Copy No...1....of 14 3

Prime Minister
Agree with 'X'
Duty Clerk
for M.C.S.
29/9.

Agreed.
MT

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PRIME MINISTER

SYSTEM X

As Patrick Jenkin's minute of 15 September foreshadowed there have been significant developments and I am writing in Patrick's absence abroad to tell you of these.

BT have, subject to approval by the Government, reached an agreement with GEC and Plessey on the future arrangements for the development and manufacture of System X. This provides for Plessey to be appointed as the prime development contractor with procurement initially being divided between the GEC and Plessey and competitive tendering introduced progressively from 1983 and totally as from end-1985. In turn BT will withdraw from detailed participation in the development programme.

Jeffrey Sterling has played an important role in bringing the industry together with BT and has closely followed the discussions from which this solution has emerged. In his view it represents the best solution on which agreement can be reached and it provides many of the benefits which BT sought in their original proposal to rely solely on a single supplier. In particular a more competitive spur would result from:

(i) the very substantial penalty and bonus arrangements which the companies have accepted for the System X production and delivery programme;
and

(ii) fixed price development contracts for the remainder of the existing BT-funded programme with subsequent enhancements of System X being funded entirely by GEC and Plessey.

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Jefferson's confidence in System X is high and when the revised arrangements are made public BT would announce their intention to place very substantial orders for System X. Nevertheless, retention of the freedom to adopt if necessary an alternative (and inevitably foreign) design has been very firmly insisted upon by the BT Board, in part as a counter to any non-competitive practices which might develop in a 'two- supplier, one customer' environment and more importantly, as an insurance against the technical and operational risks involved in BT's major digitalisation programme. I recognise these arguments and the very real possibility that BT during the next two years or so will wish to make at least limited purchases of overseas equipment. If such a situation should arise, Sir George has assured me that his Board would wish to consider how to achieve the maximum economic benefit to the UK.

As I see it the major problem for us to consider is that BT's proposed solution would lead to the immediate exclusion of STC from System X other than completion of its residual development work. However BT would propose to allocate STC a level of alternative business, mainly in existing TXE4a switching, which would in the short/medium term compensate them for the loss of System X business. Concentration of System X responsibility on GEC and Plessey would therefore leave STC's switching volume and profitability unaffected (or even possibly improved) until 1987. In the interim STC would need to build on its submarine cable strengths and its current move into the office automation area to generate new business to compensate for the loss of public switching. Failure to do this could, however, result in the eventual loss of up to five thousand jobs in Northern Ireland and at New Southgate.

We judge that in the shorter term, the new proposal would mean for STC improved prospects for employment in Northern Ireland (because of the increased TXE procurement) and some loss of jobs (5-600) primarily at New Southgate. Most of these however will be skilled engineers who should have good re-employment prospects either elsewhere in STC as it moves into new business or in other information technology companies.

STC is aware that alternative arrangements for System X are under consideration and the possibility of it having no future in this business is one which the company must have recognised.
Sir Kenneth Corfield however is not aware of this agreement reached by BT, GEC and Plessey and I would expect him, possibly with the ITT Chairman Mr Araskog (who is currently in Europe) to make strong remonstrations to the Government when this is made known to him. Sir Kenneth Corfield will undoubtedly argue that despite the additional business which will be offered him, exclusion from digital switching technology will seriously affect

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M12/M12AES

STC's future technological capability. The logical consequence of the new technology inevitably however is driving the switching industry in the direction of concentration, as Arnold Weinstock now fully recognises, and STC's performance on System X development has undoubtedly been the weakest.

Jeffrey Sterling has pointed out that we need STC's acquiescence to the BT/GEC/Plessey proposal if the alternative arrangements are to be introduced without damage to the System X programme. Furthermore the proposal obviously affects STC's long term business prospects and ITT should be advised of it before a final decision is taken upon the sale of 40% of STC's shares (now proposed to be undertaken within the next week or so).

Sir George Jefferson has therefore asked to know whether the Government is prepared to support the proposals mentioned above so that he can make the position clear to STC. In view of the imminence of the proposed sale of shares he wishes to advise Sir Kenneth Corfield as soon as possible, preferably on the morning of Friday 1 October.

Whatever we do there must be job losses in this industry. These proposals, which have emerged from long discussions between BT and all three companies, would give STC five years of assured and profitable business with which to fund diversification of its business. In turn GEC, Plessey and BT have reached an arrangement of the kind which offers real prospects for a successful home and export System X business.

