Post & Tel 1

David and I had a word about this on Fri evening. We have to get the Treasury moving and fast. MR

PRIME MINISTER

I think you should read the attached note on British Telecom financing.

It says, in effect, that there are three ways of enabling B.T. to invest more without causing any addition to PSBR in the current recessionary year. (Or in future years for that matter).

a. Consumer Bonds - which might raise, say, £1,000 from each of a million households to provide £1,000m.

b. Leasing - the Treasury will only allow leasing if some abstruse technical rule which they invented is made to govern the transaction.

c.1. Turnkey operations, which defer the cost to B.T. until they have in use a particular asset whose revenue can then finance the cost.

[2. Normal loan decisions which do not require that seven year pay out investments can only be advanced by borrowing money for 29 years.]

The issue is very simple - are you prepared to instruct the Treasury that they must achieve B.T. financing at no cost to the PSBR rather than allow them to insist upon commercially insane rules which force B.T. to forego investments or increase the PSBR ?

If we could cross this particular bridge in relation to B.T. it would have implications for the financing of all other profit-making nationalised industries, especially gas and electricity. It would even have implications for the development of investments in the coal industry which could be financed outside the PSBR against future revenue from coalfields.

I do not think the Treasury operate in the real world. The above paper is evidence. (More evidence was supplied this week when Treasury insisted that we demand pari passu ranking for our guarantee to I.C.L. with their secured borrowing. This was totally unreasonable by any commercial standards, though Lord Benson could, no doubt, have asked for it in a polite way. But to insist that this was what we required them to grant us, when we were at the same time asking them to do us a favour rather than the other way around, suggests an inability to accept that the world is not the way we would like it to be).

This Treasury attitude has so many damaging consequences that I suspect the insistance on breaking Treasury rules in the case of B.T. would have considerable beneficial effects elsewhere.

I think we have reached the point where the appropriate individual in the Treasury has to be told to do it or else make way for someone who will. "Pray do not argue the difficulties".

DW.

If you agree that this is worth pursuing, I should like a (brief) discussion before you take any action.

PS I have already written to the Treasury (Flag A) on the advice of the Policy Unit and with your authority asking them to come up with an imaginative solution to the BT problem. I would have thought it would be better to await their response before issuing any "instructions". I have told the Treasury that you are expecting something soon. They tell me that Nigel Lawson and the Chancellor are applying their minds to this. I will chase them again next week.

TL 19/3

Mr WIG/SOL

THE SECRETARY OF STATE

c.c. PS/Ministers
PS/Secretary
Mr. Croft
Mr. Solomon
Mr. Wigglesworth
Mr. Nieduszynski
Mr. Brown

BT FINANCING

I heard yesterday afternoon that there is a possibility that Treasury officials will recommend that BT be given an increase of £190 million in their EFL for 1981/82. This would come out of the Contingency Reserve and thus not affect PSBR. I believe this to be the worst of all possible decisions for it does nothing towards promoting a sense of commercial reality in BT.

2. I met with Sir George Jefferson on Friday morning to discuss his financing problems. I told him that I now agreed with him that substantial privatisation by way of regionalisation would have to be postponed, probably into the life of the next Parliament, as our first priority would be to set up self-accounting regional companies. He said that he would welcome this approach and accepted the need for reporting accountants as a first stage.

3. He also told me that he was proposing that Peter Benton become the Chairman of BT Enterprises Limited which would act as the holding company for a number of joint ventures with the Private Sector on peripherals, etc., and which would also include Prestel.

4. We agreed the following three-pronged approach which I believe could be constructed in such a way as not to add to the PSBR but would also allow an acceleration of BT's investment programme. I believe this to be now crucially necessary particularly as a major part of the benefit would go to companies like GEC and Plessey which will undoubtedly be facing substantial inroads in their market as a consequence of our liberalisation policy.

My three suggestions are:

A. <u>Consumer Bonds</u>:

A Consumer Bond is a short-term loan obligation issued by BT which would afford the holder a discount on his telephone account of, say, 10% per annum of the capital value of the Bond. I understand that the Revenue are likely to object to the tax-free nature of the benefit and it therefore might be necessary to provide for this in the Finance Bill. The concession could be framed so as to apply only to similar

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obligations of Nationalised Industries. [To balance the benefit to high tax payers, the Bond could be framed so as to give special concessions for Pensioners and other Social Security beneficiaries. It could, for example, produce a return of 15% per annum for these categories.]

Complicated to Administer.

The Effect on PSBR

I am told that if the loan obligation was for a period of two years, the Treasury would not score against the PSBR. If necessary we could limit ourselves to such a term but it would be a pity if we had to incur all the additional administrative costs merely to keep it within what can best be described as an artificial distinction. It may well be that a 2-year Consumer Bond could have provision for renewal at the option of BT and still comply with the Treasury definition. It would make sense to press for an extension of the term without affecting the PSBR.

Unhelpful Theology!

If we could be allowed to issue a Consumer Bond for the longest possible term without being scored against the PSBR, then the net effect would be either a reduction in the PSBR or a restoration of the Contingency Reserve.

We should go for £200 million and BT could make the arrangements to start selling the Bonds this side of the Summer.

B. Leasing:

Many, if not the majority, Private Sector companies enter into leasing agreements as a method of off-Balance Sheet financing. The Treasury accepts that the capital value of any leasing agreements entered into by Nationalised Industries does not count against PSBR. Nevertheless, for some time now, they have deducted the capitalised value of any leasing agreements against EFLs. This has had the result of dissuading Nationalised Industries from entering into leasing transactions.

