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cc. A. Wiggins  
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10 DOWNING STREET

From the Private Secretary

11 March 1981

The Prime Minister has seen the Secretary of State for Industry's letter of 5 March to the Chancellor about financing BT's investment programme.

She strongly supports Sir Keith's view that the investment programme should go ahead and that it would be indefensible to require BT to start cancelling investment orders. She hopes that the Chancellor will find a way of accommodating either the bond devised by Warburgs, or some of the other proposals that have been made to help solve the problem in 1981/2.

Looking to 1982/3, she also supports Sir Keith's view that the private sector should be enabled to finance BT's highly profitable investment programme. She has noted his suggestion that we should look again at our treatment of leasing. She does not think that leasing should be ruled out solely on grounds of revenue loss through tax relief. She points out that transferring resources to the private corporate sector is one of the Government's objectives; transferring employment to the private sector is another. Leasing might provide a stepping stone towards transferring the maintenance and even the operation of some exchange equipment to the private sector.

I am copying this letter to Ian Ellison (Department of Industry), David Wright (Cabinet Office) and Gerry Spence (Central Policy Review Staff).

T. P. LANKESTER

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

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CABINET OFFICE  
Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

Qa 05273  
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From: J. R. Ibbs

*Tim - Keith speaks  
me about this. I  
agree with J-H's  
note. Can we  
write to the  
Treasury accordingly.  
not.*  
6 March 1981  
*cs. A. Duquoin*

Dear Chancellor,

British Telecom's Investment Programme

In his letter to you dated 5 March the Secretary of State for Industry seeks agreement that BT should be allowed a £200m. increase in its EFL.

As you know, the CPRS is currently carrying out a study of BT's long-term investment and financing needs. The work already done has confirmed that BT's investment programme is profitable, necessary if business and commerce are to have an efficient service, and essential if the opportunities offered by IT are to be seized.

To raise the sum of £200m. by increasing the tariff by more than the amount already envisaged does not appear feasible as it would put the increase far above the projected rate of inflation.

I support the request made by the Secretary of State. If an increase in the total of EFLs is not acceptable, my own view would be that the importance of maintaining investment in BT is such that money should be looked for by holding back the spending of other nationalised industries. However, I realise that although this concept would be normal (although very painful) in private industry, such aggressive implementation of priorities has yet to be accepted in the public sector.

I am sending a copy of this letter to the Prime Minister, the Secretary of State for Industry, and to Sir Robert Armstrong.

*yours sincerely,*

J R Ibbs

The Rt Hon Sir Geoffrey Howe QC MP  
HM TREASURY  
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PRIME MINISTERBRITISH TELECOMS FINANCING

Flm A  
You will have seen Keith's letter to Geoffrey of 5 March. I have spoken today about it to David Young. I believe that your intervention will be necessary in order to break through the conventional thinking of the Treasury.

1. DoI are preparing a list of twelve different and imaginative suggestions for funding BT investment outside the PSBR. So far, every one of them has been stalled or vetoed by the Treasury.
2. There is of course a real fear at the Treasury that any method of increasing BT's investment will end up adding to a PSBR at a time when it is extremely important that the PSBR is not allowed to expand. That is a problem which does not worry DoI and must worry the Treasury.
3. The more imaginative the financing suggestions are, the further away they get from causing any PSBR problems. But, at the same time, they then begin to look more unconventional to the bureaucratic mind. One example which emerged from a brainstorming session here with Alan and David Young was a "consumer bond" in which telephone subscribers could buy a bond which entitled them to a tax-free reduction in their telephone bills over a period of years. The analogy would be the commuter's season ticket which has similar tax-exempt discounts. This one (of many) suggestions has not been killed yet but has of course been resisted by the Treasury and the Inland Revenue. But it would put BT in direct contact with a new group of investors, in this case their own customers.
4. What seems to be missing in the Treasury is an ability to analyse risks (eg commercial or administrative risks for the consumer bond vs. PSBR-type risks from increased EFLs) and a marketing man's approach to financing.
5. BT is the most important example of de-monopolisation, opening up to competition and the first steps towards privatisation. One of the most effective catalysts for changing the thinking of a nationalised industry management is to put them in the same position that the management of any other enterprise is in - under

market pressures to design, package and sell his equity and debt to the financial markets in exactly the same way as he must sell his products and services to the consumer market. It is a totally different activity from the Chairman of BT being briefed to come round to the Chancellor with the begging bowl for extended EFLs with all the usual lobbying and political log-rolling. This shift is a central part of what the Government should be trying to achieve for nationalised industries.

6. One of Keith's proposals is the greater use of leasing. Apart from the immediate cash flow advantages, leasing has longer-term attractions on policy grounds. If a private sector company owns exchange equipment, it should be a short step to their staff maintaining and even operating it. If that can be done, we switch to labour relations in the wholly different climate to private sector disciplines. (We understand there is heavy overmanning in BT at present.) Treasury objections to leasing are understandable: the lessors' ability to claim tax relief means lost revenue for Government. But it's no good simply refusing to think further than this. There are advantages as well as drawbacks: transferring revenue from the Government to the private corporate sector is one of our objectives; transferring employment to the private sector is another.
  
