PO-CH/NL/0872
PART A

Part. A.

SECRET

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COMMERCIAL IN CONFIDENCE.

PO -CH /NL/ ~~0144~~ 0872

PART A

Chancellor's (Lawson) Papers:

FUTURE PLANS FOR BRITISH
TELECOM

Disposal Directions: 25 Years

25/8/95.

PO -CH /NL/ ~~0144~~ 0872
PART A

Copy no 1 of 3

DEPARTMENT OF TRADE AND INDUSTRY
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Secretary of State for Trade and Industry

30 April 1984

SECRET AND PERSONAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

D Nigel.

BRITISH TELECOM - RPI-X

The Board of British Telecom discussed yesterday our proposals for BT's capital structure and the RPI-X formula. I enclose a copy of the letter that Sir George Jefferson sent to me after that board meeting. (I must emphasize that I have given an undertaking to Sir George that only three copies of this letter will be made - one which Sir George is retaining in his safe, the copy which I now enclose and the copy which I am sending to 10 Downing Street. I have promised Sir George that my Private Office will retain the original and I must ask you to do the same).

2 You will see that the BT Board has concluded that it can live with our proposals. This is welcome. But it is clear from Sir George's letter that we have not obtained BT's wholehearted support: this could have implications for the flotation. Nor is BT prepared to provide the assurance in respect of residential rentals that we would have found politically attractive. I regard both developments as unfortunate. I appreciate that you felt unable to agree to my proposal that we should reduce the formula to RPI-2 if inflation fell to 3 per cent or less. I remain of the view that a relatively minor concession of this kind would have secured BT's full commitment to the package.

X 3 Sir George Jefferson suggests that we should carry out informal discussions among institutions about our proposals. I see no advantage in this. I propose instead announcing the principles of our decisons on capital structure, RPI-X, the subscriber voucher scheme, and employee incentives by means of an oral statement in the House of Commons next Wednesday, 2 May. I am enclosing a draft of a statement on which I should be grateful for early comments. I shall also be consulting Sir George Jefferson on the terms of the announcement.

4 I am copying this minute, and the attachments, to the Prime Minister.

Yours
Norman

NORMAN TEBBIT

Encls

Copy no 1 of 2

British
TELECOM

from the Chairman
Sir George Jefferson CBE

British Telecommunications

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Prestel Page 383

IN STRICTEST CONFIDENCE

The Rt Hon Norman Tebbit MP
Secretary of State for Trade & Industry
Department of Trade & Industry
1 Victoria Street
LONDON
SW1H OET

25 April 1984

Dear Norman,

"RPI-x" AND CAPITAL STRUCTURE

As you know, I put the position we have reached in our negotiations on these issues to our Board this morning. The Board were conscious that the four issues of "RPI-x", the capital structure, dividend policy and the regulatory regime all interact and that they all need to be considered as a whole.

The Board's concern is, of course, to establish a satisfactory basis both for the flotation of BT and for its future existence as a robust private sector company, while at the same time recognising that those customers whose network services will not be subject to significant competition in the next few years will need reasonable reassurance on our pricing strategy.

Having considered the present proposals, the Board remains most concerned at the lack of flexibility in managing the business, as well as the potential impact on the marketability of the shares.

In particular, on "RPI-3" the Board has asked me to emphasise the downside risks to the company in respect of income and expenditure over the five year period and the potential adverse consequences on cash flow for our modernisation programme and the development of new ventures. Any radical reassessment of our modernisation programme would have, quite apart from the implications for our customers, serious consequences for our supply industry. The risks arise from the very high element of fixed costs and the serious problem in the short term of being able to cut costs to match a shortfall on call income, which as you know is largely dependent on the general level of economic activity.

Furthermore the Board's own belief, reflecting the advice of its advisers and brokers, is that a figure of x greater than 2 will be a significant factor in the market's perception of the acceptability of this issue, and is at best likely to require a significantly higher yield than would otherwise be the case and could affect the ability to achieve a satisfactory take up.

The Board

The Board, therefore, very much doubts the wisdom of the proposed RPI-3, and feels that the Government should give serious further consideration to these points. At the very minimum it feels you should follow the suggestion, which I have already made to Kenneth Baker, that further soundings should be made in the financial markets before any announcement or irrevocable decision is made.

On the supplementary assurance you sought on residential rentals, the Board fully recognises the political and consumer difficulties. Nevertheless, it is concerned about the restraint which a ceiling of RPI+1 on our residential rentals would place on our ability to rebalance our tariffs during the five year period, given the failure of residential rentals to cover marginal costs, let alone make an adequate return, and the difficulties likely to be faced by BT if it is forced to maintain markedly unbalanced tariffs in a competitive environment. The Board therefore concluded that it would prefer a ceiling of RPI+2 with the assurance itself expressed in terms of the Board's intention.

Given the Government's determination to reduce still further the rate of inflation, should you decide to proceed on the basis of RPI-3, the Board feels that the change to RPI-2, if inflation were to fall to 3% or less, is an important safeguard and would be of some reassurance to the market.

Furthermore, the Board has also asked me to make clear that with RPI-3 it would not be prepared to agree a higher opening dividend than that currently assumed, since it is already concerned about the cash flow implications of price constraint and would not be prepared to contemplate a further cash drain through increased dividends. Clearly this could have significant implications on the issue price.

As I said at the outset the capital structure, dividend policy RPI-x and competition policy issues all need to be seen together and the Board is concerned in particular that there should be a mutually satisfactory solution to the competition issues, set out in my letter of 13 April to Kenneth Baker.

In conclusion the Board has asked me to restate its view that it would be more appropriate to proceed on RPI-2 rather than on RPI-3 and feels that the Government should give serious and urgent consideration to this point for the reasons stated, before finalising its position.

However should the Government having weighed all the factors conclude that it can only proceed on the basis of RPI-3, and that it can successfully launch the company on that basis, the Board would be prepared, subject to an acceptable resolution of all outstanding issues, to give its support to the Governments plans.

Yours sincerely

George

SIR GEORGE JEFFERSON

Copy no 1 of 3

DRAFT STATEMENT ON BT PRIVATISATION

With permission, Mr Speaker, I should like to make a statement about the privatisation of British Telecom.

A

The Government intend that the BT flotation should provide an opportunity to promote wider share ownership by both the public and employees of the company.

Employees who work at least 16 hours per week for BT and who have been in continuous employment with BT from 2 April 1984 until a date shortly before the flotation will benefit from a special scheme.

They will be offered about £70 worth of free shares paid for by the Government. For every share purchased by the employee, the Governnment will provide a further two free shares, up to a maximum of £200 of free shares for £100 of purchased shares. Employees will therefore have the opportunity to acquire about £370 worth of shares for an investment of about £100. As in past sales, these shares will have to be vested in a trust for a minimum of two years.

In addition, a discount of 10 per cent off the public offer price will be offered to all employees at the time of

JH2AGD

flotation on purchases of up to £2000 worth of shares, provided that they are held for a specified period.

Both BT employees and those in receipt of a BT Staff Superannuation Scheme pension at the time of the flotation will be given priority allotment rights when applying for shares.

A

Second, there will be a special offer to telephone subscribers in the form of vouchers which can be used to offset part of the cost of their quarterly telephone bills for a subsequent period. ~~The~~ details ~~of this offer~~ will be announced closer to the flotation.

As a result of these measures we are confident that very many of BT's employees and customers will become shareholders in BT plc.

B

I turn now to the broad outlines of the capital structure with which BT plc will enter the private sector. We have concluded that the initial debt of the company to the Government in the form of debentures should have a capital value of £2,750m, carrying interest at between 12 1/4% and 12 3/4%. An order under Section 62 of the Telecommunications Act 1984 effecting the replacement of BT's present debt will be laid before Parliament in due course. The Government will assign sufficient of these debentures to the residual statutory corporation to enable

JH2AGD

it to meet the deed of covenant obligation to BT and the Post Office Staff Superannuation Schemes, as required by the Telecommunications Act 1984.

BT plc will also issue to the Government preference shares to the value of £750m. These preference shares carrying a gross dividend of 11.75% will be non-voting and redeemable at BT's option, or in any case after 30-35 years. Apart from BT's continuing foreign and short-term borrowing, the remainder of the company's assets will be financed by ordinary shares and reserves.

Turning to BT's future operating environment - we announced last year that the tariff increases on some of BT's services should be kept below the rate of inflation. We have now concluded that the services concerned will include local calls, business and residential rentals and trunk calls. The constraint will apply to a weighted average of these services. Its level will be RPI-3, that is 3% points less than the increase in retail prices generally over the preceding year. We are satisfied that this will reassure BT's customers and ensure real pressure for efficiency - whilst allowing BT to adjust tariffs on these services to reflect market demands. To protect low users BT has given an undertaking that the residential rental charge will be

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kept as low as possible;~~and~~ will in any case not exceed RPI+2 in any year; and that a low-user rental rebate scheme will be maintained.

Details of the operation of the RPI-X provision will be set out in the BT licence which will be laid before Parliament soon.

JH2AGD

2816/17

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 25 September 1986

CHANCELLOR

FST to CH/EX 25/9

A FREE DISTRIBUTION OF BT SHARES

1. You asked me to have a look at the possibility of a free distribution of BT Shares. I have discussed this with a small group of officials and advisers and this paper is the result. I am grateful to Mr Monck for having produced it in a very short time.

2. We have not been able to go into all the precise problems associated with the Electoral Register but, having gone over the ground, I believe that most of the practical problems of such a huge distribution could be solved. We could even justify the £20 million administrative costs of the issue on the grounds that they would be the necessary price for spreading ownership and making the privatisation of BT irreversible.

3. On the other hand:-

(a) It is clear we couldn't do it before the General Election, unless the election were after April 1988. (But we would need legislation before then).

(b) The annual £100 million cost to the company of administering a share register of 40 million people could probably be reduced but the figure would still be pretty forbidding and the company would obviously not be keen on this.

(c) £140 per head in my view is hardly credible as a distribution of capital.

(d) If forced to choose I would prefer to go for tax cuts rather than a free distribution of such small amounts. If we continued with tax cuts there would be the obvious PSBR problems.

(e) There would be some criticism for giving away something for nothing. No doubt some people would lose the certificates or not know what to do with them. There would be some criticism that it would be better to have sold the shares to those who really wanted to own them.

4. My instinct is that the exercise has less point after a General Election when BT might be recognised as being "irreversibly" in the private sector.

5. However, there is the question of whether a free distribution could be put in the Manifesto and whether it would prove highly attractive. Others may have different views, but I suspect that it would receive a bit of a mixed reception. I doubt if it would be a great winner. For me the real political attraction would have been if we could have already distributed the shares before the Election and challenged Labour on whether they would then try to reverse it. That seems difficult. There are the other objections as well.

6. Somewhat reluctantly my conclusion is that a free distribution is not really a starter.

NL

FINANCIAL SECRETARY

SECRET

A FREE DISTRIBUTION OF BT SHARES

This note is a preliminary assessment of the proposal that the Government's holding of shares in BT should be distributed free to all adults aged 18 or more. It has been prepared quickly and without consultation outside the Treasury, though it has drawn on some earlier papers, notably the 1980 internal Pliatzky† report and published proposals by Sam Brittan.*

† Ch/We have a copy if you are interested
AWK

Objective

2. The main objective would be to spread share ownership even more widely than privatisation has already done to make "everyone a shareholder". It would also be welcome, if renationalisation were made more difficult by the distribution.

Value of individual gift

3. Shares would be worth about £140 per head (equivalent to about 75 shares) if distributed to 40 million adults, on the assumption that HMG's remaining shares is still worth about £5.5 billion at the current price of £1.84, compared with £8.3 billion at the peak share price of £2.78. The dividend might be about £5 a year after tax. (BT's 1985-86 dividend would have given only about £4 after tax). This would be well below the minimum worthwhile levels suggested (admittedly arbitrarily) by Pliatzky of £750 and £75 per head respectively (in today's prices). Sam Brittan envisaged holdings worth about twice this amount. Both had in mind the distribution of more than one company's stock.

MONCK PAPER

Timing

4. The distribution could not take place before April 1988. The timing is constrained by HMG's undertaking to BT in 1984, quoted in the prospectus:

> "It will not sell or otherwise dispose of any of this holding (except under the arrangements for the share bonus) before 9th April 1988. Subject to this undertaking, it is HM Government's policy to sell residual shareholdings in privatised companies as the circumstances of the companies and market conditions permit. Before any such sales or disposals and the arrangements therefor are made, HM Government will take into account the views of the Directors of the Company."

This effectively rules out a gift as well as a sale.

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*A People's Stake in North Sea Oil (1978), updated in Unservile State Paper No.26(1982).

The politics and economics of privatisation (Political Quarterly April-June 1984).

5. Legislation could also affect timing. The formal position is that the Government is free, as an ordinary individual is, to give away what it owns, provided there is no specific statutory barrier, though it is obliged to lay a minute before Parliament. But the Treasury Minute procedure seems extremely inadequate for a gift of this magnitude. And the Government would probably need legislative cover for the costs of the initial distribution and for continuing costs (see paragraphs 18-27 below), even if it decided to finance one or both of these expenditures by selling or keeping some of the BT shares.

6. Although the timing of implementation is constrained, the timing of announcement is not.

Effect on price of shares in the market

7. A major sale of shares usually depresses the price; there is a discount on the market price in rights issues or secondary privatisation sales. But in time the share price should adjust to reflect expected future profitability, ending up at the same level whether the shares are sold or given away.

8. There are, however, differences between a gift and a sale which could affect the initial or very early level of the share price, though they do not all point in the same direction:

(a) the immediate effect of a gift is in itself less likely than a sale to depress the price either of BT shares or of equities in general;

(b) if the free distribution of shares to all adults is perceived as making renationalisation less likely, it would tend to make the BT price higher than it would otherwise be;

(c) if a significant proportion of those receiving free BT shares were initially keen to turn the shares into cash if that was allowed (see paragraph 17 below) and ready to accept lower prices than buyers would have done, the price might possibly be lower than with a sale for a period shortly after the distribution (or, if this was anticipated, after the announcement). This is, however, speculative and unprovable ex post.

The arguments at (a) and (b) could probably be used effectively to meet any complaints from existing holders.

Public expenditure and PSBR

9. Giving BT shares away would make a £5½ billion hole in privatisation proceeds. Receipts from BT are spread over 1988-89 to 1990-91 in present plans; it might be possible to offset some of the effect by bringing forward other sales earlier, but the practical scope for this, eg on Water and Electricity, is limited. We would be much less confident of getting £5 billion in 1988-89 and 1989-90. The public expenditure planning total, and the PSBR would, other things being equal, go up by the same amount. The extent of the presentational problems would depend on the time of the announcement.

Macro-economic effects and policy choices

10. The macro-economic effects of giving away BT shares rather than selling them depend on how the proceeds of a sale would have been used. In the context of present policies, two extreme cases should be considered; these assume that the sales proceeds would have been used either to reduce income tax or to reduce borrowing. (A third logical possibility is that the proceeds could have been used to increase public expenditure, but this is ignored because it is not realistic to suppose that public expenditure on programmes would be significantly lower if BT shares are given away rather than sold.)

11. At some point the gift of shares has to be paid for in higher taxes than if the shares had been sold. In the first case (in which proceeds of the sale would have been used to lower taxes) taxes would be higher by amounts similar to the proceeds forgone during the period of disposal. In the second case (sale proceeds would have been used to reduce borrowing) taxes are slightly higher indefinitely to pay for the higher debt interest on the extra borrowing. Higher taxes damage incentives and reduce enterprise and labour supply. In the first case of temporarily higher taxes, there may also be disincentive effects stemming from the <u>changes</u> in tax rates. On the other hand there may be some beneficial supply side effects as a result of the wider spread of share ownership.

12. There may be some effects on expenditure and nominal demand in the short term. Among the likely short term effects are:

(a) an increase in expenditure by those people, most of them probably with relatively low incomes, who sell their shares on receipt (or, if this is not permitted, use them as security for loans). This would occur whether the gift were financed by tax or borrowing;

(b) in the tax-financing case a reduction in expenditure by some taxpayers, especially those who do not sell their shares but who would not have bought any in a normal sale;

(c) changes in interest rates: in the tax-financing case, a reduction in the yield on equities because the general level of equity prices is likely to be depressed less when shares are given away than when they are sold; in the borrowing case a possible increase in the general level of interest rates because the reduction in the yield on equities may be outweighed by the increase in gilt yields necessary to induce people to hold the extra government debt. Some of these interest rate effects would extend into the long term.

