoting from the House of Lords *Hansard* of 13 January, when Lord Lyell, replying on behalf of the Government said:

"but the network, the actual wiring which goes from one place to another across the country . . . will remain the entire responsibility of British Telecommunications."—[*Official Report, House of Lords,* 13 January 1981; Vol. 416, c. 8.]

That was at a time when the Minister had received the Beesley report.

Mr. Baker: I do not think that the hon. Gentleman heard what I said in my statement. The Logica report assumed that we would allow total resale straight away. Therefore, its figures are very different, and the findings are exaggerated as a result.

supply services to third parties, including simple resale. This raises wider issues and my right hon. Friend will examine the consequences further in consultation with BT and other interested parties.

Professor Beesley also drew attention to the implications of his recommendations for international services and for competing public networks. No liberalisation in the area of international services is proposed at the present time, but the implication of this will be explored further with BT.

In his statement on 15 April, my right hon. Friend restated his intention to consider the scope for allowing the provision of additional transmission services. A number of organisations have been investigating the market possibilities and the first application has already been received. This is a detailed application from Cable and Wireless, BP and Barclays for a licence to provide a business transmission system known as "Project Mercury". The Government are giving active consideration to this proposal and are, in principle, in favour of such a development. A technical examination of the project is under way and a decision will be announced as soon as that has been completed. Meanwhile, BT is being encouraged to respond sympathetically to requests to remove some anomalies affecting private networks, a number of which have already been licensed.

The diversity of uses to which the network can and will be put increases the importance of having a modern dynamic terminal equipment market in the United Kingdom. The arrangements for liberalisation of the supply of terminal equipment for attachment to the network are in hand, and there have been extensive discussions with industry and other interests about the order of priorities for this phased introduction of full competition. New technical committees of the British Standards Institution have already begun work on the writing of the necessary standards. A working party of the British Electro-Technical Approvals Board—BEAB—which has been invited to act as the authentication body under the new arrangements, is discussing the detailed procedures that it will follow. A report on progress will be laid before the House as soon as possible.

In the context of greater competition, Professor Beesley also stressed the need for removal of constraints on BT's capital investment. The Government share BT's belief in the benefits flowing from a modern and efficient telecommunications network and have allowed BT to increase its investment substantially over the last two years. BT is currently investing some £5 million per day and already has the largest investment programme in the country. In the interests of its customers, BT would like to invest more.

The Government are glad to acknowledge that under Sir George Jefferson's leadership BT has made substantial progress in improving its services to its customers and in accelerating the introduction of modern technology. The Government are concerned to respond as positively as the constraints on public expenditure and public sector borrowing permit to the needs of BT's vital investment programme, especially when that is directed to modernisation. The Government will in particular keep very much in mind the need for the corporation to be able to compete successfully in the environment that it will increasingly face.

With this in view, the Government have received from BT a proposal for a new borrowing instrument which is being considered sympathetically. If accepted, this would be taken into account in fixing BT's level of external finance.

Mr. Stanley Orme (Salford, West): We should have liked very much to debate the long statement made by the Minister as it has a great deal of content and the proposals will have far-reaching effects. We are most concerned that Professor Beesley's report has been so overwhelmingly adopted by the Government. We believe that it was a hasty report and that the period of two months allowed for consultation after its publication was totally inadequate. We are most dissatisfied with the way in which the Government are handling the matter.

Does the Minister agree that the proposals will take essential traffic—and the best traffic—away from the public network operated by BT, thereby reducing its ability to make profit and undermining its investment programme?

Secondly, will not the proposals go far beyond anything else proposed in the EEC or by any of our other main competitors? Is the Minister aware—will he give details on this—that British manufacturers are concerned about the uncertainty surrounding the British telecommunications industry? Will not the proposals have a detrimental effect on British manufacturers and lead to a flood of foreign imports?

Finally, what effect will the proposals have on the cost to the consumer? We are very concerned about this. The Minister has said that in the first stage the Government will consider selling off some of the units. Will not this lead to an enormous increase in cost and a reduced market for British Telecommunications? What will be the effect of that on domestic consumers, not least those in rural areas?

Mr. Baker: My right hon. Friend the Leader of the House is present and has no doubt heard the right hon. Gentleman's comments about the possibility of having a debate when we resume.

The right hon. Gentleman raised three points. First, he asked whether this would take essential traffic away. Some traffic, of course, will be taken away, but the Opposition should view this in proportion. The revenues of BT this year will exceed £5 billion. In the various recommendations and submissions made to us, the effect on BT's revenue in 1983, 1984 and 1985 of the measures on liberalisation that we have recommended will be between £70 million and £100 million turnover at the most, in relation to a turnover which this year was £5 billion and rising substantially.

The right hon. Gentleman's second question concerned the attitude of manufacturers in the United Kingdom. They are principally affected by the measures already announced concerning liberalisation of the attachments—the handsets, and answering equipment and the PABXs. I assure the right hon. Gentleman that I have had no representations recently from any manufacturer expressing concern about this. Indeed, all the large companies—GEC, Plessey, STC and Pye—are engaging in significant cost reduction exercises so that when the equipment area is properly liberalised they will be able to compete successfully in the United Kindom and also to export.

The right hon. Gentleman's third question concerned the effects on tariffs. I wish to orefute the wild allegations response—an inadequate response—to the Public Accounts Committee report on the role of the Comptroller and Auditor General?

Mr. Pym: I shall convey to my right hon. Friend the Secretary of State for Energy the hon. Gentleman's views about his first point, the importance of which I appreciate. I think that there will be an opportunity in the next Session for a debate on the Select Committee report to which the hon. Gentleman referred. I believe that it will be a strong candidate for a day's debate. I agree with the hon. Gentleman that it should have the attention of the House.

Sir Anthony Meyer (Flint, West): Has my right hon. Friend seen early-day motion 570, signed by hon. Members on both sides of the House, relating to world starvation?

[That this House supports the manifesto of the 54 Nobel Prize winners calling for immediate international action to combat mass starvation in the Third world.]

If my right hon. Friend cannot give an assurance that there will be a debate on the motion before the Mexico summit, will he at least ensure that the urgency of this aspect of relations with the Third world is properly seized by Ministers before the delegation leaves for Mexico City?

Mr. Pym: There have been recent opportunities to debate the subject—on the Brandt report and on the Consolidated Fund Bill. No doubt there will be other opportunities when we return.

Mr. Kenneth Marks (Manchester, Gorton): As the Secretary of State for the Environment will not report back from Liverpool until after the House has risen, will the Government urgently consider the heavy costs that county councils such as Manchester and Merseyside face for additional police activity and the compensation for damage? Will the Government consider applying the same system to help those authorities as the Department for the Environment uses for flood and storm damage?

Mr. Pym: The hon. Gentleman is right. It is important, and the Government are currently considering that difficult matter.

Several Hon. Members *rose—*

Mr. Speaker: Order. I propose to call those hon. Members who have been rising in their places.

Mr. Kenneth Lewis (Rutland and Stamford): If, by chance, my right hon. Friend is asked to bring us back before the due date, will he choose the time very carefully indeed, and may I help him by suggesting that he might bring us back in the middle of the Labour Party conference, because Labour Members will not have much to do there as it will not take much notice of them and they may as well be here?

Mr. Pym: I note my hon. Friend's helpful suggestion, but I would not wish to cause too much disappointment to too many people.

Mr. David Winnick (Walsall, North): With unemployment at its highest level since the 1930s, and with the crisis in inner city areas, is there not a strong case for us to come back before the beginning of October? Bearing in mind the crisis, why should we break up for a long period?

Mr. Pym: We are breaking up for the period that we decided to break up for because the House has reached that conclusion.

Mr. Bill Walker (Perth and East Perthshire): When the House resumes, may we have an opportunity to debate early-day motion 368 on cheque book journalism—

[That this House, deploring recent examples of cheque book journalism, calls upon Her Majesty's Government to introduce legislation making such practices illegal so that once again crime will be seen not to pay.]

and particularly the amendment standing in my name—

[Line 1, after 'journalism', add 'and in particular condemns the payment of £50 to Susan Ettles for her contribution to an article about skinheads and for the anxiety and distress caused to her widowed mother who lives in Scotland and who had no knowledge of the matter'.]?

Is my right hon. Friend aware that the articles in the *Daily Mirror* and the *Daily Record* have brought considerable distress to a constituent of mine who had no knowledge of the matter concerning skinheads and her daughter?

Mr. Pym: I note my hon. Friend's request. I shall keep it in mind, but it may be that he will have to find his own opportunity on a private Member's basis to debate that subject.

Mr. Frank Hooley (Sheffield, Heeley): The leader of the House will be aware that in the early hours of yesterday morning the House was debating certain important matters relating to the steel industry. However, is he aware that, in the course of that debate, his hon. Friend the Member for Southend, East (Mr. Taylor) alleged that the EEC Commission was threatening to withhold large capital sums that the Government had already authorised unless the British Steel Corporation's steel making capacity was reduced by a further £1 million, and that that allegation appears to be confirmed by reports in the press this morning? Will he, therefore, ask the Secretary of State for Industry to come to the House tomorrow to make a clear statement that there is no intention whatsoever of further cutting back the steel industry with the loss of tens of thousands of jobs?

Mr. Pym: I do not believe that a statement tomorrow would be appropriate. The issue that the hon. Gentleman raises is subject to negotiation by my right hon. Friend and the Commission, and, frankly, the Government are not unhopeful about the outcome.

Mr. Stanley Newens (Harlow): Has the right hon. Gentleman noted that 178 hon. Members on both sides of the House have signed early-day motion 569, which deals with the plight of glasshouse growers?

[That this House, alarmed at the increasingly unfair competition faced by the British glasshouse growers as the result of escalating energy prices, which have completely erased the advantages of providing the subsidy on oil, and the failure over a number of years of the European Economic Community to equalise fuel costs between the glasshouse industries of different countries, calls upon the British Government to take immediate action to offset the substantial financial advantages enjoyed by Dutch producers as the result of access to gas at artificially low prices.]

As we are unlikely to have a statement from the Minister of Agriculture, Fisheries and Food on that important subject before the House rises, will the right hon. Gentleman draw the matter to his right hon. Friend's attention and ensure that, as soon as the House returns, we

[Mr. Stanley Newens]

shall have an opportunity to raise it in the House? Does he accept that it is of vital importance to those people, who are mainly small business men—about whom the Government are pledged to do something—and their employees?

Mr. Pym: Yes, Sir. I am able to respond with great sympathy. I have a number of glasshouse growers in my constituency, as do many other hon. Members. It is a serious situation. My right hon. Friend the Minister of Agriculture, Fisheries and Food has done as much as he possibly could but he realises the competitive difficulties of glasshouse growers. He is doing everything that he can, and I am sure that he will be returning to the subject in the autumn.

Mr. Bob Cryer (Keighley): Is the Leader of the House aware that the multi-fibre arrangement renegotiations will enter a serious phase in October-November, which is about the time when the House reassembles, and that in textile areas like mine we already have an increase in unemployment of 183 per cent. since the Tory Government came to office? Is he further aware that many people are, therefore, deeply apprehensive about the outcome of the MFA renegotiation and it is important for the confidence of the industry that it should properly be renegotiated? Can he reassure us that any developments will be reported to the House in the form of a statement by the Secretary of State for Trade at the earliest opportunity, as I am sure that he recognises that such a statement is wanted by both sides of the House?

Mr. Pym: I shall convey those views to my right hon. Friend the Secretary of State for Trade. I was glad to be able to make a day available to debate the subject before the negotiations proper began, and I have no doubt that there will be continued interest in it when we return from the recess.

Mr. John Browne (Winchester): Does my right hon. Friend accept that one of the potentially largest, fastest growing and most lucrative industries is that of video text or home information technology, and that Great Britain could well be one of the leaders in the industry but that it is fast falling behind? Is he prepared to give a day to debate the subject in the next Session of Parliament?

Mr. Pym: I cannot give that undertaking, but the subject is obviously a possible candidate, although, again, it may have to be in private Member's time. However, if we can find Government time, all the better.

Mr. Bill Walker: On a point of order, Mr. Speaker. I draw your attention to the debate on 21 July, when the hon. Member for Kilmarnock (Mr. McKelvey) alleged that the Dundee chamber of commerce had issued a statement concerning myself. The chamber has since written to him stating that it never issued such a statement and asking him to withdraw the remarks that appear in *col.* 246 of the *Official Report*. I wrote to the hon. Gentleman, and he kindly informed me that he would be unable to be here today but that he hopes to deal with the matter when the House resumes. However, I felt that that was too long to leave the matter, so I wish to place it on record.

Mr. Speaker: No doubt we shall hear more about it.

British Telecommunications

The Minister for Industry and Information Technology (Mr. Kenneth Baker): With permission, I should like to make a statement about telecommunications liberalisation. I apologise in advance for the length of the statement.

On 15 April, my right hon. Friend published Professor Beesley's report on the use of British Telecommunications' network. This recommended complete freedom for anyone to use the national network to provide telecommunications services to third parties. Comments have now been received on the report from BT, its unions, from British industry—both manufacturers and suppliers—and, of course, from user groups. The Department also held a seminar to allow a full discussion of the issues involved.

When he introduced Professor Beesley's report, my right hon. Friend said that the Government were attracted by his free market, please-the-customer approach. The comments received, often thoughtful and detailed, have done nothing to change this view; indeed, many of them have endorsed it. There now appears to be general acceptance that use of the BT network to supply services to third parties, particularly when there is an enhancement of existing facilities, stimulates additional use of the network and thereby increases BT's revenues. My right hon. Friend, therefore, proposes to use the powers in the British Telecommunications Act to allow the private sector much greater freedom to use BT'S inland network, subject in every case to technical compatibility with the network and compliance with the appropriate national and international standards.

This is a large step forward, which will help to transform telecommunications in this country from being dominated by a monopoly to being market-led and more genuinely responsibe to user demand. It will bring benefits, not only to business and industry—and, therefore, jobs—but to all sections of the community. Such a transformation cannot, however, be achieved overnight, and my right hon. Friend proposes that, as has been done for attachments to the network, liberalisation of use of the network should be introduced on a step-by-step basis. BT and United Kingdom industry will thus have time to prepare for the new regime.

The first step will involve licensing private operators to use BT circuits to supply any value added network services which BT will not be supplying before 1 April 1982, and that will take effect when BT takes over from the Post Office on 1 October this year. The second step, commencing at the beginning of 1982, will involve freedom for the private sector to use BT circuits to compete with BT in the supply of all kinds of services, provided that these services involve substantial elements additional to the basic network facilities. This freedom will not apply to simple resale to third parties of capacity on circuits leased from BT. During these two stages, liberalisation will be effected by general licences for categories of service or by specific licences where that is more appropriate. Organisations wishing to provide such services should in the first instance apply for licences to BT, which will license them in conjunction with the Department of Industry. Services already licensed by BT will, of course, be allowed to continue in operation.

A possible third stage might involve allowing the private sector complete freedom to use the BT network to number of years, largely because Cable and Wireless has not had recourse to borrowings for a considerable of number of years and has generated investment from its own cash flow.

There is an element of what my hon. Friend suggested in the concept of a preference share. The alternative would be a participating bond, but the key element of a share or a bond is that it must be related to the profit performance of the nationalised industry. Otherwise it will change nothing.

Mr. John Browne (Winchester): I fully support the initial move to privatise the industry, but I have some severe reservations, as, I suspect, do some of my hon. Friends, about the extent of the operation. A rump end of a monopoly in terms of private rural tariffs has been left behind and it could undercut prices on the trunk lines, thereby driving out competition on those lines, while raising rural tariffs. Will my hon. Friend explain what safeguards will be provided to prevent that from happening?

Mr. Baker: It is generally recognised that none of those problems will necessarily flow from the measures that I have announced or from the liberalisation. Various safeguards can be built into the provision of any value added network services as regards the terms of the interconnection with BT from the additional business. I remind my hon. Friend of what has happened in America. Where such services operate in the United States, they do so for the benefit of the main provider AT and T, the Bell system, to the extent that the company pays certain service providers for the benefit of their operations, and not the other way round.

Mr. Orme: The Minister has failed to reassure the House and many of his hon. Friends about rural services, small businesses and the elderly. If the consumer is offered a cheaper service he will choose that service. Will the hon. Gentleman, therefore, guarantee that the services that we are concerned about will not be run down and that costs will not go up as we fear? Will he guarantee the House that he will protect those services?

Mr. Baker: I appreciate that there is anxiety on that point and I confirm what I have already said. First, I counsel the House against listening to too much scaremongering. That point was made repeatedly by consumer interests, and not Government spokesmen, at the recent seminar. I also confirm that at a time when the real costs of telecommunications are falling I shall look to BT to achieve the change that we have been talking about without, as far as possible, significantly increasing charges in real terms for any class of user.

Herring Fishing (The Minch)

Mr. Donald Stewart (Western Isles): I beg to ask leave to move the Adjournment of the House, under Standing Order No. 9, for the purpose of discussing a specific and important matter that should have urgent consideration, namely,

"the need to stop immediately herring fishing in The Minch."

I apologise to you, Mr. Speaker, for not giving notice before 12 noon. I hastened to do so as soon as I had details of the matter.

This is the first time that I have submitted a motion under Standing Order No. 9. I say that not to comment on, or to pre-empt, your eventual decision, Mr Speaker, but to make the point that it is not a procedure that I invoke lightly.

The matter is specific, because it applies solely to the dangerous situation concerning herring stocks in The Minch. For three years, fishermen of the Western Isles and others who have fished these waters have acquiesced in the total ban on herring fishing in The Minch. That has been a severe sacrifice, but it was agreed in the knowledge that the herring stock had been virtually wiped out and that if it was to be saved protection had to be given and time had to be allowed to allow the stock to revive.

So severe were the restrictions that two local boats that fished only with drift nets—a conservation measure in itself—were not exempted from the ban, despite several appeals that I made to the Ministry of Agriculture.

I have received a sheaf of telegrams from skippers of vessels from Stornaway, Eriskay, Scalpay in my constituency, Mallaig on the West coast and Avoch on the East coast. The message is clear. Those skippers say that the fishing must end immediately or their livelihoods will be destroyed virtually overnight, in spite of their previous sacrifice.

The limited stocks of herring are being decimated and, because of previous experience, fishermen have no faith in talk of management controls. They all express anger and astonishment that the Government have acquiesced in the blunder.

The matter is urgent because another two or three weeks of the fishing would deplete stocks and destroy for ever the staple living of fishing communities. Today's papers report that hundreds of tonnes of herring caught in the reopened West of Scotland grounds yesterday went for fish meal. At a time of world hunger and when our fishermen need to make a reasonable living, food that should be going for human consumption is being reduced to fish meal.

It is essential that the fishing is stopped immediately, so that fair shares can be allocated to the local fleet and the traditional fleet that fishes The Minch and until satisfactory arrangements for control have been agreed. Appalling damage has been done to the stocks and that is why I seek leave to move the Adjournment of the House.

Mr. Speaker: The right hon. Member asks leave to move the Adjournment of the House for the purpose of discussing a specific and important matter that he believes should have urgent consideration, namely;

"the need to stop immediately herring fishing in The Minch."

The House will have listened with anxious care to what the right hon. Gentleman said. He knows that under Standing Order No. 9 I am directed to take into account the several factors set out in the Order, but to give no reasons for my decision.

[Mr. Speaker]

I listened with great care to the right hon. Gentleman, but I must rule that his submission does not fall within the provisions of the Standing Order and, therefore, I cannot submit his application to the House.

Fiji and Vanuatu (Gifts)

4.39 pm

The Chancellor of the Duchy of Lancaster, Paymaster General and Leader of the House of Commons (Mr. Francis Pym): I beg to move,

That Mr. Austin Mitchell and Mr. John Stradling Thomas have leave of absence to present on behalf of this House a gift of a Clerk's Table to the House of Representatives of Fiji, and a gift of a Speaker's Gavel and Desk Set to the House of Assembly of Vanuatu.

On 23 July the House approved the presentation of gifts to the House of Representatives of Fiji and to the House of Assembly of Vanuatu. The motion will give the hon. Member for Grimsby (Mr. Mitchell) and my hon. Friend the Member for Monmouth (Mr. Stradling Thomas) leave of absence to present the gifts on our behalf. They will be accompanied by Mr Michael Ryle, Clerk of the Overseas Office, and together they will comprise a formal delegation for the purpose of making the presentation on behalf of the House.

Question put and agreed to.

PV

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1.

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Copies to N Ingham
N Pattison.

PS/ *Secretary of State for Industry*

Agreed
MT

28 July 1981

Clive Whitmore Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister.

This is the statement which Mr Baker would propose to make (in the form of a Written Answer) in the light of your conclusion yesterday that we cannot announce the final decision to go ahead with Mercury this week. Are you content with it, subject to the views of the other Ministers concerned?

Dear Clive

TELECOMMUNICATIONS LIBERALISATION

We spoke about the reasons for delaying an announcement of Government approval of the Mercury project and you asked for a revised draft of the statement which Mr Kenneth Baker now proposes to make by written answer on Thursday.

Apart from a few small drafting amendments that have mostly been requested by British Telecommunications, the substantive change is the revised passage on the Mercury project which is sidelined on page 3. This follows the line suggested by Sir Robert Armstrong for use if an announcement of the decision on this project had to be deferred and has been agreed at official level by the Home Office.

Copies of this letter go to John Halliday (Home Office), Brian Fall (FCO), Peter Jenkins (Treasury), David Hayhoe (CDL), Murdo Maclean (Chief Whip) and to David Wright.

Yours ever
Ian Ellison

I K C ELLISON
Private Secretary

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DRAFT STATEMENT

TELECOMMUNICATIONS LIBERALISATION

On 15 April, my Rt Hon Friend published Professor Beesley's report on the use of British Telecommunications' (BT) network. This recommended complete freedom for anyone to use the national network to provide telecommunications services to third parties. Comments have now been received on the report from BT, its unions, from British industry - both manufacturers and suppliers - and, of course, from user groups. The Department also held a seminar to allow a full discussion of the issues involved.

When he introduced Professor Beesley's report, my Rt Hon Friend said that the Government were attracted by his free market please-the-customer approach. The comments received, often thoughtful and detailed, have done nothing to change this view; indeed many of them have endorsed it. There now appears to be general acceptance that use of the BT network to supply services to third parties, particularly when there is an enhancement of existing facilities, stimulates additional use of the network and thereby increases BT's revenue. My Rt Hon Friend, therefore, proposes to use the powers in the British Telecommunications Act to allow the private sector much greater freedom to use BT's inland network, subject in every case to technical compatibility with the network and compliance with the appropriate national and international standards.

This is a large step forward which will help to transform telecommunications in this country from being dominated by a monopoly to being market-led and more genuinely responsive to user demand. It will bring benefits, not only to business and industry - and hence jobs - but to all sections of the community. Such a transformation cannot, however, be achieved overnight and my Rt Hon Friend proposes that, as has been done for attachments to the network, liberalisation of use of the network should be introduced on a step by step basis. BT and UK industry will thus have time to prepare for the new regime.

The first step will involve licencing private operators to use BT circuits to supply any value added network services which BT will not be supplying before 1 April 1982 and will take effect when BT takes over from the Post Office probably on 1 October. The second step commencing at the beginning of 1982 will involve freedom for the private sector to use BT circuits to compete with BT in the supply of all kinds of services, provided these services involve substantial elements additional to the basic network facilities. This freedom will not apply to simple resale to third parties of capacity on circuits leased from BT. During these two stages liberalisation will be effected by general licences for categories of service or by specific licences where that is more appropriate. Organisations wishing to provide such services should in the first instance apply for licences to BT who will license them in conjuction with the Department of Industry. Services already licensed by BT will, of course, be allowed to continue in operation.

A possible third stage might involve allowing the private sector complete freedom to use the BT network to supply services to third parties, including simple resale. This raises wider issues and my Rt Hon Friend will examine the consequences further in consultation with BT and other interested parties.

Professor Beesley also drew attention to the implications of his recommendations for international services and for competing public networks. No liberalisation in the area of international services is proposed at the present time, but the implication of this will be explored further with BT.

In his statement on 15 April, my Rt Hon Friend restated his intention to consider the scope for allowing the provision of additional transmission services. A number of organisations have been investigating the market possibilities and a detailed application has been received from Cable and Wireless, BP and Barclays for a licence to provide a business transmission system (project Mercury). The Government are giving active and sympathetic consideration to this proposal and are in principle in favour of such a development. It raises certain technical issues which have yet to be fully resolved and a decision will be announced as soon as the technical examination of the project has been completed. Meanwhile BT is being encouraged to respond sympathetically to requests to remove some anomalies affecting private networks, a number of which are already licensed.

The diversity of uses to which the network can and will be put increases the importance of having a modern dynamic terminal equipment market in the UK. The arrangements for liberalisation of the supply of terminal equipment for attachment to the BT network are in hand and there have been extensive discussions with industry and other interests about the order of priorities for this phased introduction of full competition. New technical committees of the British Standards Institution (BSI) have already begun work on the writing of the necessary standards. A working party of the British Electro-Technical Approvals Board (BEAB), which has been invited to act as the authentication body under the new arrangements, is discussing the detailed procedures that it will follow. A report on progress will be laid before the House as soon as possible.

In the context of greater competition, Professor Beesley also stressed the need for removal of constraints on BT's capital investment. The Government share BT's belief in the benefits flowing from a modern and efficient telecommunications network and have allowed BT to increase its investment substantially over the last two years. BT is currently investing some £5 million per day and already has the largest investment programme in the country. In the interests of its customers, BT would like to invest more.

The Government are glad to acknowledge that under Sir George Jefferson's leadership BT has made substantial progress in improving its services to its customers and in accelerating the introduction of modern technology. The Government are concerned to respond as positively as the constraints on public expenditure and public sector borrowing permit to the needs of BT's vital investment programme. The Government will in particular keep very much in mind the need for the Corporation to be able to compete successfully in the new environment it will increasingly face.

With this in view, the Government have received from BT a proposal for a new borrowing instrument which is being considered sympathetically. If accepted, this would be taken into account in fixing BT's level of external finance.

JH.518

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PS/ Secretary of State for Industry

24 July 1981

Tim Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister

24 vii

Dear Tim

TELECOMMUNICATIONS LIBERALISATION

I enclose the draft of the oral statement my Secretary of State proposes to make on Monday, 27 July. The text is subject to some uncertainties.

2. First, the Prime Minister has indicated that she herself wishes to announce the Government's agreement to licence the additional telecommunications network proposed by Cable and Wireless, BP and Barclays Bank. If she does so, the need for my Secretary of State to make an oral statement would fall away and the statement could be made as an answer to a written question. We have already inspired a suitable written question for this purpose. I enclose a form of words which the Prime Minister might wish to consider using. I am sure that the Home Secretary and my Secretary of State would want to have the opportunity to comment on the eventual text the Prime Minister might use.

3. Secondly, it is not altogether clear that the way will be open for an announcement of the additional telecommunications network as early as Monday afternoon. My Secretary of State believes that it would be a mistake not to announce the additional network orally in the House before the Summer recess. He therefore hopes very much that Sir Robert Armstrong will conclude his discussions in time for the announcement to be made on Monday. He realises that this may not be easy but there appears to be no scope for an oral statement on a matter of this importance later in the week.

4. I understand that the text of the draft statement has been discussed with Home Office officials. Peter Jenkin at the Treasury has been most helpful in securing agreement to the final

/paragraph

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paragraph dealing with BT's finances.

5. Copies of this letter go to John Halliday (Home Office), Brian Fall (FCO), Peter Jenkin (Treasury), David Hayhoe (CDL) and to David Wright.

Yours ever

Ian

I K C ELLISON
Private Secretary

JU433

DRAFT PASSAGE FOR INCLUSION IN THE PRIME MINISTER'S SPEECH

TELECOMMUNICATIONS

I can announce that the Government has decided in principle to use the British Telecommunications Act to license the Mercury proposal for an additional telecommunications network. This is a proposal by the shortly-to-be-privatised Cable & Wireless, British Petroleum and Barclays Merchant Bank to establish a modern, digital transmission network for all kinds of telecommunications. It will be based on optical fibres and modern microwave technology. Mercury are negotiating to lay their cable along British Rail's track and hope to become operational in 1983.

In addition the Government intends to allow private operators much greater freedom to use British Telecommunications' network to provide services to customers as recommended by Professor Beesley. This will be done on a phased basis. My Rt Hon Friend is making a statement in answer to a written question to explain both develoments.

These are exciting changes. At last British Telecommunications will be exposed to competition and made responsive to demand. People will be able to choose for themselves. No longer will they be told what they can have. This will generate growth and innovation in information technology. New industries will emerge providing new and better services to the customer and creating new jobs. British Telecommunications will also benefit from increased use of its network. It has an important role to play and is already responding positively to the prospect of competition. The Government has received proposals from the Corporation for a radically new form of finance. We are giving this sympathetic consideration.

DRAFT STATEMENT

TELECOMMUNICATIONS LIBERALISATION

On 15 April, I published Professor Beesley's report on the use of British Telecommunications' (BT) network. This recommended complete freedom for anyone to use the national network to provide telecommunications services to third parties. I have now received comments on the report from BT, its unions, from British industry - both manufacturers and suppliers - and, of course, from user groups. The Department also held a seminar to allow a full discussion of the issues involved.

When I introduced Professor Beesley's report, I said that the Government was attracted by his free market please-the-customer approach. The comments I have received, often thoughtful and detailed, have done nothing to change this view; indeed many of them have endorsed it. I believe there is now general acceptance that many such services, and particularly those that provide an enhancement of BT's network facilities, stimulate additional use of that network and thereby increase BT's revenue. I propose, therefore, to use the powers in the British Telecommunications Act to allow much greater freedom of access to use BT's inland network, subject in every case to technical compatibility with the network.

This is a major step forward which will help to transform telecommunications in this country from being dominated by a monopoly to being market-led and more genuinely responsive to user demand and new technology. This will bring immense benefits, not only to business - and hence jobs - but to all sections of the community. I recognise, however, that such a transformation cannot be achieved overnight and I propose that, as for attachments to the network, liberalisation of use of the network should be introduced on a step by step basis. This will allow BT and UK industry time to prepare for the new regime.

The first stage will comprise those network services which BT will not supply within the next 6 months. There will be complete freedom to supply these services when BT takes over from the Post Office in the autumn. The second stage will be freedom to compete with BT in the supply of all services which include substantial elements additional to the basic network facilities. These will be liberalised from the beginning of 1982. During these two stages the liberalisation will be effected by general licences for categories of service or by specific licences where that is more appropriate. Organisations wishing to provide such services should apply for licences to BT who will licence them in conjunction with the Department of Industry. Services already licensed by BT will, of course, be allowed to continue in operation.

