Mr Walters PS. By mistake the PM saw this! and wrote

I think this is a bit technical for the PM? May I suggest you make it into a letter to Patrick Jenkin?
MCS 24/6

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cc Mr. Gregson
Mr. Mount
Mr. Vereker

Will need a tutorial now

MR. SCHOLAR

REGULATIONS IN TELECOMMUNICATIONS: NOTE BY THE CHAIRMAN OF THE OFFICIAL COMMITTEE ON TELECOMMUNICATIONS POLICY

But I still stick to my suggestion
MCS 25/6

1. The Committee suggests (a) there should be a new body to regulate entry and market behaviour, and BT should lose this power, and (b) that the main method of regulation would be through specifying a maximum rate of return for the undertaking as a whole.

2. As the Committee point out, the maximum rate of return method has been used extensively in the United States. Research has shown that it resulted in considerable waste of investment, as the utility companies increased the denominator of the rate of return to earn margins considerably above other comparable assets. Over-capitalisation, typical in public sector and publicly controlled industries, was the widespread consequence.

3. The imposition of a maximum rate of return has many of the characteristics of the tax rate which is fairly low until the maximum rate is achieved, then it becomes a hundred per cent. We all know the consequences of that sort of tax system on cost control and enterprise.

4. It is not clear from the Committee's report whether they are referring to a real rate of return or a nominal rate of return as the method of regulation. It seems that, implicitly, they are talking about a nominal rate of return (see the discussion in para 17 on the analogue of "a fixed interest stock"). But this at least ought to be made clear. Obviously for legal and practical purposes a a nominal rate of return is the easiest to regulate. But in an environment where inflation is high and uncertain, the nominal return is clearly misleading. On the other hand, a specified real rate of return would involve complex and controversial issues about accounting practices. If they are pursuing a real rate of return, have the Committee faced these issues, particularly plant revaluation etc?

/5. But ignoring

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5. But ignoring the real versus nominal issue for a moment, it seems to me that there is a good case for imposing a tax regime on excessive profits which does not have all the disadvantages associated with the suggested 100% marginal rate. The objective ~~of policy should be to~~ encourage the entity to keep prices down, expand output and reduce costs. We could do this by having a graduated profits tax which has rates, all less than 100%, which vary according to the extent to which the entity has expanded output. The greater the expansion of output over the year the lower the profits tax. To illustrate this, supposing we agree that the average expansion of output in the next five year period is, let us say, 5%. Then that will be the standard for our profits tax of, say, 50% of profits. If, however, the entity achieves, let us say, a 7% growth rate, then the profits tax will fall to, say, 40%. If, on the other hand, a growth rate is achieved of only 3%, then the profits tax rises to 60%.

6. In order to work this sort of rule, all we need are the standard accounts together with the total sales revenue and a price index of the services. While I agree that these are all standard accounting and statistical measures, there may be some difficulties of interpretation. But no more, and I think considerably less, than in the case of the maximum rate of return.

7. The Committee considered also having a minimum rate of return. The idea of this is clearly to offset possibly onerous regulation imposed by some future government. Although the Committee came down against minimum rates of return, I can well see the point of allowing owners of the equity of British Telecom (and perhaps other companies) to have the option of converting after 1985 every £100 nominal equity into, say, 8%-10% Treasury's 2011 at par. This would provide a floor to their losses and would guard against at least total expropriation by an incoming Socialist Government.

8. Some of these ideas may have been aired to the Committee, but I thought that I would put them down in case they were not.

AW

23 June 1982 ALAN WALTERS

Copy to MS ✓

PA

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Qa 05968

To: ALAN WALTERS

From: JOHN SPARROW

28 June 1982

Regulations in Telecommunications

1. You kindly gave me a copy of your minute to Michael Scholar on the subject of telecoms. I read it over the weekend and thought you might like some comments.

2. I agree with you about the difficulties, particularly of definition, associated with the use of a rate of return concept and I also agree that there are dangers in setting a maximum rate of return. However, I think we must assume that the proposed regulatory authority will be skilled at its job and if it is, I would hope that it would be able to cope with the difficulties and dangers, by setting limits which pragmatically reflect its view of Telecom's policies with regard to cost control, increasing output, and capital expenditure. If it can form a clear view about the propriety of the objectives which Telecom is setting itself and about its success or failure in pursuing those objectives, then a well run regulatory body ought to be able to cope with the problems. At any rate, I hope that this is the case because I cannot see a better alternative. You suggest a differential tax scheme, but I am always worried about one-off tax schemes and, as we have seen at Mossmorran, these things tend not to be one-off. I have also thought a bit about the right to switch into gilts at a future date: whilst I can see the attractions of this, particularly as a hedge against expropriation, it does remove from the shares of Telecom the element of risk of complete loss which I think is an essential part of an equity share. I would quite like to keep the idea if it could be limited to the circumstances of expropriation, but I am not sure that that is constitutionally possible.

JS.

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