(d) it is difficult to say what the net effect on expenditure and money GDP of a gift rather than a sale would be, whether the gift is followed by higher taxes or higher borrowing.

13. Ministers would have to decide whether to continue with existing borrowing plans (ie the existing PSBR projections) when switching from selling shares to giving them away, or with existing taxation plans (as reflected in the fiscal adjustment projections), or a mixture. The first route implies temporarily higher taxation and the second temporarily higher borrowing, with the consequences summarised above. The decision would have to take account of:

(a) the relative weights to be attached to short-term and long-term tax objectives, that is whether a large but short-lived tax reduction (higher borrowing) is preferred to a small but permanent one (higher taxes) or vice versa;

(b) the effects on confidence and the credibility of the MTFS. It is probable that sticking to existing borrowing plans would be perceived as being more in the spirit of the MTFS than sticking with existing tax plans, because the latter would require an increase in the PSBR. If Ministers decided to stick to tax plans, they would probably need to argue that the public sector financial deficit was not affected by the choice between sale and gift and to explain the significance of this, as well as referring to the small or negligible net effect on money GDP.

Administration and costs

14. **Eligibility and identification**. Eligible adults would have to be identified from the electoral roll. The Community charge list does not come into effect

until 1989 in Scotland and 1990 in England and Wales; it covers all residents including foreigners.

15. There are about 43 million people on the electoral roll. OPCS have provided a rough estimate that the exclusion of Irish and Commonwealth voters, who were not also citizens of the UK and colonies, would reduce the number eligible to 40 million.

16. Some people are on two or more electoral rolls. The simplest course would be to prohibit more than one application and to take the risk of abuse. But it would be possible to threaten penalties.

17. **Disposal by recipients**. It would be simplest if recipients could sell the shares whenever they liked. But it would be possible at the cost of complication and probably continued State involvement to make rules analogous to the 'lock in' for employee share schemes. There could be a bar on sales for, say, 2 years and declining penalties for disposals in any of the next 3 years. Penalties need not take the form of tax, which would be costly for the Revenue, but of reducing the number of shares given to early sellers.

18. **Setting up and initial costs**. Ministers will presumably want to ensure 100 per cent, or at least 95 per cent, take-up. Anything much less would be embarrassing. This implies a thorough campaign to explain and to issue the shares.

19. A possible approach would be for copies of all 400 or so electoral rolls to be sent to a national processing centre, or maybe to regional centres. Alternatively applications could be dealt with locally, but this would not necessarily save on costs and would require the co-operation, and reimbursement, of local authorities many of which might be hostile.

20. Then the Centre could:

(i) send each adult an application form, with instructions and a prepaid return envelope;

(ii) receive applications, verify, record and inform the BT register;

(iii) send out 40 million share certificates each with an explanatory note on dividends, how to sell, etc.

These three postal transactions could cost £20 million on the basis of Gas solus costs. This could be reduced if each applicant was told, through a publicity campaign, to write (freepost?) to the Centre. But this risks lower take-up.

21. A variant which would hold down administrative costs would be to advertise extensively and require all eligible adults to write in by a given date. Those who did not would not get shares. The justification would be that the offer was to everyone who was interested, not to the indifferent and the incompetent. This of course implies a lower take-up. Those shares not taken up could be sold to the institutions.

22. But either way there would need to be a publicity campaign to prepare the population for receipt of the application forms, and to tell them about BT and the advantages of a holding in it. While the corporate advertising might be paid for by BT there would be costs of several million pounds for HMG. (The BGC pre-flotation campaign is costing about £28 million).

23. The central processing centre would have to be heavily staffed for a minimum of three-months or so. By way of illustration 5,000 CAs for 3 months would cost £6.5 million in salaries at national rates. In addition there would be costs of accommodation, computers, supervision and so on.

24. Whatever the total initial costs - and they seem likely to be in the range of £20 million to £40 million - they could be financed by reserving a sufficient number of shares for placing with the institutions, though this would be unlikely to remove the need for legislation.

25. It should be noted that, as the Treasury are about to take over the residual shareholding from DTI, the Treasury would be responsible for manning, running and paying for the scheme, except to the extent BT could be persuaded to bear part of the costs in the interest of making renationalisation harder.

26. **On-going costs for BT/HMG**. BT currently have about 1.6 million shareholders on their register. Administration of the register and distribution of dividends costs them about £2 to £2.50 per head, including distribution of annual reports and dividends. So 40 million shareholders could cost about £100 million on this basis. Each would receive annual gross dividends of £5-£10 for their £140 of shares.

27. There might be scope for cutting these costs, eg sending out dividends with bills. We might also consider replacing the requirement that full reports and accounts be sent to all shareholders with an obligation to send short financial summaries. (This would be on the lines of the provisions in the Building Societies Act). This would be done by order under the Companies Act, but if we also wanted to give shareholders the right to full information on demand (as provided for in the Building Societies Act), primary legislation would be needed.

28. BT might be persuaded to pay some or all of this continuing cost. But it seems likely that at least some would have to be reimbursed to them by HMG. This would very probably require legislative cover.

29. **Tax and Inland Revenue costs.** Normal tax rules would apply with one exception. Dividends would have standard rate tax deducted at source.

30. There are currently 410,000 higher rate taxpayers (counting married couples as a unit) declaring dividends and being taxed at higher rates. There are currently nearly 1.1 million higher rate taxpayers in total all of whom would be paid dividends on their BT shares. We would need to consult Inland Revenue for an estimate of the additional costs to them.

31. Inland Revenue currently have 90,000 non-taxpaying units claiming tax refunds on their net dividends. This figure could increase to approximately 11 million, each eligible to claim an annual rebate of around £1.50 to £2. Is it acceptable to legislate to disqualify them from claiming and to justify this by pointing out that the shares themselves were free? (We might also justify this by reference to the need to finance the £20 million or more start-up costs - see paragraph 24.)

32. Under the normal stamp duty regime, people buying shares from those who originally got them free would have to show that duty had been paid before the BT share registrar would pay them dividends.

Some possible criticisms and questions

33. These would depend on decisions on fiscal questions, practical issues and approach to Parliament. Irrespective of those decisions there would be questions about why privatisation by free gift was only starting now and why BT had been chosen. There would be strong pressure for further privatisations - Water, Electricity - also to be gifts rather than sales. The prospectuses for partial primary sales would in future need to say whether the remaining shares would be sold or distributed free.

34. Also, (if tax plans are kept unchanged) why switch now (as seem likely) to defining fiscal stance in terms of the public sector deficit instead of the PSBR?

35. Parliament and PAC etc. might complain, despite the absence of formal bars. So may existing holders.

36. If HMG were ready to incur large cash and staff costs on the BT scheme there would be questions whether there were other areas of higher priority - eg more manpower for Inland Revenue and Customs to collect tax more effectively, with the increased yield making tax cuts possible; or more manpower in any area where it is claimed that services and benefits to the general public would increase. Among others, the civil service unions would make great play of this, particularly if the increased manpower was in the Treasury.

<u>**Conclusion**</u>

37.(i) A free distribution of BT shares held by the Government does not look impossible, providing timing and probable legislative constraints are observed;

(ii) but the size of the distribution to each person over 18 (see paragraph 3 above) would be extremely small in relation to initial and continuing cost of administration;

(iii) Ministers would need to decide between higher borrowing or taxes compared with the levels that would have prevailed if the BT shares had been sold;

(iv) the administrative cost figures in the paper are no more than first shots. The estimate of continuing cost could probably be brought down but the initial cost could go either way. What is clear is that they are not negligible;

(v) it is far from clear that BT would be prepared to foot either the initial or the continuing bill, even to reduce the risk of renationalisation. But Ministers would no doubt push them as far as possible;

(vi) the remaining costs falling on Government could be financed if the Government held on to some of the shares and sold them progressively, though a large number would be needed to meet the continuing costs. If this were possible, the costs falling on Government might not add to the public expenditure figures; in effect part of the shares would go on these costs instead of being distributed free;

(vii) a large number of practical decisions and presentational problems would have to be faced. But these are not bars to the scheme.

38. This paper is designed to enable Ministers to decide whether they wish to pursue the idea of a free distribution of BT shares further. If they do, wider consultation would be needed, notably with lawyers and the Revenue, but also with others. Such consultation would clearly make the scheme more widely known. But without it Treasury officials cannot be sure that all major snags have been identified or make better estimates of the costs and the administrative steps required.

25 September 1986

SECRET

Pst cruelly this 'compelling' case on ... advisers for the Comm...

CHANCELLOR

Ch/ See first FST's note below AWK 1/10

FROM A TYRIE

DATE 30 SEPTEMBER 1986

cc FST
Mr F E R Butler
Mr Monck
Mr Cropper
Mr Ross Goobey

TYRIE to CH/EX 30/9

A Free Distribution of Shares

As you know from other submissions I favour a free distribution although I expect I am swimming against the tide.

2. Mr Monck's paper and the Financial Secretary's note have their doubts, particularly on account of the cost of administration and the small size of the giveaway. But more work is required before we can be sure about the cost of administration.

below

3. Before looking at the detail I think it is worth coming to a view on whether in principle a free distribution is desirable. Do we think that a free distribution of shares would:

(i) greatly extend knowledge and interest in share ownership;

(ii) be of any electoral value?

Extension of ownership

4. These arguments are well rehearsed. For what it is worth I think that a sizeable share distribution could compare with our trade union reform and the 1980 Housing Act as a step which might come to be seen as a landmark in changing attitudes in Britain.

5. The argument in principle against a free

distribution is that it is "giving people something for nothing", the moral corollary of the universal welfare system which some hold has sapped individual enterprise. I can imagine this might be the PM's view.

Electoral attractiveness

6. A free distribution will be appealing electorally on the following grounds:

(i) it can be portrayed as a dramatic, radical and exciting step;

(ii) it is an excellent riposte to Labour's social ownership plans for BT. 'Social ownership' can even more easily be portrayed as a "share grab" once everyone has the prospect of owning it. (There is a counter-argument that having given shares away free it will make it easier for Labour to justify snatching them back);

(iii) a BT giveaway could, like Council house sales, force Labour to give ground and modify their policy. Any adjustment to their social ownership plans so soon after producing them would be a major set back for them;

(iv) a free distribution goes some way to answer the criticism that privatisation has had more to do with raising revenue than spreading ownership more widely.

7. On the negative side:

(i) a free distribution could come to be seen as a blatant electoral bribe, but not, I think more blatant than an income tax cut.

(ii) Dare Labour argue that the size of a £150-£200 giveaway is puny?

(iii) A free distribution does call into question why former and subsequent privatisations are not also not given away. I think that the argument that this is a one-off measure to change attitudes on share ownership is a reasonable counter.

8. The obvious alternative to a free distribution would be a tax cut. If it is held that people vote with their wallets there is little to choose between tax cuts and a share handout. But there are differences. First, it is hard for Labour to claim that money represented by a free distribution could be put to better use as public expenditure. They will have no receipts to distribute from privatisation.

9. Secondly, the argument for tax cuts has been badly mudded by counter-claims for lower employment as a result of infrastructure or other spending. I think, regrettably, we can only claim a draw so far in this debate.

10. To enhance the electoral appeal of tax cuts we will have to take the 'high ground' and show that reductions in tax are essential for future economic

prosperity and higher employment.

Size

11. I think the two other notes underestimate the attraction of a £140 windfall. (It is probably worth more than £140 - BT's peak price would give a handout of £211. Much of the differernce is probably reaction to the threat of renationalisation).

12. If size were the only obstacle it would be worth considering other packages (water or BT plus BP or whatever) until one of an appropriate size was found.

Administration

12. The start-up cost of £20 million could be covered by the retention of a few shares. It would in any case be completely offset if it were decided not to permit tax refunds for non-paying units on the distributed shares.

14. The £100 million running cost of a share register of 40 million is a more serious problem. But there is considerable scope for savings. For instance, could the interim dividend be combined with the final dividend in one annual payment? Would every shareholder in BT want full share information at £2.50 per head administrative cost? As Mr Monck's paper points out, could we not provide an obligation on BT merely to supply information on request, as with building societies, combined perhaps, with the publication of accounts in all the daily newspapers. BT's performance would, after all, become an issue of truly national interest.

Conclusion

15. Are you attracted to a free distribution in principle? If so I think we need to do more work before we can take a clear view on the practical problems.

AGT

A G TYRIE

010/2765

SECRET

FROM: JILL RUTTER

DATE: 6 October 1986

PS/CST TO PS/CH 6/10

PS/CHANCELLOR

cc:
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Mr F E R Butler
Mr Monck
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Ch/ I think you still have your copy of this's think

A FREE DISTRIBUTION OF BT SHARES

You invited other Ministers' comments on the Letwins' paper about a free distribution of BT shares.

2 The Chief Secretary has commented that, while he is very keen on privatisation and wider share ownership, he is not attracted by this proposal. He sees a wide range of well known snags - ~~but~~ that it could be construed as a simple bribe, and would be criticised by those who have already bought shares - even though they too would benefit from the free distribution; it would lead to a loss of much needed revenue; the Opposition would attack it as a give away of the nation's assets.

3 Moreover, the Chief Secretary thinks that the probability is that people do not value what they are given for free and are much more likely to value an asset if they had paid something for it themselves.

4 Taking all these facts into account the Chief Secretary believes the balances of disadvantages outweighs the potential advantages.

Jill Rutter

JILL RUTTER
Private Secretary

SECRET

FREE DISTRIBUTION OF BT SHARES

SECRET

FROM: M W Norgrove

DATE: 15 October 1986

PS/CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr F E R Butler
Mr Monck
Mr Cropper
Mr Ross Goobey
Mr Tyrie

FREE DISTRIBUTION OF BT SHARES

The Minister of State has commented as follows:

"A critical question is whether the climate and culture has moved on from the days when (eg) ICI and Rolls-Royce issued shares to all employees who promptly turned them into cash. My own view is that it has, in the sense that there is a much more interested public, but that it does not yet embrace the nation as a whole and that any general scheme, however hedged about by non-sale conditions, would suffer the ICI/Rolls Royce attitudinal fate. It is significant that, despite the welcome enthusiasm for discounted council house purchase, there are still a large number of council tenants.

Norgrove → PS/CH 15/10

On the chicken-and-egg question of whether ownership begets understanding or understanding begets ownership, I would put much more money on the latter, and would expect the roots to go deeper in consequence. By and large, human behaviour changes because an individual wants it to: the motivation to ownership is important.

I am however vividly conscious that the potential pool of investors is widening as the process becomes, with each flotation, more part of popular culture. I am struck by how the TSB episode is having a knock-on effect on to British Gas. I would therefore hope that this can be carried forward further with the next BT tranche. My recollection of the last tranche is that, though there were subscriber discounts on telephone charges, it was not sold to subscribers with the same energy as British Gas is being sold to British Gas customers (I am impressed by the educational element in the British Gas package, in the form of the Stock Exchange booklet) and I would hope that the next tranche could receive a more vivid direct mail impact. The fact that telephone subscribers (I do not know how many there are) almost self-select themselves as being the precise candidates for a widening investor pool reinforces me in this. I have seen British Gas "advertising" expenditure variously stated at between £28m and £34m. Similar expenditure on the next BT tranche would look money better spent to me than the projected expenditures on a free BT issue".

MWN

M W NORGROVE
Private Secretary

3212/37

SECRET

FROM: P J CROPPER
DATE: 16 OCTOBER 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr F E R Butler
Mr Monck
Mr Ross Goobey
Mr Tyrie

A FREE DISTRIBUTION OF BT SHARES

My preference would be for HMG to make a public offer of its remaining holding of three billion BT shares, at the original offer price of 140p, on the basis that no applicant (being an adult UK resident) would get more than 100 shares. It would be a safe bet that the number of applicants would be below 30 million. The offer would have to be accompanied by draconian penalties for multiple or fraudulent application.

2. It is the ballyhoo accompanying BT, TSB and Gas that is really educating the British population to the idea of owning shares. Therefore we want as many attractive offers as possible, spread over several years. I would apply the same technique of attractive offers to the BP holding and any other concern where HMG has a big enough holding to offer something to everybody. Shares could even be grouped in packages, ie. 50 Airways plus 50 Airports.

CROPPER
→ CH/EX
16/10

3. I feel that the Free Distribution would be a case of running before we can walk. The cost of the exercise, and the cost of servicing a 40 million share register subsequently would be very great indeed. I incline to Alastair Ross Goobey's belief that many people would neither appreciate nor understand something that just came through the letter box one day.