Complete freedom of use of the BT network to supply services to third parties raises wider issues and I shall examine the consequences further in consultation with BT and other interested parties.

Professor Beesley also drew attention to the implications of his recommendations for international services and for competing public networks. I do not propose any liberalisation in the use of international circuits at the present time, but will explore the scope for this further with BT.

In my statement on 15 April I restated my intention to explore the scope for allowing the provision of additional transmission services. A number of organisations have been investigating the market possibilities and I have received a detailed application from Cable and Wireless, BP and Barclays for a licence to provide a second force business transmission system (project Mercury). I have examined this carefully and have concluded that it would be to the advantage of telecommunications in this country to have such a system. This is, however, an important decision and I

intend to move gradually. I propose therefore to licence only one such alternative business system and have decided in principle to issue a licence to project Mercury alone at this stage. The details of the licence will be for negotiation. I do not preclude the payment of a rental or royalty to BT. Meanwhile,
I am encouraging BT to respond sympathetically to requests to remove some anomalies affecting private networks, a number of which are already licensed.

The diversity of uses to which the network can and will be put increases the importance of having a modern dynamic terminal equipment market in the UK. The arrangements for liberalisation of the supply of attachments are in hand and there have been extensive discussions with industry and other interests about the order of priorities for this phased introduction of full competition. New technical committees of the British Standards Institution (BSI) have already begun work on the writing of the necessary standards. And a working party of the British Electro-Technical Approvals Board (BEAB), which has been invited to act as the authentication body under the new arrangements, is discussing the detailed procedures that it will follow. I will lay a report on progress before the House as soon as possible.

In the context of greater competition, Professor Beesley also stressed the need for removal of constraints on BT's capital investment. The Government shares BT's belief in the benefits flowing from a modern and efficient telecommunications network and has allowed BT to increase its investment substantially over the last two years. BT is currently investing some £5 million per day and already has the largest investment programme in the country. BT would like to spend more.

I am glad to acknowledge that under Sir George Jefferson's leadership and since the introduction of the BT Bill BT has made substantial progress in improving its services to its customers and in accelerating the introduction of modern technology. The Government is concerned to respond as positively as the constraints of public expenditure and the public sector borrowing requirement permit to the needs of BT's vital investment programme. The Government will in particular keep very much in mind the need for the Corporation to be able to compete successfully in the new environment it will increasingly face.

With this in view, the Government has received from BT a proposal for a new borrowing instrument which is being considered sympathetically. If accepted, this would be taken into account in fixing BT's level of external finance.

2

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

24 July 1981

Prime Minister

Some progress at last in getting BT financing outside the PSBR.

24/7

Ian Ellison Esq
Private Secretary
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1

Dear Ian

BRITISH TELECOM FINANCING

At the meeting this morning with your Secretary of State and Mr Baker, it was agreed that the following assurances could be given privately to Sir George Jefferson:-

"The Government fully recognises the importance of BT's modernisation programme - the additional £200 million on that 1981-82 year target is evidence of that. The Government accept that they have a strong case for a higher level of finance than in Cmnd 8175, but no firm commitments can be given at this stage of the year.

The Government is examining the latest Warburg bond proposals sympathetically. If accepted money provided would have to be within the overall limit for external finance decided for BT - although the proposals would mean the level of the overall limit would be higher than it would otherwise be."

It was to be made clear that while the level would be higher with a bond than without, there could be no question of a "one-to-one" increase, i.e. there could be no question of adding all the expected proceeds from the bond to the level which would have been set without it. Mr Baker expressed a preference for the term "preference share" rather than "bond". Presumably a final decision on this need not be taken now.

It was agreed that in the public statement which your Secretary of State proposes to make next week something on the following lines might be used:-

"The Government is concerned to respond as positively as the constraints of public expenditure and the PSBR permit

/to the needs of

to the needs of British Telecoms investment programme. The Government will in particular keep in mind the need for the Corporation to be able to compete successfully in the new environment it will increasingly face."

I am copying this letter to Tim Lankester and Johnathan Hudson.

Yours ever,

Peter

P S JENKINS
Private Secretary

24 JUL 1981

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JU391

Post + Telecom

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Secretary of State for Industry

20 July 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Whitehall SW1

Dear Geoffrey.

As you know, I hope to make a statement later this month announcing the decision to implement the most significant parts of the Beesley Report about liberalising the use of the BT network for value added network services. I also hope to announce agreement in principle to permit the establishment of a competitive business communication system.

2 These are, as you will appreciate, fairly radical steps and Sir George Jefferson will need some concession if he is to persuade both his Board and the POEU to accept the new competitive framework we are introducing. Sir George himself might be put in an impossible position if we were unable to show willingness to act on the financial side, as Professor Beesley himself recommended.

3 I understand that Sir George mentioned to you at a recent dinner further work he has commissioned from Warburgs. I shall be sending a proposal as soon as possible to the Treasury and I hope that you will be able to be as positive as you can in support of it so that we can carry both Sir George and BT with us on what is an important reform we are undertaking.

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

Yours ever,

Keith

Treasury Chambers, Parliament Street, SW1P 3AG

R 20/7

The Rt Hon Sir Keith Joseph MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1E 6RB

20 July 1981

Dear Keith,

BRITISH TELECOMS' TARIFF INCREASES

You sent Geoffrey Howe a copy of your minute dated 10 July to the Prime Minister. Your minute raises important questions both about the structure and the level of the tariff increases proposed.

Given the desirability of introducing increased competition into Telecommunications, we can certainly welcome the general direction of BT's proposals towards the reduction of cost subsidisation. This is an essential step in preparing for the more competitive environment in which the corporation will have to operate. However we will also need to be assured that BT are not loading their charges in such a way as to make competition totally unrewarding for any other potential supplier of telecommunications services. I hope that this is an aspect that POUNC will have in mind. We might also consider whether the charges proposed suggest fresh areas where competition can be encouraged (for example, on telephone connection charges).

While the proposals put forward would raise significant sums, they are already taken into account in BT's bids in the current IFR. As you know those bids are very large indeed and form part of an exceptionally difficult public expenditure prospect. I cannot therefore rule out the possibility that BT may eventually have to seek to increase their tariffs by amounts greater than what is now proposed, if they are not to have to reconsider their investment in modernisation. But what would of course be far preferable is for BT to look for cost savings as widely and as vigorously as possible. I hope that the work being done by the two firms of management consultants currently employed by BT will produce real benefits in this respect.

Action of this kind will also help to minimise the continuing risk of a £120 million overshoot on BT's EFL for the current year. Sir George Jefferson must be left with no illusions about the difficulties that such an overshoot would create.

Subject to these comments I am content that Sir George Jefferson's proposals should be put in POUNC.

I am copying this minute to the recipients of yours.

Leon

LEON BRITTAN

20 JUL 1981

CONFIDENTIAL

Post & Telecom

10 DOWNING STREET

From the Private Secretary

20 July, 1981.

British Telecommunications Tariff Increases

The Prime Minister has now fully considered your Secretary of State's minute of 20 July; she has also had the benefit of the advice in your letter of 14 July about the impact of the proposals on small business users.

The Prime Minister is prepared to go along with the proposals, albeit reluctantly - though this is subject to any points the Chancellor of the Exchequer may wish to make. However, the Prime Minister thinks it would be helpful if your Secretary of State could indicate to the Post Office Users National Council that the Government would like that body to look carefully at the size of the rental increases for business.

I am sending copies of this letter to John Wiggins (HM Treasury), David Wright (Cabinet Office), and Gerry Spence (CPRS).

T. P. LANKESTER

Ian Ellison, Esq.,
Department of Industry.

CONFIDENTIAL

SECRET

16

1

PRIME MINISTER

Very reluctantly acquiesce.
MT.

British Telecommunications Tariffs

You raised some questions about Sir Keith Joseph's BT tariff proposals at Flat A.

At Flag B is the further note which Sir Keith promised you. He confirms his view that it would be a mistake to try to persuade BT to abate the increase on business rentals. Even if Jefferson were prepared to do so (which I am told is unlikely), it would add to BT's EFL. It is also relevant that, while the very smallest businesses will be hard hit in percentage terms by the package of increases, the average increase in telephone bills for business customers will be only 6.9%. Nonetheless, Sir Keith could still ask POUNC to look carefully at the size of the rental increases for businesses. In this way, BT would at least be under some pressure from the media.

I have checked your point about the need for further manpower economies. BT will employ 4,000 fewer people this year than they had originally intended to, which is perhaps not a very large reduction. But DOI say that they have done, and are continuing to do, everything they can to put pressure on BT in this regard. It is at their instigation that two firms of management consultants have been brought in. And it is clear from the complaints from BT - that their EFL is too low for their investment needs - that they are under financial pressure.

Robin Ibbs (Flag C) recommends that the proposals "strike a good balance between the long term aims of economic pricing in a competitive market and the short term need to minimise BT's external financing requirement." Robert Armstrong has sent you a separate submission on telecommunications liberalisation (which is in the hot box). He suggests that, if Sir Keith's further liberalisation proposals were to be turned down on security grounds, the tariff package would be worth looking at again. His point is that the package is a good deal more favourable to businesses than to private subscribers (6.9% average increase compared with 13.4%)

/ because

SECRET

because BT are already anticipating the need to compete with a new privately run business network. In effect, he is suggesting that the increases might be made smaller for private subscribers and larger for business subscribers. However, given the view you had expressed that the increases already hurt the business sector too much, I doubt whether you will want the proposals to be held up on this account.

Sir Keith is pressing for a decision. The longer we delay, the more difficult it makes BT's EFL problem for this year. Can I say you reluctantly acquiesce, subject to any further points the Chancellor may make?

TL

15 July 1981

B

1

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

PS/ Secretary of State for Industry

14 July 1981

Prime Minister

Tim Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Dear Tim

BRITISH TELECOMMUNICATIONS (BT) TARIFFS

My Secretary of State agreed last night to provide the Prime Minister with information about the impact of BT's tariff proposals on small business users.

... 2 You will see from the attached note prepared by BT that, as the Prime Minister suspected, some small business users would experience high percentage increases in their overall telephone bills if the BT proposals go ahead. But in cash terms the increases are not so great and those most affected use their telephones very little.

3 My Secretary of State does not wish to interfere with Sir George Jefferson's commercial judgment about the proposed tariff increases. He has no statutory powers to prevent BT going ahead in the way proposed and to seek to persuade Sir George to change his mind would risk rebuttal. Sir George is attempting to act commercially in the new competitive environment being created by the BT Bill. On the other hand, if BT were persuaded to alter their proposals, this would have implications for their EFL. If, for example, the increase on business rentals were limited to that proposed for domestic rentals, the cost to BT would be up to £20 million in the current financial year and over £50 million in 1982-83. This would add to the prospective EFL excess and the public expenditure problem generally.

4 For these reasons, my Secretary of State considers that BT should be given the go ahead to approach the POUNC as soon as possible.

5 I am copying this letter to John Wiggins (Treasury), Robin Ibbs and to David Wright.

Yours ever

Ian Ellison

I K C ELLISON
Private Secretary

Small businesses would incur greater than average increases on their total bill for exchange line rentals and calls because the higher rental would be the dominant factor. The increases would be greatest for those business customers making predominantly local calls.

For the 9% of business customers with present call bills of less than £4 per quarter (oursmallest business customers) the present total bill of about £25 per quarter (including vat) would be increased by about £8 per quarter if the calls were predominantly local or by about £7 per quarter with an average mixture of trunk and local calls. Although the percentage increases (about 35% and 30% respectively) seem high, we do not believe that the actual increases in terms of cash are great enough to cause serious difficulty to the customer.

The increases on bills would be proportionately less for customers making more calls. For one-third of business customers, with present call bills of less than £20 per quarter, the present total bill of about £42 per quarter (including vat) would be increased by £13 per quarter (31%) if the calls were predominantly local, or by about £16 per quarter (14%) after May 1982 if there were an average mixture of trunk and local calls. The latter figure is, of course, very close to the average increase on the bills of residential customers.

In general, therefore, we believe that even in the case of the small business user, the absolute cash increase to be paid is not sufficiently great to depart from the overall strategy of our tariff proposals and is fair in relation to what we are asking residential customers to pay.

CONFIDENTIAL

Qa 05622 13 July 1981

To: MR LANKESTER

From: J R IBBS

British Telecom Tariff Increases

1. The Secretary of State for Industry's minute to you dated 10 July describes a complex tariff package. We regard this as a sensible move towards re-balancing of charges to different users. The main proposals are that the residential sector be expected to pay its way - moves towards this are bound to be painful; that some trunk tariffs should be reduced to help the business sector; and that international tariffs should be reduced to make the UK a more desirable place for inward investment.

2. The package contains on certain relatively minor items increases very much higher than the RPI which will affect the business sector; principally to exchange rentals, private circuit connection charges and private circuit rentals. These are clearly unpalatable but represent correction of pricing which has hitherto been too low. Their effect on the overall business telephone bill would be small, and far outweighed by the proposed reductions in 1982 in charges for international and some trunk calls. It is call charges which form the largest component in business bills; average business bills will increase by only 6.9%.

3. In summary, we think the tariff package strikes a good balance between the long term aims of economic pricing in a competitive market and the short term need to minimise BT's external financing requirement.

4. I am sending a copy of this minute to Sir Robert Armstrong.

JRI

CONFIDENTIAL

JH 417

CONFIDENTIAL

PRIME MINISTER

Prime Minister
BT have proposed some v. unpalatable tariff increases, though their average effect is 9½%. Sir Keith wants to give the go-ahead. He also warns that the EFL will be exceeded by £120m.
Acquiesce with tariff proposals, subject to the Chancellor's views?
Not yet seen the note
TL 11/7

A 2% reduction in manpower? This is ridiculously small compared with the private sector.
Surely further efforts should be made.
The package will be judged very badly by the private sector.

BRITISH TELECOMMUNICATIONS (BT) TARIFF INCREASES

Sir George Jefferson has told me of the tariff changes which BT propose to introduce during the period from this November to May next year. BT intend to put the increases to the Post Office Users National Council (POUNC) in the next few days and the formal position is that the Government has no power to intervene.

2 Details of the proposals and their expected yields are given in Annexes 1 and 2. The main features are that in early November rentals for business and residential lines would go up by £25 (37.3%) and £8 (16.7%) respectively, the unit charge for calls would be increased by 0.3p (7.5%) to 4.3p, and peak and standard period (but not cheap rate) local call time allowances would be reduced. Call box charges would remain stable but local and trunk time allowances would be reduced. In February international call charges would be reduced by 15% on average and charges for certain trunk calls would be reduced on average to 8% below current levels at the beginning of May. These tariff changes, which would take effect not less than 12 months after the last corresponding increases, are designed to raise £230 million in 1981/82 and £411 million in 1982/83 (after allowing for reductions of over £300 million in receipts from international and trunk calls). The average increase in telecommunication bills over the year to October 1982 would be about 9½%. The direct effect on the RPI would be an increase of

about 0.2% but the average residential customer would pay a larger increase (13.4%) than the average business customer (6.9%).

3 BT have designed their proposals to anticipate the competitive threat to its businesses which will arise when the supply of telecommunications services is liberalised under the BT Bill. At present different sectors of BT earn widely different rates of return; residential telephone lines for example have a rate of return of minus 2.3%, while international services make plus 20.5%. Broadly, international and trunk calls subsidise all of BT's other activities; since residential customers make far fewer long distance calls than business customers, the effect is that businesses have been subsidising the residential customer for some time. This arrangement could not persist in a fully competitive environment, where competitors could undercut, and cream off, BT's longer distance business, thereby diminishing BT's ability to subsidise domestic and rural services. The only effective way for BT to meet competition is for them to charge more economic prices for each of their different services. Seen against this background, BT's current proposals appear to be a skillful package designed to move a part of the way towards economic pricing. The proposals also provide an element of relief to private businesses and should increase the attractions of the UK as a location for internationally mobile business dependent on telecommunications. This should have benefits both for longer term employment and for our efforts to stimulate information technology.

4 BT's proposals raise several important issues. First, BT are still a nationalised monopoly and we must obviously consider whether BT have done everything in their power to contain costs and to avoid tariff increases of this order. The average increase is below the expected rate of inflation; BT have held their wage settlements to a 9% average increase, which is considerably better than the performance of other nationalised monopoly industries. BT have also introduced some manpower economies compared with previous plans - a 2% reduction - and have made other savings amounting in all to some £230m. Despite this, I have asked through Sir George Jefferson that the two firms of management consultants, which are looking at BT's costs at the moment, should examine carefully whether they can find any further savings in the current financial year.

5 Secondly, these substantial increases are insufficient for BT to avoid exceeding their £380m 1981/82 EFL by an estimated £120m. In the current public expenditure climate this is a most serious development. For the time being there is no way of telling whether BT's estimate is accurate; their revenue is highly sensitive to business conditions, an upturn in international calls could substantially reduce the EFL excess and the current work by management consultants may yield significant economies but we cannot count on this. We cannot contemplate any reduction in BT's investment expenditure. The problem underlines the seriousness of our need to ensure that BT is able

to borrow outside the PSBR and I shall be pressing ahead with Geoffrey Howe to explore the scope for achieving this on terms which do no harm to his overall policies. The threat of an EFL shortfall does suggest, however, that BT's tariff increase proposals are too low rather than excessive.

6 I have explored whether BT should be discouraged from introducing substantial reductions in trunk and international call charges at a time when it is exceeding its EFL. Unfortunately, the timing of the proposed reductions means that they will have no significant impact on BT's revenue in the current financial year. Call charges are collected in arrears, so the reductions in international charges in February will not be reflected in reduced revenue until after bills have been issued and paid at the end of the financial year. If BT were to limit the reduction in international call charges to 10% and the reduction in certain trunk charges to 6%, they might gain some £50 million extra revenue in 1982/83. This would provide no relief in 1981/82, would go against BT's commercial judgement in the new competitive environment and might do longer term damage to employment.

7 Thirdly, there is the presentational point that the increase in residential rentals (16.7%) will affect pensioners and others who make few calls but who rely on the telephone as a lifeline. This impact will be cushioned to some extent because cheap rate calls will only go up by 7.5% and a wide range of trunk calls

will be coming down quite substantially. But we can expect criticisms and BT themselves may attempt to attribute all or part of the increase to the advent of competition. We should not be deflected by these considerations; rentals for residential telephone lines have for years been uneconomic; the last Government's Nationalised Industries White Paper of 1978 (Cmnd 7131) recognised that charges should be properly related to the relative costs of supply so as to avoid arbitrary cross-subsidisation between different groups of consumers; and BT, as a commercial business, cannot be expected to subsidise one part of its activities as a social service. If we wanted to subsidise pensioners' telephones, we should do so through the DHSS vote and not through BT's pricing structure. The Chairman has pointed out that, in order to increase the rate of return on residential lines to the 5% expected of BT as a whole, residential rentals would have to be raised by some 60% compared with the 16.7% increase in fact proposed.

8 Fourthly, there is the question as to whether the tariff increases affecting business users may be excessive. The increases will be unwelcome but businesses will benefit from the reduction in trunk and international charges. I have paid special attention to the 26% average increase in rentals for inland leased circuits and the increases averaging 250% in connection charges for business circuits leased by new customers. I am assured that the present connection charges do not reflect the cost of installation and that rentals for leased circuits

Many of them don't - make trunk calls

do not reflect costs, particularly for short distance circuits. The changes therefore represent a step towards economic pricing and the additional cost to industry and commerce is relatively small. Meanwhile, I think we can look to POUNC to examine closely the cost justification for the proposed tariff changes.

9 In all the circumstances, therefore, I would like to indicate immediately to the Chairman that the Government has no objection to his putting BT's proposals to POUNC. I would tell him that we would expect him to press ahead with securing as many internal economies as possible to stay within the EFL and that we might want to look at BT's tariff proposals further in the light of POUNC's comments. Since any delay in BT going to POUNC might delay the introduction of the rental increases and so aggravate BT's EFL problems, I think we should give BT the go ahead as soon as possible.

10 I am sending copies of this minute to the Chancellor of the Exchequer, to Mr Robin Ibbs and to Sir Robert Armstrong.

KJ

K J
10 July 1981

Department of Industry
Ashdown House

IN STRICTEST CONFIDENCE

SUMMARY OF PROPOSED TARIFF CHANGES

Annex 1

From 1 October 1981

- third phase of adjustments to charges for maritime services, following changes in April 1980 and January 1981;

From 1 November 1981

- the maximum connection charge for an exchange line increased by £5 to £80 for a business line and £70 for a residential line; the present reduction of £15 for removing customers will be maintained;

- maximum connection charges for leased circuits, extensions, and customer apparatus increased by varying amounts to reflect current installation costs;

- annual rentals for telephone exchange lines increased by £25 to £92 (£23 per quarter) for business lines, and by £8 to £56 (£14 per quarter) for residential lines; the present reduction of £4 for shared service will be maintained;

- rentals for extension telephones, and customer apparatus increased by varying amounts to reflect current capital and maintenance costs;

From 2 November 1981

- unit fee for dialled telephone calls increased from 4.0p to 4.3p with corresponding changes on calls connected by operators;

- on local calls we propose also to reduce the time allowed for the unit fee from 2 mins to 1½ mins at the peak rate (9.0am to 1.0pm) and from 3 mins to 2 mins at the standard rate; the cheap rate allowance will be held at 9 mins;

- there will be corresponding adjustments on coin box charges with the time allowance for 5p reduced from 3 minutes to 2 minutes at all times and some adjustments to time allowances on trunk calls; the minimum fee for calls from our new payphones will be increased from 6p to 8p but more time will be allowed on trunk calls than from pay on answer boxes; we plan to increase the minimum fee for calls from coin box/payphones to 10p from the autumn of 1982;

- on trunk calls the higher unit fee will increase charges by 7½% but we will announce the introduction of lower prices for some calls from May 1982;

- on international telephone calls, introduction of a common charge to all existing EEC countries (except Eire which is covered by the lower inland charge structure) and reductions on some inter-continental call charges with adjustments to offset the increased fee on other international call charges;

From 1 February 1982

- a further stage of increases on inland leased circuit annual rentals up to a maximum of 50%, as already notified to customers;

- changes to the charge structure for international leased circuits with reductions on intercontinental routes;

- reductions on other inter-continental telephone call charges;

- reductions on inter-continental telex call charges with some increases on continental rates and other adjustments;

From 1 April 1982

- adjustments to inland and international telegram rates;

From the beginning of May 1982

- introduction of route pricing on inland trunk calls over 56 km using an intermediate charge band between the present under and over 56 km rates.

YIELDS

The yields from these adjustments are summarised at Annex 2.

IN STRICTEST CONFIDENCE

Annex 2

YIELDS FROM PROPOSED TARIFF CHANGES

	Average Increase %	Yield (Revenue) 1981-82 £m	1982-83 £m
From 1 October 1981			
- third phase of adjustments to various maritime charges		0.5	1.0
From 1 November 1981			
Telephone Exchange Lines:			
- Connection Charges: Business +£5 to £80	+6.7)	2.1	7.6
Residential +£5 to £70	+7.7)		
- Rentals: Business +£25 to £92	+37.3	30.8	96.1
Residential Exclusive +£8 to £56	+16.7)	40.8	125.6
Shared +£8 to £52	+19.0)		
Customer Apparatus			
- Connection charges and rentals	+18.3	27.3	82.0
Inland Leased Circuits			
- Connection charges for main circuits increased by 180 to 500%	+250	0	6.0
Miscellaneous Charges		1.5	5.0
From 2 November 1981			
Telephone Calls - unit fee 4.0p to 4.3p)	7.5	68.7	177.0
- Local calls: time allowances reduced peak - 2 mins to 1½ mins; standard - 3 mins to 2 mins; cheap - 9 mins unchanged)	+26 (including higher unit fee)	69.0	167.0
- Coin box calls: local time allowance reduced at all times 3 mins to 2 mins : adjustments to trunk time allowances : new payphone initial fee increased from 6p to 8p)		2.5	6.0
- International calls: adjustments to telephone call charges		(2.7)	(see below)
From 1 February 1981			
Inland Leased Circuits: rental increases	+26	1.0	47.0
International:			
leased circuits: changes to charge structure		(1.5)	(4.0)
telephone calls: further reductions on charges		(9.3)	(70.0)
telex calls : changes to charge structure		(1.0)	(10.0)
From 1 April 1982			
Telegrams: changes to rates: inland / international		-	) net nil
from beginning of May 1982			
Inland Trunk Telephone Calls: introduction of route pricing on calls over 56km	-8 (including higher unit fee)	-	(225)
NET TOTAL YIELD		230	411
CASH YIELD IN 1981-82		172	

JH 414

Port + Tels

DEPARTMENT OF INDUSTRY
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123 VICTORIA STREET
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Secretary of State for Industry

9 July 1981

J R Ibbs Esq
Central Policy Review Staff
Cabinet Office
70 Whitehall
London SW1

TR 18/7

Dear Robin,

Thank you for your letter of 19 June enclosing a copy of the CPRS report on telecommunications investment and financing.

I welcome your report, which I have read with interest. You argue with force that the creation of a modern digital telecommunications system should be given priority as a national objective. I am sure we shall all give careful consideration to your conclusions about financing during the course of this year's Investment and Financing Review and I am asking officials of this Department to pursue urgently with Treasury and CPRS your recommendations on the wider issues. In particular, I attach importance to your support for the promotion of competition and your recommendation to introduce greater flexibility in financing profitable investment, points also highlighted by Professor Beesley in his report. I expect to receive some proposals shortly from George Jefferson on a new form of borrowing instrument on which this Department will be seeking the Treasury's urgent advice.

May I express my appreciation of the realism and care with which the CPRS have approached their remit. As you suggest, I am transmitting a copy of the report to George Jefferson for his consideration.

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

Sincerely,

Keith

PERSONAL AND CONFIDENTIAL

JH 415

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
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Secretary of State for Industry

9 July 1981

Sir George Jefferson CBE
Chairman
British Telecom
2-12 Gresham Street
London EC2V 7AG

10/7

Dear George,

The CPRS have undertaken a study of Britain's telecommunications needs in the next ten to fifteen years and the way in which investment should be financed. I have now received their report and enclose a copy. I hope that you will find it a constructive document which recognises the importance of modernising the telecommunications network and seeks to make practical proposals about finance.

We need to initiate follow-up action. A number of the financial recommendations are under consideration in this year's Investment and Financing Review. The report's recommendations on efficiency might, if you agree, be considered in the working party which is reviewing BT's real unit cost objective. In addition, it was agreed at the time of the increase in BT's 1981/82 EFL that officials and BT management would consider the timing for forming subsidiaries and introducing private capital in the light of the CPRS report and with a view to establishing a clearer timetable. I suggest that officials and BT management should study the CPRS recommendations on joint ventures in the context of this remit.

I appreciate the importance of the financing issues to you and to the future development of BT. I would be interested in any comments you may wish to make on the CPRS conclusions and on our handling of them. In particular I look forward to seeing shortly the outcome of the current discussions the Treasury is having with Warburgs about a performance bond, which might give increased flexibility in BT's financing arrangements.

Ever,

Keith

CONFIDENTIAL

Part 7 Telecom

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Sir Keith Joseph MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1E 6RB

1 July 1981

Dear Keith,

TELECOMMUNICATIONS IN THE UK : INVESTMENT AND FINANCING

I have read with interest the report by the CPRS which Mr Ibbs circulated with his letter to you of 19 June.

The report provides a most useful point of reference for our handling of a complex subject which has lately commanded considerable attention. I especially welcomed its emphasis on the need, if BT's investment programme is to be seen as deserving of special consideration for reasons set out in paragraph 44 of the report, to give effect to that policy by establishing priorities between nationalised industry programmes - to which I am glad to see the CPRS are giving further thought as part of their current wider study. I also very much agree with the conclusion that BT must first show they are doing all they can by way of efficiency, joint ventures, and asset sales, before further bids for additional finance can be considered.

Efficiency is the key to a lot of this and I am sure that the best hope of achieving it, as the report suggests, is to maximise competition. Thus I strongly support your current efforts to implement as early as possible Professor Beesley's recommendations on liberalising the network, whose impact should be fundamental.

I am sending copies of this letter to the Prime Minister, Kenneth Baker, Mr Ibbs and Sir Robert Armstrong.

Yours,

Leon

LEON BRITTAN

CONFIDENTIAL

Prime Minister Post + Telecoms 2

Robin Ibbs' response to the comment you made on the CPRS study.

CONFIDENTIAL

Qa 05404

23 June 1981

To: MR LANKESTER

From: J R IBBS

Telecommunications in the UK: Investments and Financing.

1. Thank you for your Minute dated 22 June. I should emphasize that our view that if BT were in the private sector "it would have no difficulty in raising money" was based not on the monopoly but on the attractive prospects for the telecommunications business. This is confirmed by the interest already being shown by the private sector in the possibility of setting up alternative networks and other services to compete for parts of BT's business. The thrust of our report is to encourage the creating of such competition as quickly as possible.

2. I am sending a copy of this Minute to Sir Robert Armstrong.

JRI

CONFIDENTIAL

CONFIDENTIAL

M.T.

Post + Telecoms.

10 DOWNING STREET

From the Private Secretary

MR IBBS

Telecommunications in the UK: Investments and Financing

I showed the Prime Minister your minute of 19 June and the study on investment and financing in the telecommunications sector which you enclosed with it. The Prime Minister read the study's conclusions at paragraph 49 onwards. Her one comment was in relation to paragraph 53 where you say that if BT were in the private sector, "it would have no difficulty raising money". The Prime Minister feels that the real reason why it would have no difficulty in raising money if it were in the private sector is because it is a monopoly and can always charge higher prices to cover inefficiency.

I am sending a copy of this note to David Wright (Cabinet Office).

R

22 June 1981

CONFIDENTIAL

The National Archives

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Prime Minister

Covering CONFIDENTIAL

Qa 05404

19 June 1981

To: MR LANKESTER

From: J R IBBS

Telecommunications in the UK:
Investment and Financing

1. You may remember that on 1 September last year the Prime Minister approved a proposal by the Secretary of State for Industry that the CPRS should study the financing of investment in the public telecommunications service, including those aspects where private sector companies could in future have a role.