The Treasury has said in recent weeks that they might well permit leasing transactions not to be scored against EFLs where there could be shown to be a risk element. Since the debt obligations of a Nationalised Industry can never be in doubt, the risk element could be confined to the quantum of the yearly payments which could vary either against turnover or volume.

WHY MAKE LIFE DIFFICULT FOR INVESTMENT?

I do not appreciate the logic behind this distinction (IS THERE ANY?) but I do know it will in the end add to the cost since uncertainty is a factor which has to be paid for.

I believe that it would be open to BT to initiate a considerable expansion of their investment programme over the next two or three years by allowing them to enter into

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further leasing transactions for capital investment. The equipment manufacturers, either alone or in conjunction with the financing institutions, would be happy to provide the equipment at market terms and I could even contemplate the setting up of tertiary financing institutions whose sole business would be to lease capital equipment into Nationalised Industries.

The Effect on PSBR

There is no effect on PSBR as a result of capital expenditure. The yearly payments are, of course, a liability of the Nationalised Industry but they are covered out of revenue.

We would have to allow an automatic increase in the EFLs unless we could persuade the Treasury to drop the ruling whereby they automatically dock BT the capital value of any leasing agreements.

Even if we give automatic increases to the EFLs, it would not affect PSBR for the reasons I have outlined above.

C. Freedom to Act Commercially:

1. Many Private Sector companies indulge in turnkey operations and that is they enter into agreements to acquire either plant or buildings for a lump sum payment due on the commissioning of the plant. I am told by BT that they are denied the right to enter into this form of financing and have to make stage payments as they proceed. If we could allow BT the flexibility to enter into this type of arrangement, we could give them considerably more room to manoeuvre, both for EFLs and for the PSBR. There is no assumption of any additional risk (in fact the reverse is the case), nor would this type of arrangement be in any way unorthodox.

2. Sir George told me that the morning after the Budget he sent for his Head of Finance and asked him what effect the 2% reduction in MLR would have on either the profits or his cash flow. The answer was none because their borrowings are confined to the National Loan Fund and these are at a fixed rate of interest and for a term of 29 years. The vast majority of BT's investment decisions have a far quicker pay-out date and it is bad commercial practice to be forced to borrow for a period longer than the pay-out period on an investment.

We should really encourage BT to go to the market direct to borrow for its commercial operations. The Treasury will argue that this will increase the cost of borrowing but if it does it will be because the market will perceive these loan obligations as distinct from Gilts and they therefore should not affect Gilt sales. By rights this Department and the Treasury should each year agree with BT its market borrowing requirement for the year and let them get on with it.

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It is only this way that they will begin to examine the real need for the investment monies and the difficulties of raising them.

The Effect on PSBR

There is a case for distinguishing between the PSBR and the GGBR. By rights I would have thought that the direct borrowings of profitable Nationalised Industries should not be scored against the PSBR. It is very difficult to perceive how we can proceed with a medium-term strategy for BT without allowing them the freedom to plan ahead and to raise monies on a commercial basis.

5. In view of other discussions, I am copying this to Robin Ibbs and David Wolfson.

David Young

David I. Young
Special Adviser

17th March, 1981

Mr Wolfson

CONFIDENTIAL

Mr Young

PS/Ministers
PS/Secretary
Mr Solomon
Mr Wigglesworth
Mr Nieduszynski
Mr Brown

BT FINANCING

Many thanks for sending me a copy of your minute of 17 March to the Secretary of State.

2 We have of course been arguing with the Treasury for months about various possible methods of allowing BT to raise additional finance for investment. The Treasury have not been willing to support any of the possibilities we have put forward. I myself mentioned to Mr Ryrie on 13 March both the main proposals you describe in your minute - customer bonds and leasing. He was even less enthusiastic about them than he was about Warburgs' proposal for revenue bonds, which he now regards as ruled out in any event for some months because of possible conflict with the index-linked gilts announced in the Budget.

3 I am sure we should not give up the battle. In particular, by making BT dependent on the market for a significant proportion of its investment funds we should, if we get the mechanism right, be able to bring market pressure to bear on the performance of BT's management (though as it happens neither customer bonds nor leasing would be very effective for this purpose).

4 But BT need to know by the end of this month whether they are going to get additional finance for 1981/82 or whether they should start making drastic cuts in their planned investment programme with all the damage that would do to the telecommunications manufacturers. It may be faint-hearted of me, but I simply do not believe that we shall now be able to pin the Treasury down to accepting unorthodox methods within the next fortnight. If, therefore, they are prepared to recommend an increase of £190 million in BT's EFL for 1981/82, on the assumption that the money will be provided from the NLF and be scored against the Contingency Reserve, I very much hope that we will accept, while specifically reserving the right to continue to press proposals for new methods to raise finance. It is already agreed, I think, that as a condition of an increase in the EFL, Sir George Jefferson should be asked to accept the appointment of reporting accountants, both to examine the scope for tighter cost control in BT and to prepare the way for establishing regional companies.

WE MUST INSTRUCT THEM, NOT ARGUE WITH THEM!
DW

I am copying this minute to the recipients of yours.

Roger

R H F CROFT
Deputy Secretary
17 March 1981