4. I therefore tend to line up with the Minister of State.

P J CROPPER

COMMERCIAL IN CONFIDENCE

FROM: S P Judge

DATE: 27 April 1987

APS/CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Mr F E R Butler
Mr Anson
Mr Burgner
Dr Freeman - CCTA
Miss Peirson
Mr Dibble - CCTA

MERCURY COMMUNICATIONS

The Minister of State has seen the attached submission from Mr Dibble, and has sent the attached letter to Sir Keith Joseph MP in advance of a meeting he is having with him and Mercury Communications at 2.30pm on Tuesday.

As the Minister's letter says, his present intention is to instruct CCTA to terminate the contract with Mercury. But he will not make a final decision until after he has heard what they have to say.

The Minister would be grateful for the Chancellor's views as to whether it is necessary to inform the Prime Minister about this difficulty, and whether this should be done now or after a definite decision has been taken. If it is to be done now then the Minister of State could write on the lines of the attached draft minute.

On balance, no. Draft minute OK.

SPJ

S P JUDGE
Private Secretary

1/6 24 APR 1987 - 1/8 SP

FROM: R E DIBBLE
DATE: 24 APRIL 1987

MINISTER OF STATE

cc: Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Burgner
Dr Freeman
Miss Peirson

MERCURY COMMUNICATIONS

Following the liberalisation of the telecommunications market in 1981, CCTA has applied a competitive procurement policy to obtain rented circuits whenever possible for the Government Telecommunications Network (GTN). With active encouragement from the Department of Trade & Industry (DTI), a number of 2Mbps circuits have been rented from Mercury (part of Cable & Wireless). The most significant of those circuits provides telecommunications services to civil servants in Wales with links from London to Cardiff and Birmingham to Cardiff and they use a mixture of microwave and fibre optical cable technology.

2. Unfortunately these circuits have been plagued with a long history of technical problems which have resulted in 5 full days of lost service to Wales over the past year. This level of down time is clearly unacceptable for a major telecommunications link and our customers in Wales have quite properly demanded an improvement in the quality of the service provided on the GTN.

3. To my surprise, we have found ourselves involved in a long and fruitless battle with Mercury to get these technical problems sorted out. I had expected, wrongly as it turns out, that Mercury would have done all that they could to retain new business. We finally warned Mercury (on 7 November 1986 and 11 December 1986) that they must improve the availability of the

circuits but the warning has gone unheeded and we have recently experienced another spate of problems.

4. I believe this cannot be allowed to continue any longer and that we must show our customers in Wales that urgent, positive steps are being taken to improve their communications to the rest of the country. Indeed I was about to propose to you the termination of the Mercury contract and to rent services from the alternative supplier British Telecom (BT). This action would undoubtedly have caused some considerable disquiet in Mercury who would have complained to their sponsor DTI, and perhaps to the Prime Minister. You will recall the problems we faced previously with the replacement of the London Tandem exchange and I assume that this situation could be viewed as a controversial procurement.

5. However Sir Keith Joseph's letter to you of 14 April seeking an early meeting between you and Cable & Wireless offers a further opportunity to discuss this situation. My own recommendation is that we should terminate the Mercury contract but given the timing of your meeting with Cable & Wireless, it would be perverse to cancel the order without acquainting them with the position.

6. If you agree with this approach, then it is important to put Cable & Wireless on notice that you will be raising the issue. I attach a draft letter, and a minute which you may wish to send to the Prime Minister. I will prepare a brief on the issue for the meeting, and will be ready to attend with Dr Freeman if you wish.

R E Dibble

R E DIBBLE

MINISTER OF STATE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Sir Keith Joseph Bt CH MP
House of Commons
LONDON SW1A OAA

27 April 1987

Dear Keith,

Thank you for your letter of 14 April. As you know a meeting has been fixed for 28 April. I welcome the opportunity to learn more of Cable & Wireless, though as you know I would wish to avoid discussion of the Government Data Network project itself.

There is one other point I would wish to raise at the meeting, of which it is only fair to give you advance notice. As you may know, the Government Telecommunications Network rents a number of circuits from Mercury. I have to say that the service on the circuits serving Wales, between London and Cardiff and Birmingham and Cardiff, has been totally unacceptable, and that repeated efforts by my officials to get Mercury to improve the situation have achieved nothing. The Welsh Office have complained that the service is inadequate and it is therefore my present intention to instruct my officials to terminate the contract with Mercury.

Yours ever

Peter

PETER BROOKE

COMMERCIAL IN CONFIDENCE

MINISTER OF STATE TREASURY

DRAFT MINUTE FROM THE MINISTER TO:

PRIME MINISTER

The Chancellor and I think that you should know about a small but potentially awkward problem we are having with Mercury Communications.

CCTA have recounted the long history of faults that they have been experiencing with Mercury Communications' circuits on the Government Telecommunications Network (GTN). Despite written warnings earlier in the year of the consequences of the poor quality service, Mercury have been unable or unwilling to provide the level of quality required for a telecommunications link of this type. The major problems have occurred on the links to Wales, where network users have experienced a poor service. This has resulted in a written complaint from the Welsh Office, which I cannot ignore.

In order to improve the quality of service to Welsh users, I am at present intending to authorise CCTA to transfer the rental contract for the circuits between London and Cardiff, and Birmingham and Cardiff, from Mercury to British Telecom. Keith Joseph has fortuitously asked to bring Sir Eric Sharp, the Chairman of Cable & Wireless (Mercury's parent) to meet me this afternoon. I therefore propose to inform them of dissatisfaction with the reliability of these circuits and our intention to transfer the order from them to BT.

My officials have confirmed that the problem is confined to this particular circuit and that there is no intention of preventing Mercury from gaining other business within this area of work. Indeed I understand that the company has obtained orders for a number of other circuits covering other routes.

I am copying this minute to Nicholas Edwards and Geoffrey Pattie.

PETER BROOKE

British
TELECOM

from the Chairman
Sir George Jefferson CBE

British Telecom

81 Newgate Street
LONDON
EC1A 7AJ

Telephone number
National 01-356 5333

International +44 1 356 5333

Telex 883051

PS/ Thank Sir G, but put on Rec, Re X, I do not know a single user of both NY & London telephone systems who does not find NY marginally better. So I am particularly glad to note (I may add in this sentence).

19th August 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
The Treasury
Parliament Street
LONDON SW1P 3AG

Dear Nigel

I am sure that you are aware of the recent considerable degree of Press criticism of BT since privatisation, together with speculation as to whether the Government's approach to other privatisations should be significantly different.

It is of considerable personal concern to me that this has arisen, not just for BT, but also for the additional problems it could cause for Government.

As you know, I have done my best at all times to support the Government's policy on privatisation and competition in the telecommunications industry and in order to get some balance into this matter I wrote an article which was published on Tuesday, 7th August, in The Daily Telegraph. Attached is a copy of the original - rather fuller - document from which the article was taken which I hope will be helpful to you.

From this you will see that, although much remains to be done in transforming BT, the real causes of the "explosion" lay in a coincidence of accelerated demand, coupled with very late equipment deliveries to us, a national strike in which we successfully kept the network running (but at the price of quality of services generally due to losing about 8% of our working year) and two of the 700 new System X exchanges commissioned over the last twelve months experiencing extreme service problems when introduced into use.

Problems associated with these two exchanges have now largely been eradicated and we have taken all possible measures aimed at restoring general service levels to their pre-strike standard by the end of September.

I believe this will be substantially achieved, and further measures in hand - many long planned - will, I am sure, bring significant further improvements over the following six months.

We have also announced a price standstill for the coming year on our basic telecommunication services, which seems to have been well received and which should also be helpful in the continuing fight against inflation.

If there are any aspects of these matters on which you would like further clarification, please do not hestitate to let me know.

Yours sincerely

George

ARTICLE FOR THE DAILY TELEGRAPH

By Sir George Jefferson CBE, Chairman of British Telecom

Following the report by the National Consumers Council recently British Telecom has been the subject of numerous and severe attacks in the press on its performance since privatisation. Yet at no time in the history of telecommunications in Britain has more been undertaken towards making major improvements in all aspects of our service and our efficiency than has been put in train during this period.

Over this period we have substantially completed the creation of our digital trunk network covering the whole of the UK and today some 30% of all trunk traffic is carried digitally.

We have added some two and a half million additional customer lines to serve local customers.

We have installed a greater proportion of new optical fibre cables than major players anywhere else in the world.

We successfully dealt with enormous demands in 1986 of the City for communications and dealer rooms, so that it was the Stock Exchange computers, not our communications, that grabbed the headlines last Autumn.

We have built an entirely new mobile communications network covering most of the UK, and today serving approaching 100,000 customers.

We have introduced and proliferated an enormous range of new and effective products and network services, ranging from fast fax to megastream private circuits.

Last year, within the City of London alone, we laid 50,000 miles of new cables, twice the circumference of the earth, to help deal with what has been an almost phenomenal growth in demand there for telecommunications services.

Indeed the demand post "Big Bang" has very greatly exceeded pre Big Bang. That we were not alone in being surprised by the huge growth in trading is evidenced by the major paperwork systems indigestion which caused the City recently to consider whether it might have to restrict share trading days.

Whereas in the run-up to the Big Bang we satisfied demand by providing in the City 2,500 private circuits a month, current demand had been running at twice that figure. By drafting in some 600 additional engineers we have managed to reach a monthly supply rate of 6,500 circuits a month and if there is no further increase in demand rate the accumulated backlog will be very substantially reduced by the year end.

Overall, up to the end of 1986, the quality of performance of our network and services was steadily improving. Dramatic improvements were never going to result from privatisation, or any other structural change. Indeed looking across the Atlantic, divestiture there has resulted in deterioration of customer service and considerable confusion.

But if BT has done all these good things, why is there such a current outcry, particularly by the press?

The reasons are several, but they come together in a genuine perception of a fall in performance in the first half of 1987, following some increasing difficulties in late 1986, all of which caused genuine difficulties and a sense of grievance to a number of our customers, particularly in London, rising to a peak in the late spring of 1987, although even the NCC survey showed 90% of our customers nationwide content with our service in a poll taken only 3 weeks after our National Strike.

These difficulties must and will be overcome quickly, and I believe that by the Autumn of this year we will have recovered to at least 1986 levels of performance, with a number of areas substantially better, and continuing improvement thereafter.

In that context a word of explanation will not, I hope, be confused with complacency.

The degradation in service which started on some London exchanges in late 1986, and the beginning of a modest waiting list for new exchange lines, arose from the fact that the actual deliveries of System X exchanges ran $1\frac{1}{2}$ to 2 years late on contract. This gave rise to exhaustion of available spare lines on a number of exchanges, particularly in Central London, and increasing difficulties in keeping some of those exchanges which were over 50 years old working adequately. Efforts to order from a second supplier to relieve this hazard in time to meet these needs reliably were frustrated by powerful lobby groups whilst we were still a nationalised industry.

Fortunately, this supply bottleneck is now broken, but too late to avoid all our problems. There is a desperate urgency to bring these systems into service, and this is being successfully done with two significant exceptions to date, at a rate well in excess of that planned.

We now have nearly 700 Local System X exchanges in service, with more than one million digital exchange lines installed, and are bringing new exchanges into operation at an average of more than one every working day. We shortly hope to achieve a striking rate of two per day.

Working at this speed, particularly in Central London with all its complexities, does involve taking some risks in our efforts to bring additional capacity on stream as quickly as possible. We have to date commissioned over 40 digital exchanges in inner London pretty satisfactorily, but the introduction of the 388 and 405 exchanges did go seriously wrong and caused very considerable customer problems for a substantial period (and this further exacerbated customer reaction). I am glad to say that by mobilising expert teams from within BT and from our manufacturers, we have now almost completed the task of restoration of acceptable service from these two exchanges.

The installation of digital exchanges is not by itself the answer to quality and reliability. One of the problems we face is that digital exchanges are actually more demanding in terms of their interface with customers' equipment (a problem exacerbated for us by the proliferation in customers' equipment since deregulation), and even more importantly require high quality in our own transmission cabling.

The capital involved in renewing our underground cabling is huge. It only makes sense to replace it with types of plant which are modern. In our trunk network, we went over to solely fibre optic purchases five years ago, because the technology was then ready. It reached a similar stage only two years ago as regards use in our junction network, and this year we were able to launch a £100 million programme to link fibre optics directly into major business premises, starting in Central London. Thus the local digital switch programme is running ahead of the transmission programme solely on the basis of availability of technology. This would not have mattered, if over the past forty years there had been proper investment in capital to maintain a high standard in the conventional copper systems, but particularly in London these cables are as old and as patched as our old Strowger exchanges.

Now that the technology is available we are pushing ahead at an enormous speed to install it, but the task is a huge one and will inevitably take some years to complete.

The other major factor which contributed to a fall in standards arose from the NCU national engineering and clerical strike in January and February.

I believe the strike was foolish and unnecessary, but the settlement gave us agreement for vital changes in working practices, and much greater flexibility. Our managers then, against general expectation, kept the network running and our customers were able to maintain a very high proportion of their communications.

But there was a price. Orders for circuits, for repairs, for change in installation, continued to build up both through the strike and in the weeks that followed, when first priority had to be given to bringing the network back up to full capability. No wonder then that the NCC survey, only three weeks after the strike, showed a substantial number of customers dissatisfied. This strike affected nearly all aspects of our service including public call box maintenance, but again I am confident this will, given no further such action, be fully overcome by the late summer of this year.

Public call boxes are, of course, the butt of popular opinion in almost every country, and ours is certainly no exception. But since privatisation, we have replaced <u>every</u> public call box mechanism in London, and in most of the country, and with modern equipment. In addition, we have a major programme of replacing those august but unsanitory red boxes by modern housings which can be kept clean, and which can be used more easily by the frail and disabled. Look around you in London, or Newcastle or most parts of the country and you will see the changes we are making. But we need to do more, and as I write, better methods of service and support are being introduced, and today there are many more public call boxes than ever before.

And of course directory enquiries. By the end of 1986, we had installed at £60 million cost an entirely new national computerised DQ system which is inherently one of the best in the world. But as in so many things, particularly when they are free, the customer demand rose quickly when they discovered that they could get a number more quickly from the operator than by flicking the pages of the directory. So, although we were handling DQ calls at over 500 million per annum (a 20% increase over the previous two years) we had a queuing problem develop in which at certain times of the day it was difficult to get to the operator. But by this September, we shall have completed a £40 million capacity extension which is, I believe, already overcoming the problem and will give Britain the best DQ service anywhere. We are about the only major telecommunications operator in Europe not to charge for DQ.

Today, we see British Telecom right in the middle of a period of great transition and much remains to be done. We do not yet have the benefits of our massive network modernisation and computerised customer service programmes, yet we have the additional burden of keeping the new and the old running in parallel. At the same time, we need to drive down staff numbers to achieve international standards of efficiency, while meeting customer expectations of new and improved services. A formidable management task, by any standards, and one that is only part-way through.
But much has already been achieved, and I hope I have conveyed a sense of urgency and immense effort.

In this period, we have achieved the move from a cross-subsidied, redistributive pricing policy - tenable only in a state monopoly - to much more cost-orientated prices, essential in a competitive environment. We have managed to phase this re-balancing over a period of time, so that not only have prices come down overall in relation to RPI (some 9% below RPI movements in the period), but we have also managed to keep average movements in the business and the residential bill below the RPI.

It is against that background that I view with some scepticism the claim that British Telecom should have been opened up more rapidly to competition. In practice, we already face total competition in the supply of equipment and services, and the path has been set for the complete opening up of network competition. To have moved more quickly over the last 3 years would have meant much more rapid rebalancing of tariffs - and consequent pain for our residential customers - and called in question our policy of supporting British industry in its efforts to produce internationally competitive products. Our supply industry, like British Telecom, needed time to adapt to the newly competitive market.

As for the days ahead, British Telecom would prefer to face the stimulus of more competition rather than the stultifying effect of greater regulation.

But competition is not created by the breaking-up of a national monopoly into a number of local ones. In America, the break-up of AT&T has not led to competition in the local network. But it has led to much sharper rebalancing between local and national tariffs than in the UK, to the considerable pain and confusion of the average American customer.

X

More importantly, however, British Telecom is not large in a telecommunications world dominated by international players. It is about the same size as each of the six divested Bell companies. The challenge for British Telecom's management is to promote the range and quality of services which our domestic customers have a right to expect, while shaping the Company to be a major player for the United Kingdom in the increasingly competitive international information technology market. It is a challenge we are determined to meet.