2. I enclose a copy of our report and of my covering letter to Sir Keith Joseph. The Prime Minister will not want to read the detailed annexes, but she might be interested to glance at the report itself, and especially at the conclusions from paragraph 49 onwards.

Flag A

Anthony E. Smith

for. J.R. Ibbs

Covering CONFIDENTIAL

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05403

19 June 1981

Telecommunications in the UK:
Investment and Financing

In your Private Secretary's letter to No. 10 of 19 August 1980, you proposed a CPRS study of the financing of investment in the public telecommunications service, including those aspects where private sector companies could in future have a role. I now attach six copies of our report. You may want to send some to Sir George Jefferson, since as you will recall the initiative for this study came from his predecessor. Department of Industry, Treasury and British Telecom officials saw our report in draft form, and have been of the greatest assistance to us throughout.

I will not try to summarise our report; the conclusions and recommendations are set out in paragraphs 49 onwards. It has taken us longer to prepare than we anticipated, partly because of other commitments but also because of the size and complexity of BT's investment programme and the fast-changing nature of the market. Our studies have convinced us of the central importance to the economy of a good telecommunications system. We paid particular attention to the impact of competition upon BT and the scope for private enterprise in telecommunications. I shall be writing separately about our suggestion that a Ministerial discussion of the export prospects of of System X might be appropriate.

The Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Ashdown House
S W 1

CPRS members have taken part in this year s IFR of British Telecom. Although our remit extended over the next 10-15 years, we were well aware of Ministers' concerns about the financing of the investment programme in the short term. It is clear that there is no easy solution, but I believe that in the course of the meetings, we have made some constructive suggestions.

I am sending copies of this report to the Chancellor and Kenneth Baker and under separate cover to the Prime Minister's office. Your original letter went to all members of E, but perhaps I can leave you to judge whether you would wish your E colleagues to receive copies of our report.

A copy of this minute and the report also goes to Sir Robert Armstrong.

Anthony E. Smith

for J R Ibbs

TELECOMMUNICATIONS IN THE UK: INVESTMENT AND FINANCING

A Report by the Central Policy Review Staff

Terms of Reference

1. On 30 July 1980 the then chairman of the Post Office, Sir William Barlow, proposed to the Secretary of State for Industry that the CPRS should undertake a study with the following terms of reference :

> "To examine Britain's needs for a public telecommunications service in the next ten to fifteen years, and how the investment needed should be financed."

In supporting this proposal, the Secretary of State stressed that these terms of reference embraced the financing of all the public telecommunications services provided by the Post Office (referred to henceforth as British Telecom (BT)), including those where private sector companies could in future have a role. On 1 September 1980 the Prime Minister approved the study.

2. Although the remit was for the longer term, the CPRS was aware of both government's and BT's concerns about the financing of BT's investment programme over the next few years. If the present monopoly arrangements were to continue, then the present concerns over BT's future financing could doubtless be resolved in the course of the annual public expenditure survey. But in the period of ten to fifteen years covered by our remit, the Government's policies to promote competition and private sector participation will substantially change the picture. This report therefore deliberately takes competition as its starting point and analyses both the short and longer-term impact on BT's finances and investment. It does not contain a detailed analysis of BT's 1981/6 Medium Term Plan (MTP). Nor does it reach final conclusions on access to private sector finance which falls outside present PSBR definitions. Nor does the report discuss the organisation and international competitiveness of the telecommunications equipment supplying industry, as being beyond our remit (though there are some important and related questions here which we believe deserve Ministerial consideration).

Growth and change in Telecommunications

3. This section briefly discusses growth trends and the impact of new technology.

4. Growth. BT is the largest enterprise in the UK, employing a quarter of a million people, investing two billion pounds in 1981/2 and accounting for 2.9 per cent of GDP in 1980. Telecommunications has been a growth industry ever since it began. Between 1960 and 1980, the number of exchange connections (a measure of network size) increased 3.7 times, and the number of inland calls per year by 4.6. The percentage of homes "on the telephone" has risen from 15 per cent in 1960 to 74 per cent in 1980/81. Between 1975 and 1980, BT's revenue as a share of GDP rose from 2.1 per cent to 2.9 per cent. Even in the recession year of 1980/81, when GDP fell by about 4 per cent, the number of exchange connections grew by 4.7 per cent and call traffic by 4.6 per cent.

5. Similar figures could be quoted for most other developed countries. Two fundamental forces have powered historical growth world wide: increasing residential penetration and expansion in overall economic activity. A telephone network is a single communicating system. The more people connected to it, the more use it is to an individual subscriber, so the more calls he makes. And for the business world in an advanced economy, telecommunications is as essential to the national infrastructure as road or rail; perhaps more so as energy costs continue to rise in real terms and telecommunications costs decline in real terms.

6. The present recession has inevitably called in question the continuing growth of telecommunications in the UK. A quarter of homes are, however, still untelephoned; so growth potential certainly exists. As with television ownership, residential penetration seems likely to approach 100 per cent eventually, though the rate at which it should do so is an open question, particularly as it is an important determinant of telecommunications investment. Moreover, when the economy recovers, the growth in demand for telecommunications by existing customers will increase still further. But exchange capacity has to be planned four years in advance, and transmission capacity seven years in advance. To increase the capacity of an existing exchange or transmission link at shorter intervals entails excessive labour costs. The greatest economies in installation result from laying down capacity in advance of need.

7. Future years will resolve other uncertainties too. Service industries like banking, insurance, market operations and news services make relatively greater use of telecommunications (2.0 per cent of their output in 1978/9) than

manufacturing industries (1.4 per cent of their output). If the general trend towards expansion of service industries and decline of manufacturing continues, then more telecommunications will be required. Continuing real increases in the costs of travel and of postal and other labour-intensive services may lead to their substitution by telecommunications. And as information technology gradually replaces manual methods of storing and processing information by electronics, so people will increasingly need to communicate with computers, and one computer with another. There is uncertainty over the pace at which such developments will occur worldwide, and about the telecommunications capacity they will require.

8. Modernisation. Many of BT's exchanges (some £4180m book value at 1979/80 replacement cost) are worn out and obsolete. They need replacing anyway. Replacing mechanical by electronic switches, and analog transmission and switching by digital techniques brings several benefits: lower maintenance costs; better quality of service to the customer; more capacity per unit of investment; lower floor space requirements in exchange buildings and greater flexibility in handling of voice and non-voice (text, pictures, data) traffic. Although the UK is well up in the development of advanced techniques, many other countries are ahead of us in investing to diffuse new technology throughout their economies, thus stimulating their supplying industries. And the full benefits will not be felt until the deployment of digital equipment reaches a certain "critical mass", which in the UK will be in the early 1990s if BT's pressnt plans are allowed to mature. So it is important to press ahead. There are wider benefits too. The country which first reaches the point of "critical mass" will in the process have given its information technology industries a head start in the competition to win new international markets for attachments and services, and should in principle enable its telecommunications equipment suppliers to export at competitive prices.

The increasing influence of competition

9. There are two significant dimensions to competition in telecommunications. Internationally, the various national telecommunications authorities compete to entice internationally mobile organisations to locate in their countries. The UK is well placed. A number of international cables terminate here, call charges from the UK to many overseas countries are lower than from them to us and in consequence BT has attracted several such organisations to base themselves here. But domestic infrastructure is vital to international traffic. If France and Germany forge ahead in improving their domestic infrastructure and we fall behind,

then we shall cease to be able to attract this type of inward investment and the revenue it generates in this country. The British Bankers' Association and others fear that the City will lose ground as a major world financial and trading centre.

10. In national domestic telecommunications markets, only the US and to some extent Canada promote free competition at present. The introduction of greater competition within the UK, following the passage of the Telecommunications Bill, will signal a major difference between the UK and the rest of Europe. It will allow market forces to allocate venture capital, rather than the present pattern of centrally directed and state-funded investment. In three areas - attachments to the network, resale of network capacity (often with enhanced services) and alternative networks themselves - competition to BT could become important well before 1986 if the government were to license private sector ventures, as recommended by Professor Beesley in the latter two instances, and as already intended in the first. The next few paragraphs describe in a little more detail the effects of competition in these three sectors.

11. Competition for attachments will increase the diversity of products available and stimulate new domestic businesses in a high technology growth sector. To the extent that such competition increases the number of telephone instruments, this will also increase traffic on the network.

12. Competing alternative networks will remove BT's transmission monopoly, but only reduce its market share a little. The BT network has taken most of this century to build; even with new technology, instant wayleaves and unlimited finance, rival networks would take a decade or two to approach the scale of BT's operations, assuming they could do so profitably. So the major responsibility for public telecommunications, and particularly the local lines, will rest with BT, at least for the next ten to fifteen years. But rival networks do not need to be large to exert an important influence on tariffs, service and attitudes. They should spur BT to increase its efficiency in a way which EFLs and investment reviews never can, and should therefore be encouraged.

13. Competition for services is less clear cut, for such services will largely depend on BT for infrastructure as well as competing directly with BT in the market for services. But limbs cannot develop without a healthy trunk. If network modernisation is delayed, then the services which can be offered both by BT and the private sector will be correspondingly delayed. Conversely, a healthy

competitive services sector will stimuulate additional demands both for modern network facilities and for capacity.

14. We favour the maximum possible competition in domestic telecommunications. It will increase the UK's attractions over Europe both as a supplier and as a place to invest. It will stimulate new domestic businesses in a sector of high growth and high technology. It should bring cheaper telecommunications and a wider choice of products and services. In the long run it will spur BT to increase its efficiency. In all these areas, competition will in our view exert a more profound influence than privatisation, as indeed it has in the United States.

Issues for government

15. There are five main sets of issues for the Government :

i. What overall scale of investment in public telecommunications is justified? What assumptions should be made for the rate of growth, the pace of modernisation and the balance to be struck between commercial and non-commercial objectives? How will competition affect demand, tariffs and the financing of BT's investment programme?

ii. How much private sector participation in BT's activities should be sought? Conversely, how much should BT participate in private sector ventures?

iii. How should the investment programme be financed both in 1981/6 and in the longer term? What are the options - higher tariffs, sale of assets, greater efficiency, external finance? What would BT gain from participating in joint ventures with the private sector?

iv. If recourse to external finance is inevitable, have telecommunications a higher claim than other sectors of the economy?

v. What degree of control can the Government retain over BT's strategy and activities and how should it prevent BT from abusing its dominant market share and stifling competition?

In what follows we touch on all of these, though concentrating on i. to iii.

The Investment Programme

16. BT plans to spend £10½bn at 1980/1 outturn prices over the period 1981/6. Table 3 summarises the main features of BT's current medium-term plan; Tables 1 and 2 provide supporting financial and performance information for 1971-80, and comparable forecasts, where they exist, for 1981-6. The main difference between the 1980 and 1981 medium-term plans are, first, that the strategy for modernisation has been decided, and second that the related investment has been calculated and appraised with a greater precision than was possible in 1980. This part of the investment bid has increased, partly offset by a lower investment in local exchanges and subscribers circuits over the five-year period, in line with the recession and with reduced growth assumptions for GDP. Also in the 1981 MTP, BT has assumed a self-financing ratio of 80 to 85 per cent, leading to a 5 per cent real return on assets (RRA) and consequently to a higher call on external finance over the five-year period.

17. The plan assumes that competition will be limited to added value services which BT does not provide or intend to provide and that neither capacity resale nor alternative networks will be permitted. In the absence of declared government decisions, these were reasonable planning assumptions for BT to make; but if as we hope the Government takes a more liberal approach, then BT's investment programme will need recalculating. Competition will affect it in several ways. It will both expand the total market and reduce BT's share of it. In the short term both effects will be small in relation to the total investment programme and will therefore not affect it much. The longer term effects will depend on how new developments are divided between BT and the private sector. BT will clearly need to finance its share of new and expanding activities. And if competition drives tariffs down faster than presently planned, BT will need more finance. On the other hand, if it leads to greater gains in internal efficiency than BT presently assumes, then more resources will be released for investment, and less finance will be required from other sources. We cannot yet assess which of these factors will eventually dominate.

18. The investment plan rests on two pillars, modernisation (including improved quality) and growth. We said earlier that modernisation was desirable on broad industrial grounds. It is also economically justifiable. A recent quantitative study by BT and Treasury officials showed that the cost of modernisation foregone would exceed the financial gain from delaying network investment of £200m for a year, even before taking revenue gains from improved

service into account. There seems no reason to doubt the wider validity of these calculations. The question then becomes whether to modernise rapidly (Strategy R) or slowly (Strategy S). A comparative economic appraisal by BT of Strategy R against Strategy S gave a positive though comparatively small NPV of £35m in favour of Strategy R. There are qualitative advantages in rapid modernisation. By 1992, trunk call set up times (presently about sixteen seconds) will be reduced by 40 per cent, call failures by 25 per cent, and noisy calls by 70 per cent. New services will be accessible to 75 per cent of customers, against 14 per cent for the slower strategy. The case for telecommunications modernisation does not depend on calculations of the optimum size and profitability of the telecommunications network. BT's trunk network is profitable and growing and enjoys significant economies of scale. When digitisation is complete, maintenance costs per exchange connection will be less than half the costs of a system based on cross-bar exchanges. We believe that the economic impact of advanced telecommunications will be dramatic and far greater, for example, than that of railway modernisation.

19. The modernisation programme is centred around System X, whose major design parameters were selected in 1975. DoI officials have expressed doubts about its export prospects and we return to this later. For the UK, however, we saw no point in re-examining its suitability as the procurement programme is now well advanced.

20. So far as growth is concerned, BT intends to add a further 4.1m exchange connections in 1981-6, and has provided £3,472m for this in the Medium Term Plan. Network size will increase by 22 per cent, and residential penetration from 74 per cent to 86 per cent.

21. We have examined the methodology used by BT to forecast growth. The forecast is based on modest GDP growth assumptions which are consistent with mainstream economic forecasts. BT has assumed that tariffs will be re-balanced by 1986 to bring them more into line with underlying costs. Trunk tariffs will fall; local tariffs and rentals will increase, but in a way which increases the average residential bill by less than the RPI. The effect of recession and lower GDP growth forecasts has been to drive down the demand for telephone connections, and the 1981/6 MTP provides for one million fewer than last year's

MTP. Connection charges in themselves yield little extra net revenue because of the relatively high elasticities, and the current high rate of cessations means lost rental and call income. But BT still gains from system growth because new subscribers make and receive calls at a profitable level.

22. BT's growth forecasts are probably right if one accepts the traditional assumptions of network monopoly, connection charges geared only to recouping irrecoverable costs and negligible information traffic. But we have longer term worries. First, BT has no methodology to take account of competition, which is generally expected to speed up the process of tariff re-balancing and to produce a steeper rate of increase in residential bills. This could reduce the rate of system growth; full residential penetration would take longer, with a loss of rental and call revenue meanwhile. Secondly, competition may indirectly force BT to raise connection charges faster and this will choke off residential growth. Thirdly, in a digital system it is no longer possible to distinguish voice from pictures, text or other types of information. BT's methodology is geared to voice traffic, and it will have to develop new models for non-voice traffic which barely exists today.

23. In any case, forecasts made in a monopolist's world will, we believe, have to give way to the setting of priorities when competition develops. BT will have to allocate investment according to the resources available - which may not be enough to enable it to compete across the board - and the likely profitability of its various market sectors. In particular, we believe that universal residential penetration, even if ultimately inevitable, is a lower priority than satisfying the needs of the business sector through the modernisation of the trunk network. It may of course be a sensible non-commercial objective, on grounds of regional policy, but if so this should be clearly stated and government finance made available. If, on the other hand, business needs have priority, the government should be prepared to defend BT against complaints by frustrated would-be customers.

24. We are ready to develop these points further in any future Treasury/DOI study of growth forecasts and priorities.

25. There are two further points about the investment programme. First, from confidential information available to BT (Table 4), it seems clear that other PTTs investment programme are larger than BT's. There are no doubt special factors, but if the UK is to remain a leading world centre for service industries we ignore other countries' telecommunications programmes at our peril. Secondly, the 1981-91 business plan and the information BT has given us on its procurement profile suggest that investment on modernisation will reach a peak around 1985-7 and then decline. By that stage the cost savings from earlier investment should begin to help BT's finances and produce self-financing ratios (SFRs) of 100 per cent or more. Clearly this is speculative, and the effect of competition on tariffs could well be to reduce revenue. So far as investment is concerned, however, we believe that government and BT are essentially faced with a short-term hump. If so, the government should take a long-term view and bear in mind that inadequate investment now will mean poor telecommunications in the later 1980's, just at the time when the new private enterprises that the government wants to encourage in this sector will be in full development.

26. <u>We conclude</u> that the 1981/6 investment programme is broadly justified both on economic and wider industrial grounds. The needs of business should have priority over those of the residential sector. The provision for new information services may be inadequate.

<u>"Privatisation"</u>

27. In this short report we can only touch on the issues. The main aims of government policy are to move the business of supplying public telecommunications

into the private sector and to reduce BT's net demands on the PSBR. The Telecommunications Bill, once law, would allow BT to create joint ventures with private sector companies. So we have examined three ways of introducing private capital into public telecommunications :

i. division of the <u>public network</u>, on a US pattern, between a publicly-owned trunk (or "long lines") system and privately owned regional systems

ii. distinguishing between the <u>network</u> and the <u>devices attached</u> to it

iii. distinguishing between the <u>transmission facilities</u> provided by BT and the various telecommunications <u>services</u> they can be used to provide.

28. Annexes 1-3 examine the issues. The following paragraphs summarise their conclusions.

29. Annex 1 considers private regional companies. We argue that the balance of advantage is against replacing a single public monopoly by several private monopolies; their tariff levels and standards of service will still have to be regulated and monitored by government, and because there will be many of them, such regulation would require a large bureaucracy. This prospect alone will discourage investors, and so will the inherent unprofitability of local call traffic. Despite tariff re-balancing it is trunk traffic which will continue to generate most of the profit while local infrastructure absorbs most of the investment. We think that regional companies will not be an attractive investment. The proposal by Cable and Wireless underlines this point: the network they wish to establish is a trunk network, not a local one. BT in any case plans to make its regions more accountable and autonomous. Whether seen as an end in itself or as a prerequisite to further consideration of private regional companies, this is surely a sensible path to take.

30. <u>We recommend</u> that setting up private regional companies should not be pursued as a priority item. There is however one case which deserves further study: the provision of advanced telecommunications in the City of London, such as the current proposal to build an overlay network. We favour this, and it seems entirely appropriate that City finance rather than government funds should be harnessed to make the City a centre of excellence in telecommunications.

We therefore recommend that the joint venture approach to its financing be carefully examined by BT, in conjunction with the DOI and the Treasury.

31. Annex 2 considers the setting up of joint ventures to sell attachments to the network, such as private branch exchange (PABXs). The Telecommunications Bill, once law, will open up this market over the next three years. Joint ventures between BT and the private sector would enable BT to attract private finance into new business activities which under present PSBR constraints it would be unable to finance in full. The main benefit over time will be to relieve BT's forward investment programme of up to £200m annually. There could be some direct financial benefit in 1984/6 from the sale of equity by BT, but at an estimated £40-60m, not enough to bridge the likely financing gap in those years.

32. Annex 3 considers the formation of joint ventures to sell specialised telecommunications services to particular market sectors. If Professor Beesley's recommendations are adopted then this market could develop quite quickly. BT's existing strengths in operating services such as voice telephony and telex could sensibly take it into new large-scale services such as electronic mail and electronic funds transfer. As with attachments subsidiaries, private sector partners could bring to such ventures not only cash but also knowledge of particular technologies, applications or markets which would complement BT's skills. The effect on BT's investment programme will be more to relieve it of future investment than to raise cash directly. We recommend that BT explores and reports on the kinds of service which might be developed in this way and the investment implications.

Financing the investment programme

33. Moves to establish joint ventures will shift the boundary between the public and private sectors and yield some direct financial contribution in the longer term from sales of equity. But the financing gap remains wide in the years to 1986. The following paragraphs discuss ways of increasing the finance available to BT in the next few years, from higher tariffs, further sales of existing assets, increased internal efficiencies, and external sources, private or public.

34. Tariffs could be increased at a faster rate than has been assumed in the Medium Term Plan, which would result in residential bills rising faster than the RPI. The arguments for this are, from BT's point of view, that demand from existing customers is not particularly sensitive to price; and from the Government's, that BT should be used as an instrument of fiscal policy in a time of PSBR constraint.

35. But the arguments against are substantial. First, customers should in principle expect to benefit from the cost savings of the modernisation programme, especially when the self-financing ratio (SFR) is already high and present customers are paying for the investment through tariffs rather than future customers through borrowing. Second, higher tariffs must involve higher than planned trunk call charges since there are limits, both political and economic, to what residential customers will be prepared to pay for rentals and local calls. This conflicts with BT's objective of balancing tariffs to reflect costs. Its profits on trunk traffic are already being criticised, and higher prices will be poorly received when prices in the private sector are under such pressure. Higher telephone charges will penalise business, hinder the development of IT industries and private telecommunications service companies, create a price umbrella under which rival networks can make easy profits, and all without putting any pressure on BT to improve its efficiency.

36. Nor should longer term objectives be neglected. Once competition develops BT will be less free to set tariffs at the level required to achieve a stated RRA. This will put pressure on BT to cut costs and become more market-conscious: exactly what the government wants. It would do BT a disservice to set tariffs in the next few years at levels such that BT lost all incentive to prepare to face competition. There is a policy conflict for government between promoting competition and using BT's tariffs to gain revenue as if BT were still a monopoly. The first objective is the more important.

37. None of this rules out further tariff increases if all else fails. But clear, agreed priorities are vital. The Government should favour stable prices for business users, which will also encourage new telecommunications industries. It follows that residential customers should be required to bear the brunt of tariff increases if such there had to be despite the likelihood

of higher cessations. It should be noted that 100 per cent self-financing would yield RRAs of 7-8 per cent in the early years of the plan period, which few other businesses (including nationalised industries) could match.

38 Before leaving tariffs we should comment on BT's estimate that they will have to raise residential rentals by 50 per cent in real terms if the government licenses alternative networks. To this should be added Professor Beesley's estimate of a maximum $10\frac{1}{2}$ per cent rental increase to offset any diversion of BT revenue following the licensing of capacity resale. BT will submit its considered views to the Department of Industry in the next month or two. We cannot judge the estimates' accuracy, nor their impact on the RPI, but :

i. rentals are of course only one component of residential bills;

ii. competition on the network will simply force BT to drive trunk tariffs down, and increase rentals, faster than it already intends. While this puts pressure on BT finances in the difficult next two years, the overall aim of lower trunk charges (and profits) must be right; and BT already aims at a 5 per cent real return on residential rentals by 1986 which is consistent with its stated policy of relating tariffs more closely to costs;

iii. competition should increase overall demand;

iv. BT's existing system gives it enormous strengths;

v. BT assumes that private network operators will pitch their charges below its own. This may not always be so; a quality service for business could well sell at a premium; but clearly this would be a dangerous assumption to make for all time;

vi. BT's tariff policy will discriminate more between different markets and geographical areas. Inter-city charges will fall. Local call charges and trunk charges on less used regional lines will rise. Insofar as this reflects different costs, it is desirable, but competition will inevitably call in question the traditional practice of uniform pricing throughout the whole country.

39. Sale of assets. BT could sell installed PABXs and attachments in the competitive area of the business to its existing customers. The book value of eligible assets would be up to £400m. The equipment is obsolescent and vulnerable to lease arrangements that customers can terminate at one month's notice. There is a strong marketing case for selling it all as quickly as possible, at whatever price BT can get. BT could also offer private circuits on long leases, say up to five years, for a lump sum payable in advance. The takeup would depend on the discount rate offered, and the customer's desire for protection against tariff increases at the expense of flexibility. It should be possible to raise at least £50m by this route quite quickly; perhaps more in later years. Annexes 2 and 3 expand on these points. If BT is allowed to retain the proceeds from such sales, then the cash raised will reduce the gap between BT's EFRs and its current EFLs, and provide an incentive to proceed. There is nothing to stop BT acting now on these two suggestions, and we recommend that it does so.

Efficiency

40. This is so important a subject that we have discussed it in a separate Annex 4, attached. In brief, we welcome BT's decision to appoint management consultants to advise on its efficiency and cost-saving. We suggest in the Annex a number of further questions on which BT should report to the Government. The main issue is labour costs. The introduction of computer-based equipment will provide opportunities to streamline working practices, centralise maintenance and repair functions and introduce group working. Although the benefits will not arrive with the first electronic exchanges (in fact maintenance costs for the early System X exchanges will be higher than for existing equipment due to training costs) the ground needs to be prepared now. Innovation will present other opportunities too - to introduce incentive payment schemes and more locally based supervision and administration to reduce waste. Other important questions include the effect of competition and joint ventures on staff levels, buying in equipment from suppliers in assembled form, and property management.

41. Although in the short term the investment hump will make it hard to cut staff levels, it is all the more important for BT to minimise net new recruitment once equipment procurement and exchange maintenance manpower have passed their peaks around 1986-7. We recommend the speedy selection of appropriate BT

performance criteria and effective monitoring by the DOI. In this context it will be important to maintain international PTT performance comparisons on a regular basis (though they can never be entirely comparable) and to have effective programmes to raise BT from the middle of the pack, or below, to among the world leaders.

42. There are also procurement inefficiencies introduced by the present investment approval process. There is reason to believe that BT could negotiate lower prices from its suppliers if it could enter into long term procurement contracts. The savings could be greater than those regularly under contention in the annual reviews. We are glad that BT and the Treasury are respectively studying the scope for savings and the feasibility of approving investment further in advance. On a related point, we are unhappy about the prospects for exporting System X switching equipment (which would likewise help to cut unit costs) and will propose separately that Ministers discuss the role of government and BT in improving the prospects for System X in the light of our poor past performance in international markets.

External finance: Priorities

43. External finance must be the residual option. In the light of the above discussion we believe that BT's putative EFLs are likely to be too low, and that other sources of finance are either inappropriate or will not cover the gap, at least in the short term.

44. Given current PSBR constraints, any increase in BT's EFL will have to be found from other public sector programmes. The CPRS is considering how priorities between programmes might be determined as part of its wider study on the relationship between NIs and government. In general, however, the arguments for giving BT a degree of priority, in the absence so far of common investment appraisal techniques, are that telecommunications is a growth industry; the development of a healthy private telecommunications sector, and of business in general, depends on having a modern network; BT's demands on government have been relatively slight (steel's was four times greater in 1979-82); it is a nationwide business with an assured future; real capital costs are falling thanks to microelectronics; the inputs are generally cheap and available; and modernisation will allow more functions to be carried out more cheaply.

45. We do not discuss in this report the injection of private sector finance (including the proposals for performance and customer bonds) into BT's main operations, as distinct from the attachment and service joint ventures considered earlier. All the schemes put forward so far have foundered on the point that borrowing by BT from the private sector is de facto borrowing by the Government, because it carries the same gilt-edged guarantee of repayment. Therefore it falls within the PSBR as presently defined. We would like to explore these questions further in any renewed examination by departments of financing schemes. The main question to be considered is the measure of performance that will determine the return to the investor. In previous discussions the Treasury has pressed for a real unit cost indicator to be used, to put pressure for improved labour productivity on BT. But this may not be realistic. Investors will want a yield linked to the overall return on the <u>capital</u> they are lending to the Telecommunications Business rather than to incremental improvements in <u>labour</u> productivity. Improvements in efficiency are best tackled head-on rather than indirectly.

<u>Control and Regulation</u>

46. We discuss this also in Annex 4. Competition will reduce the need for government involvement in matters of efficiency, and its ability to determine tariff policy. Market pressures will impose their own constraints. The residual concerns of government are investment appraisal and access to finance, to the extent that BT continues to depend on government money. A balance will have to be struck here. On the one hand, network modernisation is important and should be funded. On the other, BT should not be so liberally funded that it competes across the board and clings to market sectors which private enterprise may be better placed to develop.

47. Competition will however increase the need for government supervision in certain areas. The transition from monopoly supply to competitive market-place will not be easy. The government will have to guard against BT abusing its dominant market position or its remaining monopoly powers, concerning maintenance for example. It will have to ensure scrupulous fairness in areas where BT is regulator as well as competitive supplier: in those parts of the radio frequency spectrum which BT administers, for example. And where BT currently represents the UK in international standards-making activities, the

government will need to ensure that the interests of the UK telecommunications sector as a whole are represented, and not merely the narrower and perhaps conflicting interests of BT.

48. It may be that BT can perform this dual role. But the German Monopolies Commission has recently expressed the opinion that the Bundespost (German Telecommunications Authority) cannot. And some of those to whom we spoke doubt that BT can. The question of a separate regulatory authority is outside the strict terms of our remit. But it is essential that the regulatory function should consciously favour competition, on which many of our recommendations depend.

Conclusions and Recommendations

49. We hope that what follows will be considered as a balanced overall set of proposals.

Investment

50. The next ten to fifteen years will see unprecedented growth and change in telecommunications. The telecommunications network is infrastructure, and the greatest economies of provision result from laying down capacity well in advance. A modern digital system is so central to our economic performance in the mid-1980s and beyond that it should be given priority now as a national objective.

51. We have examined BT's investment plans for 1981-6 and its modernisation plans beyond. We believe them to be broadly of the right size, though we have reservations about the justification for further growth in residential connections. BT should set its priorities to favour the needs of business.

Financing

52. There will be an investment bulge and a corresponding financing gap in 1981-6 due to the build-up of the modernisation programme. On present plans investment modernisation will peak in 1986. Beyond then, BT may become self-financing, though stiff competition may delay this. But for the next few years the financing gap will have to be bridged by a combination of tariff increases, sale of assets, gains in internal efficiency, external finance and (in later years) sale of equity in joint ventures to the private sector.

a. Tariffs. Competition will accelerate the pace at which BT brings tariffs into line with costs. This is a desirable objective and we do not favour interfering with this process for reasons of short-term fiscal policy. We therefore do not recommend further increases in real tariffs except as a last resort.

b. Sale of assets. BT could raise money quite quickly from the sale of installed PABXs and competitive attachments to its existing customers, and from offering long pre-paid leases of private circuits. We recommend that it does so.

c. Efficiency. BT should make its Regions more autonomous and accountable both to central management and, through the publication of performance statistics, to the general public. BT and the DOI should agree on carefully chosen indicators of BT's internal efficiency against which to monitor BT's long-term performance. The DOI should press BT for its plans to take the maximum advantage of the opportunities presented by new technology to reduce labour costs.

d. Joint Ventures. The creation of joint ventures in the attachments and services sector should be pursued urgently within the framework of an agreed five-year timetable even though they will not yield cash in the early years. The presumption should be that most new developments in BT's telecommunications business should be funded through joint ventures. The greatest immediate opportunity for such collaboration lies in the development of the City as a major telecommunications centre.

e. External Finance. The investment programme is important. So are efficiency, joint ventures and asset sales. If the government can satisfy itself that BT has taken steps in all these areas to minimise its call on external finance then we recommend that it should adjust BT's EFL to allow modernisation to proceed. We also recommend that the Treasury investigate ways of allowing BT to commit investment funds up to seven years ahead, if BT can ? show that this will help to negotiate lower prices with its equipment suppliers.

