


CONFIDENTIAL

P.0716

PRIME MINISTER

Future Telecommunications Policy
(E(TP)(82)2)

BACKGROUND

✓ — You will recall that on 16 March E Committee considered a paper by the Secretary of State for Industry (E(82)23) seeking policy approval for the introduction of legislation next session to convert British Telecommunications (BT) into a Companies Act company. He envisaged that 20-25 per cent of the equity would then be sold and the proceeds used to finance BT's investment instead of relying so heavily on revenue raised from charges; and that, subsequent to this sale, the Government would give up "commercial control as we have with British Aerospace and Cable and Wireless". The Chief Secretary, Treasury argued (E(82)26) that any proceeds of privatisation should accrue to the Exchequer and not to the enterprise itself, and that the Government would have to retain control over investment and borrowing until the Government had properly relinquished responsibility for BT, rather than merely disposing of 20-25 per cent of the equity. The CPRS in E(82)29 argued that privatisation of BT should not get ahead of solving the regulatory problems arising from BT's dominant market position. In addition the Home Secretary, the then Foreign and Commonwealth Secretary and the Secretary of State for Northern Ireland sent you minutes (not circulated to all) drawing attention to the need to explore the implications of the proposals for national security.

✓ — 2. The main outcome of the discussion on 16 March (E(82)9th meeting, item 1) was the setting up of the sub-Committee on Telecommunications Policy. You agreed also to the setting up of an Official Committee, chaired by the Cabinet Office, which has produced the report (E(TP)(82)2) for discussion at this meeting. The report seeks to set out the issues for Ministers in a neutral way.

CONFIDENTIAL

3. Meanwhile arrangements have been made for officials separately to examine the national security implications of proposals on telecommunications policy and to put issues to Ministers, as necessary, at the appropriate stage. At present there is no suggestion that there are insuperable objections to the privatisation of BT on national security grounds but solutions will need to be found to certain problems. The first step is for Ministers to decide whether, on grounds other than national security, they wish to pursue the privatisation proposals.

MAIN ISSUES

4. The main issues for consideration by Ministers are set out in paragraph 19 of E(TP(82)2, ie:

- i. are the advantages to be gained from the privatisation of BT sufficient to justify any possible disadvantages and penalties?
- ii. can more be done in other ways to assist achievement of the Government's objectives for telecommunications?
- iii. if privatisation is justified, what should be the nature of the new regulatory regime to accompany it?
- iv. should the legislation to privatise BT and change the regulatory regime be introduced in the 1982-83 session?
- v. what should be the next steps?

5. The most important issues are the issues of broad policy at i and ii. Should the Government, as the Secretary of State for Industry proposes, place the main priority over the next few years on privatising BT, with little further progress, apart from action already in hand, on the liberalisation of telecommunication activities, and the introduction of more competition for BT?

Pros and cons of privatisation

6. You will wish to probe carefully the extent of the contribution which privatisation is likely to make to the two objectives of telecommunications policy identified in paragraph 3 of E(TP())82)2, ie:

i. that adequate resources are available for the modernisation and development of our telecommunications systems;

ii. that the provision of telecommunications is so regulated, structured and exposed to competitive pressures that resources will be used as efficiently as possible and that there will be a flexible response to market opportunities.

7. On i the paper makes it clear that it will not be feasible to transfer the majority or more of BT's shares to private ownership before 1986 or even later. Even if legislation can be enacted next session, the initial flotation of shares in British Telecommunications Ltd (BTL) is unlikely to be feasible in the lifetime of this Parliament for the reasons set out in paragraph 13 of the paper. The initial flotation would have to be limited to 20-25 per cent because this is all the market could absorb; subsequent flotations to achieve private sector ownership of more than 50 per cent of the shares would have to take place two or more years later. It is agreed by Departments (paragraph 20 of the paper) that until 1986 or later the Government would have to retain ultimate control of BTL's access to external finance.