MR 3/55

RD

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

1 September 1987

Sir George Jefferson CBE
Chairman
British Telecom
81 Newgate Street
LONDON
EC1A 7AJ

Dear George

Many thanks for your letter of 19 August attaching a copy of the material for your Daily Telegraph article.

I take your point that in America the break up of AT&T has led to a much sharper rebalancing between local and national tariffs than in the UK, to the considerable pain and confusion of the average American customer. But I have to say that I do not know a single user of both the New York and London telephone systems who does not find New York incomparably better. So I was particularly glad to see that you are confident that the steps you have already taken and the further measures you have in hand will bring significant further improvements in BT series over the next six months.

Yours ever
Nigel

NIGEL LAWSON

British
TELECOM

from the Chairman
Sir George Jefferson CBE

British Telecom
81 Newgate Street
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prus
B Telecom
papers

7th September 1987

STRICTLY PERSONAL AND CONFIDENTIAL
Sir Peter Middleton KCB
H M Treasury
Parliament Street
LONDON SW1P 3AG

cc PPS
Mr Monck
Mr Moore

Dear Peter

I tried to call you to speak personally to you over the telphone, but I understand that you were not free. I am therefore writing this letter to you to let you know - in confidence - that I shall be announcing at our AGM on Wednesday this week important changes in the top level management of British Telecommunications plc with effect from 30th September 1987.

The Board has agreed the appointment of Mr Iain Vallance - currently our Chief Executive - to be Chairman of the Corporation with full executive responsibility and Mr Graeme Odgers - currently Deputy Chairman and Chief Finance Officer - will relinquish both of these appointments and become the Group Managing Director of British Telecommunications plc through whom all Divisional Managing Directors will report. In addition, Mr John Raisman, who is currently a Government appointed Non-Executive Director and whose appointment in that role will end on 30th September, will be appointed with effect from 1st October, as an ordinary Director of the Company and Non-Executive Deputy Chairman.

We shall in due course be appointing a new Corporate Finance Director and we will be expecting to agree with the Government the appointment of a Government nominated Director to replace Mr Raisman's role in that connection.

I have advised the Secretary of State for Trade and Industry of these changes and we have made arrangements to discuss with the Department the appointment of the new Government Director.

I shall

STRICTLY PERSONAL AND CONFIDENTIAL

I shall, after seven years with British Telecom, be severing my ties with it, but I believe there is a good team who will carry it forward to make it one of the best telecommunications companies anywhere.

In the meantime no doubt you will be wishing to make plans for the disposal of some or all of the remaining Government shares and clearly this will now be a matter on our side for Mr Vallance and Mr Odgers.

My very best wishes to you.

Yours sincerely

George

PS This is price sensitive information and I would be grateful if you would maintain strict confidence until formal release is made on Wednesday afternoon.

BRITISH TELECOM

MOORE
CHEX
15 SEPT

3692/014

CONFIDENTIAL

FROM: D J L MOORE
DATE: 15 SEPTEMBER 1987

CHANCELLOR

cc: Financial Secretary
Sir Peter Middleton
Mr Monck
Mrs M E Brown
Mr Bent
Mr M Call

BRITISH TELECOM

You asked for a short aide-memoire on the options for a further sale of HMG's shares in BT.

2. We hold about 3 billion shares, or 49.8%. In the summer they were worth about £9 billion. The price yesterday was 262p i.e. £7.9 billion for HMG's holding. The 1987 price range is 337-209p.

3. When you discussed the privatisation programme in June you provisionally agreed that there should be a BT sale in summer 1988 but that it should be of only some of the holding, perhaps a third. To sell the lot would bring in too much in the next 2 or 3 years. A decision on the amount could be taken later and tailored to our latest view on the pattern of receipts from other sales. We would probably have 3 instalments with one in 1988-89 and two in 1989-90, or maybe the third in 1990-91.

4. The case for a sale in 1988 is:

(i) no other major sale is in prospect for the year and, without BT, the privatisation and wider shareownership programme could lose momentum;

(ii) 1989 could be more difficult because Carsberg is then due to review and revise the RPI-3 formula and so uncertainties on this could overhang a sale;

(iii) 1990 could similarly be awkward because there will be a Government review of the BT/Mercury duopoly which stands until 1990.

5. However, we would need to reconsider the timing in 1988 and the alternative of deferring to 1989 if - as suggested in today's 'Financial Times' - Carsberg were to move earlier on the price formula and bring about a wide-ranging review by MMC during 1988. Deferment to 1989 could be managed in terms of proceeds objectives and could give more time for the depressed price to recover. The main objection would be loss of momentum in the programme.

6. In earlier discussions, you said that nothwithstanding the duopoly review you would want to hold open the possibility of following a 1988 sale with a 1990 sale if a shortfall on Water and Electricity receipts emerged. This remains a possibility but if a DTI review is under way there could be disclosure awkwardnesses.

7. I will update PE's overall assessment of the privatisation programme within the next month.

DJLM.

D J L MOORE

1236/33

JT

FROM: MARK CALL
DATE: 22 SEPTEMBER 1987

CHANCELLOR

Ch / 'X' below - a word with Lord Young when you next see him? 22/9

Right. I will mention the pt @ X to D.Y. [illegible]

cc Financial Secretary
Sir P Middleton
Mr D J L Moore
Mr Monck
Mrs M E Brown
Mr Bent

BRITISH TELECOM

On the vexed subject of British Telecom I don't know whether you saw the attached article in yesterday's Evening Standard. In it Michael Bett cogent~~al~~ly states the major long term problem facing BT: that domestic subscriber rates will have to rise significantly to correct historic cross subsidisation put in place for political reasons not commercial. Unfortunately it misses the point that most of the current public concern relates to service level not to charges, ie rude or slow operators, delays in installation, and overcharging.

2. A glimmer of presentational hope ~~thought~~ was provided by Roy Watts, Chairman of Thames Water, at a conference on privatisation of the water industry on Friday. He argued that the current vogue for BT bashing, both in the media and at the AGM, is a sign that privatisation is working: ie it is just this kind of public pressure that will make BT improve and from which it was immune as a state-owned monolith. I think I'd want to choose my audience before advancing that line - perhaps you could offer it as a suggestion to Lord Young?

X

MC

MARK CALL

You've never had it so good says Telecom

Standard Reporter

HOME telephone customers have had it easy so far, says a British Telecom official warning of higher charges.

Michael Bett, managing director of BT's UK Communications division, said domestic subscribers are too heavily subsidised by other parts of the business.

"They are still considerably below what they need to be in order to make an equitable contribution to BT's overall profitability," Mr Bett told Woolwich SDP MP John Cartwright, at a time BT faces increasing criticism of its charges and service.

"For many years now residential rentals have been subsidised by other, more profitable services," he said.

"We have been reducing this cross-subsidy gradually as we align our charges more closely with costs. The need for this rebalancing of charges has been reinforced by the development of competition."

Demand

Mr Bett outlined BT policy in reply to a demand by the MP for BT to reduce the standing charge for old people and others who make few calls.

He told of one pensioner for whom the rental makes up 65 per cent of the bill.

Many old people make few calls, but the phone is a lifeline and it would be tragic if they were forced to give it up because they could not pay the bill, Mr Cartwright said.

Mr Bett said BT is approached by many charitable groups and individuals seekings concessions but it is not possible to grant them.

BT's licence prevents it showing preference or discriminating against any customer or group, he added.

But because it was recognised that the phone is a lifeline for the elderly and housebound, a scheme was introduced in 1983 giving low users a rebate on their rental. Three million people a year benefit and the scheme costs BT £20 million a year, he points out.

Money

The real cost of renting a phone has fallen, Mr Bett added. In 1970 it cost a single pensioner the equivalent of a week's pension. Now it costs less than half a week's pension.

● Leader comment—Page 7

PWP

Ch/

good!

BT.

Mr Moore tells me that BT have agreed a pricing formula with Carsberg: RPI – 4½%. Vallance told D. Moore that BT were not that happy, but that they extracted some minor (unspecified) concessions, and thought they would do worse at the MMC.

2. It is, of course, still open to Ld Y to make a reference. He will not decide on this immediately. Assuming he decides not to, the way is clear for a sale next summer (shld. we think it necessary & desirable).

JS 7/7

PMG 12 OCT 1987 -15

App P.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

12 October 1987

Dear Simon

MERCURY

The Prime Minister was grateful for the report on the Government use of Mercury which you sent with your letter to me of 5 October. She has noted the very large potential savings which could be achieved by greater Government use of Mercury and she has asked that the CCTA studies of the possibility of installing Mercury exchange lines on Whitehall exchanges should be pushed ahead with all speed. She would be grateful for a report on progress in four months' time.

I am copying this letter to Tim Walker (Department of Trade and Industry).

Yours,

David

DAVID NORGROVE

PAYMASTER GENERAL
12
Dr Freeman - CCTA
PS/Chief Sec
PS/CST, PS/FST
PS/EST
Sir P Middleton

Mr Anson
Mr Burgner
Mr P Rayner
Mr Dibble
Mr J Clarke
CCTA
PMG

Simon Judge, Esq.,
Minister of State's Office,
H. M. Treasury

he.dc/perfect/sub3

FROM: R M PERFECT
DATE: 20 OCTOBER 1988

1. MR FARTHING

2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr Burgner
Mrs Case
Mr Culpin
Mr Gieve
Mr Tyrie

Ch / OK?

OK

MPM

TELEVISION LICENCE FEES

1. You will wish to be aware that the Home Office have proposed at official level that TV licence fees should be increased next April to £66 for colour and £22 for monochrome. The increases are in line with the agreed formula and we recommend you accept the proposals.

2. In January 1987 the Home Secretary announced that the licence fee would remain fixed until April 1988, and would then be revised annually in line with the movement in the RPI over the 12 months to the preceding September. This arrangement is to hold for the three years 1988-89 to 1990-91.

3. This is the second year these arrangements have been used. The Home Office have started from the unrounded figures arrived at last year, increased them by the 5.9 per cent rise in the RPI over the twelve months to September, and rounded the results to the nearest 50p. This year, both the colour and the monochrome licence fees are rounded downwards.

Calculation of television licence fee increases

£

	Present licence fee	Unrounded figure	Increased by 5.9%	Proposed licence fee	Increase from present level
Colour	62.50	62.52	66.21	66.00	+3.50(5.6%)
Monochrome	21.00	20.84	22.07	22.00	+1.00(4.8%)

4. The results are not significantly different if the calculation is based on the present licence fees, rather than the unrounded figures.

5. The downward roundings will result in an average licence fee increase of 5.4 per cent and a notional loss of revenue to the BBC of about £3.75 million. The BBC can be expected to object. But the roundings may favour the BBC another year. And given the small sum involved, the Home Office do not think their objections will carry much conviction.

6. I recommend you accept the Home Office's proposals. They hope to announce the new fees in a written PQ on the same day as the DHSS uprating announcement, presently thought to be on or around Wednesday 26 October. The Home Office do not consider Ministerial correspondence is necessary, because the proposals are in line with the agreed formula. So a reply at official level will be sufficient for their purposes.

Mark Perfect

R M PERFECT

ps3/32T

UNCLASSIFIED

Ch/ I have passed on the invitation to FST's office. FST would like to discuss in the margins of Prayers.

FROM: J M G TAYLOR
DATE: 30 December 1987

~~Disp.~~

Lf to M 8/1

Spoke to FST, who does not wish to do. Phoned Mr Scott to let him know.

MISS WALLACE

MPW 5/1

BT: CORPORATION TAX CHEQUE

Ian Scott from the BT Chairman's office telephoned me today about this corporation tax cheque. I said that I had not been handling the matter, but that I thought that the Chancellor would not wish to receive a large mock-up cheque in the manner of a pools winner.

Correct. I told BT so at the time.

MPW 7/1

2. Mr Scott suggested that the Financial Secretary might be prepared to receive the cheque on the Chancellor's behalf. I said this could be a way forward, but that I could not consult him about it since he was on leave.

3. I undertook to ring Mr Scott about this next Monday, 4 January. Mr Scott's telephone number is 356-5229. I should be most grateful if you could take this forward.

BP/K10/Bg-Sach

Chevening

Square

J M G TAYLOR

NMDx5103

Alex

1. MR ~~MOORE~~ AW 8/2

2. CHANCELLOR OF THE EXCEHQUER

From: R M BENT
Date: 8 Feb 1988
cc FST
Sir P Middleton
Mr Anson
Mr Monck o/r
Mr Turnbull
Mrs Brown

Thanks. Content. BT pref appear to have been low for retake in.

REDEMPTION OF BT PREFERENCE SHARES

You may like to know that BT recently asked about dates for the redemption of the second tranche of £250 million of Preference Shares.

2. Having consulted those responsible for Exchequer funding, we suggested that BT should submit notice in time to redeem the shares on 10 May 1988. A gilt redemption is due on that day, and redeeming the BT shares will help reduce the money market surplus created by the redemption.

3. Proceeds for 1988-89 already assume this redemption. In summary, the position now is that we have £5,100 million in the bag, with a possible extra £800 million or so if the first call on Steel privatisation can also be taken in 1988-89:

	£million
Gas III	1,600
BAA II	690
BP II	2,200
Gas debt	250
Miscellaneous	110
	5,100
Steel	800
	5,900

4. As far as ~~next year~~ 1989-90 is concerned, the position is less clear-cut. There is a certain £2,200 million from BP III, scope for £400 million from Gas debt which can be taken either side of the end of the financial year, and a possible £800 million or so from Steel II (assuming privatisation in 1988-89). Any remaining gap between proceeds and the target for the year (presently £5 billion) would have to be met either by a partial sale of the Government's residual shareholding in BT, or by an early start to Water privatisation in Autumn 1989.

I am preparing a paper on the likely outlook, and the options, for 89/90 onwards.

AW

R M Bent.

854/25

BRITISH TELECOM

Prag

Line to take

We privatised British Telecom in 1984. No decision has been taken on when to sell any of the Government's remaining shares in the company.

Ch/ content with this and line behind for No 10?

OK -

MPW
4/5

BACKGROUND NOTE

"Today" correctly states that the Government undertook not to sell any of its remaining 49 per cent holding of British Telecom shares before April 1988. We are now free to do so, and Ministers have stated that they intend to dispose of the shares in due course. A possible date for a sale would be Summer 1989, before the major water and electricity privatisations. The total holding is currently worth over £7 billion, so any sale would probably be of part of the holding only. The public target for privatisation proceeds in the next three years if £5 billion per annum.

"Today" also refers to the so-called Steel "dawn raids". The EC Commission is investigating an alleged anti-competitive cartel amongst European producers of Stainless Steel products, including BSC, and six other producers within the EC. There are no EC production quotas for Stainless products, and the UK is pressing for the removal of remaining quotas on other steel products. The Commission is the enforcement agency for pricing regulations in this area.

Line to take (only if raised)

The Commission are of course entirely within their rights in investigating any alleged breach of Community regulations. We shall of course follow the matter with interest.

(If pressed) I understand that this does not raise questions for UK restrictive trade practices legislation.

MOORF EST....	125	n/c

POPULAR SHARES

Company	Price	+/-
BAA	122	+4
BRIT GAS	173½	-1½
BRIT AIR	162	-4
BP p/p	72	-4
EUROTUNN	327	-1
TSB	101	n/c
R-ROYCE	112	-1
BRIT TEL	251½	-2½

MAJOR CHANGES

Company	Price	+/-
AMSTRAD	171	+10
FRIENDLY	250	+15
PEARSON	714	+33
LYNTON	413	+30
ENG CHINA	452	+23
CRONITE	78	+7
CADBURY	334	-13
THOS ROB	420	-35

POUND ABROAD

AUSTRIA	Sch21.50
BELGIUM	Fr 64.10
CANADA	C$2.23
DENMARK	DKr11.85
FRANCE	Fr10.40
GERMANY	DM3.07
GREECE	DRA241
HOLLAND	Gld3.47
HONG KONG	HK$14.20
IRELAND	I£1.1620
ITALY	L2275
JAPAN	Y230
PORTUGAL	Esc247
SPAIN	Pes203
SWEDEN	SKr10.80
SWITZERLAND	Fr2.54
TURKEY	L2200
US	$1.83
YUGOSLAVIA	Din2600

Rates by Allied Irish Bank.

SIGNPOSTS

	Level	Change
FT 30 Share Index	1438.1	-11.6
FT-SE 100 Share Index	1794.7	-12.5
New York Dow Jones (latest)	2048.08	-10.28
Tokyo Nikkei Dow	PUBLIC	HOLIDAY
HK Hang Seng	2641.13	+38.53
£/dollar	1.8645	-0.0070
£ Index (base 1975)	77.9	-0.2
Gold pm ($)	443.25	-2.65
Brent Crude (May)	16.105	+0.155

fast as the dollar has fallen.