It is a monopoly & can always charge higher prices to cover inefficient costs.

53. We have argued above that the financing of telecommunications investment should not depend on devising performance bonds or similar financial instruments outside the PSBR. However, BT is a profitable and growing enterprise; if it were in the private sector, it would have no difficulty raising money. We therefore believe that it is worth persevering with efforts to finance profitable investment outside the PSBR, despite the difficulties encountered so far. If ways can be found either for BT alone or for nationalised industries in general then greater flexibility will be possible in other areas of public expenditure. We recommend that Treasury officials in conjunction with the DOI pursue this.

Competition

54. There should be maximum competition throughout the telecommunications system, for attachments, services and by way of an alternative transmission network. The Government will need to recognise that competition will entail reducing the control it currently exercises over BT's tariffs and efficiency and increase the need for regulatory functions to be performed impartially.

System X

55. We recommend (paragraph 41) that the DOI submit a paper for Ministerial consideration on the export potential for System X.

ANNEX 1: LOCAL OPERATING SUBSIDIARIES

1.1 This annex considers one approach to the formation of subsidiaries by BT. Under it, BT would be split into several local operating companies, corresponding perhaps to the existing regions, and a single separate operating company for trunk traffic, perhaps called BT Longlines after its US counterpart. The local operating companies would be offered for sale to the private sector, though BT might well retain a minority stake in them. BT Longlines would remain in the public sector.

1.2 BT already intends to make its regions more accountable and autonomous. We support this aim as desirable in itself. Regional working practices and efficiency would be easier to compare; management would be better placed to bring standards up to those of the best regions; and ultimately it might prove possible to conduct pay and productivity negotiations on a regional rather than national basis. The questions we have asked ourselves are whether the sale of local companies to the private sector would yield further benefits, whether it would be an attractive proposition, and whether it would best serve the national interests.

Structure

1.3 Each private local company would be responsible for providing and operating local exchanges, local lines, and subscribers' apparatus within its geographical area. BT Longlines would provide trunk exchanges and trunk transmission circuits. Revenue from connection charges and local call traffic would accrue to the local companies. Trunk revenue would be shared between BT Longlines and the local operating companies.

1.4 Each local company would be a local monopoly. As such, its natural tendency would be to maximise profits by raising tariffs and lowering the quality of service. In the US, whose example this approach consciously copies, the Federal Communications Commission (FCC) has authority to regulate tariffs and some interstate services and to license new carriers. We would need some similar regulatory mechanism to set limits on the behaviour of the local monopoly companies. They would not be competing with each other for customers, so market forces would not operate. It is true that a form of competition would exist through publication of a league table of performance statistics; but this will be the case within BT once BT management have carried out the changes described above. Tariffs could be set to allow only the top half of the league table to make a profit and thereby provide, it is suggested, an incentive for the bottom half of the table to become more efficient. But in practice the pressures on tariffs would be all one way.

1.5 On operational grounds alone we seriously doubt the value of this approach. The US structure has evolved against a very different constitutional and legislative background: a Federal Government, and laws restricting interstate trading. From an operational standpoint, the UK's national telephone network is an integrated whole; to break it up into organisational subunits would raise artificial barriers to change and in our view inhibit progress towards the creation of an integrated digital network (IDN). It also raises complex demarcation issues about the sharing of revenue, investment and particular types of traffic.

Financing the local operating companies

1.6 Despite these reservations we have considered how such companies might finance themselves and the effect on BT Longlines, which would remain in the public sector. We would welcome the publication of a wider variety of regional statistics, including performance indicators, irrespective of whether or not the government requires BT to sell off its local operations. There are as yet no fully separate accounts for BT's regions. But clearly some will be less attractive than others to private investors. The cost and traffic patterns of Scotland, Wales and Northern Ireland are inherently unfavourable; on the revenues and costs attributable to their local operations they run at a loss. On the same basis, the North-East and the South-East generate a profit. Maintenance costs per exchange connection are about 40 per cent higher in Scotland than in the North-East, while subscribers' call revenue (including trunk calls) per exchange connection is about the same. Mean net asset value per exchange connection is 25 per cent higher in Scotland than in the North-East. To earn the same revenue Scotland therefore has to provide 25 per cent more assets and incur 40 per cent higher maintenance costs. At present these disparities are shielded from the individual subscriber by the currently accepted practice of uniform tariff and service levels. With a regional organisation this would no longer be possible. The government would have to accede to the principle that subscribers in poor or rural areas should pay more than those in the cities. But if there were to be disparities at all, the general thrust of regional policy would suggest the opposite course: that the poorer regions should be provided with cheaper telecommunications as an incentive to the development of service and information industries. Going one stage further, the cost and revenue patterns may make it uneconomic to supply small villages and isolated homes at all with telecommunications. If a local telephone company is to operate on a commercial basis, then it cannot be expected to sustain the present public service obligations which BT observes without some explicit subsidy or transfer payment.

1.7 A more fundamental problem is that local call traffic is not very profitable in this country. Nor is it in the US. Most local calls there are free at present (though charging is under consideration), which incidentally runs counter to the direction of the government's pricing policy in this country. It is characteristic of all telecommunications that the value of communication, and hence the price that can be charged, increases with distance. The profits from trunk calls cross-subsidise the provision of local networks one way or another. In 1978/9, BT's trunk and international services accounted for £309m profits on an asset base of £2145m. The Telephone Regions taken together only accounted for £37m profit on an asset base of £9554m. The regional profit total conceals variations from a profit of £40m to a loss of £28m. Over time this imbalance will be reduced, as BT moves to cost-related tariffs. The essential point, however, is that, even though BT intends to increase both local call charges and residential rentals, local tariffs would have to rise substantially more than presently planned if local telephone companies are to be viable and if they are to modernise their infrastructure, which accounts for £3½ billion of BT's investment programme in 1981-6. The following paragraphs examine various ways of improving the viability of local companies.

1.8 First, there are practical and political constraints on the extent to which local tariffs could be allowed to rise. They are a component of the Retail Price Index, a determinant of demand and a factor in decisions by businesses on where to locate. Those in the poorer and sparsely populated regions would have to pay more for the use of the telephone. While the better-off could afford to do so, the overall impact would probably be a downward spiral of cessations, slack demand, and no new businesses. In short, present regional disparities would be amplified. So the government or a regulatory body would have to set tariff ceilings on a national basis, as part of regional policy.

1.9 Second, the poorer local companies could minimise their capital spending. Over time this would lead to serious disparities in service standards and coverage between one region and another; it would also retard the digitisation of the network, undermine BT Longlines' own investment in System X, and slow down the exploitation of information technology by the business sector. In short, both local residents and the national business community would suffer.

1.10 Third, the government could subsidise on social policy grounds those parts of the country where it was not economic to provide service. But such arrangements would not be easy to operate. And we think it would be a step backwards to have to introduce direct subsidies to private monopolies when the government does not subsidise the present public monopoly.

1.11 Fourth, the government could instead require BT Longlines to subsidise the local companies, for example by charging the lossmakers a cheaper rate for the use of its trunk network, recouped perhaps by higher charges on profitable regions. This would amount to asking investors in a South-East or Midlands company to subsidise investors in a Welsh company, and seems unattractive and discriminatory.

1.12 It seems therefore that investors would have to rely on arrangements whereby BT Longlines' trunk revenue was shared out between it and the local operating companies according to a formula which was common to all regions and yet allowed the higher cost regions to finance future investment, earn a profit and carry out their legal obligation to provide service to all who want it. This would be complex, and require decisions on a revenue sharing formula outside the companies' control, perhaps administered by an FCC-like body. (Incidentally - but a further complication - if a competitive trunk transmission company were to be licensed it should presumably also make some contribution to local infrastructure; otherwise it would be profiting unfairly). The government would also have to set minimum standards of service, and provide safeguards against the abuse of local monopoly power, perhaps through the Office of Fair Trading and the Monopolies and Mergers Commission. Further, if a local company ran into financial difficulties then the government would have to come to its aid one way or another, or witness the blacking out of telecommunications in part of the country. All-in-all, this does not add up to an exciting prospectus for the investor. Nor could the government disengage itself from the heavy burden of financing the modernisation of local infrastructure.

1.13 In short, we believe that the hiving off of local operating companies will either :

i. lead to local tariffs rising still faster than BT already envisage, in other words at considerably higher rates than the increase in RPI, or

ii. force local companies to cut quality of service, or

iii. require the government to step in with subsidies, or

iv. lead to some highly complex arguments between BT Longlines and the local companies about revenue-sharing, investment, business planning and day-to-day operations such as fault-finding. The regulatory task will be difficult, and additional staff will have to be provided; the dividing line between the public and private network will be hard to establish with any consistency;

v. or some combination of the above.

1.14 We do not wholly exclude a revenue-sharing solution on the lines discussed above. We accept that private local companies ought to have a strong incentive to maximise efficiency; and they would of course serve the government's wider aims of privatisation. But this solution is not a high priority when so much needs first to be done to stimulate the competitive services and attachments sector. It does little or nothing to promote competition; it would be complicated; and there is something basically unattractive about creating private monopolies that, in order to make a profit, require a revenue-sharing arrangement with a public monopoly. The local companies would certainly be under greater financial pressure to cut their current expenditure; but there are risks of wide variations in service standards, and we think that clearer public presentation of BT's regional financial and performance statistics could achieve the same effect over time. It also seems doubtful whether regulated monopolies would attract equity finance, though no doubt loan stock could be sold if the terms competed favourably with those of other utilities. The structural arguments against splitting up an investment programme designed to create a nationwide integrated digital network are in our view powerful. Finally, while we believe that some degree of discrimination against the residential sector may become inevitable, even if BT continues to control the network as a whole, we would rather see a slowing down in the rate of new residential connections than the emergence of large differentials between residential charges in different regions. With local companies this might well be an inescapable outcome.

Conclusions

1.15 We have serious doubts about proposals to form privately owned and controlled local operating companies, and recommend that these should not be pursued as a priority item for government.

"Telecity"

1.16 There has been much discussion of "Telecity"; broadly speaking, of various tentative ideas to harness City finance to make the City a telecommunications centre of excellence and so maintain its competitive position against other financial centres. Many of the complaints about BT's performance stem from the City; equally, City telecommunications account for about 5 per cent of BT's investment programme. The following considerations seem important to us:

i. there is certainly a need for City institutions, individually or collectively, to define and forecast their future telecommunications accurately, and for BT to help them to do so. At present BT does not sufficiently seek out major customers to find out what they are likely to want. The City is not blameless either. While the new commodities markets were well planned, the abolition of exchange control, which inevitably increased foreign exchange dealers' demand for telecommunications, seems to have taken them all by surprise;

ii. leaving money supply arguments on one side, there is a lot to be said for the City and BT drawing up a "City telecommunications plan" covering overall City requirements over, say, the next five years, and for City institutions to help finance investment from which they would directly benefit. If BT were in private hands such schemes would be welcomed, not least by the government;

iii. we wonder, however, whether such a solution is feasible given the enormous diversity of City interests. This is not to say an effort should not be made; but banks, shipping companies, commodities dealers and so on may well be more interested in financing their own direct concerns than in coming together for the City's overall good. The danger is a series of ad hoc demands on BT which make planning difficult and lead to unnecessary duplication of facilities;

iv. if as Sir Eric Faulkner of the British Bankers' Association, and chairman of the City Liaison Committee, believes, the insurance houses and pension funds might well be willing to put long term money into improving City telecommunications, then this would give the investment programme a necessary long-term degree of certainty; though again money supply considerations would be a complication;

v. it is possible to envisage a non-profit making City/BT joint venture, akin to the French groupements d'interet economique (GIEs), to finance and coordinate the development of City telecommunications;

vi. we welcome BT's intention to build an overlay network in the City, and believe it would be entirely appropriate in this and other instances to harness City rather than government funds to make the City a centre of excellence in telecommunications.

1.17 This is no more than a preliminary examination of the issues. They deserve further study. BT and the City Liaison Committee have established a joint working group. We recommend that the Department of Industry and Treasury should maintain close contact with it through the Bank of England, and be ready to pursue any promising areas that require the collaboration of government, for example in cases where PSBR or money supply considerations seem likely to present obstacles. We would hope that these studies could be pursued with some urgency. The government cannot allow the City to be disadvantaged as a financial centre, and other European countries are fast improving their telecommunications infrastructure.

ANNEX 2: THE ATTACHMENT MARKET AND THE CREATION OF JOINT VENTURES

Introduction

2.1 Whereas the approach in Annex 1 draws a boundary between the local network and trunk facilities, this one draws a boundary between the network, considered as a single entity, and the devices attached to it. The telephone instrument is the most obvious, but others are proliferating such as call answering machines, computer terminals, computers themselves and facsimile copiers. It is the attachments which turn the switching and transmission facilities of the telephone network into a communications service of value to the user. Each type of attachment has its own problems of R and D, production, and marketing. Under this approach BT would set up subsidiaries for each family of attachments, each competing with the private sector. Some could then be offered for sale to the private sector, or joint ventures could be created. The parent company, BT Network, would retain responsibility for providing switching and transmission facilities up to a termination point in the subscribers' premises. Its subsidiaries would sell or lease attachments. This approach would be consistent with Professor Beesley's argument that a distinction should be drawn between the network and the uses to which it is put. BT may well find this form of organisation appropriate, quite apart from the potential it offers of attracting private sector finance.

2.2 Neither this approach nor the one described in Annex 3 have been tried on any scale before. For the investor (who might be another company in the telecommunications industry), an attachment company, private or public, is an investment vehicle with a clearly defined business interest, on whose chances of success he can take a view. It should be able to raise investment funds from the market to design, develop, produce and sell attachments. Aside from normal commercial risks, the greatest uncertainty facing such a company, irrespective of the distribution of equity in it between BT and private capital, is the attitude Government adopts over capacity resale and the maintenance of attachments. Professor Beesley has recommended complete liberalisation of the domestic market; BT would prefer competition to be limited to those services which it does not provide. And even after the Telecommunications Bill becomes law BT will retain the monopoly power to discriminate against private sector competitors. At best BT could delegate by licensing independent maintenance companies. At worst, it could develop and impose its own idiosyncratic technical standards and approval procedures.

Joint Ventures and Subsidiaries

2.3 These could take several forms, each with different financing implications. Common to all are the assumptions that they would be Companies Act companies, free to deal with BT on an arms length basis for common services such as data processing, and separately assessable for tax. The differences between them arise from present Treasury rules about ownership, control and financing. A wholly owned subsidiary would have its borrowing counted against the PSBR and against BT's EFL. At the other extreme, an associate company in which the private sector had majority ownership and control would fall completely outside the public sector. In between, there are two further possible forms. First is the "Ryrie concession" company. Subsidiaries in which BT retains control, but has sold 50% or more of the equity, and in which private sector equity is at least 40% of the balance sheet, may borrow money on their own account outside BT's EFL. The Treasury may also consider allowing such borrowing to fall outside the PSBR. Second is the case where BT retains control and majority ownership. Borrowing by such a subsidiary does count against BT's EFL and the PSBR, but it has yet to be decided whether BT could retain the proceeds of sale without their EFL being correspondingly reduced. For the purposes of this annex we define joint ventures as either "Ryrie concession" companies or privately controlled associate companies.

2.4 DOI and BT officials have already begun to examine the scope for setting up joint ventures once the Telecommunications Bill becomes law. They have so far considered three possibilities covering the sale of PABXs, radiopaging services, and Prestel; and a fourth which groups all these into a single subsidiary selling all competitive products and services. Table 1 estimates the cash which could be raised, assuming that they were able to take advantage of the "Ryrie concession" :

TABLE 1

Jan 1981 prices £m	PABX	Radiopaging	Prestel	All competitive Products and services
Value of net assets	8-15	2-3		60-120
Cash receipts from sale of 40% capital	3-6	3-4	22-60	40-60
Cash receipts from sale of existing asset base	100-200	2-3		200-400
Possible timing	1983-4	1983		1983-4

Prestel's valuation depends critically on when the sale of shares takes place. BT believes that the business might have a current value to investors of only £15-20m, but that by 1985 it could be valued at £75-150m.

2.5 The sale of an existing asset base is in principle a quite separate transaction from the creation of a subsidiary, though it may help to prepare the way. The case for selling existing assets is to raise cash and protect against cancellations. With the advent of competition the customer will have a greater choice of PABX's and other equipmen . Many will decide to return their leases of BT equipment, much of which is obsolete, at the standard one month's notice. We return to this later.

2.6 The creation of joint ventures will take time. Depending on their size and structure, it will take 2 to 5 years before equity can be sold. Only Prestel is a profit centre at present. BT's other service and attachment operations have no separate accounts, and all will need to start life as wholly owned BT subsidiaries to develop a track record before sale. Staff terms of employment and pension rights will need to be negotiated; tax implications studied; and transfer prices and management charges apportioned between BT and the new companies.

2.7 There are some general advantages in the creation of BT subsidiaries, and others that apply more particularly to joint ventures. The formation of BT subsidiaries, dealing at arms length with BT, will allow competition with the private sector to take place on an equal footing; whereas if BT were itself competing difficult regulatory issues would arise, along with suspicions, however ill-founded, of discrimination against competitors who themselves needed to use BT's network. Secondly, subsidiaries competing in particular markets will make BT as a whole and its employees individually more conscious of customer needs. Joint ventures will, in addition, both enable BT and the private sector to tap each other's strengths and skills, and help BT to finance its investment programme. They should attract private capital provided investors are satisfied that they will be run and staffed efficiently as free-standing concerns; and they will be able to raise private capital where BT itself and its majority-owned subsidiaries would under present rules, not be free to do so. The expanding market for attachments will create new demand for network services. Admittedly BT would be selling a future stream of profits; but we believe this consideration is outweighed by the advantages described above.

2.8 The question arises whether BT should relinquish control over joint ventures. They would then no longer be part of the BT group, their accounts would not be consolidated, and their expansion would not be constrained by any curbs on BT's overall investment levels that led to the rationing of investments in or loans to BT's subsidiaries. BT could raise more money from further sales of the companies' equity, which could then be reinvested in development of the network.

2.9 But we do not recommend going as far as 100 per cent privatisation of all BT's activities in the competitive sector. One of the government's - and BT's management's - objectives is that BT should become more market-conscious and efficient. Simply redrawing the boundaries of the monopoly, and confining BT to the network, will not achieve this. Nor will BT employees be brought to recognise that customers have a choice and that pay levels depend on productivity gains.

2.10 We believe that BT should set itself a time limit for bringing the subsidiary or subsidiaries to the market. There are always good reasons for delay, such as the impossibility of creating subsidiaries and selling equity in time to meet short term EFL pressures. All the more reason to have a clear medium term programme and for both government and BT to stick to it.

2.11 But this brings into sharp relief the handling of sales during the transitional period. It may not always be possible to sell half or more of a new subsidiary's equity on favourable terms in one go. At present BT would not be allowed to retain the proceeds of a sale of, say, 20 per cent without a corresponding reduction in its EFL; nor would the subsidiary's borrowings count outside the PSBR.

2.12 This may be too inflexible a ruling. We do not want to argue the case for "staging" of divestment in the narrow context of BT; the Treasury will want to consider the wider implications. Moreover, there are solid arguments against allowing a subsidiary of which BT still has majority ownership and control to borrow outside the PSBR. But :-

i. BT will need flexibility in determining the time and amount of sales, to secure the best return;

ii. if as we have suggested BT commits itself to a clear timetable for divestment, its hand in negotiating with potential investors could be weakened if staging were not permitted;

iii. it may be easier to gain union cooperation by a more gradual approach.

We recommend that the DoI explore this issue further in conjunction with BT and the Treasury; but the first priority is to establish an agreed timetable for divestment and the creation of joint ventures and associates.

2.13 What we broadly have in mind is that BT should first determine and cost the asset base of all its activities in the competitive sector (in the post-Beesley climate) and should reach agreement with the government to sell an agreed average percentage, say between 50 and 60%, of those assets to private interests at the best price it can obtain. These sales should be completed by an agreed date, say summer 1986, but BT would have flexibility to sell equity any time between now and then; in practice between 1983 and 1986 since it will take at least two years to form subsidiaries for the reasons given in paragraph 2.6 above. In IFR terms, this would mean that a 1983-6 block target figure for sales of assets would be set, but it would not be broken down into annual targets because this would unduly constrain BT in its search for suitable partners and weaken its hand in seeking the best price. Provided the overall average target was achieved it would not matter if BT sold a high proportion of equity in one company and only a minority in another; but in the latter case staging arrangements would not apply.

Impact of attachment subsidiaries on BT's investment programme

2.14 BT's latest Medium Term Plan anticipates net investment in 1981-6 (allowing for apparatus leasing) in what it terms the "competitive area" amounting to £1091m in 1980-1 outturn prices, or 10½ per cent of estimated overall investment requirements of £10334m. To this figure should be added an appropriate share of the £1661m to be spent on accommodation, computers, transport and so on. The "competitive area" as defined by BT includes extension telephones, PABXs and call connect systems, radiopagers, modems, text terminals and Prestel. Investment in these areas will therefore run at rather more than £200m annually, again at 1980-1 prices.

2.15 These plans reflect BT's expectation of a dominant, though reducing, market share in the competitive area in the years after the Telecommunications Bill becomes law. Over 1981-6, for example, BT has told us that it assumes a reduction in its share of the telephone instrument market overall from 99 per cent to 93 per cent, and a reduction from 93 per cent to 90 per cent of its share of <u>annual</u> new business, masking a steeper predicted decline in its share of business demand and an improvement in residential market share, which is likely to be less attractive to competitors anyway. If the first 'monopoly' telephone were excluded, the private sector's inroads into the available market would look more impressive. In other sectors, BT tells us that it forecasts a reduction in its share of the medium size PABX market from 100 per cent to 72 per cent over the period, and of callmakers and loudspeaking telephones from 85 per cent to 75 per cent.

2.16 BT itself would not rely on these estimates either of the size of the "competitive sector" or of BT's share of it. First, BT has assumed that there will be no duplication of services provided or "to be provided" by it. Assuming, however, that Professor Beesley's recommendations are accepted, we would expect increased demand for telecommunications services to lead to growth both in the attachments market and in network traffic. Secondly, the size of the competitive market will also depend on the economic climate and the speed with which apparatus standards are written and approved.

2.17 BT's share of the "competitive market" will depend on the speed with which new UK supplier companies emerge and the extent of foreign competition once the proposed three-year period of adjustment has ended. The effect of abolishing the present restrictions is likely to cut both ways, enlarging the total market but reducing BT's share of it. In this report, however, we do not try to predict either the size of the competitive market or BT's share of it. If BT creates joint ventures, they will raise their own funds in the markets. The "saving" to the investment programme of "BT Network" would then take three forms :

i. a once-for-all sale of existing assets by BT Network to its customers, which as we have said could proceed irrespective of (ii) and (iii) below;

ii. the sale of equity to private investors. In both cases (i) and (ii), we believe that BT Network should be allowed to retain the proceeds if it is to have any incentive to sell;

iii. the assumption of responsibility by the joint ventures for future borrowing for capital investment in their market sectors.

2.18 Paragraph 2.4 set out BT's estimate of maximum receipts of £40-60m from a sale of 40% of equity, and a further estimate that if the entire existing asset base could be sold this might realise some £2-400m. BT has since told the government that in its view only 10% of its existing customers would in fact exercise an option to purchase rather than continue with present leasing arrangements, yielding perhaps £15m in 1981-2, £10m in 1982-3 and nothing thereafter, all on the assumption that the sale price will equal an average three years' rental. We believe that BT should aim to sell most of its existing and obsolescent asset base, to guard against its being displaced by competition (which would reduce its earning capacity to zero). BT has also allowed in the MTP for a 20% take-up rate among customers for new PABXs, to yield £120m in 1982-3 on the basis of a front-loaded lease equal to eight years' rental.

2.19 Paragraph 2.14 suggested that BT's forward investment programme could be relieved of £200m (more in outturn prices) if, as we strongly believe, its investment in the competitive sector should be financed through joint ventures borrowing the funds they require from the markets. These sums are small by comparison with BT's annual expenditure on fixed assets. They look better, however, when compared to the external financing requirements that BT has forecast for 1982-3 onwards.

2.20 However, the joint venture approach is unlikely to release enough capital in 1981-6 to fund the modernisation programme. Indeed the investment 'savings' are in that part of the programme which is easiest for BT to justify at present, for the payback period on telephones, PABXs and so on is short - about a year in the case of an ordinary telephone. So BT's EFL should not simply be reduced by the extent of the 'savings' from joint ventures. This would force BT to cut the important modernisation programme.

Conclusions

2.21 We support the creation of joint ventures throughout the attachments sector and believe they would attract private capital. BT and the government should establish and commit themselves as soon as possible to a clear medium-term timetable and quantified target for the creation of joint ventures. Provided the targets are clear the interim arrangements can in our view be flexible. We are opposed, however, to a 100 per cent sale of assets because this would cut BT off from the stimulus of competition.

2.22 Joint ventures will yield some financial benefit to BT in the longer term, and the sale of the existing asset base in the short term, but in neither case enough to finance the modernisation programme in 1981-6. The case for our recommendations is mainly operational but also has financial benefits. BT's new developments in the competitive sector should be driven and funded by the markets. This together with an appropriate regulatory climate will stimulate efficiency and ensure fair competition and equal access.

ANNEX 3: BT AND THE TELECOMMUNICATIONS SERVICE SECTOR

Introduction

3.1 What follows is a preliminary discussion of a complex subject. The best way to proceed will only become clear once the government has responded to Professor Beesley's recommendations on capacity resale. We have tried to look 'beyond Beesley' but do not pretend that the recommendations in this annex are the only way ahead.

3.2 The approach developed in this annex would argue that the fundamental distinction to draw is between a transmission facility and the service it provides. Voice telephony and telex are two separate services, but provided by the same physical transmission system; in this context, BT is both transmission supplier and service provider. But the two roles are distinct. At present, organisations with special service requirements are permitted to procure their own communications equipment and attach it to private circuits leased from BT. Airlines communicate passenger and flight information; banks carry financial transactions; news services distribute information gathered at one point to many others. The crucial restriction at present is that none of them except BT is allowed to resell their services, nor to transmit information between third parties for a fee. The services market is therefore limited by what BT chooses to provide.

3.3 The forces for change are strong. They arise both from the push of new technology, which makes new services possible, and from the pull of new markets as customers and would-be service operators see potential for new services. It is against such a background that Professor Beesley has recommended that the resale of services be permitted. If as we hope it is, then two developments could take place in the private sector quite quickly. First, existing specialised services now confined to an organisation's own needs will be offered more widely and on a commercial basis. The effect of permitting resale is hard to quantify; many organisations will have no desire to sell services to third parties. And those organisations which have developed specialised information services, such as Reuters and the Stock Exchange, will go on using their networks primarily for that purpose. The main difference is that, in the Stock Exchange case for example, one broker will be permitted to communicate with another across the Stock Exchange network rather than the public network, and the Stock Exchange will be able to charge for the call.

3.4 Second, there will be those who wish to challenge BT in its traditional service markets of voice telephony and telex. BT is naturally worried about damage to its business arising from the latter. We think that the opportunities facing BT outweigh the threats. Further, in the world of digital technology, where all forms of information including voice are reduced to a stream of pulses, it is logically impossible to sustain (or enforce) a distinction between voice telephony, telex, and other services.

3.5 We see two strategic options facing BT. Either it could withdraw from services markets (including in extremis, telephony) and concentrate on providing transmission facilities. The planning, provision and funding of a nationwide transmission system will in any case be an important task, and the lack of adequate capacity may be the pacing factor which limits the growth of information technology industries. But under this scenario BT would be largely removed from the marketplace, and for the reasons given in the previous annex we think this the wrong way to go. Or it could develop and market new services as will the private sector. Two such services whose development seems particularly suited to BT's strengths and capabilities are text transmission by communicating word processors, and electronic funds transfer at the point of sale. Both are briefly described below.

3.6 Communicating Word Processors (CWPs): A word processor consists of a computer linked to one or more terminals equipped with keyboard and visual display unit (VDU). Letters, reports and memos can be entered and edited at the keyboard and displayed on the VDU. They can be sent to other terminals ('electronic mail'). Thus within an office the functions of manipulating, transmitting and filing documents can be handled electronically, reducing the need for conventional filing systems, memoranda written on paper, and so on. Some organisations in the UK are using such systems in a small way and seeing the benefits of fewer delays and lower costs. In a CWP system word processors on different sites are connected through the telecommunications network, thus extending their advantages to a whole organisation and ultimately to the entire business community.

3.7 Electronic Funds Transfer (EFT) is intended to replace cash payment at retail shops. At the point of sale the customer hands the cashier a machine readable card. The card is read by a terminal connected over the telecommunications network to a computer holding up-to-date information on customers' accounts. The assistant enters the amount to be paid. The computer checks the customer's account and, if there are sufficient funds, debits it, transfers the funds to the shop's account and sends confirmation back to the terminal. The main benefits are the savings in the costs of handling cash and in convenience for the customer. But without good telecommunications EFT cannot even be contemplated.

3.8 The systems management problems facing CWP and EFT networks are formidable; it could be that these have discouraged their development so far. At present the banks are interested in launching EFT on the public switched network; but BT accepts that if the organisational hurdles can be overcome the banks might in time want a stake in a dedicated network. On the other hand, it could be that only an organisation like BT is capable of developing nationwide EFT and CWP systems, the banks and office products companies having so far failed to do so. These are both areas in which the Minister for Information Technology might seek to stimulate progress.

3.9 In this introduction we have defined "services" to embrace all communications services using dedicated circuits. These might be leased from BT as at present, or in the post-Beesley climate, leased or bought from rival suppliers of alternative networks, or perhaps bought from BT; the possibilities are many. They will all be able to carry third party traffic if they wish. Finally, we would expect a number of these new private networks to carry voice as well as non-voice traffic, since in the early years voice traffic will be necessary to achieve high load factors. This has implications for BT's tariffs, and in itself makes it important for BT to consider its market response.