This situation has been brought about largely through Jeffrey Sterling's efforts and the constructive attitude of the other parties, and above all Arnold Weinstock's personal involvement which has led to much-needed changes in GEC Telecoms management.

X I believe we should give our agreement to these proposals and I should be glad to hear as soon as possible that you are content for me to give our go ahead to BT.

I am copying this to the Chancellor, Patrick Jenkin and to Sir Robert Armstrong. I should be grateful if this could be given the usual limited circulation.

I am sorry to trouble you with this so soon after your return.

K.B.

KB
29 September 1982

M12/M12AES

British
TELECOM

Public Relations Department
2-12 Gresham Street
London
EC2V 7AG

R29

A public affairs background briefing

BT file.

D

29/9.

PERFORMANCE IN PERSPECTIVE

Report & Accounts

British Telecom's first Report & Accounts as an independent corporation records a profit of £458 million for the 12 months to 31 March 1982. Every penny will go towards the £2,000 million annual investment now needed to modernise Britain's vital public telecommunications network, to improve services and to meet increased demand.

The 1981-82 turnover of £5,708 million reflected business growth of 5.6%. Improved productivity led to a 2.1% cut in real unit costs. Price increases were kept below the general rate of inflation.

Prices

With performance and financial prospects improving, main service price increases planned for 1 November have been deferred until at least next April.

"A Report to Customers"

This briefing seeks to put British Telecom's 1981-82 performance and prospects into perspective. More details can be found in "A Report to Customers", a companion document to the Report and Accounts (see page 7).

BRITISH TELECOM TODAY

The business is undergoing faster, more radical changes than at any time in the history of the telephone service. It has responded positively to changing market conditions and the challenge of competition.

It is meeting head-on all of today's complex challenges - seizing new business opportunities, rapidly expanding the range of products and services, reorganising to improve efficiency and cut costs, and applying the latest technology to create the multi-purpose telecommunications network essential to Britain's economic revival and future prosperity.

PROFITS

Telecom's 1981-82 profit of £458 million represented a margin of 8p in the £ on turnover - far from excessive by normal commercial expectations.

Commenting on this result, British Telecom's Chairman, Sir George Jefferson, has said:

> "A year ago the Government criticised us for failing to meet our profit target. This year we are pleased to have exceeded our target, despite tariff increases which averaged less than the general rate of inflation.
>
> The level of 1981-82 profits is broadly in line with that necessary to assure a sound trading position for the Corporation and makes a useful contribution towards financing the massive capital requirements for modernisation and growth, now running at £2 billion a year".

Even so, a £458 million profit represents only about one-fifth of Telecom's current annual investment programme.

WHERE PROFITS CAME FROM

Telecom's 1981-82 profits were achieved in a fast-changing environment. Three key elements contributed to the improved financial performance:

1 Efficiency

During the year the business's real unit costs were reduced by 2.1%.

2 Business Growth

Despite the forecast effects of the general economic recession, the volume of business handled grew by 5.6% over 1980-81 - a telling indication of the importance of telecommunications services and of the need for Telecom to prepare now for the eventual economic upturn.

3 Revenue

Telecom's turnover grew from £4,554 million in 1980-81 to £5,708 million in 1981-82, yet price increases introduced in November 1981 averaged less than the general rate of price inflation.

International services contributed £218 million of the overall profits. Inland telephone call business was profitable, but all other sectors of inland services - including business and residential rentals and public telephone kiosks - traded at a loss.

WHERE THE MONEY GOES

All Telecom profits are reinvested in the business for the benefit of its 4 million business and 14 million residential customers. In recent years the business has had to find at least 85% of total annual capital needs from its own resources - that is, from operating profits and depreciation provision. An annual investment programme of £2 billions, at current prices, is the minimum essential if Telecom is to catch up with the legacy of past under-investment and provide a modern total public communications network capable of aiding economic growth and meeting demand for new information technology-based services.

Telecom's 1981-82 investment included £700 million in new exchanges, £400 million in transmission equipment, £84 million in customer equipment and more than £60 million in international cables and equipment.