Trafalgar House, the shipping, property and construction group which owns the QE2 as well as the Ritz, reported excellent interim profits yesterday, up 58% to £85.3m pre-tax.

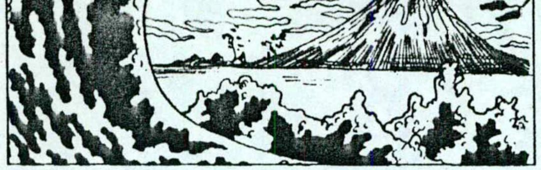
But it was with no thanks to the hotels and cruises division, where the weak dollar and the effects of the stock market crash have hurt bookings.

Chairman Sir Nigel Broackes said that along-term strategy had not been altered.

It was the housebuilding boom that took Trafalgar's profits higher than any analyst had forecast.

The buoyancy of the residential market, especially in the south-east, enabled Ideal Homes to increase its margins.

Chase Property Holdings, which it acquired last year, was included for a couple of months, contributing about £2m to the division, where prof-



its jumped £16m to £50.5m.

The QE2, back in service after a long spell of renovation, pushed profits for the division up £9m to £18.3m.

It is booked for the next two years for long charters in Japan, where it will take part in World Expo in 1990.

Bob Haville, top analyst at Morgan Stanley, has lifted his profit forecast by £10m to £230m for the full year, and thinks the shares at 326p, up 2p, offer good value.

operation, was given the green light yesterday by the Government, which has accepted the OFT's view that the offer need not be referred to the MMC, *writes Peter Davies.*

Meanwhile, BAe's defence technology manufacturer Royal Ordnance, acquired for £190m from the Government in April 1987, has formed a joint venture with US explosives manufacturer Ensign Bickford to make and distribute high-explosive products.

Royal Ordnance will invest $1m (about £450m) in it now, and more later.

... the form of an introduction) is scheduled for May 17, and the next move will be a full quote sometime toward the end of 19..

The shares closed ... 65p, valuing the group at just under £20m.

Broad gain

SHARES in Broad Street, the PR outfit run by former Argyll chief Jimmy Gulliver, rose 2p to 42p as chairman Gulliver and co-directors snapped up over 2m shares.

Today

49% Telecom stake on line to be sold

by GEORGE CAMPBELL

THE GOVERNMENT'S privatisation programme may get a surprise boost later this year with the disposal of its remaining 49.8% of British Telecom.

Preliminary talks are understood to have taken place with merchant bank Kleinwort Benson on the timing of the sale.

Meanwhile, the controversial £2bn British Steel flotation will definitely go ahead later this year, despite fears that the issue could be shelved after surprise raids on EEC steel producers (including British Steel) by the European Commission.

The raids refer to pricing policies between 1984 and 1986. British Steel refused to comment yesterday, but observers believe that the document-seizing exercise —at rivals Thyssen, Krupp and Spain's Acerinox as well as BS — was overdone.

The raid came in response to complaints last year from buyers that prices of stainless steel were rising sharply, while those of other steel products were static or falling.

"The pricing arrangements were fixed with the European Commission's full knowledge," said one steel watcher. "They will not have any impact on the market for a considerable time ahead."

But sparks may still fly in July, when steel surcharges come into effect.

At the time of the BT privatisation, in November 1984, the Government undertook not to sell any more of its holding in the telecommunciations group until April 1988.

Convinced

Based on last night's price of 254p, the remaining chunk is worth £7.6bn. The shares have outperformed the market by well over 20% since October.

The City, however, is far from convinced that the sale would be a winner, even though Telecom owns Cellnet, the main rival to Racal's soon-to-be-floated Vodafone portable phone network.

Observers believe the Government may delay the sell-off because of the imminence of the water and electricity privatisations.

Acid rain dropping on Davy

PROBLEMS with acid rain control have burnt a large hole in profits at Davy Corporation, after troubles with air purification plants in German power stations.

The engineering group warned yesterday that profits for the year to end-March would be halved to just over £10m because of a £17.5m provision to cover modifications to two the plants.

The shares brightened 5p to 138p on relief that Davy had found a solution to the problem, which has dogged the price for months.

The previous year carried a £7.4m provision, also related to the German contract.

Liz Dolan

Reserves soar to record level

THE UK official reserves — our holdings of gold and foreign currencies — hit an all-time high last month.

Treasury figures released yesterday give further confirmation of a booming Britain.

Official reserves rose by $338m in April, pushing the year's figure to $47.8bn, more than double that of a year ago.

"They may be meaningless to the man in the street," explained Treasury spokesman John Frinton, "but they do act as a cushion against bad times. This applies when sterling comes under pressure overseas."

Meanwhile, there was no new borrowing under the European monetary exchange cover scheme, which permits the UK to barter foreign currency for gold.

The public sector also repaid a bundle of debts. British Coal repaid $105m, British Nuclear Fuels $40m and British Steel $32m.

But the situation could all change if sterling reverses its upward move and goes into a spin.

Unichem inquiry

PLANS for a 1990 stock market flotation by Unichem, the co-operatively-owned pharmaceutical wholesaler, may be shattered by an OFT investigation launched yesterday.

To retain its co-op structure, Unichem offered shares to members in proportion to the value of their purchases. Complaints from competing wholesalers, who cannot offer similar inducements, triggered the OFT inquiry into whether the scheme restricts or prevents competition.

In Seers. 5183

CH/EXCHEQUER
REC. 21 SEP 1987 ✓21/9
ACTION PMG
COPIES TO

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

18 September, 1987.

bf. with whose
ltr 31/7
6/10

Dear Cathy,

MERCURY

The Prime Minister would be interested to know what use the Government makes of the services offered by Mercury, and how great the advantages are in doing this. I should be grateful for a note.

I am sending a copy of this letter to Tim Walker (Department of Trade and Industry).

Yours,

David.

(David Norgrove)

Mrs. Cathy Ryding,
HM Treasury.

Note Passed on to PMG office that DTI wanted to be aware with reply: officials to contact Catherine Bradley [illegible]

COMMERCIAL IN CONFIDENCE

From: S D H SARGENT

Date: 23 June 1988

NOTE FOR THE RECORD

cc Chancellor
Financial Secretary
Mr Anson
Mr Monck
Mr Moore

Mr Iain Vallance, Chairman of BT, called on Sir Peter Middleton this morning. Mr Malcolm Argent, BT Company Secretary, and Mr Moore were also present.

2. Mr Vallance said that he had seen Brian Carsberg (OFTEL) on 22 June to hear details of his proposals for the new pricing regime which would run for 4 years from July 1989. He would find it very difficult to recommend the BT Board to accept the proposals. The proposals contained a number of additional ingredients over and above those contained in the present pricing regime. The total constraint was RPI minus 4.5; but because of changes in the coverage the effective rate for comparison with the existing RPI minus 3 was in practice RPI minus 4.75 or 5. Within this, there would be sub-caps on particular items such as connection charges. BT's estimates were that the proposals would cut earnings per share from some 10% to around 4 or 5%, and the core business would move into a profit decline of some 5% per annum. The rate of return on capital would, over the next 4-5 years, fall from 18% to around 12%, which was less than BT's cost of capital.

3. Carsberg's own estimate was that the pricing regime would allow a return on capital of around 15%. He had originally been looking at a CCA rate of return, but had moved away from this

having seen that BT's figures were low. However, his main assumptions about the business were far more bullish than BT's own.

4. Mr Vallance went on to say that Carsberg had gone away to reflect on BT's views before putting a formal proposal to them on Friday afternoon. If BT were unable to agree the proposal it would go to the MMC. Even if BT did agree it, Lord Young would be able to refer the issue to MMC anyway if he chose. Carsberg had indicated that he would be happy to see the issue referred to the MMC. He clearly felt under pressure to squeeze BT and would be happy to share the responsibility with others. Mr Vallance felt that the present proposals were such that a reference to the MMC would be preferable. Nevertheless it would be a dispiriting experience for the company, and one which could be expected to have a depressing effect on the share price, although the extent and duration of this was unpredictable. Moreover, because an MMC reference would not get under way before the autumn and would take several months to complete, an early summer secondary flotation would no longer be feasible since this would require work to start in January. All this was very tiresome, but he could not go to shareholders and recomend the regime proposed by Carsberg.

5. Sir Peter Middleton thanked Mr Vallance for putting him in the picture and said that he would be grateful to be kept in touch with developments.

S D H SARGENT
Private Secretary

mjd 2/152Jn

COMMERCIAL IN CONFIDENCE

CF. 30/6

FROM: J M G TAYLOR
DATE: 27 June 1988

MR D J L MOORE

cc PS/Financial Secretary
PS/Sir P Middleton
Mr Anson
Mr Monck

BT: SECONDARY FLOTATION

The Chancellor has seen Mr Sargent's note for the record of 23 June. He has noted, in particular, Mr Vallance's suggestion that a MMC reference would rule out a summer secondary flotation. He would be grateful for a note on this.

J M G TAYLOR

60

BF for Tebbit bilateral

COMMERCIAL IN CONFIDENCE

From: S D H SARGENT
Date: 27 June 1988

NOTE FOR THE RECORD

cc Chancellor
Financial Secretary
Mr Anson
Mr Monck
Mr Moore

Iain Vallance (BT) rang Sir Peter Middleton this afternoon, following their discussion on 23 June about OFTEL's proposals for the new pricing regime.

2. Mr Vallance reported that after two further meetings with Mr Carsberg OFTEL's proposals were still as described in last week's conversation, except that Carsberg had indicated that if BT were willing to adopt CCA for their main accounts he would be willing to re-examine the figures to see what they would look like on that basis. Mr Vallance said that he was not sure how the Board would feel about this suggestion. The Board meets on Tuesday 28 June, and Mr Vallance will report further after that. He felt that Carsberg had boxed himself in by sending a copy of his original proposals to Lord Young. This made it difficult for him to change them significantly without appearing to back down under BT pressure. Sir Peter Middleton said that he would try to have a word with Sir Brian Hayes. Mr Vallance said that Norman Tebbit was seeing the Chancellor tomorrow on another matter and might raise the issue then.

S D H SARGENT
Private Secretary

COMMERCIAL IN CONFIDENCE
CONFIDENTIAL

From: S D H SARGENT
Date: 29 June 1988

NOTE FOR THE RECORD

cc PPS
PS/Financial Secretary
Mr Anson
Mr Monck
Mr Moore

BT: NEW PRICING REGIME

Iain Vallance (BT) rang Sir Peter Middleton on 29 June. He reported that the previous day's Board meeting had been long and gloomy. The Board could not believe that the end of the road had been reached with OFTEL, and they instructed a negotiating team to go back to OFTEL. This would be done at the end of the week. However, Mr Vallance was not hopeful that any progress would be made; Carsberg was unlikely to respond to pressure from BT. However, since he appeared to be quite happy with the prospect of the issue going to the MMC, it might be helpful if he had a clearer understanding of the Government's position regarding the prospect of an MMC reference. Because of the effect on BT's share price and on the timing of a secondary flotation, a reference would not be in the Government's interests. Moreover, if the Carsberg proposals remained unchanged this might be interpreted by the City as an indication that all the privatised companies were to be subjected to an equally tough regulatory regime.

2. Sir Peter Middleton commented that there could clearly be no question of the Government putting pressure on Carsberg. It would be possible for the Government's attitude to an MMC reference to be made clear to him, but he was doubtful whether this would make much difference. However, he would reflect further on the position. Mr Vallance said that he was thinking of reporting to Lord Young on where matters stood. Sir Peter Middleton replied that this seemed a good idea.

S D H SARGENT
Private Secretary

pe.sh.djlm.mins1

CONFIDENTIAL

Thanks. Let's hope clearing BT and keep up our £8 billion for 1989-90, £8bn water £8bn; but I note the MMC reference would not rule out an autumn 1989 sale.

Ch — See PS/PEM's notes of 27 + 29 June, behind, for latest developments.
29/7

FROM: D J L MOORE

DATE: 29 JUNE 1988

CHANCELLOR

cc: Financial Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mrs Brown or
Mr Bent

BT: SECONDARY FLOTATION

You and the Financial Secretary have asked whether an MMC reference on the BT price formula would rule out the possibility of a BT secondary sale in summer 1989. I think it would make it very difficult indeed. But if the other sales go ahead as planned, we should still be able to get around £5 billion a year privatisation proceeds.

2. If BT and the Regulator agree on the new price formula, which would run from mid 1989, a firm decision would be announced this year unless Lord Young intervened with a decision that the matter should be referred to the MMC. If they do not agree, it will be referred anyway.

3. We have hitherto assumed that either way we would be sufficiently clear on the outcome by the end of this year to start planning a summer 1989 sale if you then decided you wanted one. We think you would want to announce the sale no later than January if it were to be in June or July. From the announcement to the appointment of advisers can take a minimum of 4-6 weeks and we must leave sufficient time for planning what would not necessarily be an easy sale given the poor image of the company, let alone other factors.

4. But the discussions between BT and the Regulator have dragged on longer than expected. They might of course reach agreement. But if they do not, a reference to the MMC would be announced,

presumably by the end of July. DTI would want to give the MMC 6 months to report on what could be a complex inquiry and, of course, the first of its kind. This implies a report by the end of January. But it could be later than that if the MMC asked for an extension. This must be possible because they are not likely to get going before September and they already have a lot on their plate. I am sure DTI would want to grant an extension if asked and it would be important to the reputation of the regulatory regime that the MMC did have sufficient time to make a good job of it. There is, therefore, a risk that the MMC would not report before next February or March.

5. From the time of their report there is then a possible further 2 or 3 months before a final decision is promulgated. The Regulator first has to send a copy of his unpublished report to the Secretary of State who has 14 days in which to decide whether there are any grounds (eg, security) for not publishing it in whole. It is then published and if the MMC have found that a licence amendment is required the Regulator gives public notice that he proposes to change the licence. He then has to allow at least 28 days for representations by BT and others before he takes a final decision and announces it.

6. It could, therefore, be around Easter before we knew the final decision. This would not present disclosure difficulties for a summer sale but I feel that it could be too late for it to be sensible to go ahead. As explained above, we think a summer sale ought to be announced in January. But you would not want to announce the intention of the sale before the MMC had reported, even if you were prepared to consider announcing it before the final decision was promulgated. Moreover, BT themselves would be very preoccupied with work on the MMC reference and its aftermath and this no doubt influences Mr Vallance's view that a reference would rule out a summer sale.

7. Does this matter? There are three main reasons for considering a summer 1989 sale:

i. the possibility of a sale of some of HMG's BT shares, with flexibility on how many might be sold, gives a comforting cushion in planning the privatisation programme and looking at the target for proceeds;

ii. the sale would fill a gap in the privatisation programme between Steel (November 1988) and Water (November 1989) with an opportunity to promote wider share ownership and to try out sales techniques eg, on tenders;

iii. last, and least, it would be welcome to BT who would like a reduction in HMG's 49% holding.

But these are not overriding arguments for an early sale.

8. On proceeds, I will circulate some new tables prior to your July meeting on Water and Electricity. The proceeds from those sales, and the balance between debt and equity, is still extremely uncertain. Even so, provisionally I think that it should be possible to get around £5 billion a year with the combination of debt and equity from 51% sales or from equity receipts alone from 60% sales.

9. Irrespective of an MMC reference and of proceeds considerations, there is a possibility that you would not choose to sell BT then. As you know, some of the Building Societies are thinking of flotations. If one or more of them were going for summer 1989, or thereabouts, and if they were aiming for the retail market and their own customers, it may not be a good idea go then for a major BT sale. If the Building Societies are planning flotations it would be better to let them get out of the way in good time before the Electricity and Water sales.

10. I would not lose much sleep on BT's aspirations. They still have a poor image among their customers and in the City and they need to create and build up confidence in their management. Until they do so it does not make them an easy sale.

11. If, for whatever reason, it were decided not to sell in summer 1989, the possibility of a BT sale over the next 2 or 3 years would still be a useful option in your locker. If problems emerged that delayed the start of the Water, or even the Electricity, sales BT could be brought into play in November 1989 or possibly summer 1990. It would very probably not be possible to have a sale later in 1990 or until Autumn 1991 because a review of the BT/Mercury duopoly is due to start in November 1990. But, assuming Water and Electricity had gone to plan, 1992 could be a good time for a BT secondary because possible new privatisations would be waiting for enabling legislation in the new Parliament.