A possible BT approach to the services market

3.10 We envisage that BT would set up joint ventures for EFT and other specialised communications services. Each would seek private sector investors and business partners, perhaps an equipment supplier, a major potential user or a financial institution. They would research market requirements, define the services to be provided and the tariffs, develop equipment specifications, raise the necessary capital and procure appropriate network facilities. If they qualified for the 'Ryrie concession', or indeed had majority private ownership and control, then their borrowing would not count against BT's EFL.

Alternative networks

3.11 In our report we have described the effects of 'alternative networks' on both the supply of competing services and the provision of raw transmission capacity independent of BT. In response to the latter, BT could choose to extend its terms of business to embrace the sale or front-loaded leasing of private circuits as distinct from the present practice of renting them on an annual basis. There are precedents for the sale of circuits in the funding by national PTTs of international cables: each national PTT intending to use the cable puts up capital in exchange for the indefeasible right to use a certain amount of the cable's capacity. Subject to Inland Revenue ruling, there could also be tax advantages if a company bought physical assets such as transmission lines and were allowed accelerated depreciation of the asset value.

3.12 BT opposes alternative networks, and the government has not yet made its decision. We strongly support a decision to license them, for reasons which this report as a whole makes clear.

BT's preliminary response

3.13 BT has doubts about the sale of private circuits. It points out that the needs of private network operators tend to be specialised. The average life of a private circuit is only five years and a quarter of all private circuits undergo some reconfiguration every year because the operators' business premises and plant are constantly changing location. It doubts therefore whether sale in perpetuity makes operational sense and, more important, whether the new owner of a physical network would have an asset he could easily resell given that the network ends in a number of particular sites in which potential buyers will have no interest. BT itself might well be the only organisation with an interest in buying the network back. We asked whether the right to a specified amount of circuit capacity might not be a more saleable asset than the physical lines; but BT doubts whether such a scheme would have any tax advantages for the 'owner'. This needs confirmation.

3.14 BT is prepared, however, to give both existing and new private sector operators a choice between present lease arrangements and a front-loaded lease of 2-4 years' rental, with an appropriate discount. As in all such schemes, there is an immediate gain to BT and lower revenue in later years. BT does not expect a high take-up, perhaps only 10 per cent.

3.15 Underlying BT's reaction is its belief that the network is indivisible and that in the longer term the integrated services digital network will remove any need for private circuits. We find it hard to believe however that some large business customers will not continue to prefer the security of ownership and freedom from maintenance restrictions or possible strike action that dedicated independent networks offer. They should certainly retain the freedom to choose.

3.16 This last point requires further consideration by government. For the time being, we see two ways ahead:

i. BT to offer the choice of front-loaded leases to private network operators (paragraph 3.14 above);

ii. participation by BT in joint ventures where the requirement is for entirely new dedicated networks. CWP and EFT seem promising candidates, and their potential nationwide coverage and expense probably rules out any attempt by BT to finance and develop them on its own. We accept that reconfiguration will pose genuine problems to any joint venture, (paragraph 3.13 above) but are not satisfied - certainly at this early stage - that no solution exists.

<u>Impact of service subsidiaries on BT's investment programme</u>

3.17 BT believes that 10 per cent of existing private network operators might want to switch to front-loaded leasing arrangements, and would expect to receive £30-40m in 1982-3. In later years it foresees no net revenue gain because the loss of future rental from those who have availed themselves of these arrangements will cancel out the gain from new participants in them.

3.18 By way of comparison, BT derived around £100m in 1979-80 from the rental of private circuits, a figure which will rise since BT wants to put leases on a cost-related basis (which might be an inducement to switch to front-loaded leases). With reservations, BT has also predicted an investment requirement in its 1981-6 programme of around £300m for the 150,000 additional private circuits that it foresees. If as we expect competition increases demand for private circuits this figure could prove an underestimate. It can only be a guess, but BT's estimate of revenue from front-loading may prove too cautious. Much depends on the financial arrangements that competing suppliers offer.

3.19 As there is no provision in the investment programme for CWP or EFT service networks, it is safe to say that these will put further pressure on BT's finances unless developed by joint ventures.

Wider impact on BT's revenue

3.20 There would be a loss of revenue to BT from diversion of trunk traffic onto new private networks, and to a lesser extent from diversion onto existing private networks permitted to resell voice capacity. But that would happen whatever the nature of the lease arrangements between BT and the private operators concerned. Moreover, as Professor Beesley has shown, the planned increases in BT's charges for local calls to reflect costs more accurately would eliminate much of the 'cream' from resale. BT's real problem is that competition for trunk traffic may drive tariffs down faster than BT would wish, with consequences for the SFR and therefore for the investment programme as long as external financing remains constrained. Again, however, this will happen anyway whether private operators procure their networks from BT or from some other transmission company.

Conclusions

3.21 If Professor Beesley's recommendations are accepted, resale of capacity permitted and alternative networks licensed, then two significant new demensions will be added to the telecommunications services markets. We believe there may be scope for adjustments in BT's market strategy to meet this new environment, in particular for the creation of joint ventures to finance private circuit networks offering both voice and non-voice services, and for the sale by BT of private circuits. BT has some understandable doubts, and at the moment there seem to be two ways forward, i. the offer by BT of the choice of front-loaded leases of private circuits and, in the longer term, ii. joint ventures for complex and expensive ventures such as CWP and EFT requiring the construction of new dedicated networks. As the future competitive environment is so unclear, we would not want either BT or the government to lose sight of more far-reaching proposals.

ANNEX 4: CONTROL, REGULATION AND EFFICIENCY

Introduction

4.1 Before 1969 telecommunications and the postal services were run as a Department, under the government's direct control. Since then they have been a state monopoly. Later this year BT will become a corporation separate from Posts, with the power to raise money under conditions that remain to be agreed and to establish subsidiaries, and subject to competition. In common with other nationalised industries, its activities are tightly controlled by the government, for a variety of reasons. First, where its decisions such as on pay and prices have undesirable economic and social consequences, then they may need to be changed. Second, it needs external financing; so its planned use of government money needs to be carefully scrutinised, which involves regular and careful examination of its investment and expenditure plans. Third is the need to counter the natural tendency of any monopoly to become inefficient, to fritter away investment funds in pay increases and to dissipate the benefits of new technology in wasteful work practices.

4.2 There is no doubt that many business customers, especially in the City, remain dissatisfied with the service that BT provides and with the speed of installation of new equipment. We received evidence on this point from the British Bankers' Association and Telecommunications Users' Association, among others. It is acknowledged that service has improved, and waiting lists cut, in the past year; but there is still a long way to go. The causes are various; some would stress working practices, BT would say it needed more investment capital, but we suspect that the heart of the problem - and one where neither side can entirely escape criticism - has been a failure to engage in adequate forward planning of new facilities, coupled with a need for BT to put more management resources into project appraisal and control.

Control and Efficiency

4.3 When the system of cash limits and EFLs was introduced, it was hoped that it would provide sufficient leverage to gain improvements in efficiency. But it does not follow that, because increased efficiency generates internal savings and reduces the external financing requirements (EFR) that the converse is true and that squeezing the EFL automatically yields greater efficiency.

The reasons for this are worth examining. First, the EFR is hard to predict, being the difference of two large numbers: the inflow of revenues and outflow of costs. Second, BT management in attempting to meet a given EFL target has a greater range of options than improving efficiency. Cutting long-term investment is the easiest, in that it postpones the crunch.

4.4 Third, the EFL is a short-term financial target whereas internal efficiency is a long-term goal requiring sustained commitment and effort. It is probably not realistic for BT to achieve much more than 3-5 per cent per annum improvement in real labour productivity (excluding capital intensification) over the long-term. BT would argue that this is a far stricter (though in our view fairer) yardstick than that used by many companies in the private sector. For a view of its overall "productivity", including the effect of capital intensification, it is probably sufficient to quote some figures from the 1976 NEDO (McIntosh) report on the nationalised industries. Average annual growth in the telecommunications business from 1960 to 1975 was 9.9 per cent; employment rose by 2.1 per cent (mostly in the sixties); output per head grew by 7.7 per cent; comparable figures for the average in manufacturing industry were 2.7 per cent, -0.7 per cent and 3.4 per cent. But there are difficulties in comparing a public sector monopoly with manufacturing industry as a whole. If instead one compares BT's performance with those of other PTTs in Europe, as the DOI and BT have done, BT - with all the normal reservations about the problems of comparing different countries' practices on a common basis - tends to be no higher than the middle of the pack.

4.5 Similar observations apply to the performance bond devised by BT and Warburgs. The original aim behind the proposal for a performance bond was to provide BT with access to sources of venture capital, the return on which would be linked to the overall success of the Telecommunications Business. But as discussions progressed, and the performance criteria were defined, it became clear that Treasury officials had a different view of performance; one defined largely in terms of improvement in real unit costs. The discussions have so far foundered on this point. It is clear that, to attract investors, the return on capital needs to be linked to the overall use made of the capital rather than to some indicator designed for a narrower and different purpose such as measuring improvements in labour productivity.

So far, neither the aim of raising capital nor that of improving efficiency has been achieved. More work needs to be done on performance bonds and on other ways of attracting private capital outside PSBR constraints.

4.6 The conclusion we draw from this anlaysis is that control of efficiency by squeezing finance and by attaching strings to it is not very effective. In a competitive world, the chances of it being so will be still less. BT will have market pressures to add to its portfolio of arguments for greater financial freedom. Clearly the government must have regard to BT's use of funds in fixing the extent of its future access to funds. But:

i. the instruments whereby BT promotes operational efficiency (and effectiveness) should not be confused with those designed for wider macroeconomic purposes;

ii. short-term gains in efficiency always fall short of government hopes, and the government needs to get away from a search for short-term savings, dominated by the annual IFR and EFL-setting rounds, and to work on the basis of realistic longer term targets, drawn up by BT with appropriate advice from outside consultants, to which BT and the government can commit themselves and against which the government can monitor BT's use of funds.

The next two sections develop these points.

Choice of instruments

4.7 To provide an overall framework for their discussions of efficiency BT and the government at present rely largely on a real unit cost index. In 1978 BT told the government that it expected "a general reduction in the real unit costs of the telecommunications services of some 5 per cent over the five years to 1982-3".

4.8 After initial successes BT has fallen short of this target. A working party of government and BT officials is now studying the reasons. BT would like the real unit cost index redefined. While we do not want to go into undue detail in this annex, some general points are worth making. The target is essentially a ratio of current account costs, excluding interest, at constant prices divided by income at constant tariffs; in other words, the ratio cannot be manipulated in BT's favour by adding higher revenue based on tariff increases to the bottom line. This is as it should be because otherwise there would be no pressure to take action on costs and because tariff increases have in the past been influenced by wider government aims such as the need to meet EFLs and reduce the PSBR. But it should be recognised that higher real tariffs result in lower volumes. Thus income expressed at constant tariffs is below what it would otherwise have been. There is a case in logic for removing both the primary and secondary effects of higher tariffs.

4.9 The other main reasons for the shortfall, according to BT, are a lower GDP outturn, which has also reduced revenue; higher depreciation caused by modernisation shortening asset lives; and pay costs including both pay rates and staff numbers. In the context of efficiency the government should put pressure only on costs that lie within BT's power to contain. That applies particularly to pay, where wages have tended to rise faster than the RPI in most years, but not to depreciation or the effects of changes in GDP.

4.10 Even so, real unit costs calculations suffer from being averaged over the business as a whole. BT has a multitude of separate performance indicators for all sections of the business, for example internal and external maintenance. Only at these lower levels can concrete steps be taken to improve efficiency. We do not pretend to have covered this ground in detail and make only two general points. First, it must be for BT to take the necessary action, although the use of outside consultants might well provide BT with useful insights into how the business' efficiency could be improved. Secondly, the DOI will in our view need to acquire greater expertise in understanding how BT's manpower planning works and the significance to be attached to the data which BT provides.

4.11 The proposed creation of separately accountable BT regions, discussed more fully in Annex 1, should make local management more aware of their regions' allocable costs since it will identify differences in regional performance and may eventually lead to local pay and productivity agreements based on best regional practice. This would be a valuable reinforcement to other indicators and targets based on nationwide performance by different sectors of the work force.

Long-term and Short-term aims

4.12 Improved efficiency is a long-term goal. If the government wishes to force the pace, then it should do by means of an appropriate policy instrument which will operate over the long term. Competition over the whole range of services and products offered by BT is one such instrument. We referred briefly in our report to restrictive labour practices, delays in the provision of service, especially exchange lines, and delays in correcting faults and providing maintenance. An alternative network of the sort proposed by Cable & Wireless will provide a competitive reference point for all three, though a start would be made by earlier moves towards liberalisation and competition for attachments. But there are limits to what can be achieved in the short term, and the internal savings made possible through improved efficiency will fall far short of the funds necessary to finance the investment bulge of the next few years.

4.13 Over the next fifteen years, the effects of competition are hard to predict. Certainly it will reduce the government's freedom to press for higher tariffs and therefore constrain the available finance. The commercial implications of tariff policy will have to be considered as well as the economic ones.

4.14 BT's costs should decline dramatically in the late 1980s and 1990s. There are two reasons for this, both to do with technological change and the modernisation programme. First, the procurement profile reaches an expenditure peak in the mid-80s for trunk transmission and switching, and around 1988 for local switching. Thereafter installation staff numbers and costs will fall. There could still be savings in the shorter term if BT's suppliers were to carry out more of the work of assembling exchanges.

4.15 Secondly, overall maintenance manpower, in terms of man hours, is expected to fall from 81,000 now to 70,000 in 1991-2, with the peak, as with procurement, coming in the mid-80s. Maintenance divides into field and exchange maintenance. Field maintenance includes repair and renewal of cables; BT would argue that numbers will only decline with lower system growth. While exchange maintenance will only account for a third of total maintenance costs at peak manpower levels in the mid-80s, it nevertheless offers considerable scope for staff savings in the longer term. For a given size of exchange a digital exchange will require in 1990-1 about a quarter of the maintenance effort of the Strowger electro-mechanical exchanges that are now being phased out; less than half that of Crossbar; and around half that of TXE 4. These comparisons are all in terms of maintenance staff hours per exchange connection per year.

4.16 We have compared the graph of manpower requirements with the graph for estimated natural wastage, normally 4-6 per cent per annum. The gap between the two lines must be filled either by recruitment or redeployment of staff from other duties. Premature redundancy (which the unions would bitterly contest given the present employment security agreements) is not therefore necessary. If BT could reduce its manpower requirement line down to that for natural wastage, some 3,000 jobs could be trimmed. BT will naturally wish to continue to recruit staff in order to maintain a sensible mix of ages and skills; but this is a good example of the sort of issue we have in mind that needs a long-term look.

4.17 We have not had the resources to examine BT's staffing structure with any care. But in any large organisation there is normally some scope for short-term savings. It has now been agreed that the consultants whom BT has recently appointed will examine the scope for early savings in addition to their other tasks, in connection with the government's agreement to a £200m increase in BT's 1981-2 EFL.

4.18 Before leaving this subject we have one general comment which links back to previous comments on the use and abuse of ratios as performance criteria and the distinction between labour and capital productivity. BT often cites the correlation between telephone penetration (telephone per 100 head of population) and productivity measured in telephones per member of staff. Once UK penetration reaches US or Swedish levels BT's productivity will look very impressive. But productivity can also be improved by reducing staff. A 1970 BT discussion paper on manpower productivity in telecommunications makes the point concisely in words which may still apply:

> "In simple terms, our objective in manpower productivity terms could perhaps be said to achieve the highest level of telephone penetration <u>without increasing the number of staff employed in the business</u>" (our underlining).

4.19 Despite the potential for further volume growth in telecommunications, we think that absolute staff numbers could and should decline as modernisation proceeds, though we would not press for a rate of decline exceeding that of natural wastage. The formation of BT subsidiaries, and later joint ventures, provides a further opportunity to reduce staff numbers since we would not expect private capital to be forthcoming with current BT conditions of employment.

Procurement and Efficiency

4.20 Assuming that the bulk of BT's requirements will continue to be met by UK suppliers, the question arises whether the present rules for giving BT access to government funds work against the efficient long term procurement of capital goods. An example will illustrate the point. The development costs of an electronic exchange are high. They must be recovered over the production life of the exchange; a long production run means lower real unit costs. Certainty is important, and BT as buyer would be in a strong position to negotiate lower prices for exchange equipment and attachments if it could enter into long term procurement contracts. But BT has no guarantee of access to long-term funds. Its investment programme is fully approved, after some negotiation, only for the current year, and partly approved for the succeeding four years. The Telecommunications Equipment Manufacturing Association (TEMA) has told us that the selling price of a small modern PABX could be reduced by 40 per cent if a long production run was certain; similar economics could well apply to System X exchanges. By forcing BT to plan a ten-year project on a year-to-year basis, the overall costs may well be increased by several hundred million pounds. This is not the fault of BT management. Nor could these savings be realised by applying pressure on the EFL. Rather, they are a consequence of the investment approval process; the cost of keeping options open for future years' public expenditure. Permitting BT to commit funds up to, say, ten years ahead could yield substantially more efficient use of investment funds both in the short-term, and overall.

4.21. A recent example may be the supply of telephones. Two years ago, BT came under heavy criticism for its long waiting lists, and decided to increase stocks; the suppliers geared up production only to find - according to TEMA - that because of last year's cash limits BT had to destock and orders to suppliers fell by 30 per cent. One of the many advantages of competition is that, with more market outlets, suppliers will have a better chance of levelling out fluctuations in demand. Nevertheless, BT will remain by far the largest market (about £500 million a year at present to TEMA members alone) and we welcome the recent agreement by BT and government departments, in response to our raising of this issue, to examine the scope for economies in procurement costs if all or most of BT's modernisation programme could be put on an assured long term basis.

Property

4.22 It has been put to us that BT lacks professional expertise in managing an existing property portfolio of £1 billion and an additional portfolio of about £1 billion likely to be acquired over the next 5 years. The management of BT's property resources comprises two distinct issues, net area utilisation which is a question of competent professional planning, and the possible advantages for BT of sale and leaseback arrangements. The last has PSBR implications which we understand are being pursued separately.

Regulation

4.23 As a competitor, BT will be in a strong position in the new marketplace for telecommunications supply. First, it is the dominant supplier, with all the associated advantages of market presence, economies of scale, price leadership, countrywide organisation and technical clout. Second, it has regulatory powers; to allocate frequencies in those parts of the frequency spectrum which it controls, and to license services. Third, it has the monopoly right to commission and maintain attachments and most PABXs. By implication, it therefore has the right unilaterally to prevent the attachment of equipment which it dislikes on grounds that it is unmaintainable, or to attach excessive maintenance charges or unreasonable conditions to the use of such equipment. There is already some evidence of this happening arising from within the government service, and the private sector has expressed its fears that BT will adopt predatory practices against its competitors.

4.24 BT also represents the UK in international standards-making activities. Clear, well-written standards are vital to telecommunications and information technology; without agreed international standards, international telephone calls would be impossible. And the emergence of a competitive market for attachments, services and alternative networks depends on appropriate standards and certification procedures.

4.25 In all these areas, BT will have two conflicting interests. First, as a regulator, to ensure an orderly market. Second, as a competitor, to strengthen its own dominant position and maximise its share of the market. The private sector has expressed the opinion to us that BT will not be able to separate the roles of player and referee in a way that is fair to the other players. This problem lies beyond our remit. But we have assumed the emergence of a liberal and open marketplace and many of our recommendations depend on it. It is therefore important that the regulatory stance adopted should consciously favour competition, and, where necessary, prevent BT from abusing its dominant market position.

Conclusions and Recommendations

4.26 There are two developments already in progress which will affect consideration of efficiency. The chairman of BT has appointed management consultants to advise on the creation of separately accountable regions, and it has been agreed that they will also examine the scope for early cost savings. We support both these initiatives.

4.27 Other issues relevant to 1981-6 are:

i. given that absolute staff numbers are likely to decline in the long term, can BT prevent them rising (by 4,000) in the period 1981-6?

ii. would contracting out more exchange assembly work improve efficiency?

iii. £192m is to be spent on improved diagnostic equipment in 1981-6. By how much will this expenditure improve productivity in maintenance and repair work?

iii. could investment in property be more efficiently managed, given, for example, the large amount of unused space at Baynard House?

4.28 In the longer term, when equipment procurement and exchange maintenance manpower have passed their peaks the task must be to minimise net new recruitment into BT and to allow natural wastage to have its impact on staff levels. There should be a firm lon-term plan to that effect.

4.29 We <u>recommend</u> that BT study the questions raised in the above two paragraphs, with the assistance where necessary of consultants, and report its findings to the Department of Industry.

4.30 We also <u>recommend</u> that any new real unit cost index should be directed towards reducing those costs that lie within BT's power to contain, especially pay; that the work of selecting appropriate performance criteria, both regional and by workforce sector, be speeded up; and that the Department of Industry take steps to monitor BT's manpower planning more thoroughly. Recourse to an external audit mechanism could be another way of proceeding.

4.31 In general, BT and the government need to work on the basis of realistic long-term performance and productivity targets, drawn up by BT with outside advice where appropriate, to which they can both commit themselves and against which the government can monitor BT's use of funds.

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TABLE 1

BT's Financial Performance: Forecasts from 1981 onwards

(1980 MTP forecasts in brackets)

Current prices, as forecast, unless otherwise stated; in £m.

	1981	1982	1983	1984	1985	1986
Income	4518(4518)	5420(5225)	6363(5827)	7241(6466)	8214(7295)	9219(–)
Expenditure	4308(4086)	5098(4624)	5934(5148)	6746(5687)	7631(6377)	8536(–)
Profit	210 (432)	322 (601)	429 (679)	495 (779)	583 (918)	683(–)
As % of income	4.6 (9.6)	5.9(11.5)	6.7(11.7)	6.8(12.0)	7.1(12.6)	7.4(–)
Tariffs, adjusted for inflation (1970 = 100)	75.4	78.3	75.3	71.2	67.8	64
Capital requirements (fixed assets)	1587*(1502)	1940(1976)	2577(2080)	2990(2350)	3278(2607)	3525
(including changes in working capital)	1623*(1355)	2238(2075)	2717(2162)	3048(2417)	3400(2713)	3691(–)
Movement in net liquid funds						
Financed from: internal resources	1385(1520)	1738(1840)	2131(2059)	2409(2302)	2741(2626)	3103(–)
net external borrowing	238*(-165)	500 (235)	586 (103)	643 (115)	659 (87)	588(–)
Self-financing ratio (%)**	85 (112)	78 (89)	79 (95)	79 (95)	81 (97)	84(–)
Financial target (as % of net assets)	6 (6)	6† (6.5)	6.5† (6.5)	6.5† (6.5)	6.5† (6.5)	
Financial achievement	4.6	4.7¯	5¯	5¯	5¯	5¯
EFL (target)	223 (78)	180 (111)				
EFR (actual/forecast)	238 (179)	500 (235)	586	643	659	588

*Distorted by billing backlog

†Targets set in Cmnd 7841 with the reservations set out in Cmnd 8175

¯BT figures, based for 1982 onwards on achieving a 5% RRA

**Recalculated from BT figures (which are before loan repayments) on basis comparable to those for 1971-80

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TABLE 2

BT's Financial Performance 1971-80

Current prices unless otherwise stated.

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Income	785.7	884.1	1002.3	1160.5*	1388.1*	2166.8	2658.0	2924.0	3243.9	3558.9
Expenditure	692.2	826.1	1012.0	1221.9	1582.6	2012.1	2292.6	2597.4	2907.5	3429.8
Profit	93.5	58.0	(9.7)	(61.4)*	(194.5)*	154.7	365.4§	326.6	336.4	129.1
As % of income	11.9	6.6	(1.0)	(5.3)*	(14.0)*	7.1	13.7	11.2	10.4	3.6
Tariffs, adjusted for inflation (1970 = 100)	102.1	94.0	88.6	84.2	80.4	103.9	103.5	89.8	82.6	74.0
Capital requirements (fixed assets)	426.2	537.3	625.5	696.4	787.2	915.9	834.6	844.6	996.5	1240.8
(incl changes in working capital)	492.2	460.2	623.8	807.7	927.0	695.0	771.2	912.3	1045.8	1352.1
Movement in net liquid funds	(49.0)	35.2	(7.5)	(216.3)	(22.4)	216.9	278.9	79.1	(108.7)	(348.4)
Financed from:										
internal resources	250.8	247.2	240.8	298.0	368.7	641.9	841.9	1039.5	1110.0	1070.3
net external borrowing	192.4	248.2	375.5	293.4	535.9	270.0	208.2	(48.1)	(172.9)	(66.6)
Self-financing ratio (%)	51.0	53.7	38.6	36.9	39.8	92.4	109.2	113.9	106.1	79.2
Financial target (as % of net assets)	9.6	10.0	10.0	–	–	–	6.0**	6.0**	6.0**	5.0**
Financial achievement	9.8	8.6	6.9	6.4	5.2	14.1	7.6**	6.1**	6.9**	4.6**
EFL (target)										
EFR (actual)										

*The figures for 1974 and 1975 are before compensation for price restraint.

§The figures for 1977 are before provision for elimination of profit above the Price Code reference level.

**The return on capital for the years from 1977 to 1980 has been calculated in real terms ie with return (before charging interest payable on medium and long-term loans but after charging historic and supplementary depreciation) expressed as a percentage of net assets revalued at replacement cost.

TABLE 3

BRITISH TELECOM'S 1981 - 6 MEDIUM TERM PLAN

Appendices 1 and 2 of BT's latest MTP are attached. These give much relevant information.

2. BT plans to spend £10,324m in 1980-1 prices between 1981-6 on fixed asset acquisitions (£14,310m in forecast outturn prices). The main categories are:-

	£m
Growth of the conventional inland telephone service	3472
(of which prime telephones and wiring	763
(local cable network	744
(exchanges and inter-exchange	1965
Quality of service	487
Network modernisation	2927
Information traffic	156
International circuits	470
Accommodation, computers etc	1661
Investment in the competitive sector as defined by BT	1091

3. Compared to the 1980 MTP, BT's investment requirement for the years 1980-5, as set out in its latest MTP, has increased by £400m in 1980-1 prices (£1857m in forecast outturn prices).

4. Total BT staff stood at 247,000 in 1980-1 and is forecast to stand at 252,000 in 1985-6.

TABLE 4. INTERNATIONAL COMPARISONS

£m Approx Total Investment at 1980/81 out turn prices

	R/E	1980(/1)	1981(/2)	1982(/3)	1983(/4)	1984(/5)	TOTAL
UK		1,587	1,801	2,021	2,121	2,174	9,704
Germany	4.56	2,133	2,607	2,457	2,263	2,114	11,574
France	10.56	2,135	NA	NA	NA	NA	

Prime Minister. 14

MLJ 13/6

TOP SECRET

Copy No 2 of 5 copies

MT.

Home Secretary

LIBERALISATION OF THE TELECOMMUNICATIONS MONOPOLY

Thank you for your minute of 11 June.

2 I share fully your concern to protect your security interests. What you suggest on value added network services (VANS) and mini networks is very helpful and I am grateful for the understanding way in which you have approached these issues. In particular, substantial liberalisation of VANS has been an essential part of our programme for telecommunications from the outset and it was clearly foreshadowed in the statement which, with colleagues' agreement, I made to Parliament last July.

3 That statement also indicated that we as a Government would be exploring the scope for licensing alternative network facilities, including satellite business systems. You will recall that we have all been greatly concerned about the ability of the telecommunications unions to extort excessive pay settlements through exploiting their grip on essential communication services and their ability to inflict serious damage on the whole business community. By encouraging private sector interests to provide an alternative service at least to the main business centres, independent of British Telecommunications, we may be able to loosen this grip on the national jugular, whilst at the same time securing improved efficiency, a release of high technology enterprise and attracting international business to this country.

4 So far the response to my statement has been encouraging. A consortium, in which Cable and Wireless, British Petroleum and Barclays Merchant Bank are taking the lead, have prepared imaginative plans for a new network. They have conducted a market survey in the City which showed that 98% of those approached supported the proposal for an alternative network to reduce their vulnerability to disruption.

5 I therefore believe that from a number of points of view it would be strongly in the national interest to allow the consortium to implement their proposals. If this were done, there would be no need for the foreseeable future to consider licensing more than this one additional network. But if we had to reject the consortium's proposals, without any convincing reason which we could make public, there would be a widespread feeling that the monopoly power of the unions had been reinforced and we might indeed be seen as having altered our policy stance in response to union pressures.

6

7 I am sending copies of this minute to the Prime Minister, the Foreign and Commonwealth Secretary and to Sir Robert Armstrong.

K J
18 June 1981

The National Archives

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010 PT

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

The Rt Hon Sir Keith Joseph Bt MP
House of Commons
LONDON
SW1

9 June 1981

4

Prime Minister

You may be interested to see this.

WR 10/6

MO

Dear Keith

TELECOMMUNICATIONS LIBERALISATION

When you made your recent statement on the Beesley report, you said that you would be considering Professor Beesley's recommendation that the private sector should be allowed to provide additional transmission services in competition with British Telecoms, and that you hoped to make a further statement as soon as possible.

I recognise that there are some difficult questions which need to be considered before we can decide whether to license a private sector telecommunications network, but I hope that this in the end will prove feasible. I thought that it would be useful at this stage to register with you the interest of the British Railways Board in this issue. The Board has a national network of wayleaves along which a competing system could be laid and could also provide city centre sites for the location of microwave transmitters. If the Board can utilise these facilities, this will both provide them with an income and reduce the need for reinvestment in their own telecommunications network. They are accordingly currently negotiating with the consortium formed by Cable & Wireless, of which you are aware.

There may, of course, be questions about one nationalised industry competing against another, but I do not see this as a difficulty since the Board may simply take a rental from the consortium and, even if they become equity participants, would hold no more than a minor stake. Since the consortium would be predominantly private sector, there would be no question of an extension of the public sector. I welcome this initiative by the Railways Board and I hope that it will eventually be possible to establish a network using their facilities.

Yours ever.

Norman

NORMAN FOWLER

Post + Tele

2

Prime Minister

Treasury & DoI seem close to agreement on BT's additional £200m.