In his statement accompanying the Report and Accounts, the Chairman listed some of the 1981-82 achievements reflecting this investment. They included:

- four modern electronic exchanges opened every week and the first four digital System X exchanges brought into service

- the world's longest link using lightweight optical fibre glass cable, for voice, data and visual services, installed between London and Birmingham

- International direct dialling extended to all UK customers, giving them the best overseas service in the world

- an almost nationwide radiopaging service completed, plus an automatic car radiophone service in London

- nine new telephone models introduced, including a special handset for the disabled, and extension phones offered on sale as well as rental terms, with plug and socket installation for easier portability

- half a million new phone lines installed, with 72% of small business orders met within two weeks and 70% of residential orders within three weeks

- eight out of ten line faults put right inside one working day

- the waiting list for phones of two months or more through equipment and cable shortages cut from 122,000 to 20,000 - and now down to 13,000

PRICES

During 1981-82 Telecom cut the prices of many international and inland trunk calls over major routes by up to 33% - benefits worth more than £200 million in a full year to customers.

There is now more good news on prices for 1982-83. British Telecom has accepted the challenge of deferring main service price increases planned for 1 November 1982 until at least April 1983. This means that main service prices will have stayed unchanged for at least 17 months from November 1981.

The November 1982 price proposals would have added 3.3% overall to average bills - well below current general price inflation - but three significant developments since they were announced in early July have enabled Telecom to defer the entire package:

1. There have been continuing good results from the internal efficiency and cost-cutting drives

2. Interest rates have fallen rapidly, saving Telecom millions of pounds on loan repayments

3. The rate of inflation has fallen and the fall is forecast to continue

Another factor influencing the deferment decision was that Telecom would have operated the new prices for only four months of the current financial year - bringing in an estimated extra £45 million - with most of the revenue benefit coming in the full year 1983-84.

But Sir George Jefferson warned, in announcing the deferment, that looking forward to 1983-84 is subject to considerable uncertainty.

He said that charges for some services were still running well below actual costs, and that the maximum profit level recently suggested for Telecom by the Post Office Users' National Council would fall far short of meeting the Government's new 5½% real rate of return target set for the business.

HOW TELECOM PRICES COMPARE

This is British Telecom's current ranking among the seven largest world operators for typical single-line bills, using purchasing power parity currency conversions and indexing UK figures to 100:

Business		Residential	
Italy	132	West Germany	160
West Germany	123	France	148
France	115	Italy	134
UK	100	Japan	108
Japan	81	USA (New York)	108
USA (New York)	80	UK	100
Netherlands	61	Netherlands	88

Compared with the cost of most other everyday goods and services, British Telecom's prices have risen more slowly since 1970. The Telecom Tariff Index, adjusted for inflation, shows that Telecom prices have fallen in real purchasing power terms by 17½% since 1970.

THE FUTURE

The realities of competition require a rebalancing of some British Telecom prices to bring them into line with costs. Nevertheless, Telecom's aim is to keep prices down and further reduce the real cost to customers of its services, consistent with earning a proper level of return on capital.

"REPORT TO CUSTOMERS"

British Telcom's 1981-82 achievements and business objectives are explained and illustrated in more detail in "A Report to Customers", published as a companion to the Report and Accounts. It contains information on finance, prices and profits, service and performance, new technology and how customers can get the best out of Telecom's services. For a copy please write to British Telecom (Ref RTC), Room 110, 85 Watling Street, LONDON EC4M 9BN.

British Telecom Report and Accounts 1981-82 is available through Her Majesty's Stationery Office bookshops, price £1.50.

If you have any enquiries about this briefing please call:

Ivor Mills	on	01-357 3734
	or	
Peter Carver	on	01-357 3168

Press and Broadcasting enquiries should be made on 01-357 3814-9.

Public Relations

Prime Minister (2)
MCS 4/10

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 4 October 1982

Kenneth Baker Esq., MP.
Minister of State for Industry and
Information Technology

Dear Kenneth

SYSTEM X

Thank you for sending me a copy of your minute of 29 September to the Prime Minister reporting on BT's latest proposals. My office earlier indicated that I did not wish to raise objection. But I thought I should let you have a somewhat fuller response.

I agree that the proposals represent in outline a considerable improvement both on present arangements and on earlier proposals for change. In particular, there should be considerable advantage in concentrating responsibility for design in the hands of one company (with BT taking a much less influential role) and in genuine competition between Plessey and GEC at the manufacturing stage. I accept that the consequences for STC are unfortunate but, given the need for change, I do not see how something of this kind could have been avoided. Moreover BT's intention to give STC the lion's share of the remaining work on TXE 4 exchanges give the company a reasonable breathing-space in which to adjust to the new situation.