8. The question of whether, before majority private ownership is achieved, any additional resources would be made available for investment by BTL would depend on the resolution of two matters in dispute between the Department of Industry and the Treasury, ie:

a. should BTL be permitted a higher level of external finance during the transitional period when some of its shares are privately owned than BT, as a public corporation, would have been allowed in those years?

CONFIDENTIAL

b. should part of the proceeds of the sale be made available to BTL as additional finance for investment?

The Treasury view on both these points is that, until a majority of the shares in BTL are privately owned, its financing requirements will have to be considered in the normal way against other claims for public expenditure. They might agree that it could be presented that more finance would be available because of progress towards privatisation, so as to assist in reducing union opposition to privatisation (the Secretary of State for Industry's "partnership" concept). The Treasury would however be reluctant to agree that more finance should in reality be provided. Unless this view is rejected by the sub-Committee, it follows that no additional resources will be provided for investment as a result of the privatisation of BT until 1986 or later; it could indeed, depending on the timing, rule out the issue of the BT bond, and the additional resources for investment provided by it.

9. On the second objective (ie more efficiency and market responsiveness) it is agreed by Departments (paragraph 21 of the paper) that, even if BT were privatised, it would still have a dominant position in telecommunications services and that the commercial prospects of the new company would be influenced by regulatory decisions taken either by the Government or Government agencies. Although the Department of Industry would argue that the status of a Companies Act company rather than a corporation would put pressure on BT to speed up the process of making itself more commercial, for example by the reform of its accounts and management structure, it seems unlikely that privatisation would, of itself, do much to improve BT's efficiency and market responsiveness. The main obstacle in that direction is likely to be BT's dominant market position.

10. There are also some possible disadvantages of privatising BT. There is likely to be a major diversion of effort from other useful progress on liberalisation and improving efficiency, and an increased risk of difficulty with BT's unions (paragraph 24 of the paper). The fact that there will have to be a twilight period between the initial flotation of shares in BT and majority private sector ownership creates some awkward problems; although a

CONFIDENTIAL

transitional regime could be devised, on the lines indicated in paragraph 14 of the paper, this would both worsen the prospects for the initial flotation and complicate the Government's relationship with an enterprise for which it still has responsibility for two years or more. Finally, as paragraph 25 of the paper explains, the flotation of BT, even when staged over some years, may reduce the market's ability to provide equity finance to the private sector (this is a worry particularly of the Bank of England) and limit the scope for other flotations of publicly owned enterprises for several years.

Scope for progress in other ways

11. If Ministers take the view that the benefits to be derived from privatisation are outweighed by the disadvantages, or that the benefits are too marginal or too long term to justify making this a high priority of telecommunications policy, the case is reinforced for exploring how far the Government's objectives for telecommunications can be achieved in other ways, notably by more liberalisation. In his minute of 20 April (not copied to the sub-Committee) Mr Sparrow has stressed that, whatever Ministers decide about privatisation, this will be a long and complex exercise, and that it is important to make more progress in reducing BT's monopoly powers and increasing competition.

12. The progress already being made to liberalise the telecommunications market is summarised in paragraph 4 of E(TP)(82)2. It should be noted however that these developments are unlikely to affect more than about 5 per cent of BT's overall turnover by 1985/86; BT's plans assume that in 1985 over 90 per cent of business telephones and 95 per cent of domestic telephones will continue to be connected to their network. Further action to reduce BT's share in the market could take the following forms:

a. There could be legislation to remove BT's powers to licence others to run telecommunications systems and to approve apparatus for connection to its network.

(The Department of Industry do not think that legislation would be justified for this purpose alone and that there is adequate scope for liberalisation within the existing legislative framework.)

CONFIDENTIAL

b. Liberalising the supply of international services to permit "value added network service" operators to operate across national frontiers and Mercury to offer switched international services.

(This is already under consideration by the Department of Industry.)

c. Permitting private firms to re-sell to third parties capacity from circuits they lease from BT, in effect providing competition for trunk traffic.