MAP 21/v

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Sir Keith Joseph MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1

21 May 1981

cc Mr Wolfson
Mr Wallace
Mr Duguid

Dear Keith,

BT's INVESTMENT PROGRAMME

In Geoffrey Howe's absence abroad I am replying to your letter of 8 May on this subject. This gives your and BT's response to the conditions set out in Geoffrey's letter of 10 April which should accompany an immediate increase of £200 million in BT's EFL.

There were 3 main sets of conditions. On the first, which concerned arrangements to ensure that the additional sums are used only for capital expenditure, the response seems satisfactory; and I note that BT are not now seeking any assurance about future funds beyond the figure of £200 million.

The second set of conditions concerned the financial target and performance aims and the need for an outside enquiry into the scope for cost-saving in BT including savings in 1981-82. On the question of the financial and performance objectives, I am content that our officials and CPRS should look further at what are appropriate objectives and report back; and that for the financial target BT should aim to secure in 1981-82 a 5% return on their net assets.

However I remain very concerned about the possibility of further claims by BT on external finance later this year. I accept that since there are already two groups of consultants (Coopers & Lybrand and McKinseys) looking at aspects of BT's operations it would be unreasonable to require BT simultaneously to take on a third body of this kind. But the type of study we had in mind, which was concerned with the scope for cost-saving and greater efficiency, goes wider than financial and management controls and organisational restructuring, important though these are in the medium term. I must therefore ask that as a minimum the existing consultants should add the search for possible cost-savings to the work that they are already doing; and that additional instructions should be given to ensure that they take this dimension into their work. If I can have your assurance on this point I would be ready not to press the issue of a separate enquiry further for the time being.

The remaining conditions concerned increased competition and privatisation. I note that Sir George Jefferson is prepared to accept the competitive environment envisaged by Beesley and that BT are considering establishing subsidiaries wherever there is a commercial reason for doing so. However this falls somewhat short of the firm time-table that Geoffrey Howe had wished to establish and I think that a rather clearer view about the direction and speed of progress is essential. I would therefore suggest that our officials and CPRS discuss this further with BT in the light of the forthcoming CPRS report with a view to establishing a time-table of this kind.

Subject to your agreement on these points I would be willing to agree to the £200 million increase in BT's EFL for 1981-82. This should be announced by means of a PQ as soon as possible on the basis of a text agreed between our officials.

Copies of this letter go to the Prime Minister, to all members of E Committee and to Sir Robert Armstrong.

Leon

LEON BRITTAN

JH 115

Post + Telecomm

Mr Walters
Mr Duguid
Mr Wolfson

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

11 May 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of The Exchequer
HM Treasury
Parliament Street
London SW1P 3HE

12/5

Dear Geoffrey,

BRITISH TELECOM FINANCING

In my letter to you of 8 May, I referred to the need to find a long-term solution to British Telecom's financing problems. + PM

In this context, you may like to see a recent personal letter from Sir George Jefferson, which gives some idea of the strength of his feelings on the matter. I enclose a copy. In the light of the points which Sir George makes, I believe that we should make real progress by the early summer in identifying practical solutions to the problem, so as to enable the issue to be resolved within the timescale of our consideration of the Beesley report. I suggest that officials hold discussions without delay about different forms of a bond and any other options for a solution.

I am copying this letter, with a copy of Sir George's letter, to the Prime Minister.

Yours

Keith

British Telecom
from the Chairman
Sir George Jefferson CBE

British Telecom
2-12 Gresham Street
LONDON
EC2V 7AG

Telephone
National 01-357 3773
International +44 1 357 3773
Telex 883051
Prestel Page 383

16 April 1981

PRIVATE & PERSONAL

The Rt Hon Sir Keith Joseph Bt MP
The Secretary of State for Industry
Department of Industry
Ashdown House
LONDON SW1E 6RB

Dear Sir Keith,

This is a private and personal letter to you in confirmation of one aspect of our short private discussion on Tuesday.

In that discussion I indicated that I regard it as absolutely essential to my ability to run British Telecom as a satisfactory business and to lead it in the direction in which I believe the Government wishes, that a solution should be found to enable it to be seen that the BT Board will be free to raise finance outside the PSBR constraints, and in a manner suitable to its needs and the realities of the status of the business and its environment.

I do not regard the pressures from the Treasury for network privatisation, or short of that, the use of profit-linked bonds, as being realistic or attainable in the context of the current Bill and the present thoughts on regulation.

I hope my track record of support for privatisation of British Aerospace will serve to give credibility to my assertion that the above statement is related to practicalities, not to dogma on my part.

The form and publication of Beesley and the timescale in which the Government will now be committed to pronounce on it, add an urgency to the solution of this problem.

Whilst I recognise the difficulties of the Treasury, I must plead that the liberalisation aspects of the BT Bill put BT as a nationally-owned industry in a special situation, with a right and need for special treatment in this respect.

/If

PRIVATE & PERSONAL

If I am to maintain credibility as Chairman in the eyes of this organisation, I must have a solution to this problem in place by the time you reach conclusions on Beesley, particularly if those conclusions are anything like those originally envisaged.

We have therefore probably only until about the summer recess to solve this matter.

I am sorry to press this on you, but whilst I have all my life undertaken difficult tasks, I have also had to learn to recognise impossible ones. I must also make very clear the importance I attach to time for adjustment in relation to any major changes that you may envisage.

I hope we can discuss these matters further when I return from abroad.

Best wishes

Yours sincerely

SIR GEORGE JEFFERSON

CONFIDENTIAL

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
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Secretary of State for Industry

2

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

8th May 1981

Prime Minister

A progress report on BT.

Dear Chancellor

BT's INVESTMENT PROGRAMME

Thank you for your constructive letter of 10 April recognising the place of a modern telecommunications industry and infrastructure in the economic welfare of the nation.

2 For my part I recognise the difficulties any increase in BT's EFL has for your control of public expenditure and the PSBR totals. I have emphasised this point to Sir George Jefferson, with whom I have discussed the 3 sets of requirements you set out as preconditions for increasing BT's EFL for 1981/82 by £200m.

3 Sir George fully appreciated our concern about the £200m being used for investment and for no other purpose. He is prepared to provide auditors' certification to demonstrate that the money was used for capital expenditure. He has made clear to the Unions that a moderate pay settlement is essential to safeguard BT's investment programme. I am satisfied that both he and the Unions understand our position.

4 Your second requirement related to importing external expertise to assist BT achieve greater cost savings. The Prime Minister has suggested that this should also look at the opportunities for savings in the longer term, particularly from greater efficiency as new technology is introduced over the next few years, including the opportunity to break restrictive practices. Sir George fully accepts the need to restructure BT's organisation and functions and to introduce a proper financial and management accounting system into the business. He has already set up an integrated team under the new board member for finance, Mr Perryman, to achieve this and has asked both McKinseys and Coopers and Lybrand to assist the team.

CONFIDENTIAL

5 Coopers are well placed to look at BT's financial and management controls since they will have to audit the accounts. They are in particular being asked to help speed up the introduction of integrated modern management accounting systems at all levels in BT. McKinseys' role will be to assist BT in an organisational restructuring aimed at shortening lines of communication, coupled with a movement to profit centre accountability. They have looked at BT in the past and I am told that they have the right expertise to recommend improvements in efficiency of the kind the Prime Minister has in mind, notably in the areas at present affected by restrictive practices. I am sure Sir George is right in wanting McKinseys and Coopers to be closely involved with Mr Perryman's team so that BT management can identify with their recommendations - the point made by the Prime Minister - and so accept them more readily.

6 This will be a large exercise, involving a lot of top management time, and its aim will, effectively, be to transform long established civil service traditions into a commercial enterprise. In the short term Sir George sees little prospect of squeezing any more savings this year, beyond the £250m he has already achieved, without cutting back on the vital network modernisation programme. He emphasised that there would be a 4% growth in BT's overall system but no increase in staff in 1981/82. In the circumstances I do not think it businesslike to distract top management time from BT's main priority of reorganising itself in response to new competitive and technological conditions for the sake of a separate exercise with the outside consultants to find short-term savings which at best are likely to prove small. However, if potential savings come to light in the course of McKinseys' or Coopers' investigations, BT would of course implement them urgently with a view to helping to bridge the remaining financing gap in 1981/2; I know that BT have in mind to steer the course of the investigation so as to produce benefits as soon as possible. We may also have some particular ideas, relating principally to the medium and longer term, which we would want to see included in the terms of reference.

7 I am sure we should establish another financial target covering the next few years. As you acknowledge, the 6½% level agreed last summer may not be appropriate in present circumstances and I agree with the Prime Minister that the existing performance aim may also need redefining if we are to get BT fully committed to its achievement. I think we need to ask officials, in consultation with CPRS, to report on both these objectives as soon as possible in the light of the discussions which have already been set in hand with BT. In the meantime, and without prejudice to the level of financial target which we may decide is appropriate for 1982/83 onwards (which will have to be considered in some detail in the course of the Investment and Financing Review), I think I should say in announcing the £200m increase in BT's EFL what return on net assets in the current year

the Government expects BT to achieve. I think this should probably be 5%, which would be consistent with the last published target (approved by the last Government). It would compare with 4.6% achieved in 1980/1 and should give BT management a challenging task since on present forecasts they will only achieve a return of 3.7% without a November tariff increase and not more than 4.7% with one.

8 Finally, as regards competition and privatisation, Sir George was prepared to accept the fact that BT would have to adjust to the competitive environment envisaged by Beesley, although he wanted to see clarified your suggestion that BT absorb any costs arising within their EFL. Whether or not these costs can reasonably be absorbed will of course depend on an evaluation of Beesley which has yet to be made.

9 On privatisation, Sir George explained that BT was actively considering ways and means of setting up separate subsidiaries in whichever areas of its activity there was a commercial reason to do so. Work is most advanced in the area of attachments and it is here that we might expect some results in the shorter term. BT is prepared to outline its thinking here in further discussions with officials.

10 I believe that Sir George is fully aware of the need to satisfy both the Government and the public and that BT is making every effort to put its own house in order and that it is not seeking an increase in its EFL to cover up its own deficiencies. I therefore suggest that officials should get together now with CPRS and BT as the Prime Minister suggests, and agree on the terms of an announcement to be made as soon as possible.

11 At the same time, I do not think we should give up our efforts to find a long-term solution to BT's financing problem consistent with our public expenditure and PSBR requirements. Sir George reiterated his interest in some form of bond and there may also be some possibility in joint leasing companies with the private sector. Now that we are agreed about the commercial justification of an adequate telecommunications investment programme, I am sure that we need to find new mechanisms for financing it consistent with our policy for introducing greater private sector capital and say into the public sector. We invited the CPRS to report on this subject some time ago and I suggest we re-examine possibilities as soon as we have the report, bearing in mind particularly the desirability of promulgating clear public guidelines as envisaged by the Prime Minister.

12 I am copying this letter to the Prime Minister, to members of E Committee and to Robin Ibbs and Sir Robert Armstrong.

Yours sincerely Richard Riley

for KEITH JOSEPH
(Approved by the Secretary of State and signed in his absence)

Pst v Pol

10 DOWNING STREET

Mr Lankester TL 1/5

I doubt if the PM needs to see this yet.

CPRS and DoI have good reasons for preferring McKinseys or Coopers to the MMC.

A letter from KJ will make these points shortly.

Andrew D.
30/4.

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

cc Cabinet Office
CPRS

Post
&
Tels NBorn

cc A Walters
A Duguid
D Wolfson

From the Secretary of State

CONFIDENTIAL

Tim Lankester Esq
10 Downing Street
London, SW1

29 April 1981 29/4

Dear Tim,

My Secretary of State has seen the correspondence on BT's investment programme, resting with your letter to John Wiggins of ~~14~~ April.

My Secretary of State agrees that there is a case for an outside enquiry into possible cost savings. He suggests that further consideration by officials should be given to the form of such an enquiry before a final decision is taken. There seems much merit in continuing to build up the use of the Monopolies and Mergers Commission as the principal instrument for investigations into the costs and efficiency and standards of service of nationalised industries unless there are compelling reasons to the contrary. In that way the Commission build up experience of the industries which in turn can further increase their effectiveness. The Commission themselves use management consultants where appropriate. Their reports so far on nationalised industry references have been searching and realistic. As to whether management would identify itself better with an enquiry mounted by consultants rather than by the Commission, he thinks that while there is a risk of some management hostility to any external enquiry wished upon an organisation by Government, the Commission has so far established a good working relationship with the bodies it has investigated under Section 11.

Yours ever,

Nicholas McInnes

N McInnes
Private Secretary

CONFIDENTIAL

29 APR 1981

CONFIDENTIAL

JS

cc last para + ~~AW~~ ~~AD~~ DW

10 DOWNING STREET

From the Private Secretary

14 April 1981

Dear Tim.

BT's INVESTMENT PROGRAMME

The Prime Minister has read the Chancellor's letter of 10 April to the Secretary of State for Industry about BT's investment programme. She agrees with the Chancellor's proposition that £200 million should be added to BT's EFL for 1981/82 for investment purposes on certain conditions - subject to the following points:

(i) The Prime Minister very much agrees that there should be an explicit understanding that the £200 million should be used for investment and for no other purpose.

(ii) As regards the condition that there should be an outside inquiry into cost saving, the Prime Minister suggests that this should look not only at cost saving in the immediate future but at the opportunities for greater efficiency which will rise as new technology is introduced over the next few years. For example, the latter should provide a unique opportunity for breaking restrictive practices. With this in view, the Prime Minister feels that it might be better to use management consultants to carry out the inquiry rather than the Monopolies and Mergers Commission. This would make it more likely that BT's management would identify itself with the inquiry and see it as a useful management tool.

(iii) The Chancellor acknowledges that the 6½ per cent financial target agreed by Ministers last summer may not be appropriate in present circumstances. The Prime Minister believes that there may also be some doubt about the appropriateness of the existing aim of a 5 per cent annual reduction in real unit costs which the Chancellor proposes to observe. This objective was set in very different economic circumstances, and it might be desirable for it to be re-defined along with the financial target.

(iv) The Prime Minister very much agrees that rapid progress should be made on competition and privatisation, and with the

/ implementation

JS

implementation of the proposals in the Beesley Report. However, she believes that further studies should not be confined to the creation of private regional companies: for there may be more promising options, for example, in the creation of joint ventures in the attachments and services fields, and competitive alternative networks.

(v) The Chancellor refers in his penultimate paragraph to the difficulty of devising alternative methods of financing, and he expresses the hope that BT will come up with further ideas in this area. In the Prime Minister's view, the need is much more for the Treasury and for the Department of Industry to agree on clear, and not hopelessly impossible, rules which could be made known in the City so that we can tap the resourcefulness of wider interests.

(vi) The Prime Minister assumes that there will need to be further discussions about the announcement of the £200 million increase in the EFL, and the associated conditions. She suggests that the CPRS might be involved in these discussions.

I am sending a copy of this letter to the Private Secretaries to members of E Committee and to David Wright (Cabinet Office).

Tim Lankester.

A.J. Wiggins, Esq.,
HM Treasury.

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

14 April 1981

Nick Sanders Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

cc Mr Ingham
return to MJS pl

Dear ~~Nick~~ MJ

TELECOMMUNICATIONS: LIBERALISATION

Because of pressures on tomorrow's Parliamentary timetable the Chancellor of the Duchy asked my Secretary of State if it would be possible for him to shorten the statement circulated under cover of my letter to you of 13 April.

In the light of the Chancellor of the Duchy's request, my Secretary of State now proposes to make the attached statement tomorrow.

I am copying this letter and the attachment to recipients of earlier drafts of the statement.

Yours ever
Richard

RICHARD RILEY
Private Secretary

With permission, Mr Speaker, I wish to make a statement about liberalisation of telecommunications in the United Kingdom.

2 On 21 July last year, I outlined to the House new competitive arrangements covering apparatus attached to the telecommunications network. Independent standard making and certification bodies are now at work on rules which will replace British Telecommunications' monopoly over approvals of apparatus. Both BT and the private sector are making arrangements to supply apparatus in competition.

3 Today, I am publishing an economic survey by Professor Beesley which reaches radical conclusions about network services. Copies have been placed in the Libraries of both Houses. Professor Beesley recommends full freedom for private sector suppliers to use the national network to provide telecommunications services to third parties. He envisages BT setting an open and uniform price for all users of its network irrespective of whether the users re-sell any of the capacity they lease. Professor Beesley recommends that private companies should be able to lease circuits - parts of the network - from BT and sell to the public telecommunications services carried on those circuits.

4 Professor Beesley points out that data and voice communication technologies are rapidly converging, making the existing BT monopoly arbitrary and constricting. He argues that, if private firms were free to use the network, this would bring

about innovation and substantial consumer benefits. BT would lose some revenue to its competitors but much of this should be offset by increases in traffic as the private sector provided more services using the BT network. BT would be free to compete subject to safeguards of fair competition.

5 If Professor Beesley's recommendation were adopted, I would expect BT to be spurred to provide an even better service. New profitable enterprises and new jobs would be generated as both BT and new entrants stretched themselves to capture new, and in many cases as yet unknown, markets.

6 Professor Beelsey's report marks a clean break from previous approaches. Implementation of his recommendation would transform the UK market for telecommunications.

7 The Government is attracted by the free market, please-the-customer, arrangements recommended by Professor Beesley. The implications are, however, far reaching and I am inviting views over the next two months before coming to detailed decisions in July. I hope BT will participate in working out the implications and details of what is recommended.

8 Although outside his terms of reference, Professor Beesley has also considered the implications of possible liberalisation of use of BT's international cirucits and of possible competition for the main BT network within the UK. The free use of international circuits raises complexities and I am inviting BT to

comment. I indicated in my statement of 21 July that I intended to explore the scope for allowing the provision of additional transmission services. A number of organisations have been investigating the market possibilities and I will make a further statement on this subject as soon as possible.

9 In discussing the implications of network liberalisation, Professor Beesley stresses the need for removal of constraints on BT's capital investment. Mr Speaker, the Government recognises the importance of a modern telecommunications infrastructure to the development of the whole economy and, within the inevitable constraints imposed by the need to control public expenditure and the PSBR, I am discussing with BT the possibility of increasing the amount of external finance available to safeguard BT's vital investment programme.

10 The opportunities for both BT and others over the whole field of telecommunications equipment and services are immense. The quicker BT and its competitors respond by expanding their range of products, systems and services the better.

PV

CONFIDENTIAL

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
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PA

MJS

PS/ Secretary of State for Industry

cc Press Office
+ return to MJS please

13 April 1981

N J Sanders Esq
Private Secretary
10 Downing Street
London SW1

Dear Nick

TELECOMMUNICATIONS: LIBERALISATION

My Secretary of State has seen John Halliday's letter of 7 April about the proposed statement on Professor Beesley's Report.

In the light of the views expressed by the Home Secretary, and following discussions between officials, my Secretary of State has prepared the attached revised statement which he understands will be acceptable to the Home Secretary. This allows for collective Ministerial consideration of the aspects of the Report which are of particular concern to the Home Secretary before the Government makes any substantive comment on them.

My Secretary of State now proposes to make this statement on 15 April.

I am sending copies of this letter to John Halliday and the recipients of his letter of 7 April.

Yours ever

Richard.

CONFIDENTIAL

With permission, Mr Speaker, I wish to make a statement about the Government's policy on moving towards greater freedom in the telecommunications market in the United Kingdom.

2 On 21 July last year, I explained to the House the framework for new competitive arrangements covering apparatus attached to the British telecommunications network. Since then we have made good progress. Independent standard making and certification bodies are now at work on rules which will replace the present monopoly over approvals of apparatus enjoyed by British Telecommunications (BT). Both BT and suppliers are gearing themselves for the competitive era.

3 Today, I am publishing the report which I commissioned from Professor Beesley on the subject of network services. I have arranged for copies to be placed in the Libraries of both Houses.

4 Professor Beesley has completed an economic survey of the impact of complete freedom of network use. His conclusions are radical. He recommends full freedom for private sector suppliers to use the national network to provide telephone and telecommunications services to third parties. He envisages BT setting an open and uniform price for all users of its network irrespective of whether the users re-sell any of the capacity they lease. This means that private companies, in Professor Beesley's view, should

be able to lease circuits - parts of the network - from BT and sell to the public telecommunications services carried on those circuits.

5 Professor Beesley bases these radical suggestions on the premise that data and voice communication technologies are rapidly converging, making the boundary of the existing BT monopoly arbitrary and constricting. He argues that, if private firms were free to use the network in innovative ways, this would bring substantial consumer and user benefits which would outweigh his projection of the possible maximum loss - some 2% of turnover - of net revenue by BT which would result from the reduction in its monopoly. One reason for this small effect is that any loss of revenue should be offset to some extent by increases in traffic as more and more services are provided by the private sector. BT would be free to compete subject to minimum safeguards to ensure fair competition.

6 If Professor Beesley's recommendation were to be adopted, I am confident that BT would be spurred to provide an even better service. I also envisage new profitable enterprises and new jobs being generated as both BT and new entrants stretch themselves to capture a share in new, and in many cases as yet unknown, markets.

7 Professor Beesley's report marks a clean break from previous approaches. Implementation of his recommendation would transform the UK market for telecommunications.

8 The Government is attracted by the free market, please-the-customer, regime recommended by Professor Beesley. It would promote the UK as a leading world communications centre. The implications are, however, far reaching and I propose to invite views over the next two months before coming to detailed decisions in July. I will be inviting BT to participate in working out the implications and details of what is recommended.

9 In the course of his report, although outside his terms of reference, Professor Beesley also briefly considers the implications for his main findings of the possible liberalisation of use of BT's international circuits and of the possible introduction of competition to the main BT network within the UK. His suggestions on these subjects are being considered.

10 As Professor Beesley himself recognises, in the case of the use of international circuits the international dimension raises additional complexities. I am inviting BT to make their comments to me.

11 On the provision of additional transmission services, the House will recall that I indicated in my statement of 21 July that I intended to explore the scope for allowing the private sector to provide such services. I am aware that a number of organisations have been investigating the market possibilities and I will make a further statement on this subject as soon as possible.

12 Finally, in discussing the implications of network liberalisation, Professor Beesley stresses the need for removal of constraints on BT's capital investment. Mr Speaker, the Government recognises the importance of a modern telecommunications infrastructure to the development of the whole economy and, within the inevitable constraints imposed by the need to control public expenditure and the PSBR, I am discussing with BT the possibility of increasing the amount of external finance available.

13 The opportunities for both BT and new market entrants over the whole field of telecommunication equipment and services are immense. The quicker we seize these opportunities and expand our range of products, systems and services at home the better for us as users and as providers both in the domestic and in the highly competitive but ever expanding world communication market.

14 APR 1981

E. D. Wolfson
A Walters
A Duguid

Prime Minister
The Chancellor has at last taken a decision on BT's investment programme. There are some useful CPRS comments below; if you agree, I will pass them on to the Treasury and D of I as representing your views. Content?
TL 13/4

Yes

CONFIDENTIAL

Qa 05317

To: MR LANKESTER

From: J R IBBS

13 April 1981

BT's Investment Programme

Flag A

1. You asked for our views on the Chancellor's letter of 10 April to the Secretary of State for Industry.

2. We agree that the £200m. of investment immediately at issue for 1981/82 is fully justified on cost saving and wider industrial grounds. We also agree generally with the three conditions proposed by the Chancellor, subject to certain reservations.

Condition (1): We agree that there should be an explicit understanding that the £200m. should be used for investment and for no other purpose.

Condition (2): We agree that there should be an outside enquiry into cost saving. This should, however, look not only at cost saving in the immediate future but at the opportunities for greater efficiency which will arise as new technology is introduced over the next few years. For example, this should be made to provide a unique opportunity for breaking restrictive practices. This suggests to us that, of the alternatives proposed by the Chancellor, there may be merit in using management consultants rather than the Monopolies and Mergers Commission. We want BT management to identify itself with the enquiry and to see it as a useful management tool: we would hope they would see management consultants as useful reinforcements to their own efforts.

The Chancellor acknowledges that the $6\frac{1}{2}$ per cent financial target agreed by Ministers last summer may not be appropriate in present circumstances. In our view there is equally some doubt about the appropriateness of the existing aim of a 5 per cent annual reduction in real unit costs which the Chancellor proposes to preserve. This objective was set in very different economic circumstances and, in our view, should be redefined along with the financial target.

Condition (3): Like the Chancellor we feel that rapid progress should be made on competition and privatisation, and with the implementation of the proposals in the Beesley Report. We believe, however, that further studies should not be confined to the creation of private regional companies: there may be more promising options, e.g. in the creation of joint ventures in the attachments and services fields, and competitive alternative networks.

3. We have two further points on the Chancellor's letter:

(i) In his penultimate paragraph he refers to the difficulty of devising alternative methods of financing, and hopes that BT will come up with further ideas in this area. In our view the need is much more for the Treasury and the Department of Industry to agree on clear, and not hopelessly impossible, rules which could be made known in the City so that we can tap the resourcefulness of wider interests.

(ii) There will need to be further discussions about the announcement of the £200m. increase in the EFL, and the associated conditions. We suggest that the latter should be agreed between the Departments concerned and that the CPRS might be involved.

4. I am sending a copy of this minute to Sir Robert Armstrong.

JH

CONFIDENTIAL

File

GWP

BF 13/4/81

Posts Telecoms

10 DOWNING STREET

From the Private Secretary

MR. IBBS
CABINET OFFICE

I should be grateful for your views on the Chancellor's letter of 10 April on BT's investment programme. Since the Prime Minister is leaving on Tuesday, could I please have this by Monday evening?

I am sending a copy of this note to David Wright (Cabinet Office).

T. P. LANKESTER

10 April 1981

CONFIDENTIAL

~~Sir~~ D. Wolfson.
A. Walters
A. Duguid.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

10 April 1981

The Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

P 10/4

Dear Keith

BT'S INVESTMENT PROGRAMME

You wrote to me on 5 March about the problems that we face in providing for BT's investment programme in 1981-82 and thereafter and your letter included financing proposals which attempted to deal with the problem.

I share the view - as clearly do the Prime Minister and Robin Ibbs also - that a modern telecommunications industry is essential for the UK's future industrial and commercial prosperity and that we should if at all possible enable BT to maintain a programme of investment adequate for this purpose. There is no doubt room for argument as to precisely what level is adequate at any time. But I have little doubt that the £200m of investment that is immediately at issue for 1981-82 can be justified both in terms of cost-saving to BT and on wider industrial grounds. As you say, Treasury officials (in collaboration with your Department and BT) have been involved in quantifying the benefits of this tranche of investment. The cost-savings alone are very striking, even if other benefits such as improvements in quality, developments in new services and spin-off to the private sector are left out of account.

My problem is how to agree to this investment - which will mean increasing BT's 1981-82 EFL - without putting the public expenditure and PSBR totals at risk. The importance of keeping control over these aggregates for the remainder of this Parliament hardly needs emphasis. I am bound to say that your proposals do not appear to overcome the problem. While BT remains in the public sector - in other words, short of a degree of privatisation not yet envisaged - sums raised by BT whether from the NLF or private sector sources

/are part of the PSBR.

are part of the PSBR. Despite this I have been anxious to see if more direct methods of market borrowing through some form of BT bond could bring benefits to monetary control and greater market disciplines on BT's performance. My officials and yours have had a number of discussions with BT and Warburgs, but the various proposals considered so far do not seem to offer benefits of this kind.

For the immediate future any increase to BT's EFL in 1981-82 will therefore have to come from the Contingency Reserve. The reserve, although larger than in previous years, is barely adequate in relation to the uncertainties (eg arising from possible developments in coal or steel) that lie ahead. To allocate £200m to BT now must involve considerable risk that other desirable but currently unforeseen expenditure will be squeezed out later or that we will exceed the planned totals.

Nor is £200m the end of the story. As your letter makes clear, BT are likely to be seeking a further increase later this year. Your letter refers to a total of £450m. I understand that BT have now revised their estimate of total requirements downwards to £320m, ie £120m above the £200m immediately at issue. This reduction is welcome as far as it goes. But with demands as large and as volatile as this, there must be a real danger either that we face a succession of claims by BT during the year or that money that we make available for investment in systems modernisation is used instead to make up shortfalls in revenue or to cover cost escalation. It is essential to guard against both possibilities - and I have a number of points to make in relation to this. However, for the present, while I take note of BT's estimate of their likely requirement, I can give no undertaking that further funds will be made available for BT later this year. Indeed, I would expect BT to take all steps available to them to minimise the need for more. Settlement of a pay increase at a level no higher than assumed in their EFL calculations is one vital aspect of this: I would regard an excessive settlement as eroding their claim to further funds this year.

There are a number of conditions - concerning the use to which additional finance is put, the need to cut costs and increase efficiency, and progress towards increased competition and privatisation - that seem to me essential counterparts to an immediate increase of £200m in their EFL.

/First, we must have

First, we must have an explicit understanding from Sir George Jefferson that the £200m is used for investment and for no other purpose. This assurance would need to be supported by appropriate accounting arrangements to ensure this. It would be intolerable if the money were to be used for general support or to concede excessive pay increases. All in BT and the unions must accept that it was earmarked for investment only.

Second, there must be a wide-ranging and sustained drive by BT to cut costs and improve efficiency. I suspect that there is ample scope for this - see, for example, their failure to control stock levels which was a factor underlying the EFL increase in 1980-81. A number of lines of approach seem to me to be necessary. We need to ensure that the approach to cost-saving is radical and determined, and for this some form of outside enquiry is, as you imply, essential. The Monopolies & Mergers Commission is one possibility. Their recent enquiries into the Post Office and the commuter railway have been thorough and useful. They have relevant resources which they could supplement as necessary by hiring consultants. Alternatively it would be possible to employ management consultants direct. If so, it would be necessary to see that they had a remit sufficiently wide to allow them to investigate efficiency, manning levels, restrictive practices, and not simply the financial aspects of the business. A wide-ranging enquiry, however conducted, is bound to take time. But if it were mounted quickly with a requirement to produce an interim report within 3 months some of the benefits should come through in the present financial year. I should like my officials to be consulted about the terms of reference of the enquiry.

To buttress this effort we need a satisfactory agreement with BT about the level of their financial target and about performance aims. The existing published financial target is 5 per cent return on assets, but last summer E Committee increased this to 6 per cent for 1980-81 and 6½ per cent thereafter, although these increases have never been announced. This is an unsatisfactory position. If 6½ per cent is an over-ambitious objective for a recession year, I should like to know what level you think should be adopted. As far as the performance aims are concerned, BT will have to make real efforts to recover lost ground in relation to these. Here, after doing quite well for two years, they came badly adrift in 1980-81. As a starting point they should for the next two years (which are the remaining years of the target period) adhere to the level implied by the existing

/aim ie a 5 per cent

aim ie a 5 per cent annual average reduction in real unit costs.