12. To sum up, we must wait to see whether there is to be a reference to the MMC. If there is, I think the odds must be strongly against a summer 1989 sale. But no firm decisions are needed now and we will keep the position under review.

DJLM.

D J L MOORE

pe.sh.djlm.mins.11.10.2

CONFIDENTIAL

Mr Moore: I am content to proceed as here recommended provided it is clear (at most clinch BT) that we retain the BT fallback as suggested in para 13 (see X). N.

FROM: D J L MOORE

DATE: 18 OCTOBER 1988

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Scholar
Mr Odling-Smee
Mrs Lomax
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mrs Brown
Mr Williams
Mr Bent
Mr Holgate
Mr Tarkowski
Mr Lyne
Mr Call

There is some overlap between this + the separate BP/KIO question (see sep. folder, enclosed). Do you want a meeting on this, once you have taken a view on the BP/KIO question? Or content to decide now on points summarised in para 1? (NB – supplementary recommendation on (ii) at 'X' in para 7) 19/10

PRIVATISATION PROCEEDS: 1988-89 ONWARDS

This note brings up to date our assessment of proceeds and invites you:-

i. to agree that the Autumn Statement should allow for the Steel first instalment due in December and show total estimated proceeds of £6 billion for 1988-89, (though the precise outturn will differ from this deliberately round figure);

ii. to note that the estimates in this paper assume gross total proceeds of £2.3 billion for Steel, with instalments provisionally split 40:60 (though the advisers are now thinking of nearer to 50:50);

iii. to note that, on our present estimates for Water and Electricity, total proceeds in each of the 3 Survey years could be nearer to £6 billion than to £5 billion if we were to have partial sales of, say, 70%; but

iv. to agree that, in view of the considerable uncertainties, it would be prudent to stick to published estimates of £5 billion a year; and

v. to agree that we should now confirm to BT that because of the privatisations in the pipeline we are not planning a 1989 sale and that, assuming the Water and Electricity sales go to plan, there will be no room before the next Election.

1988-89

2. In the current year we expect receipts before Steel to be about £5075 million, of which nearly all is paid or due from instalments.

3. With a £2.3 billion Steel sale, split 40:60, the first Steel instalment net of sale costs would be £845 million. This would give an outturn for total proceeds of about £5900 million (or £6100 million if the split were 50:50). With a £2 or a £2.5 billion sale, the outturn would be approximately £5800 or £6000 million (40:60).

4. Although the price for Steel shares will not be announced until 23 November, GEP wish to publish in the Autumn Statement an assumption of £6 billion from proceeds in order to explain the PSBR assumptions. PE agree with that, but it will be important to guard against commentators jumping to conclusions on our assumption for Steel proceeds; and for marketing reasons it will be necessary to announce the balance of the 2 instalments before Impact Day.

5. The line must be that £6 billion is obviously a well rounded figure which includes some allowance for Steel but not an estimate of the first instalment. Moreover, commentators should realise that there are other uncertainties eg, we could bring forward into 1989-90 some or all of £400 million Gas debt repayment due in March or April 1989.

This should be emphasised

push 1988-89

Steel proceeds

6. In earlier papers we have assumed £2 billion net proceeds. Estimates will firm up over the next month with discussions on profit and dividend forecasts, yield and PE assumptions. But the advisers are now talking of proceeds in a range £2-2.7 billion.

7. The estimates in this paper assume £2.3 billion split 40:60, though our latest information is that the advisers might move up to as much as 50:50. With an allowance of £75 million for sale costs 40:60 would give £845 million in 1988-89 and £1380 million in 1989-90. We strongly recommend that the final decision on the split should be determined by the advice on the best way to market the Steel sale and maximise proceeds. We can rebalance total annual proceeds to some extent, if that is desirable, by decisions on the Gas debt repayments.

X

1989-90 to 1992-93

8. The table annexed to this note shows estimated totals over the four years. The 'pipeline' figures could be on the pessimistic side (eg, if Rover proceeds in 1989-90 are scored as privatisation receipts) but not to an extent which affects the broad conclusion of the paper. The assumptions for Water and Electricity are based on the very provisional estimates of equity proceeds given to us by the advisers and the departments; they make no allowance for Water and Electricity debt repayment in the period.

9. These estimates may prove optimistic but, assuming they are not dramatically so, it is clear that to keep to a £5-6 billion range for annual proceeds we must continue to plan for partial sales of Water and Electricity. As you know from the recent discussions of the Electricity Distribution and Water sales, the departments and the advisers would probably like around 70% sales, for underwriting and other reasons. If the two generating company sales and Scottish Electricity were also 70% our present figures suggest net proceeds in the range £5.7 to 6 billion a year - see bottom row of figures in the annex.

10. But even though the outturn may prove to be nearer to £6 billion a year, I think we should stick for the time being to £5 billion a year for the published totals:-

i. although the Water and Electricity Distribution estimates for equity proceeds were brought up to date in the recent exercise, they are still subject to a wide margin of error;

ii. a great deal more work needs to be done on the estimates, which may well be optimistic, for Scottish Electricity and for the two generating companies; the estimates for Big G are particularly questionable because of the nuclear complication; we will not have any better figures until the initial contracts are in place next Spring;

iii. while 70% might be taken as a working assumption at this stage we do not need to go firm on it yet, and it may be that the generating and Scottish sales should be at a different percentages;

iv. it is possible that Big G and Little G might swap slots (eg, if there are problems in resolving nuclear difficulties) which could add to the difficulties of smoothing the annual totals;

v. when estimates of gross proceeds firm up we will have to build in an allowance for discounts to get the sales away, for employee concessions and for any bonus shares;

vi. although the present table makes a very rough and ready deduction for sale costs, which will be particularly significant in 1990-91 when there are three sales, a lot more work is needed on these figures;

vii. a case could emerge for assuming some debt repayments in the period and, if so, this would be some offset to any more pessimistic assumptions on equity.

Faced with all these uncertainties, it seems much better to stick with the published £5 billion a year and not to move until we have much more confidence in the assumptions.

11. GEP would also recommend sticking to the published £5 billion a year. First, the undeclared proceeds would be useful insurance in support of the published Reserve. Secondly, they hope to produce an outcome for the planning total which improves on market expectations and would prefer to avoid the risk of accusations, however illfounded, that this had been achieved by opportunistic changes to proceeds totals.

British Telecom

12. BT want a major disposal of the HMG holding (currently worth over £7 billion) to take them away from the 49% brink before the next Election. At one time it looked as though summer 1989 might be suitable for a BT sale of, say, £2 billion. It now seems better to leave that period free for any possible Building Society flotations ahead of Water and Electricity.

13. Moreover, given our present problems of keeping proceeds down to £5-6 billion a year, and of finding sufficient slots for Water and Electricity, there is no room for a BT sale this side of the Election. We can, however, keep the possibility in reserve for deployment if the present programme went badly wrong. Otherwise there could be a sale shortly after the Election, provided this was not inhibited by Oftel's next price formula review. This would top up proceeds for 1992-93 and fill a gap before any further privatisations were possible.

14. If you agree, Sir Peter Middleton could now tell Mr Vallance that this is our working assumption. It will come as no surprise to them.

Residual holdings in the 1990s

15. If all the Water and Electricity sales are partial, a thought for the early 1990s is that the Treasury could be holding shares in up to 31 separate companies. That is, in BT; 10 Water Authorities; 12 Distribution companies; 2 Generating; 2 Scottish Electricity; and smaller to minimal holdings in BP, Gas, BAA and BA. We must try to ensure that we are not tied down too much, if at all, by prospectus undertakings on the period before any secondary sales can be made. When it comes, it will be a major sales programme. But we will wait until nearer the time to advise on how to handle it!

Conclusions

16. These are summarised in paragraph 1.

DJM.

D J L MOORE

pe.sh.std.layout.1

CONFIDENTIAL

PROCEEDS: WATER AND ELECTRICITY SALES OF 100% assuming:

- instalments 40:30:30 (45:55 Scottish Electricity)
- equity only; no provision for debt repayments in the period
- £350 m Gas debt repayment due in March/April 91 paid in 90-91

	89-90	90-91	91-92	92-93	
Total in the Pipeline (including 1380 for Steel)	4200	950	120	450	
Water	2600	2000	1900	-	
Distribution	-	1800	1400	1400	
Big G	-	2800	2100	2100	
Scottish Electricity	-	900	1100	-	
Little G	-	-	2000	1500	1500 in 93-94
TOTAL 100% Water and Elec.	6800	8550	8620	5450	
75%	6150	6575	6495	4200	
70%	6020	6200	6070	3950	
65%	5890	5825	5645	3700	
60%	5750	5450	5220	3450	
* Costs of 70% sales	- 175	- 500	- 150	-	
Net proceeds (70%)	5845	5700	5920	3950	

* NB Underwriting and Receiving Bank costs vary with size of sale.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Ch.

BT

Ld. Young wants a word in the margins of Cabinet.

2. He is concerned that, if no more of BT is sold this side of an election, it will be fairly easy for a government of another colour to re-nationalize it. He .. wants to suggest that you might think about further reductions in the Govt. holding before the Election.

3. You need do no more than listen. It may be worth rehearsing the reasons for not planning to sell any more pro tem

25/iii...

chex.rm/jt/26 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 19 October 1988

MR D J L MOORE

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Scholar
Mr Odling-Smee
Mrs Lomax
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mrs Brown
Mr Williams
Mr Bent
Mr Holgate
Mr Tarkowski
Mr Lyne
Mr Call

PRIVATISATION PROCEEDS: 1988-89 ONWARDS

The Chancellor was most grateful for your minute of 18 October.

2. He is content to proceed as recommended, provided it is clear (and made clear to BT) that we retain the fallback of a BT sale if the present programme were to go badly wrong.

J M G TAYLOR

PP B.

~~Sue~~ Julie –
For Info.

I think this has gone to all MPs.
But in view of PS. you may wish to see it.

Tony

21/12

Pl file
British telecom

Ch/ A short acke. from me?
Or no reply nec?
28

2/12
Julie.

British
TELECOM

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Head of Public Affairs

Corporate Relations

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The Rt Hon Nigel Lawson MP
House of Commons
LONDON SW1A OAA

30 November 1988

Dear Mr Lawson,

You may remember that my Chairman, Iain Vallance, wrote to you personally just over a year ago about the problems our customers in some areas were experiencing with service from British Telecom.

It is in the same spirit that I now draw your attention to the results of the Company's efforts since then. We have just published the third of our six-monthly reports on the quality of service in five main areas. They are (figures for September with September 1987 and March 1988 in brackets):

- 91.6% of faults cleared within two working days (86% & 90.2%)

- 94% of public payphones working (76% & 92%)

- 55.1% of business orders completed in 6 working days (48.3% & 60%) and 56.3% of residential orders in 8 working days (42.5% & 62.2%)

- 80.5% of operator calls answered in 15 seconds (79.4% & 86.7%)

- 81.3% of Directory Enquiry calls answered in 15 Seconds (75.1% & 81.2%)

The details are contained in the Quality of Service Report for October 1988 which is enclosed. With your permission, I shall continue to send you these half-yearly reports so that you are able to monitor the detailed statistics of the quality of service we are providing for our customers.

But quality is only part of the picture. We recently issued also a progress report on several other aspects of our activities. The brochure "This is British Telecom" shows that:

- By August next year, the end of our guaranteed price freeze, main tariffs will have been held for very nearly three years (we last changed the "basket" of prices in 1986 when we actually reduced them).

- Investment - currently nearly £2.5b - continues to run at a higher level than our pre-tax profits.

- British Telecom made cash payments to the Treasury for the year 1987/88 of nearly £1.4b in tax, dividends and debt repayments.

We think that, taken together, this is not a bad record. Problems remain: demand for our services is still, in certain areas, growing at rates which not even some of our customers were able to anticipate. The renewal of our network - adding volume to the lines which connect to our new digital exchanges (two new ones coming into service each day) - brings its own transitional difficulties. But we are committed to continuing to improve service to <u>all</u> our customers, setting ourselves publicly announced targets, and monitoring and reporting our performance as we go.

If you have any enquiries about any of these matters, I should be only too pleased to deal with them.

Yours,

Peter Carver

Peter Carver

Enc

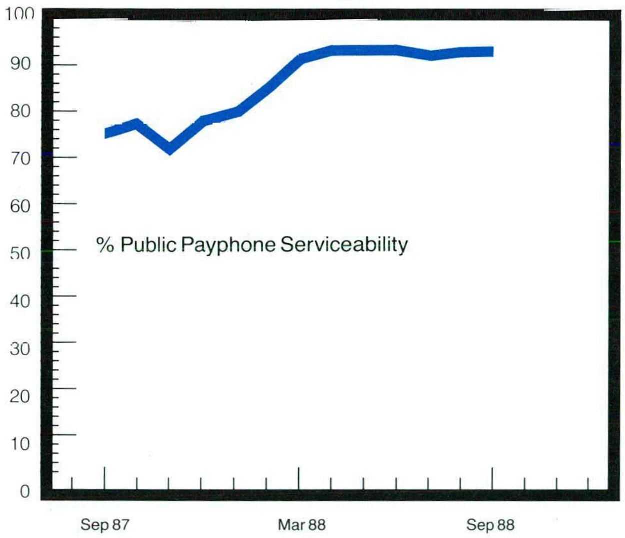
PS And another world-record breaking cheque will be with you soon!

British TELECOM

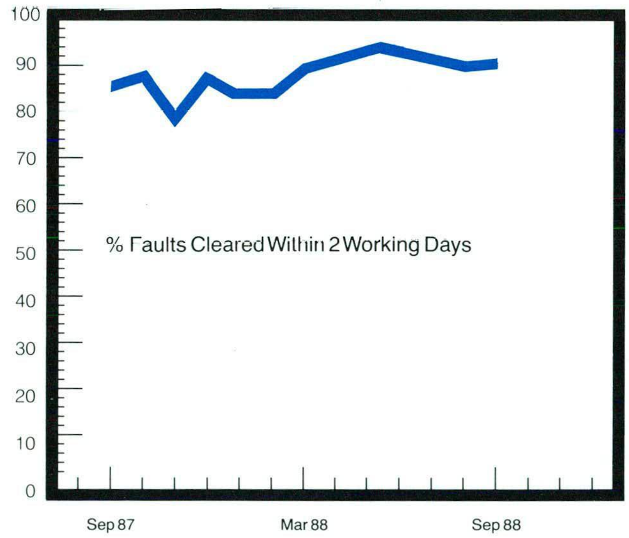
Quality of Service Report

April–September 1988

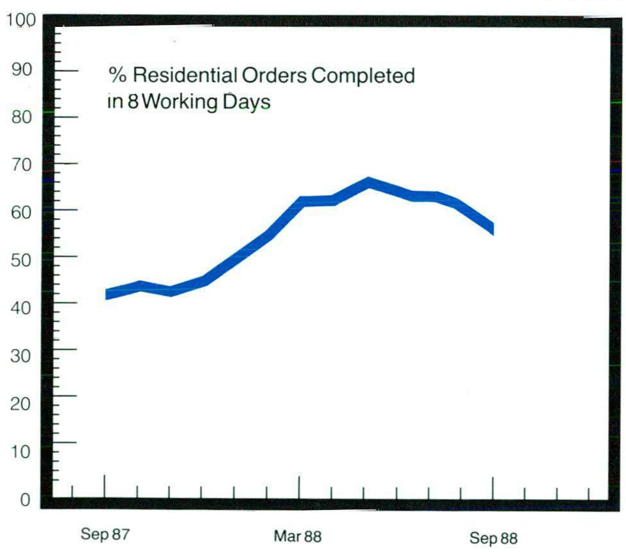
Public Payphones

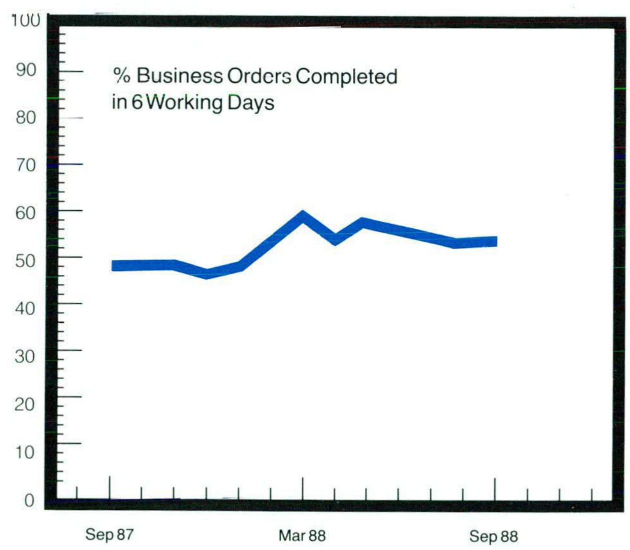


Fault Repair



Provision of Service





Directory Enquiry (142/192) calls answered in 15 secs	75.1%	81.2%	81.3%

Payphones

Our performance in achieving more than 90% of our Payphones working in March of this year has continued to improve and in September 94% of Payphones were working, according to the independent research carried out for BT and OFTEL. We will reach our target of 95% by March of next year, and we will then raise our sights to a higher target. The problem of vandalism of our boxes seems to be reducing, partly because we have installed card and credit-card phones and partly due to the public's co-operation with our anti-vandalism campaign. There are now more than 12,000 cardphones out of the current total of 83,000 – and we are continuing to increase the number of Payphones overall.

