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POST AND TELECOM
cc Mr. Wolfson

MR. SCHOLAR

BRITISH TELECOM REGULATION

Yesterday I attended a meeting at DoI which was chaired by the Secretary of State, accompanied by the Minister of State and the Under Secretary. The purpose was to see how to proceed with both the drafting of the regulation component of the British Telecom Bill and what additional work needed to be done before the prospectus stage.

There has been a long and at times acrimonious debate between the civil servants and me. Basically the officials wanted to have a regulatory system based on the maximum rate of return. Under my probing they have changed that a bit, such that the maximum is not absolute, but the essentials of it remain.

I have been at pains throughout to point out that the maximum rate of return regulation is a proven failure. It is not merely that it results in very substantial waste, but it also requires enormous proliferation of bureaucracy, lawyers, economists, etc in order to police it. There is ample evidence of this in the United States and in other countries that have maximum rate of return controls. In the United States it is impossible to find anyone who will say a good word for such regulatory systems.

I proposed an alternative system which required virtually no bureaucracy, no monitoring of costs, no monitoring of prices, and which at the same time was designed to induce the Telecom firm to cut prices and expand output and operate at the lowest possible cost. My system was a combination of output subsidy and profits tax. The Ministers at the meeting said, to a man, that they found my scheme had great attractions. The civil servants, however, were unanimous in condemning it. They preferred the proven failure of the rate of return method to any new method of control. (This was in spite of the fact that their consultant, Michael Beesley, had compared my system with the rate of return system and come down firmly in favour of my mechanism.)

The Ministers, however, although acknowledging many of the arguments, avoided the defeatism of their civil servants. They saw there was a point in at least pressing on to see whether we couldn't do rather better than drift once more into the familiar failures.

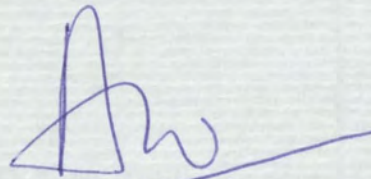
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Thus they have instructed their officials to allow in the Bill for the setting up of a system of regulation which I had suggested. They also agreed that much more work needed to be done on my alternative system and envisaged engaging a suitable consultant to develop the details of my scheme and examine the likely consequences of it.

I am pleased with this outcome, and readily agreed to it. It is as much as one could have wished.

21 October 1982



ALAN WALTERS

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MR SCHOLAR

FUTURE OF
BRIT TEL

10 DOWNING STREET

Mr. M.S. Bradbury,
Department of Industry,
Ashdown House,
123 Victoria Street,
London, SW1.

1 October 1982

Dear Mr Bradbury

BRITISH TELECOM: FUTURE REGULATORY FRAMEWORK

I have now read the report of the Department of Industry chaired Working Group on rate of return regulations and you may wish to be aware of my comments in the attached note, which I am copying to Mr. R.H.F. Croft.

Yours sincerely

Alan Walters

ALAN WALTERS

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1 October 1982

NOTE ON THE REPORT OF THE DEPARTMENT OF INDUSTRY GROUP
ON RATE OF RETURN REGULATION IN TELECOMMUNICATIONS

The report suggests that the BT licence would specify the overall maximum rate of return on capital employed. Furthermore, each business, local, trunk and international, would have a separately specified rate of return. However, by an investigative process, presumably by the DGT, BT management is to be provided some incentive to improve internal efficiency by having the limit on profitability raised in any year in return for "demonstrated improvements made in that year".

A number of points emerge from this paper:

- a. Except for vague talk about "flexibility" DoI has not met the powerful criticism that marginal tax rates of 100% are deadly; they are the stuff that Socialists are made of.
- b. The DoI system will require a large bureaucracy, comparable to those doing similar jobs in the United States, and will benefit mainly the accountants, economists and lawyers. It would require frequent monitoring of costs, efficiency, and it would also need an allocation of joint costs - which in most cases would have no substantive basis at all.
- c. It would be impossible to formulate the DoI conditions in an issue document for BT stock. No-one would know how they would work out or what the conditions would be. There would be immense uncertainty and this must affect the success of the placements or sales of the stock.