My third condition concerns increased competition and privatisation. Again there are two sides to this. First, BT must work positively with the changes proposed in the Beesley report, if we finally decide (as I imagine we may well do) to adopt its recommendations; and they should be ready to absorb any costs arising within their EFL. Second, there is the privatisation of the central network. Many of our problems in financing BT's investment programme would disappear to the extent that the Corporation's assets could be transferred into the private sector. I realise that we cannot hope for significant progress in 1981-82 but we should go as far and as fast as we can. I know that thought is being given to regionalising BT's accounts. What I think is lacking is a firm time-table covering this and all the subsequent stages - establishing subsidiaries or preferably associated companies, legislative action, and so on- which would ensure that action is carried forward. Any help that management accountants can give to this exercise (as you have in mind) is welcome. But the main thing is to establish a time-table quickly and then to keep up the pressure.

All these elements are necessary if BT's demands for increased funds are to be met within agreed totals for 1981-82 and if we are to take some steps towards avoiding a recurrence of this problem in subsequent years. I do not see any other basis on which I could be expected to agree to such a substantial increase (£200m) as is currently proposed. As it is, we will not wholly eliminate the threat to overall public expenditure arising from BT's position.

Finally, I confess to some frustration and disappointment that we have not collectively been able to devise some alternative methods of financing that would both tap new sources of savings and bring market disciplines to bear on BT's performance. I very much hope that BT will come up with further ideas in this area. So long as the criteria above can be met we shall give them every encouragement.

The next step is for your officials (in consultation with mine) to hold urgent discussions with BT to secure their agreement on the various conditions I have proposed.

/Subject to that

Subject to that I would be willing to agree to an immediate increase in their 1981-82 EFL of £200m. This will of course need to be announced as soon as possible.

In view of the importance of this issue, I am copying this letter to the Prime Minister, to all members of E Committee, and to Sir Robert Armstrong.

GEOFFREY HOWE

From: THE PRIVATE SECRETARY

Post and Telecoms

CONFIDENTIAL

HOME OFFICE
QUEEN ANNE'S GATE LONDON SW1H 9AT

7 April 1981

✓ MJS

I have told the PM that the statement has been deferred MJS 7/4

Dear Nick,

TELECOMMUNICATIONS: LIBERALISATION

The Home Secretary has seen the minute of 3 April from the Secretary of State for Industry, with the draft of a statement on Professor Beesley's Report, upon which he invited views.

The Home Secretary believes that if the recommendations in the Report were given full effect they would have security implications both on his side, and for the Foreign and Commonwealth Secretary (who has now been sent a copy of the proposed statement). He takes the view that the recommendations in the Report will need careful study here and in the Foreign and Commonwealth Office, and further discussion with the Department of Industry. While the draft statement does not commit the Government to how, or to how far, effect should be given to the Beesley Report's recommendations, the Home Secretary believes that its tone - even in the amended version circulated with Ian Ellison's letter of 6 April - will be taken as a warm endorsement of the Report, and to that extent will prejudge the important discussions which are necessary. A shorter and more neutral statement was not, I understand, acceptable to the Secretary of State for Industry.

With this consideration in mind, and the understandings reached previously on the maintenance of digital PABXs, the Home Secretary believes it right that the Ministers concerned should have an opportunity to consider the issues more fully before a statement of the sort proposed is made. I have passed on the Home Secretary's views to Ian Ellison in Sir Keith Joseph's office, and I understand that the statement has now been deferred.

I am sending copies of this letter to the Private Secretaries to the Chancellor of the Exchequer, the Secretary of State for Foreign & Commonwealth Affairs, the Secretaries of State for Trade, Industry and Transport, the Chief Whip, Sir Robert Armstrong and Mr. Ibbs.

Yours ever,

John Halliday

J. F. HALLIDAY

N. J. Sanders, Esq.

CONFIDENTIAL

-7 APR 1987

CONFIDENTIAL

FILE

Parl. & Ind

PA

10 DOWNING STREET

From the Private Secretary

6 April,1981

Telecommunications Liberalisation

The Prime Minister has seen your Secretary of State's minute of 3 April. She is content for him to make an oral statement along the lines he suggests tomorrow, subject to the agreement of other colleagues concerned, including the Home Secretary.

I am copying this letter to John Wiggins (HM Treasury), John Halliday (Home Office), Stuart Hampson (Department of Trade), Tony Mayer (Department of Transport), Murdo Maclean (Chief Whip's Office), Nick Huxtable (Chancellor of the Duchy of Lancaster's Office) David Wright (Cabinet Office) and Robin Ibbs (CPRS).

N. J. SANDERS

I Ellison, Esq
Department of Industry

CONFIDENTIAL

Vos 1 E/ 9/4

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

NOTE

Statement deferred for further consideration by Home Office, FCO + DOI

NBPM at this stage

MS 7/4

Secretary of State for Industry

6 April 1981

John Halliday Esq
Private Secretary to the Home Secretary
Queen Anne's Gate
London SW1

Dear John

TELECOMMUNICATIONS: DRAFT STATEMENT

... I enclose a revised version of the draft statement which my Secretary of State plans to make tomorrow, 7 April. This includes a number of changes designed to meet the Home Secretary's reservations about the text enclosed within my Secretary of State's minute of 3 April.

2 It would be most helpful if you would let me know before 11.30am tomorrow whether the amended draft is acceptable to the Home Secretary.

3 Copies of this letter go to Francis Richards (FCO), John Wiggins (Treasury), David Hayhoe (CDL), Stuart Hampson (Trade), Tony Mayer (Transport), Robin Ibbs and David Wright. A copy also goes to Nick Sanders (No 10) and Mr Heap in the Foreign + Commonwealth Office.

Yours ever

Ian

I K C ELLISON
Private Secretary

DRAFT STATEMENT

With permission, Mr Speaker, I wish to make a statement about the Government's policy on moving towards greater freedom in the telecommunications market in the United Kingdom.

2 On 21 July last year, I explained to the House the framework for new competitive arrangements covering apparatus attached to the British telecommunications network. Since then we have made good progress. Independent standard making and certification bodies are now at work on rules which will replace the present monopoly over approvals of apparatus enjoyed by British Telecommunications (BT). Both BT and suppliers are gearing themselves for the competitive era.

3 Today, I am publishing the report which I commissioned from Professor Beesley on the subject of network services. I have arranged for copies to be placed in the Libraries of both Houses.

4 Professor Beesley has completed an economic survey of the impact of complete freedom of network use. His conclusions are radical. In his principal findings he recommends full freedom for private sector suppliers to use the national network to provide telephone and telecommunications services to third parties. He envisages BT setting an open and uniform price for all users of its network irrespective of whether the users resell any of the capacity they lease. This means that private companies, in Professor Beesley's view, should be able to lease

/circuits ...

circuits - parts of the network - from BT and sell to the public telecommunications services carried on those circuits.

5 In the course of his report Professor Beesley also suggests progressive liberalisation of the use of international telephone and telecommunications links from the UK, subject to the payment of a royalty to BT. This would mean that consumers would have a greater choice of international telecommunications services. In addition, Professor Beesley recommends that it would be consistent with a policy of liberalisation to consider allowing the provision of additional networks. Finally, he stresses the need for removal of constraints on BT's capital investment. Professor Beesley bases these radical suggestions on the premise that data and voice communication technologies are rapidly converging making the boundary of the existing BT monopoly arbitrary and constricting.

6 I turn to Professor Beesley's main recommendation, full freedom for private sector suppliers to use the national network to provide services to third parties. The national network is a national, and not exclusively a BT, asset. Professor Beesley argues that, if private firms were free to use the network in innovative ways, this would bring substantial consumer and user benefits which would outweigh his projection of the possible maximum loss - some 2% of turnover - of net revenue by BT which would result from the reduction in its monopoly. One reason for this small effect is that any loss of revenue should, be offset to some extent by increases in traffic as more and more services are provided by the private sector. BT would be free to compete

/subject

subject to minimum safeguards to ensure fair competition.

7 If Professor Beesley's recommendation were to be adopted, I am confident that BT would be spurred to provide an even better service. I also envisage new profitable enterprises and new jobs being generated as both BT and new entrants stretch themselves to capture a share in new, and in many cases as yet unknown, markets.

8 Professor Beesley's report marks a clean break from previous approaches. Implementation of his recommendation would transform the UK market for telecommunications.

9 The Government is attracted by the free market, please-the-customer, regime recommended by Professor Beesley. It would promote the UK as a leading world communications centre. The implications are, however, far reaching and I propose to invite views over the next two months before coming to detailed decisions in July. I will be inviting BT to participate in working out the implications and details of what is recommended.

10 I turn now to Professor Beesley's suggestions. I shall be considering further his ideas concerning liberalisation of the use of international circuits, though, as he himself recognises, the international dimension raises additional complexities. I am inviting BT to make their comments to me.

11 On the provision of additional transmission services the House will recall that I indicated in my statement of 21 July that I

/intended ...

intended to explore the scope for allowing the private sector to provide such services. I am aware that a number of organisations have been investigating the market possibilities. I now invite all those with an interest in this subject to submit proposals and comments before the end of June so that the Government can consider the implications of licensing an additional network later this year, following enactment of the BT Bill. We shall ensure that any comments by BT are taken carefully into account before any decisions are taken. I will also be considering the rules for interconnection of existing private networks and any new network with the main BT network.

12 Finally, Mr Speaker, the Government recognises the importance of a modern telecommunications infrastructure to the development of the whole economy and, within the inevitable constraints imposed by the need to control public expenditure, we will seek to provide BT with the greatest possible freedom to proceed with its investment plans.

13 The opportunities for both BT and new market entrants over the whole field of telecommunication equipment and services are immense. The quicker we seize these opportunities and expand our range of products, systems and services at home the better for us as users and as providers both in the domestic and in the highly competitive but ever expanding world communication market.

1. MR. ~~SANDERS~~

2. PRIME MINISTER

c.c. Mr. Ingham

Given the "radical" nature of these proposals, involving opening up the domestic and international networks to competition, I am sure that we must await the Home Secretary's advice before going ahead with this.

MJS 3/4

Sir Keith Joseph wishes to make an oral statement on Tuesday setting out his further plans for privatising British Telecoms: first, the provision of additional services over BT's network; and second, the provision of additional network and transmission services in competition with BT. The first of these is somewhat controversial because of the adverse effect some argue it would have on BT's revenue. But Professor Beesley of the London Business School has concluded we should not be worried about this effect. Nonetheless, Sir Keith feels it is prudent to ask for comments before a final decision is taken. Professor Beesley's report will be published on Tuesday at the same time.

Provided other Departments, in particular the Home Office, are content, do you agree that Sir Keith should make this statement and that Beesley's report should be published?

Yes - if Home Secretary agrees. MT

T.L.

3 April, 1981.

cc Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Strauss

MR. LANKESTER

BT PROPOSAL

I can well argue the case that British Telecom investment might have such a high rate of return, say 30%, that it would be well worth incurring an additional £½Bn on the PSBR this year if we were to thereby reduce it by £170 million in all years subsequently. Indeed as a tax payer I would not mind paying an additional £100 today ~~or~~ this year if I were to receive a remittance of £33 from my taxes in all subsequent years. Therefore you may well argue that there should have been an increase of half a penny on the standard rate in order to pay for BT's investment this year, which would reduce the PSBR back to £10½Bn.

The choice is an interesting one, but there is of course nothing sacrosanct about £10½Bn, and as you know I would have preferred an even lower figure. But if you have an enormously profitable investment, and everyone argues that the BT investment is desperately needed, then somehow it must be financed. That is the only point I was making. We cannot, or at least we should not, stick at an arbitrary cut-off.

AW

3 April 1981

JFF

cc Mr Hoskyns
Mr Ingham
Mr Wolfson

PRIME MINISTER

TELECOMMUNICATIONS LIBERALISATION

I am convinced that most of the problems associated with British Telecommunications (BT) - delays with connections, high charges, slow introduction of modern equipment, the stranglehold of the Post Office Engineering Union - flow from its monopoly and the consequent lack of competition.

2. The BT Bill paves the way for a major opening out of competition in the supply of telecommunications services. This should secure a badly needed improvement in attitudes, efficiency and customer service whilst reducing unit costs and stimulating a host of new business activities some of them as yet undreamed of; indeed the threat of competition has already brought about a sharpening of BT's attitudes in recent months. I foresee this country becoming a focal point for telecommunications services exploiting our national skill in software and innovation and providing new jobs and new scope for small businesses. I am also planning measures which will make it possible in the longer run to privatise a substantial part of BT's activities.

3. This minute seeks colleagues' agreement to two immediate further steps towards greater freedom in the telecommunications market.

4. I announced, on 21 July last year, the broad outline of our plans to introduce greater competition in three aspects of telecommunications. The first concerns the freedom of private sector companies to supply business and consumer apparatus for connection to the telecommunications network in competition with BT. The main

/element

element of this part of our policy was published last July and detailed practical arrangements are evolving well in consultation with user and producer interests, BT and the unions. As you know, we recently announced a substantial further relaxation of BT's monopoly in the maintenance of digital stored programme controlled ~~digital~~ PABXs.

4 The second and third strands of our plans embody:

(a) greater competition in the supply of value added network services (private sector provision of services over the network owned by BT); and

(b) additional telecommunications services (private sector provision of additional telecommunications networks in competition with BT).

5 There is a risk that these services might divert revenue away from BT and push up domestic telephone rental charges which are at present subsidised by uneconomically high long-distance charges.

6 The problem, as it relates to the freedom to offer services over BT's network, has been examined by Michael Beesley, a professor of economics at the London Business School. I attach a copy of his report. He has concluded that BT's potential loss of revenue would be small in relation to its turnover.

7 Under the worst case assumptions, and I stress that they are the worst, BT's potential loss of revenue by 1984-85 could be recouped by an increase of £6.4 in the annual domestic telephone rentals by then expected to be £60 (that is, an increase of 11%). But

 /in ...

in practice the effect of diverting traffic away from BT is likely to be very much less. Beesley points out that any loss of revenue will tend to be offset because demand would be stimulated by competition and this would work through into a greater demand by service operators for leased BT circuits. Moreover, in practice, BT has already started to move towards equalising its returns from local and long-distance traffic by raising domestic rentals and local charges more than long-distance charges. Beesley recommends complete freedom for private sector firms to use the BT network subject to certain safeguards to ensure fair competition. Beesley's pres cription would have the added advantage of requiring very little regulatory effort; complete freedom of network use for value added services could be accomplished by the issue of a single irrevocable general licence under the powers contained in the BT Bill.

6 Private sector provision of additional telecommunications networks in competition with BT was outside Beesley's terms of reference. He has argued, however, on the basis of US experience (the only available guide) that the practical effect of allowing competition in the provision of networks would be small but that it would have an important influence on BT's behaviour. Competition would provide a market, as opposed to regulatory, safeguard against overcharging, delays and poor service by BT, particularly for business users.

7 Beesley's arguments are persuasive. His conclusions have, nevertheless, been challenged by BT and are likely to be criticised by the POEU. Both gave detailed evidence on the unrestricted use

/of ...

of BT lines during the study and the indications are that both recognise their defensive arguments as thin - the total estimated loss of revenue is an insignificant percentage of BT's annual turnover. However, there has, of course, been no public debate on Beesley's findings and I, therefore, think that it would be appropriate to publish his report and to invite public representations before final policy decisions are taken. But I consider that there should be a firmly positive ministerial response now.

8 I would like, at the same time, to carry forward the other strand of policy to which I have referred - namely the provision of additional network and transmission services in competition with BT. The impact of this demonopolisation is, however, difficult to judge in advance. US experience suggests that the number of competitors will be small. The extent of competition will depend on complex market judgements and on the costs involved. I would, therefore, like to issue a general invitation for proposals from private interests before policy decisions are taken, as an even-handed and effective way of securing basic information on which such decisions must rest. The Department has kept in touch with Cable & Wireless (C&W) about the proposal for an independent business network that C&W has been investigating with BP and Barclays. There would be certain advantages if additional network services, at least on a national scale, were to be provided by an organisation like C&W with a sizeable Government shareholding. But I do not wish at this stage to limit consideration to a single consortium.

9 I intend to publish the Beesley report on 7 April, the earliest

/practicable ...

practicable date after the BT Bill has left the House of Commons. On the same day I would propose to make a statement along the ... lines of the attached draft to which I seek colleagues' agreement.

... 10 I am sending copies of this minute and the attachment to the Chancellor of the Exchequer, the Home Secretary, the Secretaries State for Trade, and for Transport, the Chief Whip, Sir Robert Armstrong and Robin Ibbs.

KJ

K J
3 April 1981

Department of Industry
Ashdown House
123 Victoria Street

JH

DRAFT STATEMENT

With permission, Mr Speaker, I would like to announce the Government's next steps towards greater freedom in the telecommunications market in the United Kingdom.

2 On 21 July last year, I explained to the House the framework for new competitive arrangements covering apparatus attached to the British telecommunications network. Since then we have made good progress. Independent standard making and certification bodies are now at work on rules, which will replace the present monopoly over approvals of apparatus enjoyed by British Telecommunications (BT). Both BT and main suppliers are gearing themselves for the competitive era.

3 Today, I am publishing the report which I commissioned from Professor Beesley on the subject of network services. I have arranged for copies to be placed in the Libraries of both Houses.

4 Professor Beesley has completed an economic survey of the impact of complete freedom of network use. His conclusions are radical. First, in his principal findings he recommends full freedom for private sector suppliers to use the national network to provide telephone and telecommunications services to third parties. He envisages BT setting an open and uniform price for all users of its network irrespective of whether the users resell any of the capacity they lease. This means that private companies, in Professor Beesley's view, should be able to lease circuits - parts of the network -

/from ...

from BT and sell to the public telecommunications services carried on those circuits. Secondly, Professor Beesley suggests progressive liberalisation of use of international telephone and telecommunications links from the UK, subject to the payment of a royalty to BT. This would mean that consumers would have a greater choice of international telecommunications services. Thirdly, Professor Beesley argues in favour of the provision of additional networks. And fourthly, he stresses the need for removal of constraints on BT's capital investment.

5 Professor Beesley bases these radical conclusions on the premise that data generation and telecommunication technologies are rapidly converging making the boundary of the existing BT monopoly arbitrary and constricting. The national network is a national, and not exclusive BT, asset. Professor Beesley argues that, if private firms were free to use the network in innovative ways, this would bring substantial consumer and user benefits which would outweigh his projection of the possible maximum loss - some 2% of turnover - net revenue by BT which would result from the reduction in its monopoly. BT, which provides good but far from perfect service, would be free to compete subject to minimum safeguards to ensure fair competition.

6 If Professor Beesley's proposals are adopted, I envisage that BT would be spurred to provide an even better service.

/I ...

I also envisage new profitable enterprises and new jobs being generated as both BT and new entrants stretch themselves to capture a share in new, and in many cases as yet unknown, markets.

7 Professor Beesley's reports marks a clean break from previous approaches. Implementation of his recommendations would transform the UK market for telecommunications.

8 The Government sees great merit in the free market, please-the-customer, regime recommended by Professor Beesley. It would promote the UK as a communications centre serving the whole world. The implications are, however, far reaching and I propose to invite views over the next two months before coming to detailed decisions in July.

9 The Government has decided to go forward with plans for the consideration of the introduction of telecommunications transmission networks provided by the private sector in addition to those provided by BT. I am, therefore, inviting the formal submission of initial proposals, if possible by the end of June, for the competitive supply of additional transmission networks. I will wish to consider these first proposals so that I can be in a position to issue licences later this year. I will also be considering the rules for interconnection of private networks with the main BT network.

10 The opportunities for both BT and new market entrants over the whole field of telecommunication terminals, transmission and services are immense. The quicker we seize these opportunities and expand our range of products, systems and services at home the better for us as users and

/as ...

as providers both in the domestic and the highly competitive but ever expanding world communication market.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 April 1981

T.P. Lankester, Esq.,
No.10 Downing Street
S.W.1

Dear Tim

BRITISH TELECOMMUNICATIONS

I enclose a briefing note for the Prime Minister's use when she sees Lord Weinstock and Sir Kenneth Bond of GEC tomorrow morning.

Yours ever

Peter

PS. JENKINS

BRITISH TELECOMMUNICATIONS : BRIEF FOR PRIME MINISTER

Lord Weinstock, Chairman of one of BT's three main supplier firms, is thought to be worried about Government financing constraints on BT's investment programme. He suspects that the Treasury is being obstructive, both in setting too tight an EFL for 1981-82 and in refusing to relax rules which might allow the EFL to be circumvented. He is likely to argue for some kind of financing device, such as a hire purchase scheme, to get round the problem as he sees it.

2. Nobody doubts that BT's investment programme - they want to spend about £2 billion in 1981-82 - must have high priority. This is profitable investment, geared to the information technology revolution with its pervasive effects on the competitiveness of British industry; geared, too, to hopes that the service sector, given the right infrastructure, can lead an economic revival. It has much to do with exports - our hopes of selling our fully digital "System X" to a rapidly expanding world market, against fierce competition. And the supplier industry, including GEC, are at a critical point of changeover to the new technology, when the momentum of ordering must be maintained.

3. As background: the problem is in part immediate, in part longer-term. Immediately, an EFL set six months ago is now proving too tight for the necessary level of investment, because of falling revenue forecasts; because hopes of privatising peripheral parts of BT in 1981-82 have not been realised; and because BT's cost control has been poor. Longer-term, we aim to reconcile this burgeoning programme with the PSBR constraints partly by privatisation, partly by a new look at how we control nationalised industries.

4. The right way to tackle the immediate problem is to recognise it as one of conflicting claims on available finance within the framework of the monetary target: whether nationalised industries such as BT should get a bigger share

of available funds, and if so at whose expense (the private sector, the consumer, BT employees, other programmes, or the taxpayer). Ministers are urgently considering a package which will allow BT an EFL increase, probably of £200 million which would have to come out of the contingency fund, and in return for provisos about cost-control and early moves on privatisation. This should not, of course, be revealed, although if agreed it would be announced very soon.

5. There have of course been the suggestions, which seem attractive at first sight, that we should go for a financing device, such as a revenue bond, or some kind of leasing or hire purchase scheme. But on closer examination these devices turn out not to help, since they do not generate extra real resources, do nothing to improve BT's performance, and tend to involve more expensive forms of finance without removing the adverse monetary effects of additional borrowing. Thus, if our rules do not allow leasing schemes to evade the EFL constraint - a point that worries GEC - there are good reasons for this.

Line to take

6. The Prime Minister could make clear that, on the matter of priority for BT's investment programme, there is nothing between the Government and Lord Weinstock. The arguments are well understood and our general objectives are the same.

7. We differ on the financing route. We do not believe that devices such as GEC seek are the answer. The issue is one of conflicting claims on available finance, whether within the public sector or between public and private sectors, and the Government cannot avoid responsibility in either case. Lord Weinstock can rest assured that we have the matter well in hand and that an early announcement can be expected.

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2

PRIME MINISTER

MJS

BRITISH TELECOMMUNICATIONS BILL

It is hoped that Members will find the attached Brief of use both for the Post Office Engineering Union/Union of Communications Workers lobby on Wednesday 1st April 1981 and for that day's Report stage of the British Telecommunications Bill. For further information, Members may wish to consult the Conservative Research Department's Brief for the Second Reading of the Bill (PCC(80)19: 28th November 1980), copies of which are available at the Whips Office.

Contents

Conservative Research Department
32 Smith Square, London. SW1

RH/CFM
27.3.81

1. A New Framework for Telecommunications

Sir Keith Joseph, Secretary of State for Industry, in his speech on the British Telecommunications Bill's Second Reading noted why a new liberalised framework of telecommunications was necessary:

> "Telecommunications is in a stage of rapid development and growth. It is essential that we allow these developments to evolve as rapidly as possible for the benefit of the public. A new revolution is upon us, spurred by the dramatic reduction in the unit cost of computing power and electronic memory. The combination of technical advances in micro-electronics, computing, telecommunications and automation makes the application of these interlocking technologies fundamental to the progress of industrial economies. We have the economic means to put within the reach of everybody the power to store, retrieve and process information on a scale impossible only a few years ago. Telecommunications lies at the heart of this transformation and can play a vital part in the future efficiency of businesses of all kinds everywhere. We cannot afford to lag behind in its development and use" (Hansard, 2nd December 1980, Cols. 209-210).

The virtues of liberalising the use of the telecommunications network are:- in those areas where the new British Telecommunications (BT) will have to compete with the private sector better service to the customer can be expected;

- BT's monopoly will not be use to stifle the development of new services and equipment.

- BT will be able to concentrate on its most important role, that of providing, modernising and maintaining the main telecommunications network.

In order to achieve these three ends, the Government have brought forward a Bill which will allow maximum flexibility in the future, by granting the Secretary of State for Industry wide powers to grant licences, while ensuring that the integrity of the telecommunications network is safeguarded by retaining aspects of the BT monopoly.

2. The Issue of Licences

The Government have stated that they intend to liberalise by licensing powers in three areas:

i) There will be liberalisation of the supply, installation and maintenance of all equipment attached to the network, with the exception of the subscriber's first telephone and the maintenance of private branch exchanges (PABXs). In Committee the Government accepted an amendment requiring the Secretary of State to consult BT before exercising this power. General licences will normally be used, though individual licences can deal with one-off installations. To ensure that attachments to the network are technically compatible with it - and so do not impinge upon other users - technical approval will be carried out by a self-financing independent body (the BEAB) working to standards published by the British Standards Institution. The system which will emerge will be one where BT is not approving equipment. The Government is actively considering the PABX maintenance question.

ii) The Government intend to liberalise the use of the network for third party 'Value Added Network Services' (VANS). Examples of VANS are: radiophone services, radio paging, message answering systems, facsimile, computer bureaux, word-processing bureaux and Viewdata (e.g. Prestel). VANS also include the resale to third party of capacity, leased or otherwise acquired from the network operator, to provide cut-price telephone calls. General licences are envisaged, supplemented by individual ones where necessary. Professor Beesley will in due course be reporting on the scope for liberalisation.

iii) The Bill permits the licensing of additional transmission systems - through individual licensing. These would be in co-operation with BT. Sir Keith has said that he would "consider (private sector applications) with sympathy" (ibid, Col. 212).

(See below - Section 4 - for the issues of timing and imports)

3. Financing Telecommunications

Those who repeatedly allege that the Government is failing to support public sector capital investment should look at what is happening in telecommunications.

In 1981-2 over £2 billion of investment by BT in telecommunications is planned to meet consumer demand, modernise the network and introduce new services. That (at constant prices) is a higher figure than any year since 1974-5. Having extended BT's External Financing Limit for 1980-81, the Government has agreed to allow it to borrow £223 million in 1981-8 - less than BT would have liked but a big increase on recent years when net repayments by BT were required.

The Government accepted an amendment to the British Telecommunications Bill which would give BT the legal power to borrow in the money market if the Government agrees. Discussion between the Department of Industry and the Treasury is in progress on this point.

It is also worth noting that BT should be able to raise money outside its EFL (and so unconstrained by PSBR considerations) through participation (without control) in joint ventures with the private sector in those areas where BT will be competing - particularly as regards new attachments and services.

4. Trade Union Anxieties Answered

Members should read the following in the light of the comments contained in the POEU/UCW paper of 19th March 1981 which they will have received.

a) Pensions: The Unions are opposed to a split pension fund. Mr. Kenneth Baker, Minister of State for Industry, is engaged in continuing consultations with those concerned in this matter.

b) The Monopolies: The unions claim that "Both telecom and postal services in rural areas will be threatened by the breaking of the monopolies" because the most profitable parts will be "creamed off". In fact, the opposite is the case. The customer, whereever he lives, will be offered a wider choice of equipment in telecommunications, and services in both telecommunications and in certain categories of mail. Furthermore, because many of BT's activities will now be conducted in competition with the private sector and under the watchful eye of a Secretary of State who has wide powers to liberalise telecommunications and to suspend the Post Office's monopoly, if necessary, of the letter mail, better standards of service can be expected in future.

c) Imports: The Unions also claim that modifying the telecommunications monopoly "will open the way for a flood of imports from America and Japan." The Government is well aware of the need to avoid such an eventuality. Sie Keith has stated that the liberalisation of attachments to the network will be phased over a period of about three years in order to give the British telecommunications manufacturing industry time to adjust (Hansard, 2nd December 1980, Col. 214). It is intended that prior publication of relevant standards for equipment will also do so. In Committee Mr. Baker spelt out the system for the agreement of standards by the BSI and for testing of equipment by the BEAB. This will ensure that all equipment, including imports, will be subject to exacting procedures. Furthermore, the Government will be actively seeking assurances from other countries of reciprocal trading opportunities for our manufacturers. These negotiations will have to be bi-lateral until the EEC agrees to equally liberal proposals for telecommunications terminals throughout the EEC.

The Bill provides for the Government to control the timing of liberalisation by (i) the timing of Clause 15 licences, (ii) the timing of approval standards, (iii) the timing of approvals under Clause 16(2), principally for apparatus not covered by an approved standard, (iv) the 'post-dating' of British standards. The fact that equipment, of foreign or domestic origin,will have to be approved by the independent testing authority will prevent low quality foreign equipment flooding the market. It is, of course, in part a reflection of the unsatisfactory effect of having the Post Office as sole customer - which this Bill will end - upon our industry that such extensive measures are necessary.

d) Jobs: The allegation that jobs will be lost as a result of liberalisation is not born out by the experience in the United States, where over the last 15 years, as a result of liberalisation, job opportunities have increased - both as a result of new services and companies coming into existence and as a result of other businesses being able to become more competitive. In fact failing to take advantage of the information technology revolution, through a timid refusal to open up the network to new services and equipment, would be a sure prescription for fewer jobs. The unions allege that "American progress owes more to investment than competition" - but it is the fact that telecommunications has been opened up to the private sector that has allowed direct access to that investment.

e) Unfair Competition: The Unions claim that competition with the private sector will be "unfair to BT". It will not. Indeed, in order to prevent unfair competition to the private sector - such as had to be prevented with Direct Labour Department activities - the Bill ensures in Clause 4 that BT be required to set up self-accounting subsidiaries to stop hidden cross-subsidation of the Corporation's competitive activities. The Director General of Fair Trading will look out for any evidence of unfair trading practices by public or private sectors. The hidden 'cross-subsidation' danger only applies to BT, not to the private sector, because, of course, unlike BT a private company is constrained by the ultimate threat of bankruptcy - a point which Labour Members refused to grasp at Second Reading.

f) <u>BT's Alleged Cash Starvation</u>: For investment, see above.