Everything will depend on how the parties operate the new arrangements. It is essential that the pressures on the companies to reduce the cost of System X to competitive levels should work effectively. The procedure whereby Plessey share information on design with GEC with whom they subsequently compete for orders is a somewhat uncomfortable one. It would be all too easy for the two companies to lapse into a cosy or even collusive relationship. This is something that will need to be very carefully watched. I am glad that George Jefferson seems determined to use the threat of foreign procurement as a means for keeping both companies on their toes. It will also help if you make clear that export or development assistance will depend on the Government being satisfied that System X is an essentially competitive product which the companies are fully committed to marketing.

In the longer term I would hope that the new arrangements will lead to progressively lower procurement and operating costs for BT as System X is produced under conditions of greater competitiveness and as the costly TXE 4 acquisitions are phased out rapidly. This is something which we should certainly want to explore in the context of BT's next Corporate Plan.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

GEOFFREY HOWE

4B

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PA
FES 10/12

Prime Minister (1)

Shall I thank* on your behalf Jeffrey Sterling and the others involved?

*notwithstanding the mistake which is the subject of Lord Cockfield's minute (attached)!

Yes please – but let us wait until the other matter is discussed with
MT

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PRIME MINISTER

I am very glad to be able to report that following discussions this morning between Sir George Jefferson and Jeffrey Sterling, Sir Kenneth Corfield has agreed to the proposals for the future arrangements for System X production and marketing. The news of this whole operation will be released early next week.

This is an encouraging development which will I am convinced lead to a more efficient and competitive switching industry in the UK, accelerate the introduction of digital switching technology into Britain and improve prospects for sales abroad.

The placing of STC shares could proceed on the following Friday but STC is insistent that this placing should not be referred to by anyone until Friday, total secrecy is vital. This whole affair has been a team effort which Jeffrey Sterling has led very well indeed.

I am copying this to Geoffrey Howe, Arthur Cockfield and Sir Robert Armstrong.

K.B.

KENNETH BAKER
1 October 1982

M61/M61AAR

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

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cc

COPY NUMBER 2 OF 12 COPIES

Prime Minister

An important omission

MCS 1/10

From the Secretary of State

SECRET

Kenneth Baker Esq MP
Minister of State
for Industry and Information Technology
Department of Industry
Ashdown House
123 Victoria Street
London
SW1E 6RB

1 October 1982

Dear Kenneth,

RE: SYSTEM X REORGANISATION

You sent me, somewhat belatedly, your minute of 29 September / with MCS to the Prime Minister, describing the proposals for re-allocating the development and supply of System X. There are two aspects on which I should comment.

First, I am concerned that the arrangements produce a more effective export effort than we have seen to date. The companies, whose record in telecommunications is poor, really do need to be spurred into action and I hope that any decisions on future Government support will very much take this point into account.

Second, there is the separate, but crucial, competition policy aspect of the proposed arrangements. British Telecom are clearly aware that an agreement of the sort proposed will almost certainly be registrable under the Restrictive Trade Practices Act 1976. It could not be kept from the Restrictive Practices Court on the grounds that it was insignificant. But I would be prepared to consider an application for exemption under Section 29 of the Act - which has only once been used - on the grounds that it was of importance to the national economy. No doubt BT will have been advised by their lawyers that I can only make such an Order in respect of a proposed agreement and that the agreement would have to be laid before Parliament and made available for public inspection. If these conditions are not met, or the agreement does not fit the criteria in Section 29, there would be no alternative to the agreement being registered and defended before the Court. This is not a matter which is subject to Ministerial discretion. If the law bites, it goes into action and no-one can stop it. You may also want to remind BT that any announcement they make now should be couched in terms which do not themselves constitute a registrable agreement.

From the Secretary of State

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The competition rules of the Treaty of Rome also need to be borne in mind. The arrangements would probably be caught by Article 85(1) and the parties will want to consider notifying it to the Commission so that they can seek exemption under Article 85(3). I should not like to predict what attitude the Commission would take and this will need careful handling.

My officials are in touch with yours about how these matters should be handled. Meanwhile, you will want to remind BT that these competition issues have to be faced and that they should not prejudice them in anything which they may say at this or any later stage.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, the Secretary of State for Industry and to Sir Robert Armstrong.

Yours,

Arthur

LORD COCKFIELD

Post & Telecoms, Post Office,
Pt 5

Telecom

FILE

da

SECRET 4

Copy No. 7 of 7 Copies

bc JV

10 DOWNING STREET

From the Private Secretary 30 September 1982

Dear Neil,

System X

The Prime Minister saw on her return last night from the Far East your Minister's minute of 29 September about System X.