It is also noteworthy that the high availability of working Payphones stretches right across the country – in Central London where we are beginning to have competition, and in rural areas where it seems unlikely that any competitor will wish to offer an alternative service.

	September 1987	March 1988	September 1988
Public Payphones working	76%	92%	94%

Future

In our May report this year we mentioned a number of new developments such as itemised billing, market research and new computer systems. Our Customer Service System (CSS) is now widely available. Some 10 million customers are already enjoying the service and many of those customers have remarked on the benefits they see in being able to deal with a single contact point within British Telecom.

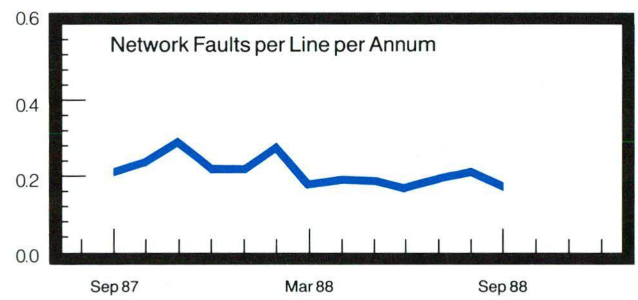
Our itemised billing programme is on course with 28 of our exchanges, serving more than 420,000 customers, now offering this facility. Take-up by our customers is running at about 35% of this total. Our aim remains to make the service available to 50% of our customers by 1990, with 100% coverage by 1995.

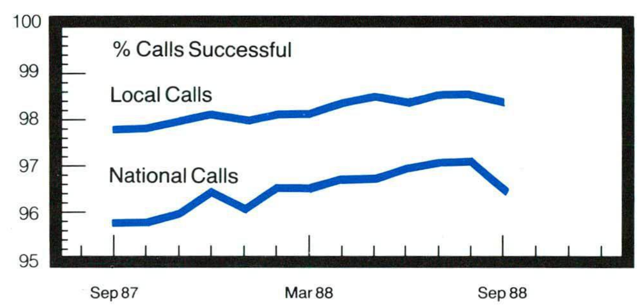
Also, we have a programme in place to reduce substantially the average time it takes to install and repair private circuits. We expect to have made significant progress on this programme by the end of this financial year.

Finally, we will remain determined to build a telecommunications service which meets the needs of our customers at a time when the real price of that service is falling. As a result of our price freeze on our mainstream services, from November 1986 until at the earliest August 1989, and our recent agreement to increase prices by 4.5% less than the general rate of inflation as from next year, our customers, who have already benefitted from a 12% real reduction in prices over the last 3 years will benefit from at least a further 18% over the period to 1992.

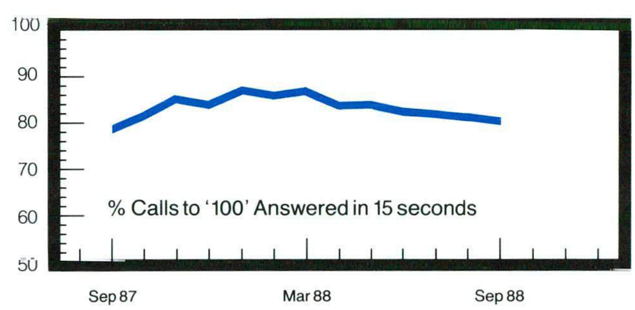
MICHAEL BETT
Managing Director
UK Communications
November 1988

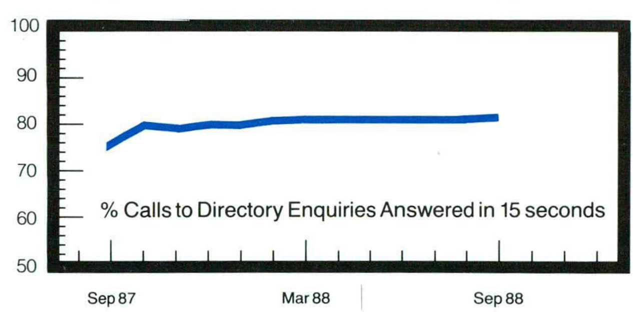
Network Reliability





Operator Services





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New formula extends the benefits

From next August, RPI-3 changes to RPI-4.5. The principle of price control is maintained but another 1.5 percentage points is added to the formula, keeping prices down even further in real terms.

The "basket" of services is at the same time being expanded to include operator controlled calls. It would also be extended to cover charges for directory enquiries if they are introduced. This will increase even more the downward pressure on other charges in the "basket".

The agreement will be for four years until July 31, 1993, as against the five years of the present agreement.

The "basket" is an average of prices but British Telecom has given a voluntary assurance that it will continue as before to keep any increase in exchange line rentals at no more than RPI+2 each year – that is, a limit of two per cent above the rate of inflation.

It has extended this assurance under the new agreement to connection charges.

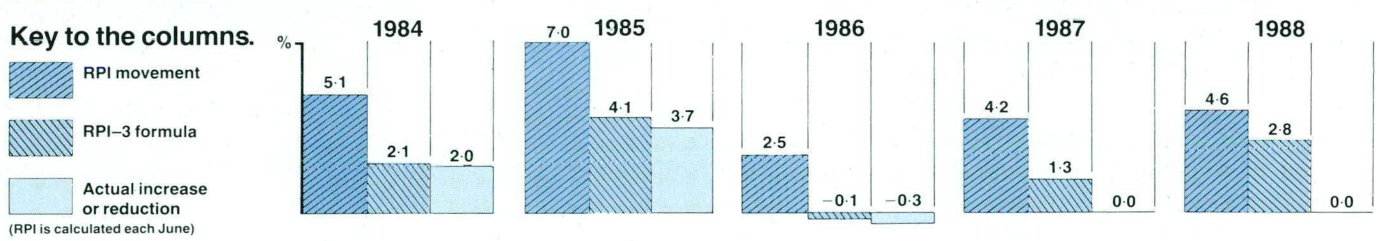
The possible introduction of a separate price cap for private circuits is being discussed with the Office of Telecommunications (Oftel).

Call box charges are not included in the price controls, partly because British Telecom makes a large loss on these services, which have to be subsidised out of other prices, and partly because of the liberalisation which is taking place in the payphone market.

International services are not being included either. This is because of the fast developing competition in this field, which is holding down prices, and because the introduction of controls could destabilise the market as a result of the way in which international payment arrangements are made between telecommunications authorities.

But prospective profits from international services have been taken into account in setting the overall price control level.

HOW THE COMPANY HAS KEPT PRICES EVEN LOWER THAN REQUIRED UNDER THE RPI–3 FORMULA.



Investing in a world-class network

The new tighter regime of RPI-4.5 comes as British Telecom is financing a huge investment programme designed to give Britain one of the most up-to-date telecommunications systems in the world.

This programme is running at £2.5 billion a year. New digital exchanges are being opened at the rate on average of nearly two every working day. This long-term process of changing from the old to the new, while continuing to improve quality of service and expand business in the short term, is immensely complicated. And the whole process puts great strain on staff resources. Largely because of deferred investment in the 1970s, British Telecom is having to put in the new digital exchanges on a more compressed timescale than any other major telephone company in the world.

The sheer scale of this operation can cause problems in the short term. The new technology has to bed in with the old, and that temporarily affects the quality of certain services. But overall the programme has gone remarkably smoothly.

Today, British Telecom already has one of the most modern long-distance and international networks in the world. It is rapidly changing over the local exchanges and this programme will continue for several years. More and more customers will benefit from this new technology as the programme continues.

Annual investment by British Telecom outstrips the profits it makes.

For the 1987-88 year:

Capital spending	£2,387m
Pre-tax profit	£2,292m

But the big job that lies ahead now is the modernisation of the local network – the mass of cable under the streets connecting customers to the local exchange. Every customer has his or her own pair of wires that goes all the way from the socket in the house through the junction box in the street and on to the local exchange. Currently there are some 23 million customer connections.

Modernising and renewing these links is an immense undertaking. But it is only when there is complete end-to-end connection with modern technology that the full benefits become apparent to the customer. Unfortunately it will be some years before there is the desired quality on all calls.

This modernisation programme is costly in both capital investment and manpower in the short term. But it is of vital importance to the company, not only in terms of bringing benefits to the customer but also in delivering the long-term efficiency improvements necessary to meet business targets, and to give shareholders a satisfactory return on their investments.

Spur to greater efficiency

When the price control formula was started, it was an experimental one. The main alternative considered was a limit on the rate of return the company could make.

This was rejected in 1984 and has been rejected again by the Director General of Telecommunications, Professor Bryan Carsberg, following the extensive discussions on the new formula he undertook with interested parties.

The price control approach is also preferred by British Telecom because it is simple to understand and administer. Above all it gives a clear assurance to customers about future prices and provides a spur for British Telecom to improve efficiency by keeping down costs.

A limit on the rate of return by restricting profit would give no incentive to efficiency and to cutting costs. In simple terms, why bother with efficiency if increases in rates of profit above a fixed level are effectively prohibited?

Improved efficiency and profitability are also vital in another key area for customers – quality of service. British Telecom actually invests each year sums *greater* than its pre-tax profits – and it is on this investment that the creation of a modern network, with improved and additional services, depends. British Telecom is currently investing at a rate some 40 per cent above that of 4 years ago.

British Telecom regards the 4.5 figure for X as a very stretching target, but it is determined to meet this while continuing to extend and improve its many customer services.

Phone bills which rise in future will usually do so because the customer is using the phone more, resulting from a combination of low prices and rising quality, changing social habits and the improved and expanded services which will be available.

The new formula will be monitored by Oftel through the regular publication of statistics showing a representative residential customer bill to help ensure that a fair proportion of the benefits of improved efficiency go to residential customers.

In addition, British Telecom will be launching a new service for people who do need a phone but do not make a high volume of calls – such as the elderly and disabled.

Details are being finalised but customers who make few calls will be given the option of a lower quarterly rental limited to not more than 60 per cent of the normal residential exchange line-rental.

Improving quality of service

British Telecom now publishes half-yearly quality of service reports which list the key indicators of service to the customer.

These reports are providing a public discipline and yardstick by which British Telecom acts – and very significant improvements are now being made.

For example, faults cleared within two working days now total 90.2 per cent and operator calls answered in 15 seconds total 86.7 per cent.

Another powerful quality boost is the acceptance by British Telecom of liability to customers when it fails to meet telephone installation targets or when telephone service faults go unrepaired.

British Telecom is now developing the detailed arrangements under which it will pay a fixed daily penalty of £5 for delay beyond a second day taken to restore service due to network faults, or if it is more than two days late in providing a line.

This means that a week's delay would result in a residential customer receiving a rebate worth more than the quarterly line rental charge.

Customers can be sure the company will strive to avoid this self-imposed penalty!

Alternatively, the company will accept liability for claims for loss up to a specified limit of £5,000 for business customers and £1,000 for residential customers where such loss can be proved.

British Telecom is determined that the price cuts in real terms over the next four years will go hand in hand with improving quality so that the customer reaps the full benefit of modern technology.

The use of the new technology of optical fibre is an important part of network modernisation.

British Telecom has installed more fibre kilometres proportionately than any other telecommunications operator in the world – over 435,000 kilometres.

Calls are transmitted as beams of laser light down hairthin strands of ultra pure glass.

This not only improves the quality and reliability of calls immensely but gives the telephone system far greater capacity.

An optical fibre cable can currently carry the same number of calls as a copper cable ten times its size.

The growth of competition

Price regulation acts as a surrogate for competition. It stands in place of free and fair competition until such time as prices are determined by competitive pressures. In British Telecom's case, it reassures the customer that the company is acting in the public interest.

But it is not always realised how much competition already exists. Customers now have complete freedom of choice for a wide range of products and services, where previously they had little or none. They can rent or buy equipment, and can even wire extensions themselves: in fact, one in five homes with telephones now has no British Telecom-supplied equipment. And British Telecom products account for only 40 per cent of all 'off the shelf' telephone sales.

In the business sector, where competition is most intense, the company now holds a 60 per cent market share in the sale of small switchboard systems: it was previously 100 per cent. And of the larger systems, with over 100 lines, it supplies 40 per cent.

In other areas, such as the provision of 'value added' or 'enhanced' services – anything from electronic mail to recorded information services – there is complete freedom of competition; and the international arena is already highly competitive.

Price regulation concentrates on network services, where it is going to take longest for competition to emerge, as vast investment is required. But even here, there is already significant competition. Mercury is up and running, and attacking the most attractive parts of British Telecom's business. Private networks pose an increasingly potent threat to the company's traditional business. And the cable TV companies are being given incentives to provide local network communications services.

Pride in public service

There is a significant difference between British Telecom's operating environment and that of its competitors. While British Telecom is required to provide a public telecommunications service on demand, to all parts of the UK – including rural services, 999 emergency services, facilities for the disabled, directory enquiries and public call box services – the licence conditions imposed upon its competitors are generally less onerous, and, therefore, they can concentrate on the most lucrative market niches. For instance, British Telecom's main network competitor, Mercury, concentrates on providing services for major companies in and between major UK cities.

British Telecom's commitment to public service is reflected by the fact that its annual expenditure on modernisation of the entire UK network is about five times greater than the capital value of the existing Mercury network.

Competition is undoubtedly good for the customer. But in a regulated industry, the fields in which it is permitted need to be given careful thought. Mercury's recent arrival on the payphone scene brings this issue into sharp focus. Under its licence, British Telecom runs a national network of 80,000 cash and card payphones as a public service. Revenue from profitable sites, such as stations, airports and business centres, is offset by low financial returns in remote rural areas – and inner city zones where vandalism is commonplace. Mercury, however, has no such commitments and is free to site its payphones wherever it considers they will provide maximum commercial advantage.

British Telecom is proud to be the universal supplier of telecommunications in the UK. It welcomes the spur that competition brings and believes that, in most areas of its business, competition is preferable to its surrogate of regulation. But where the hybrid of competition and regulation exists in the transitional period, great care needs to be taken to ensure that the universal provider of service is able to meet its public service commitments on a fair and equitable basis.

SUMMARY

Customers now have, in the words of the Director General of Telecommunications, "an unprecedented assurance" about prices. Any overall price increases should be very low indeed.

By 1993, when the RPI-4.5 formula runs out, the relevant prices will have fallen by about 30 per cent relative to inflation since privatisation.

But that will not be the end of the process. The economics of British Telecom's investment will really begin to show through in the 1990s, boosting quality and lowering prices.

Customers are now set for a long period when their telecommunications costs will continually fall in real terms.

Telecommunications will be one clear area where the cost cutting effects of modern technology will be seen. RPI-4.5 spells out the minimum benefits to be enjoyed. There will be more to come.