(Also already under consideration by the Department of Industry.)

d. Permitting further competing networks in addition to Mercury.

(The Department of Industry do not favour this and it could have difficult implications for national security.)

e. Privatising parts of BT.

(The Department of Industry believe that the deficiencies of BT's accounting arrangements prevent such partial privatisation for several years.)

13. If Ministers favour more action on liberalisation either in addition to privatisation or as an alternative, more work will need to be done by officials in drawing up a package of proposals, identifying what could be done under existing legislation and what would require new legislation.

Regulatory regime

14. In the light of their decision on the major policy issue of whether to privatise BT, the sub-Committee will need to consider the nature of the regulatory regime for telecommunications. In the event that privatisation were to be approved paragraphs 15-18 of E(TP)(82)2 discuss the nature of the regulatory regime which would be needed. More detailed work will have to be done on this. At present it will be helpful to have guidance from Ministers on two points:

a. whether, as proposed in the paper, regulations should be confined so far as possible to the minimum requirements (ie restraining BTL from


CONFIDENTIAL

abusing its market dominance to oppress its competitors or its customers);

b. whether, subject to further work on feasibility, responsibility for regulation should be entrusted to existing bodies, adapted as necessary, in preference to the creation of a new body.

Timing of legislation

15. In the Home Secretary's paper for the Cabinet on the legislative programme 1982-83 (C(82)10) a Telecommunications Bill is listed as one of the 14 "programme" Bills recommended for inclusion in the 1982/83 legislative programme although it is recognised in the Home Secretary's detailed companion paper (C(82)11) that the policy is still under consideration. Paragraph 29 of E(TP)(82)2 explains the difficulties involved in getting the legislation ready in time. It is in any case relevant that, as noted above, the first flotation of shares in BTL is unlikely to be feasible within the lifetime of this Parliament, although Ministers may still feel it worthwhile to get the enabling legislation onto the Statute Book before the election.

16. The chances of getting the legislation ready in time will be further reduced if Ministers are unable to take a firm policy decision in favour of privatisation very soon. If Ministers were to opt instead for the approach of more liberalisation, further work would be needed to identify the need for legislation in the next session.

Next steps

17. If Ministers decide in favour of legislation in the 1982/83 session to privatise BT, they will need to authorise the next steps set out in paragraph 31 of E(TP)(82)2. It should be noted in particular that, although there is to be no consultative document and no early statement of policy, the Department of Industry envisages informal consultation with the Chairman and Board of BT, and subsequently with the unions. As soon as this takes place the Government's intentions to privatise BT are likely to become public and the Government will probably have to make some interim statement.



CONFIDENTIAL

HANDLING

18. You will wish to give the Secretary of State for Industry the first opportunity to comment, particularly bearing in mind that the paper before the sub-Committee is an inter-departmental official report prepared on a neutral basis. The Chancellor of the Exchequer (who will be substituting on this occasion for the Chief Secretary, Treasury) is likely to be the other main contributor but you will wish to invite comments from all those present, ie the Home Secretary, Lord President, Secretary of State for Trade, Minister of State, Department of Industry (Mr Baker) and Mr Sparrow.

CONCLUSIONS

19. You will wish to reach conclusions on the main points listed in paragraph 32 of E(TP(82)2, ie:

- i. whether legislation should be introduced to change BT from a public corporation to a Companies Act company, to permit the sale of a majority at least of its shares to the private sector, together with a transitional regime of control during the interim period, and to introduce appropriate regulatory arrangements for telecommunications;
- ii. whether they wish more work to be done on exploring the scope for achieving the Government's objectives for telecommunications in other ways, for example by further action to reduce BT's monopoly;
- iii. if legislation is to go ahead, whether the regulatory arrangements should be broadly on the lines indicated in paragraphs 15 to 18 subject to further work by officials;
- iv. whether the legislation should be in the 1982-83 session;
- v. if so, whether the next steps should be as outlined in paragraph 31.

PLG

P L GREGSON

20 April 1982