She agrees that Government endorsement may be given to the arrangements which BT have reached with GEC and Plessey: and to their other proposals as set out by your Minister.

I am sending a copy of this letter to John Kerr (HM Treasury), Jonathan Spencer (Industry) and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

Neil McMillan, Esq.,
Department of Industry.

SECRET

Post etc

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 6401
SWITCHBOARD 01-212 7676

FROM THE
MINISTER OF STATE
FOR INDUSTRY AND
INFORMATION TECHNOLOGY
KENNETH BAKER'S OFFICE

NBPM
MCS 1/10

CONFIDENTIAL
COVERING SECRET

John Rhodes Esq
PS/Lord Cockfield
Department of Trade
1 Victoria Street
LONDON SW1

30 September 1982

Dear John,

SYSTEM X

I enclose a copy of the minute which Mr Baker sent to the Prime Minister last night. with MCS

As I told you on the telephone, the Prime Minister has now indicated that she is content for BT and the two companies to be given the go-ahead to finalise their discussions.

I understand that officials in this Department were in contact with yours yesterday to seek urgent discussion of both the export and possible competition policy aspects of the proposed agreement between the companies. When these discussions are completed and both your Secretary of State and my Minister have received advice from officials on these aspects, Mr Baker would of course be at Lord Cockfield's disposal should he wish to meet.

I am copying this letter to Michael Scholar, Jonathan Spencer Margaret O'Mara and David Wright.

Yours ever,

Neil McMillan

N M McMILLAN

M59/M59ABW

30 SEP 1982

11 12 1 2 3 4 5 6 7 8 9 10

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vb

Z

16 September 1982

The Prime Minister was grateful for your Secretary of State's minute of 15 September about System X, which she read without comment.

I am sending copies of this letter to John Kerr (HM Treasury) and Richard Hatfield (Cabinet Office).

MCS

Jonathan Spencer, Esq.,
Department of Industry.

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JH 920

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TOTAL COPIES 13

COPY No. 1

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Prime Minister (2)

To note.

MCS 15/9

PRIME MINISTER

I wish to bring you up to date with the situation on System X, which we last discussed on 27 July, in view of the role you may be invited to play in signing STC's contract with the Chinese.

2 You will recall our concern at the over-capacity in the industry (GEC, Plessey and STC) and, in particular, fear that the present management and procurement arrangements for System X were unlikely to result in internationally competitive industry. Following our discussion Jeffrey Sterling took on the task of exploring possible solutions of the problem with the companies and British Telecom. While it is still far from clear what the outcome will be, he has clearly gained the confidence of the industry, all parts of which are now agreed that the present situation cannot continue. Not the least of Jeffrey's successes is Arnold Weinstock's acceptance, despite his earlier denials, that the industry does have a very real problem which needs to be resolved. Arnold has replaced the Managing Director at GEC Telecommunications and is taking a close personal interest. He is discussing with Sir Kenneth Corfield the possibility of their putting their main switching interests together. He has also suggested privately to Jeffrey a solution which would place System X design leadership with Plessey, with GEC and Plessey sharing the actual manufacture of System X. Jeffrey is pursuing

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the possibility with the other parties.

3 There is, however, a new complication of which you should be aware. You should know that last Friday (10 September) STC advised my Department that ITT, who wishes to reduce its holding inSTC from 75% to 35%, have been given a slot for a placing on 28 September. Current share prices suggest the sale would raise about £230 million. However, it is difficult to see how ITT can go to the market when STC's principal business - which is responsible for more than 80% of STC's profits - is surrounded by such uncertainty. My view on this has been made very clear to Kenneth Corfield; he fully recognises the problem. There could be pressure from ITT on us to resolve the uncertainty to allow them to go ahead with the placing, but I see no way in which we could do this which would not put at risk the prospects which are now beginning to emerge of a long-term solution to the System X problem.

4 The situation is still very fluid and the next few weeks are likely to see considerable activity. I hope that by the time you return from the Far East, I shall be able to put a fuller report to you. Meanwhile, in view of the great commercial sensitivity of these issues (especially for STC's share price), I should be grateful if this minute could be given a very limited circulation.

5 I am copying this to the Chancellor and to Sir Robert Armstrong.

PJ

P J

15 September 1982

Department of Industry