7. We suggest that Tim Lankester writes a note to Geoffrey's office summarising these points and saying that you wish to see a much more positive attitude to Industry's proposals from the Treasury.



JOHN HOSKYNS

~~See Mr Duguid.~~

MR



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Secretary of State for Industry

5 March 1981

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

*See Geoffrey.*

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We face serious difficulties - and opportunities - with BT's investment programme.

2 Demand for telecommunications facilities is running ahead of supply, particularly in the City. Existing telecommunications services are (sometimes grotesquely) inadequate and there is a need to bring in the new digital technology as quickly as possible for businesses. The telecommunications manufacturing industry depends on BT orders both for the development of modern telecommunications equipment - for example System X - and for loading its factories. Officials here and in the Treasury are satisfied that there is a very strong economic case for BT's investment plans. The investments themselves will be profitable, quite apart from the benefits they will confer on commerce and industry.

3 BT's investment programme ought to go ahead on both commercial and national interest grounds. The only doubt is whether the scale of the investment is sufficient.

4 As a nationalised industry, BT borrows on Government credit and cannot go into liquidation. The current BT Bill will pave the way for privatising part of BT's activities and thereby removing them from the Government's credit, but progress will not be fast enough for our immediate problems. The Bill also introduces an entirely new framework for telecommunications in this country. BT will have to compete on many fronts - terminals, so-called value added network services and even the network itself. Professor Beesley, whom I recently commissioned to report on the scope for value added network services, has demonstrated that the present constraints on BT's investment are basically incompatible with freer competition.

5 So far BT has funded virtually all of its investment from revenue - a situation which no comparable growth industry in the private sector would contemplate. This has meant tariff increases which are resented and indefensible. Now that we are entering on a new period of telecommunications growth and competition the likelihood

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is that BT will continue to be a large net borrower for years to come and therefore a permanent burden for the PSBR unless we can find some alternative solution.

6 In addition now, the recession is hitting BT's revenue. BT under its new Chairman is striving for improved performance and to keep the tariff increase to a level no higher than the going rate of inflation, which will be an improvement. Yet BT warns us that unless its EFL is increased, equipment orders will have to be cancelled. This will severely damage the industry and its employment, telecommunications users and our position as a Government encouraging new technology.

7 Of course the private sector would gladly finance BT's highly profitable investment programme. In my view we need to decide in principle that, commencing in 1982/83, BT (and if necessary other clearly profitable nationalised industries like BNOC) must be allowed to develop methods of raising its own funds for investment from commercial sources outside PSBR constraints. If you agree, this may for example mean revising the definition of public expenditure to exclude leasing. We must be prepared to allow BT to conduct its own operations (including if necessary leasing its exchange equipment etc from the private sector) within clearly established PSBR rules without detailed day-to-day control by the Government. Treasury should be asked to produce clear PSBR rules which should be published and made known in the City.

8 Arrangements like those I envisage cannot be introduced overnight. BT's immediate problem and the threat to its investment programme mean that we need to take immediate action for 1981/82 as well. The Chairman of BT has sought a £450m increase in his EFL in 1981/82. This is clearly excessive. Warburgs have, however, devised a bond which will enable BT to borrow £200m direct from the market. If approved, the bond will count against BT's EFL and the PSBR but would go a long way to mitigate the macro economic consequences of an increase in the EFL. The bond would help us presentationally since BT will go to the market direct, a course which is not open to unprofitable nationalised industries. I think we should agree to the principle of a bond and the necessary increase in the EFL for 1981/82 only. I would make our agreement conditional upon the bond involving a substantial element of risk. I would also make it conditional on BT agreeing to the appointment of management accountants who would explore the kinds of economies within BT that Michael Heseltine's accountants found within the water industry. They could also explore the steps required for BT to establish subsidiaries and introduce private capital on a timescale significantly faster than BT at present envisage.

9 I hope you will agree that, in principle, BT should be enabled to operate so that in 1982/83 its investment can be financed outside the PSBR but within approved PSBR rules and that in 1981/82 BT should be allowed a £200m increase in its EFL on condition that management accountants are appointed and that the money is raised by the sale

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of bonds. The £200m change in EFL will need to be included in your public expenditure plans.

10 Unless we take some such steps very soon investment orders will be cancelled and jobs lost in industries which will raise a clamour about the folly of government's preventing the profitable provision of new intensely needed services all of which could be easily financed by the private sector. We have been months considering options and each one has been vetoed. We are now up against a real time constraint.

11 I am copying this letter to the Prime Minister, Sir Robert Armstrong and Robin Ibbs.

*Yours sincerely*

*Ian Ellison*

KEITH JOSEPH  
(Approved by the  
Secretary of State  
but last page re-typed  
in his absence)

5 MAR 1987