If you would like further information, please contact:
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Telephone: 01-356 5352

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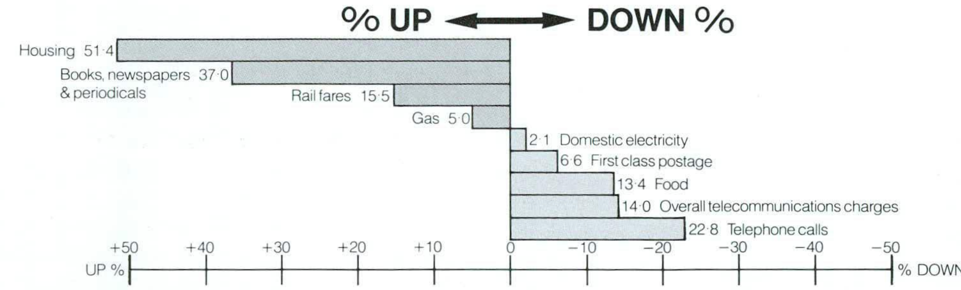
This is British Telecom

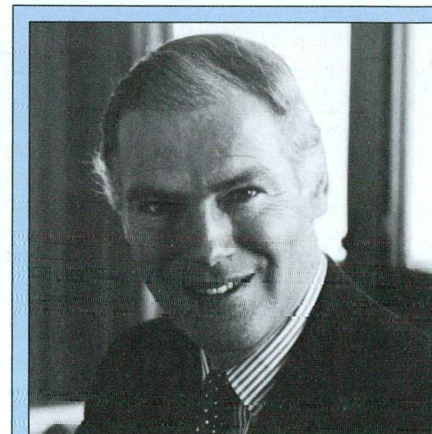
How the company is holding down prices – and improving services

Three year price freeze

By next August, prices on British Telecom main inland services will have stayed unchanged for almost three years – a record few other companies in the UK can match. It is the result of increasing efficiency, coupled with the price formula laid down in the operating licence when British Telecom became a public limited company in 1984. From next August, that formula is being revised to give a 50 per cent greater benefit to customers. Price changes on main services will have to be set each year at an average of at least 4.5 per cent below the rate of inflation as measured by the Retail Price Index.

Price changes relative to Retail Price Index over 10 years to March 1988.





Iain Vallance

CHAIRMAN ON TASK AHEAD

"Improvements in efficiency are particularly important as we face the challenge of our pricing formula that will apply from August 1989. The tightening of the screw from RPI-3 to RPI-4.5 represents a tough target for us to meet.

"We believe we can achieve this, while still generating sufficient funds to finance our huge investment programme . . . and give shareholders a good return on their investment. Our aim will be to take full advantage of the marketing opportunities created by improved quality of service and low prices to the customer.

"I am particularly pleased that our sound trading position has enabled us to extend the current price freeze on our main UK services until at least August 1989. That's a freeze of nearly 3 years. And it is worth recalling that the last changes in the price of these services, in October, 1986, represented a net reduction in the average bill – not an increase."

The Chairman, Iain Vallance, speaking at the company's AGM at the National Exhibition Centre in July.

The price control formula

British Telecom has been governed by a price control formula since it became a public limited company in 1984. The formula was called RPI-3 and applied to a "basket" of main services comprising telephone line rentals and local and national dialled calls (excepting payphone calls) and accounting for nearly 50 per cent of total revenue.

It meant that prices on those services could not be increased on average by more than 3 percentage points below the rate of inflation as measured by the Retail Price Index (RPI).

This formula was laid down for five years as a condition of British Telecom's main operating licence and expires in July, 1989.

It has worked very effectively, making telecommunications one of the few services where prices have sharply fallen in real terms over the past few years. By July, 1988, the fall was some 14 per cent relative to inflation since August 1984.

The fall in prices in the "basket" itself in real terms has actually been greater every year since 1984 than the curbs laid down by the formula.

In fact, British Telecom introduced a voluntary total price freeze on the "basket" services when it made its annual review of tariffs in November, 1987. In April, it extended this freeze further until March, 1989, and has now extended it still further to the end of the RPI-3 formula in July 1989.

The freeze is an example of how keenly and effectively British Telecom has operated in the interests of the customer, going beyond the letter of the price control formula.

Ch/ last yr you declined this despite much pushing from BT. Have you changed yr view?

MPD

Chancellor/Br Telecom

FROM: MICHAEL GUNTON
DATE: 9 DECEMBER 1988

1. MR GIEVE

I agree JG

2. CHANCELLOR

Definitely one for FST.

cc Mr Bush

BRITISH TELECOM TAX

On 1 January 1989 British Telecom is due to pay its annual tax bill. As last year it will be a record amount - some £700 million. Last year they entered the Guiness Book of Records for handing over the world's largest cheque and gained some publicity from the fact. This, after already being in the Guiness Book for registering the world's biggest loss over one year !

Having retained their new title this year they want more publicity and suggest that there is a photocall when the cheque is handed over. They have asked if the Chancellor would cooperate by receiving the cheque from BT's chairman with Ros McWhirter of the Guiness Book of Records on hand to verify its validity as a record.

They suggest that this is done on Wednesday or Thursday during the first week of January. Would the Chancellor agree to this in principle ? If so, I will go ahead with the arrangements. If he does not want to do it might I suggest the Financial Secretary ?

I think this is worth doing as it supports our argument that privatisation is not "giving away the family silver". Privatised firms instead of being a drain contribute to the national purse.

Michael Gunton

MICHAEL GUNTON

CONFIDENTIAL
MARKET SENSITIVE

From: S D H SARGENT

Date: 13 January 1989

NOTE FOR THE RECORD

cc PPS
Mr Moore

BRITISH TELECOM

Iain Vallance and Malcolm Argent called on Sir Peter Middleton at 9 am on 13 January.

2. Mr Vallance said that he had concentrated on three key areas in the last 15 months. The first was getting the core business into equilibrium; the second was reorganising the Board and divisional structure, which was now largely completed. The third was taking a fresh look at BT's strategy, and in particular at the need to develop businesses outside the UK which were not necessarily part of their core activity. The environment in the UK was bound to get tougher, with increasing competition and tight regulation, and BT had received no real encouragement from the report of DTI's MacDonald Committee. One area of obvious interest was mobile communications. The BT Board would be meeting that afternoon to decide on a proposal to take an initial 22% stake, costing some $1½ billion in McCall, the only US company with a coast to coast cellular facility. The stake would be debt financed. There were constraints preventing BT from taking a larger stake at this stage. They did not expect any strongly positive cash flows to result until the mid-1990s because of the way that the business was developing, but they were confident that the position would improve rapidly thereafter. BT did not intend to be a passive partner. They felt they had a great deal to offer McCall, while the stake would offer them the opportunity to deploy some British technology in the US.

3. Mr Vallance said he was about to deliver the same message to Lord Young. If the Board approved the plan that afternoon it was intended to announce the acquisition of the stake the following Thursday, but a story had appeared in the previous day's Evening Standard and it might not be possible to hold off making an announcement until then. This was the largest of BT's strategic moves at present. They would continue to keep the Treasury in touch with developments. Sir Peter Middleton thanked Mr Vallance for putting him in the picture. He said that he would pass the news on to the Chancellor that morning. He did not see any need for BT to inform the FCO.

S D H SARGENT
Private Secretary

Sir P Middleton

c Mr A C S Allan

FROM: MRS TODD
DATE: 17 JANUARY 1989

MR WATTS

You may like to see!

MCS 17/1

cc: Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Day

BT CT PAYMENT

See the attached photocall from last Friday's Daily Telegraph. IR Finance division rang me on Friday to ask if Treasury could cash that cheque and if so, please could they have some of it.

2. The story behind the headline is ironic and interesting. In fact BT attempted to do the opposite that the picture suggests and made the CT payment by what was no doubt intended to be the most indirect and slowest route. They lodged their cheque for £753 million with the IR local office in Inverness after banking hours on Friday 30 December. If things had gone in their favour, the cheque would have been lodged with the IR branch's local bank on Wednesday 4 January (the Tuesday being an additional bank holiday in Scotland) and would not have cleared from BT to IR (HMT) until Monday 9 January, ten days after BT delivered their cheque to IR. Instead, IR took the fastest cheque clearance route available: they dataposted it to arrive at their main Shipley accounting office first thing on Tuedsday morning, Shipley then put it onto the train down to London to the Bank of England who then obtained clearance for it that day, Tuesday 3 January.

3. All credit (forgive the pun) to IR, not least for keeping us (and thus the Bank) informed of the cheque's progress and likely clearance date at every stage along the way. Our daily forecast for the first week in January assumed £750 million for BT on the Wednesday rather than the Tuesday. But we are now all the wiser to the play of these games. All part of the January open season for IR receipts!

Pilin Todd

P TODD

NEWS

...estigators' ...rdict on jet ...ngines due ...ter 14 days

By John Harlow

...K on stripping the ...s from the Boeing 737- ...at crashed on the M1 ...unday is expected to ...n Monday at the Paris ... of SNECMA, which ...hem.

...work will take at least a ...nd the first formal find- ...e expected within 14 ...Air Accident Investiga- ...Branch inspectors will ... the work.

...ets of checks have been ...l by British aviation ...ies on 38 British air- ...n the CFM-56 engines ...wiring carrying fire and ...n information to the ...dashboard.

...ngine checks indicate ...stigators are concerned ...e possibility of oil over- ... or the break-up of ...r bearings in the left ...f the British Midland ... jet—the one passen- ...on fire.

... night the nine British ...ad cleared the wiring.

...American airlines ... 292 Boeing 737-300s ...ght 737-400s were ...d by the Federal Avia- ...ority to test fire and ... warning systems in ...its within three days.

...uropean airlines have ...luntary checks on wir- ...ngines, bringing the ...37s and Airbus A320s ... to more than 500.

...737-300 operators are ...aring to incorporate ...viation Authority ...ns to increase the fre- ...of routine engine

...spokesman said: "We ...t these are precau- ...ing the availability of ...ific evidence from the ...vestigation."

...workers hope to open ...southbound lanes of ... this morning but the ...d side might not ...l after the weekend.

...ershire police con- ...rday that a 31-year- ...had been suspended ...leged theft of a life- ... the wreckage.

...r exercise yesterday ...proved communica- ...ndle relatives' tele- ...about victims, and a ...uter programme to ...sualty details, was

Picture: T...

Mr Graeme Odgers, group managing director of British Telecom, delivering a £753 million cheque Corporation Tax yesterday to the Treasury in Whitehall, the largest ever written in Britain

Trade row puts steak & kidney pies at risk

By Our Agriculture Correspondent

MEAT processors fear the steak and kidney pie could be one of the first casualties of the meat imports row between the Common Market and the United States.

The price of kidneys for manufacture has already risen by about 60 per cent since September, and further rises are inevitable unless the trade war ends soon, Mr Fraser Wilson, managing director of importers CDB Meats, said yesterday.

"It will hurt the meat industry, but at the end of the day the person who will pay for this will be the housewife, because it must lead to enormous increases in price," he added.

The Common Market banned imports of hormone-treated

Britain urges cuts in harmful ozone gases

By Our Political Staff

BRITAIN IS to seek further world cuts in the emission of gases which are causing potentially calamitous damage to the Earth's ozone layer.

The move follows a meeting of Ministers, chaired by Mrs Thatcher, at Downing Street yesterday — the first such Government gathering to discuss the impact of pollution on the world's climate.

Eight Whitehall departments were represented.

Although no decisions were taken, senior Ministers are keen to reduce emissions of chlorfluorocarbons (CFCs) which scientists believe have caused the hole in the ozone layer and are a contributor to global warming, known as the "greenhouse" effect

sions to fall by at least 85 per cent by the end of the century.

There is to be an international conference in London in March, which the Prime Minister will address with the aim of recruiting Third World countries to the campaign against atmospheric pollution.

Mr Ridley, Environment Secretary, has recently returned from Peking where he urged the Chinese government to take part in tackling global warming.

Ministers are anxious the reduction of CFCs by Western countries should not be undermined by the growth in emissions in countries which have not signed the Montreal protocol.

The Downing Street meeting

Doctors ca... for no-faul... damages pl...

By David Fletcher Health Services Correspondent

DOCTORS pay £90 milli... year in insurance to inden... them against being sue... patients, but only half ... money reaches those wh... damaged when treatm... goes wrong, Dr David Bol... the British Medical Ass... tion, said yesterday.

Under existing arrangem... compensation is paid only w... the injured patient succeed... the courts in proving neglig... on the part of the doctor.

No matter how deserving ... patient might be of finan... help, there was no certainty ... would receive it, Dr Bolt tol... conference in London on a ... fault compensation ...

British
TELECOM

Iain D T Vallance
Chairman

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Sir Peter Middleton
Treasury
Parliament Street
LONDON
SW1P 3AG

cc PPS
Mr Monck
Mr Moore

PMP

19 January 1989

Dear Peter

I enclose details of the acquisition of 22% of McCaw which we announce today. This stake in the largest cellular operator in the US provides an excellent opportunity to exploit overseas the skills we have developed in the UK.

Yours ever

Iain

I D T VALLANCE

British
TELECOM
News release

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PB6 January 19, 1989

BRITISH TELECOM MAKES MAJOR EXPANSION INTO USA MOBILE COMMUNICATIONS MARKET

British Telecom is expanding its interests in the fast-growing mobile communications market by making a significant strategic investment in McCaw Cellular Communications Inc, the USA's leading Cellular Telephone operator. McCaw owns or has an interest in some 130 cellular telephone operations throughout the United States.

When the investment is completed British Telecom will hold 22% of the equity of McCaw. The total consideration is about US$1.5bn.

Commenting on the announcement, Iain Vallance, Chairman of British Telecom, said:

"Over the last twelve months, we have been concentrating on driving forward our programme to improve our telecommunications services here in the UK, while at the same time reviewing our worldwide strategy for the Group.

"The review has emphasised two main themes - on the one hand, we must continue to enhance our investment in our UK network and, on the other, we must anticipate the globalisation of telecommunications markets and reinforce the development of those businesses that are independent of our regulated markets in the UK. The potential impact on our regulated activities of any slowdown in the UK's economic growth further points up the need for such diversification.

"In diversifying, we shall focus upon deploying overseas the technical and commercial skills we have developed in the UK and concentrate on those market sectors that show real long-term growth potential.

"Mobile communications, where we have extensive experience in the UK, fits these criteria perfectly. We see mobile communications as becoming increasingly important as we move through the 1990s into the next century. It is a fast developing market, where BT aims to become the world leader. In terms of coverage and potential subscriber base, McCaw is by far the largest cellular operator in the United States which is, in turn, the largest market in the world. The Board believes that the opportunity to invest in this early stage of McCaw's development offers BT a unique opportunity to lay the foundation for long-term growth in this key market.

"Our investment in McCaw is seen by both sides as a real operating partnership, not just a financial arrangement. We have much to bring to that partnership, in terms of our technical and commercial experience in cellular operations, just as there is much that we can learn from McCaw."

British Telecom is the principal supplier of telecommunication products and services in the United Kingdom. It is active in all aspects of the UK mobile communications market. In particular, its 60 per cent owned subsidiary, Cellnet, provides cellular telephone services capable of access by about 95 per cent of the population. The total UK market for cellular services now stands at almost 500,000 customers and is expected to grow to at least 1 million customers by 1991.

Note to Editors

The agreement between British Telecom and McCaw gives BT equivalent voting rights for its 22% shareholding. BT will appoint four directors (out of a total of 19). The remainder of the Board comprises 10 directors nominated by the McCaw Chairman, two nominated by the other major shareholders, and three independent directors, who have special responsibilities.

British Telecom will subscribe approximately 37 million McCaw shares of common stock for a total consideration of US$1.5 billion. This will represent 22% of the equity of McCaw as enlarged by the subscription. The subscription will be satisfied in cash and is expected to be completed within the next few months. The agreement is subject to the fulfilment of certain conditions, including US regulatory review.

The extent of any subscription in US cellular companies is constrained by US legislation, which limits the level of total non-US ownership to 25%. BT's investment will therefore absorb the bulk of available foreign ownership in the Company.

The value of the investment will be established and maintained in BT's balance sheet after allowing for a goodwill amount of approximately one third of the purchase consideration. This goodwill will be written off against reserves. In calculating the investment value for balance sheet purposes BT will include its pro rata share of McCaw's anticipated losses.

McCaw is engaged in the acquisition, construction and operation of cellular and other mobile systems throughout the United States. It is by far the largest cellular telephone company in the United States as measured by the number of persons situated in the cellular operating locations it already owns or has the right or obligation to acquire. The size of the US cellular market is approximately 2 million customers at this time and continues to display exceptionally strong growth.

McCaw is presently controlled by McCaw family interests and Affiliated Publications Inc. through their ownership of class B shares, which carry 10 votes per share. Its Class 'A' shares, which carry one vote per share are traded on NASDAQ. BT is purchasing a mixture of A & B shares and will have 22% of the company's shares and votes.

To complement BT's investment in McCaw, McCaw's previously largest shareholder, Affiliated Publications Inc, has simultaneously announced a major restructuring in its McCaw holdings. Affiliated, publisher of the Boston Globe, Billboard Magazine and a number of specialist magazines, will re-organise; and as a result, the McCaw shares previously held by Affiliated will be distributed directly to Affiliated's shareholders. These shareholders include two Trusts, each of which will continue to have the right to nominate a director.

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For further information please contact: British Telecom's Corporate News Room on 01-356 5366.