<u>APPENDIX</u>

<u>Significant Developments at and after Committee Stage</u>

i) Acceptance of an amendment to the basic licensing power contained in Clause 15 whereby the Secretary of State must consult with BT before licensing the running of systems which would otherwise infringe BT's exclusive privilege (see above).

ii) Acceptance of an amendment to give BT power to borrow in the money markets with Government permission (see above).

iii) Insertion of a sub-section 65(1)(d) allowing conveyance of an overseas letter to an aircraft by a messenger sent tor the purpose and the conveyance of the letter out of the UK by that aircraft. This is a development of the original intention that the carriage of all time-sensitive/valuable mail would be permitted by a suspension of the monopoly made by order under Clause 67(1) of the Bill and that carriers would have to charge a fee of at least £1 per item. It gives air couriers the <u>additional security</u> of a statutory exemption.

iv) On 9th March 1981 the Government's intention to sell just less than 50 per cent of the shares in Cable and Wireless Ltd was announced. It followed extensive consultations with the Governments in the countries involved. The powers are contained in Clause 76. The Government intend to refrain from using their rights as shareholder to intervene in the company's commercial decisions. Net proceeds to the Government should be more than £100 million (Hansard, 9th March 1981, Cols. 619-622).

JU

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
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Secretary of State for Industry

23 March 1981

Lord Weinstock
The General Electric
Company Limited
1 Stanhope Gate
London W1A 1EH

R
9/4

Dear Arnold.

With the gist of your letter of March 16, I entirely agree. We and Treasury Ministers have been for months seeking a way to achieve some private sector finance for BT's investment and are still striving. We need no persuasion. I hope that GEC will have useful discussions with officials about your in house ideas.

Yours sincerely,

Keith

PS/KB
PS/MM
PS/Sec
Mr Croft
Mr Solomon
Mr Wigglesworth
(on file)
PS/Prime Minister ✓

Post & Tel 1

David & I had a word about this on Fri evening. We have to get the Treasury moving and fast. MR

PRIME MINISTER

I think you should read the attached note on British Telecom financing.

It says, in effect, that there are three ways of enabling B.T. to invest more without causing any addition to PSBR in the current recessionary year. (Or in future years for that matter).

a. Consumer Bonds - which might raise, say, £1,000 from each of a million households to provide £1,000m.

b. Leasing - the Treasury will only allow leasing if some abstruse technical rule which they invented is made to govern the transaction.

c.1. Turnkey operations, which defer the cost to B.T. until they have in use a particular asset whose revenue can then finance the cost.

2. Normal loan decisions which do not require that seven year pay out investments can only be advanced by borrowing money for 29 years.

The issue is very simple - are you prepared to instruct the Treasury that they must achieve B.T. financing at no cost to the PSBR rather than allow them to insist upon commercially insane rules which force B.T. to forego investments or increase the PSBR ?

If we could cross this particular bridge in relation to B.T. it would have implications for the financing of all other profit-making nationalised industries, especially gas and electricity. It would even have implications for the development of investments in the coal industry which could be financed outside the PSBR against future revenue from coalfields.

I do not think the Treasury operate in the real world. The above paper is evidence. (More evidence was supplied this week when Treasury insisted that we demand pari passu ranking for our guarantee to I.C.L. with their secured borrowing. This was totally unreasonable by any commercial standards, though Lord Benson could, no doubt, have asked for it in a polite way. But to insist that this was what we required them to grant us, when we were at the same time asking them to do us a favour rather than the other way around, suggests an inability to accept that the world is not the way we would like it to be).

This Treasury attitude has so many damaging consequences that I suspect the insistance on breaking Treasury rules in the case of B.T. would have considerable beneficial effects elsewhere.

I think we have reached the point where the appropriate individual in the Treasury has to be told to do it or else make way for someone who will. "Pray do not argue the difficulties".

DW.

If you agree that this is worth pursuing, I should like a (brief) discussion before you take any action.

PS I have already written to the Treasury (Flag A) on the advice of the Policy Unit and with your authority asking them to come up with an imaginative solution to the BT problem. I would have thought it would be better to await their response before issuing any "instructions". I have told the Treasury that you are expecting something soon. They tell me that Nigel Lawson and the Chancellor are applying their minds to this. I will chase them again next week.

TL 19/3

Mr Wolfson

THE SECRETARY OF STATE

c.c. PS/Ministers
PS/Secretary
Mr. Croft
Mr. Solomon
Mr. Wigglesworth
Mr. Nieduszynski
Mr. Brown

BT FINANCING

I heard yesterday afternoon that there is a possibility that Treasury officials will recommend that BT be given an increase of £190 million in their EFL for 1981/82. This would come out of the Contingency Reserve and thus not affect PSBR. I believe this to be the worst of all possible decisions for it does nothing towards promoting a sense of commercial reality in BT.

2. I met with Sir George Jefferson on Friday morning to discuss his financing problems. I told him that I now agreed with him that substantial privatisation by way of regionalisation would have to be postponed, probably into the life of the next Parliament, as our first priority would be to set up self-accounting regional companies. He said that he would welcome this approach and accepted the need for reporting accountants as a first stage.

3. He also told me that he was proposing that Peter Benton become the Chairman of BT Enterprises Limited which would act as the holding company for a number of joint ventures with the Private Sector on peripherals, etc., and which would also include Prestel.

4. We agreed the following three-pronged approach which I believe could be constructed in such a way as not to add to the PSBR but would also allow an acceleration of BT's investment programme. I believe this to be now crucially necessary particularly as a major part of the benefit would go to companies like GEC and Plessey which will undoubtedly be facing substantial inroads in their market as a consequence of our liberalisation policy.

My three suggestions are:

A. Consumer Bonds:

A Consumer Bond is a short-term loan obligation issued by BT which would afford the holder a discount on his telephone account of, say, 10% per annum of the capital value of the Bond. I understand that the Revenue are likely to object to the tax-free nature of the benefit and it therefore might be necessary to provide for this in the Finance Bill. The concession could be framed so as to apply only to similar

..../Cont.

obligations of Nationalised Industries. [To balance the benefit to high tax payers, the Bond could be framed so as to give special concessions for Pensioners and other Social Security beneficiaries. It could, for example, produce a return of 15% per annum for these categories.] Complicated to Administer.

The Effect on PSBR

I am told that if the loan obligation was for a period of two years, the Treasury would not score against the PSBR. If necessary we could limit ourselves to such a term but it would be a pity if we had to incur all the additional administrative costs merely to keep it within what can best be described as an artificial distinction. It may well be that a 2-year Consumer Bond could have provision for renewal at the option of BT and still comply with the Treasury definition. It would make sense to press for an extension of the term without affecting the PSBR. Unhelpful Theology!

If we could be allowed to issue a Consumer Bond for the longest possible term without being scored against the PSBR, then the net effect would be either a reduction in the PSBR or a restoration of the Contingency Reserve.

We should go for £200 million and BT could make the arrangements to start selling the Bonds this side of the Summer.

B. Leasing:

Many, if not the majority, Private Sector companies enter into leasing agreements as a method of off-Balance Sheet financing. The Treasury accepts that the capital value of any leasing agreements entered into by Nationalised Industries does not count against PSBR. Nevertheless, for some time now, they have deducted the capitalised value of any leasing agreements against EFLs. This has had the result of dissuading Nationalised Industries from entering into leasing transactions.

The Treasury has said in recent weeks that they might well permit leasing transactions not to be scored against EFLs where there could be shown to be a risk element. Since the debt obligations of a Nationalised Industry can never be in doubt, the risk element could be confined to the quantum of the yearly payments which could vary either against turnover or volume. WHY MAKE LIFE DIFFICULT FOR INVESTMENT?

I do not appreciate the logic behind this distinction but I do know it will in the end add to the cost since uncertainty is a factor which has to be paid for. IS THERE ANY?

I believe that it would be open to BT to initiate a considerable expansion of their investment programme over the next two or three years by allowing them to enter into

...../Cont.

further leasing transactions for capital investment. The equipment manufacturers, either alone or in conjunction with the financing institutions, would be happy to provide the equipment at market terms and I could even contemplate the setting up of tertiary financing institutions whose sole business would be to lease capital equipment into Nationalised Industries.

The Effect on PSBR

There is no effect on PSBR as a result of capital expenditure. The yearly payments are, of course, a liability of the Nationalised Industry but they are covered out of revenue.

We would have to allow an automatic increase in the EFLs unless we could persuade the Treasury to drop the ruling whereby they automatically dock BT the capital value of any leasing agreements.

Even if we give automatic increases to the EFLs, it would not affect PSBR for the reasons I have outlined above.

C. Freedom to Act Commercially:

1. Many Private Sector companies indulge in turnkey operations and that is they enter into agreements to acquire either plant or buildings for a lump sum payment due on the commissioning of the plant. I am told by BT that they are denied the right to enter into this form of financing and have to make stage payments as they proceed. If we could allow BT the flexibility to enter into this type of arrangement, we could give them considerably more room to manoeuvre, both for EFLs and for the PSBR. There is no assumption of any additional risk (in fact the reverse is the case), nor would this type of arrangement be in any way unorthodox.

2. Sir George told me that the morning after the Budget he sent for his Head of Finance and asked him what effect the 2% reduction in MLR would have on either the profits or his cash flow. The answer was none because their borrowings are confined to the National Loan Fund and these are at a fixed rate of interest and for a term of 29 years. The vast majority of BT's investment decisions have a far quicker pay-out date and it is bad commercial practice to be forced to borrow for a period longer than the pay-out period on an investment.

We should really encourage BT to go to the market direct to borrow for its commercial operations. The Treasury will argue that this will increase the cost of borrowing but if it does it will be because the market will perceive these loan obligations as distinct from Gilts and they therefore should not affect Gilt sales. By rights this Department and the Treasury should each year agree with BT its market borrowing requirement for the year and let them get on with it.

..../Cont.

It is only this way that they will begin to examine the real need for the investment monies and the difficulties of raising them.

The Effect on PSBR

There is a case for distinguishing between the PSBR and the GGBR. By rights I would have thought that the direct borrowings of profitable Nationalised Industries should not be scored against the PSBR. It is very difficult to perceive how we can proceed with a medium-term strategy for BT without allowing them the freedom to plan ahead and to raise monies on a commercial basis.

5. In view of other discussions, I am copying this to Robin Ibbs and David Wolfson.

David Young

David I. Young
Special Adviser

17th March, 1981

Mr Wolfson

CONFIDENTIAL

Mr Young

PS/Ministers
PS/Secretary
Mr Solomon
Mr Wigglesworth
Mr Nieduszynski
Mr Brown

BT FINANCING

Many thanks for sending me a copy of your minute of 17 March to the Secretary of State.

2 We have of course been arguing with the Treasury for months about various possible methods of allowing BT to raise additional finance for investment. The Treasury have not been willing to support any of the possibilities we have put forward. I myself mentioned to Mr Ryrie on 13 March both the main proposals you describe in your minute - customer bonds and leasing. He was even less enthusiastic about them than he was about Warburgs' proposal for revenue bonds, which he now regards as ruled out in any event for some months because of possible conflict with the index-linked gilts announced in the Budget.

3 I am sure we should not give up the battle. In particular, by making BT dependent on the market for a significant proportion of its investment funds we should, if we get the mechanism right, be able to bring market pressure to bear on the performance of BT's management (though as it happens neither customer bonds nor leasing would be very effective for this purpose).

4 But BT need to know by the end of this month whether they are going to get additional finance for 1981/82 or whether they should start making drastic cuts in their planned investment programme with all the damage that would do to the telecommunications manufacturers. It may be faint-hearted of me, but I simply do not believe that we shall now be able to pin the Treasury down to accepting unorthodox methods within the next fortnight. If, therefore, they are prepared to recommend an increase of £190 million in BT's EFL for 1981/82, on the assumption that the money will be provided from the NLF and be scored against the Contingency Reserve, I very much hope that we will accept, while specifically reserving the right to continue to press proposals for new methods to raise finance. It is already agreed, I think, that as a condition of an increase in the EFL, Sir George Jefferson should be asked to accept the appointment of reporting accountants, both to examine the scope for tighter cost control in BT and to prepare the way for establishing regional companies.

WE MUST INSTRUCT THEM, NOT ARGUE WITH THEM!
DW

I am copying this minute to the recipients of yours.

R H F CROFT
Deputy Secretary
17 March 1981

File

DSG

Lord WEINSTOCK

S/S Industry

19 March 1981

31/3

Chase?

31/3

Yes M MAP

Lord Weinstock has sent the Prime Minister a copy of his letter of 16 March to your Secretary of State. about Post Office telecommunications. The Prime Minister would like to see a copy of his reply.

M. A. PATTISON

Ian Ellison, Esq.,
Department of Industry.

The National Archives

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10 DOWNING STREET

Prime Minister

We discussed this very briefly this morning.

The meeting Mr Whitelaw suggests has now been arranged for 1730 on Thursday of this week.

AJC
17.iii

Thank you

MT

2

10 DOWNING STREET

PRIME MINISTER

Lord Weinstock has asked that you should see the attached copy of a letter he has sent to Sir Keith Joseph about the communications network.

Would you like to see Sir Keith's reply?

Yes please

MAP

MT

16 March 1981

The National Archives

LETTERCODE/SERIES PREM 19 .... PIECE/ITEM 875 .... (one piece/item number)	Date and sign
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bc MR WOLFSON
MR DUGUID

jfh

16 March 1981

Thank you for your letter addressed to my colleague Caroline Stephens, with which you enclosed a copy of one to the Secretary of State for Industry about the communications network. I will place this before the Prime Minister.

MAP

The Lord Weinstock.

THE GENERAL ELECTRIC COMPANY LIMITED
1 STANHOPE GATE · LONDON W1A 1EH
01-493 8484

16th March, 1981

Dear Miss Stephens,

The Prime Minister once told me that a letter meant for her eyes would be sure of reaching its destination if addressed through you. I enclose a copy of the letter I have written to the Secretary of State for Industry about the communications network. I believe the subject to be quite important. The letter is not long, and because I think it would be helpful if the Prime Minister saw it, I would be grateful if you would show it to her.

Yours sincerely,

Lord Weinstock

Miss C. M. Stephens,
Personal Assistant to the Prime Minister,
10, Downing Street,
LONDON, S.W.1.

16th March, 1981

Dear Keith,

During the many years I have been familiar with the Post Office, it has been impossible not to observe its lack of operating efficiency, the technical conservatism of its engineers and management with regard to the standards to be met in telecommunications equipment and, most particularly, the ineptitude of its decisions concerning the switching systems to be used in telephone exchanges.

In the early 1960's, we tried to persuade them to adopt a computer controlled crossbar system. Towards the end of the decade they decided to use crossbar without computer control. In 1971, we argued against the introduction of TXE4 as an alternative system, because it was based on old technology, was without computer control and, like the

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unsophisticated crossbar system, was unexportable. We tried to persuade the Post Office to push ahead faster with development of System X for the longer term and to buy computer controlled crossbar in the interim. The Post Office rejected this line of argument, on the basis of unreliable output from a computer study of the economic case.

At May, 1980, the connections provided from telephone exchanges to subscribers in the UK were in the following proportions:

Strowger	89%
Crossbar	6%
TXE4 and TXE2	5%

(see British Telecom Business Plan 1980-90).

Strowger connections in Japan were 19%, United States 26%, France 27%, Sweden 40%, Italy 74% and The Netherlands 85%.

Other indicators confirm the backward nature of our telecommunications network in terms of penetration and fault

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rates; and we have many out-dated private automatic branch exchanges and telephone handsets connected to the network.

These issues were discussed extensively with Sir William Barlow when he became Chairman of the Post Office Corporation. There were marked changes in the attitude of the Post Office and a plan was set in train to modernise the network and the terminal equipment. We fully support this plan to provide an advanced, reliable, cost-effective network capable of handling speech, television and data as vital to the national infrastructure of a modern country and as necessary to provide an adequate base for our industry's exporting effort. Without it, the development and marketing of systems and ancillary equipment to provide for modern information systems, the so-called "office of the future", will be at best delayed.

I have no doubt that Sir George Jefferson is fully seized of the crucial importance of expanding and modernising the network.

But these things cost money; in the present economic climate, British Telecom cannot generate out of its current revenue the cash for such a programme. The steps already taken to increase the British Telecom borrowings within the Public Sector

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Borrowing Requirement are necessary to meet the contractual commitments for purchases entered into some time ago. Projecting forward into 1981-82 and beyond, it is not difficult to foresee the need for further funding for capital equipment. In the light of the new limits HM Government has set on the PSBR, either British Telecom will have to resort to the private money market or cut back its capital equipment purchases dramatically.

George Jefferson is surely pursuing this subject vigorously with the Treasury, and in case it makes any difference, I want to support him. GEC has some ideas in-house which may be helpful, including providing financial assistance with respect to equipment supplied by GEC, and we would welcome the opportunity of exploring these possibilities with HMG as soon as possible.

I hope you will not read this letter as just another plea to change your general line of policy; it means only to suggest that if constructive minds are set to the problem, there are ways in which British Telecom can be supported in

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a sensible manner without upsetting the Government's econom-
ic strategy or losing important benefits in terms of employment
and exports.

Lord Weinstock

The Rt. Hon. Sir Keith Joseph, BT., MP.,
Secretary of State,
Department of Industry,
Ashdown House,
123, Victoria Street,
LONDON, SW1E 6RB.

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary 11 March 1981

The Prime Minister has seen the Secretary of State for Industry's letter of 5 March to the Chancellor about financing BT's investment programme.

She strongly supports Sir Keith's view that the investment programme should go ahead and that it would be indefensible to require BT to start cancelling investment orders. She hopes that the Chancellor will find a way of accommodating either the bond devised by Warburgs, or some of the other proposals that have been made to help solve the problem in 1981/2.

Looking to 1982/3, she also supports Sir Keith's view that the private sector should be enabled to finance BT's highly profitable investment programme. She has noted his suggestion that we should look again at our treatment of leasing. She does not think that leasing should be ruled out solely on grounds of revenue loss through tax relief. She points out that transferring resources to the private corporate sector is one of the Government's objectives; transferring employment to the private sector is another. Leasing might provide a stepping stone towards transferring the maintenance and even the operation of some exchange equipment to the private sector.

I am copying this letter to Ian Ellison (Department of Industry), David Wright (Cabinet Office) and Gerry Spence (Central Policy Review Staff).

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

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Tim - Keith spoke to me about this. I agree with J-H's note. Can we write to the Treasury accordingly. MS.

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

Qa 05273
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From: J. R. Ibbs

In PM's box

6 March 1981

cc: A. Duguid

Dear Chancellor,

British Telecom's Investment Programme

In his letter to you dated 5 March the Secretary of State for Industry seeks agreement that BT should be allowed a £200m. increase in its EFL.

As you know, the CPRS is currently carrying out a study of BT's long-term investment and financing needs. The work already done has confirmed that BT's investment programme is profitable, necessary if business and commerce are to have an efficient service, and essential if the opportunities offered by IT are to be seized.

To raise the sum of £200m. by increasing the tariff by more than the amount already envisaged does not appear feasible as it would put the increase far above the projected rate of inflation.

I support the request made by the Secretary of State. If an increase in the total of EFLs is not acceptable, my own view would be that the importance of maintaining investment in BT is such that money should be looked for by holding back the spending of other nationalised industries. However, I realise that although this concept would be normal (although very painful) in private industry, such aggressive implementation of priorities has yet to be accepted in the public sector.

I am sending a copy of this letter to the Prime Minister, the Secretary of State for Industry, and to Sir Robert Armstrong.

Yours sincerely,

J R Ibbs

The Rt Hon Sir Geoffrey Howe QC MP
HM TREASURY
S W 1

CONFIDENTIAL

6 March 1981
Policy Unit

PRIME MINISTER

BRITISH TELECOMS FINANCING

Flag A

You will have seen Keith's letter to Geoffrey of 5 March. I have spoken today about it to David Young. I believe that your intervention will be necessary in order to break through the conventional thinking of the Treasury.

1. DoI are preparing a list of twelve different and imaginative suggestions for funding BT investment outside the PSBR. So far, every one of them has been stalled or vetoed by the Treasury.

2. There is of course a real fear at the Treasury that any method of increasing BT's investment will end up adding to a PSBR at a time when it is extremely important that the PSBR is not allowed to expand. That is a problem which does not worry DoI and must worry the Treasury.

3. The more imaginative the financing suggestions are, the further away they get from causing any PSBR problems. But, at the same time, they then begin to look more unconventional to the bureaucratic mind. One example which emerged from a brainstorming session here with Alan and David Young was a "consumer bond" in which telephone subscribers could buy a bond which entitled them to a tax-free reduction in their telephone bills over a period of years. The analogy would be the commuter's season ticket which has similar tax-exempt discounts. This one (of many) suggestions has not been killed yet but has of course been resisted by the Treasury and the Inland Revenue. But it would put BT in direct contact with a new group of investors, in this case their own customers.

4. What seems to be missing in the Treasury is an ability to analyse risks (eg commercial or administrative risks for the consumer bond vs. PSBR-type risks from increased EFLs) and a marketing man's approach to financing.

5. BT is the most important example of de-monopolisation, opening up to competition and the first steps towards privatisation. One of the most effective catalysts for changing the thinking of a nationalised industry management is to put them in the same position that the management of any other enterprise is in - under

market pressures to design, package and sell his equity and debt to the financial markets in exactly the same way as he must sell his products and services to the consumer market. It is a totally different activity from the Chairman of BT being briefed to come round to the Chancellor with the begging bowl for extended EFLs with all the usual lobbying and political log-rolling. This shift is a central part of what the Government should be trying to achieve for nationalised industries.

6. One of Keith's proposals is the greater use of leasing. Apart from the immediate cash flow advantages, leasing has longer-term attractions on policy grounds. If a private sector company owns exchange equipment, it should be a short step to their staff maintaining and even operating it. If that can be done, we switch to labour relations in the wholly different climate to private sector disciplines. (We understand there is heavy overmanning in BT at present.) Treasury objections to leasing are understandable: the lessors' ability to claim tax relief means lost revenue for Government. But it's no good simply refusing to think further than this. There are advantages as well as drawbacks: transferring revenue from the Government to the private corporate sector is one of our objectives; transferring employment to the private sector is another.

7. We suggest that Tim Lankester writes a note to Geoffrey's office summarising these points and saying that you wish to see a much more positive attitude to Industry's proposals from the Treasury.

JOHN HOSKYNS

JU

Mr Duguid.

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
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Secretary of State for Industry

5 March 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3HE

12/3

Dear Geoffrey.

We face serious difficulties - and opportunities - with BT's investment programme.

2 Demand for telecommunications facilities is running ahead of supply, particularly in the City. Existing telecommunications services are (sometimes grotesquely) inadequate and there is a need to bring in the new digital technology as quickly as possible for businesses. The telecommunications manufacturing industry depends on BT orders both for the development of modern telecommunications equipment - for example System X - and for loading its factories. Officials here and in the Treasury are satisfied that there is a very strong economic case for BT's investment plans. The investments themselves will be profitable, quite apart from the benefits they will confer on commerce and industry.

3 BT's investment programme ought to go ahead on both commercial and national interest grounds. The only doubt is whether the scale of the investment is sufficient.

4 As a nationalised industry, BT borrows on Government credit and cannot go into liquidation. The current BT Bill will pave the way for privatising part of BT's activities and thereby removing them from the Government's credit, but progress will not be fast enough for our immediate problems. The Bill also introduces an entirely new framework for telecommunications in this country. BT will have to compete on many fronts - terminals, so-called value added network services and even the network itself. Professor Beesley, whom I recently commissioned to report on the scope for value added network services, has demonstrated that the present constraints on BT's investment are basically incompatible with freer competition.

5 So far BT has funded virtually all of its investment from revenue - a situation which no comparable growth industry in the private sector would contemplate. This has meant tariff increases which are resented and indefensible. Now that we are entering on a new period of telecommunications growth and competition the likelihood

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is that BT will continue to be a large net borrower for years to come and therefore a permanent burden for the PSBR unless we can find some alternative solution.

6 In addition now, the recession is hitting BT's revenue. BT under its new Chairman is striving for improved performance and to keep the tariff increase to a level no higher than the going rate of inflation, which will be an improvement. Yet BT warns us that unless its EFL is increased, equipment orders will have to be cancelled. This will severely damage the industry and its employment, telecommunications users and our position as a Government encouraging new technology.

7 Of course the private sector would gladly finance BT's highly profitable investment programme. In my view we need to decide in principle that, commencing in 1982/83, BT (and if necessary other clearly profitable nationalised industries like BNOC) must be allowed to develop methods of raising its own funds for investment from commercial sources outside PSBR constraints. If you agree, this may for example mean revising the definition of public expenditure to exclude leasing. We must be prepared to allow BT to conduct its own operations (including if necessary leasing its exchange equipment etc from the private sector) within clearly established PSBR rules without detailed day-to-day control by the Government. Treasury should be asked to produce clear PSBR rules which should be published and made known in the City.

8 Arrangements like those I envisage cannot be introduced overnight. BT's immediate problem and the threat to its investment programme mean that we need to take immediate action for 1981/82 as well. The Chairman of BT has sought a £450m increase in his EFL in 1981/82. This is clearly excessive. Warburgs have, however, devised a bond which will enable BT to borrow £200m direct from the market. If approved, the bond will count against BT's EFL and the PSBR but would go a long way to mitigate the macro economic consequences of an increase in the EFL. The bond would help us presentationally since BT will go to the market direct, a course which is not open to unprofitable nationalised industries. I think we should agree to the principle of a bond and the necessary increase in the EFL for 1981/82 only. I would make our agreement conditional upon the bond involving a substantial element of risk. I would also make it conditional on BT agreeing to the appointment of management accountants who would explore the kinds of economies within BT that Michael Heseltine's accountants found within the water industry. They could also explore the steps required for BT to establish subsidiaries and introduce private capital on a timescale significantly faster than BT at present envisage.

9 I hope you will agree that, in principle, BT should be enabled to operate so that in 1982/83 its investment can be financed outside the PSBR but within approved PSBR rules and that in 1981/82 BT should be allowed a £200m increase in its EFL on condition that management accountants are appointed and that the money is raised by the sale

/of ...

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of bonds. The £200m change in EFL will need to be included in your public expenditure plans.

10 Unless we take some such steps very soon investment orders will be cancelled and jobs lost in industries which will raise a clamour about the folly of government's preventing the profitable provision of new intensely needed services all of which could be easily financed by the private sector. We have been months considering options and each one has been vetoed. We are now up against a real time constraint.

11 I am copying this letter to the Prime Minister, Sir Robert Armstrong and Robin Ibbs.

Yours sincerely

Ian Ellison

KEITH JOSEPH
(Approved by the
Secretary of State
but last page re-typed
in his absence)

PART 2 ends:-

27.2.87

PART 3 begins:-

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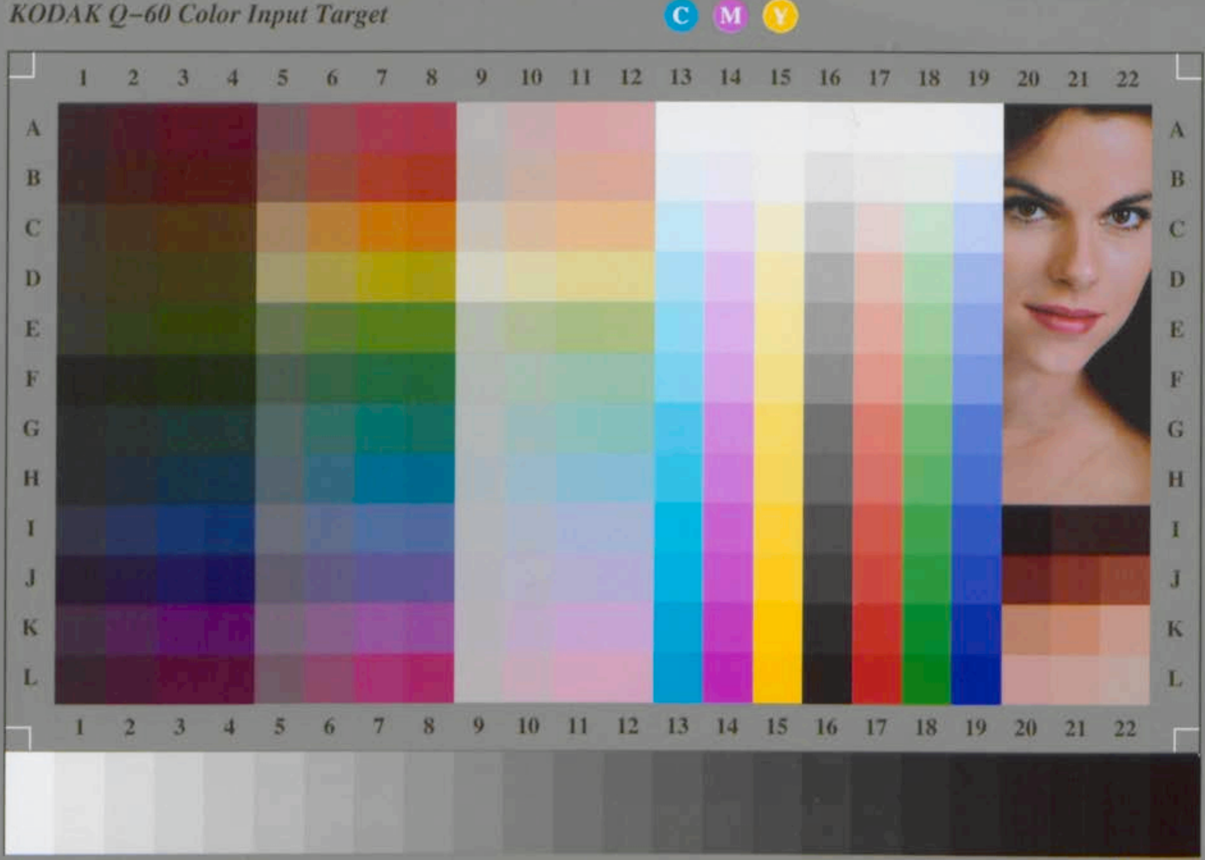

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