I am surprised by the argument, and it seems to be the only argument, that is put against my suggested sliding scale in ANNEX III. It is argued there that my scheme is a "fair weather" one and that if demand does not, in a particular year, increase as much as the average, then there will be deleterious effects on retained profits

/and cash flow.

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and cash flow. The argument mixes up a reduction in demand with a reduction in output. The whole point of my scheme is to encourage the Telecom Company to slash prices and expand output when demand falls. Only by these means will they defend their post tax profits. Indeed, it is conceivable that, with the high elasticity of demand which we know exists in certain markets (long distance leisure calls), on a fall in the demand there may well be such an incentive to reduce prices that output of telephone calls actually increases! And this is just what we want - expand in a slump.

The alternative model, seemingly embraced by DoI, is the traditional one of a public monopoly - I suppose British Rail is the current example, but the electricity supply industry is also very close to their model. As demand has fallen relative to expectation, these industries have to put up their real prices in order to attempt to maintain their revenues. I do not think that this is a model we ought to follow.

The DoI also objects to the fact that the weights in the output index would be fixed and there would be little incentive to "diversify into new products". This would, of course, occur if you were silly in fixing the output weights in an inappropriate way. But you are perfectly free to fix them in any way that you believe is appropriate. For example, you could weight local calls more heavily, relative to their gross revenue, and international calls. Similarly, you could put in a large weight for business that you thought it would be advantageous to expand. This objection, therefore, seems to me rather pedestrian and unimaginative.

I do not regard the MMC as either a known quantity or a reliable regulator. There is no track record of them regulating an industry like BT, and where MMC have reported in areas only a short distance removed from their normal sphere of activity, the judgements have been properly and justly criticised. (Examples are the House of Fraser and the Royal Bank of Scotland references).

/CONCLUSION

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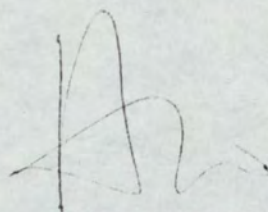
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CONCLUSION

The DoI Group has not produced an adequate report on the various options available. It seems to be trying to find its way to some sort of means of compromise and conventional wisdom. The conclusions lack the required degree of incisiveness, cogent argument and analytical soundness. I find it difficult to recommend support of these conclusions.

1 October 1982



ALAN WALTERS

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NOTE FOR THE FILE

cc for information
✓ Mr Flesher
Sir Derek Rayner
Mr Cassels

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EFFICIENCY IN BRITISH TELECOM

1. Before I went on leave I had a visit from Mr V H B Macklen, CB (63), formerly a Deputy Secretary on the scientific side of MOD. He is personal adviser to the Chairman of BT, Sir George Jefferson, where his remit is on the efficiency side. The purpose of the meeting was to discuss matters of common interest.
2. Mr Macklen said that he had virtually no staff of his own but that he had a call on five people in BT and one outsider; the outsider appears to be Sir William Cook, formerly Chief Adviser (Projects and Research), MOD, although I may have got this wrong.
3. Mr Macklen said that implementing recommendations was a major problem. BT had a civil service system but worse. The organisation was more centralised than it had been when the Post Office was in Whitehall and "no redundancy" agreements with the trades unions were a great impediment. He felt that he was tackling large questions with few weapons.
4. BT is a huge organisation, employing some 0.25 million people. The HQ comprises 25,000 staff. So far Mr Macklen has looked at the Corporate Personnel Branch at HQ; it employs some 1,500 people, a number which he thinks can and should be reduced to 50 - 150.
5. The method of examination is to interview officers, asking what their functions are, what they do and what they should do under the new circumstances in prospect for BT. Other questions include what can be put outside, rather than being done in-house; the effect of the working relationships with HMSO and PSA; and the question whether Telephone Areas could be made cost or profit centres.

6. Mr Macklen said that his reports went to the Chairman and the Board Member responsible; the Board Member was allowed two months to get his ideas straight, after which decisions were taken. The review method had worked reasonably well in the Corporate Personnel Branch, but he thought that the pace of change required a more rapid response than BT could easily manage.

7. At HQ the main needs were to slim down the size of the organisation, which was huge; to define management responsibility much more clearly; and to obtain better managers. Throughout the organisation there seemed to be substantial grade-drift and he doubted whether the sort of changes needed could be managed without resort to early retirement.

8. Looking beyond HQ, Mr Macklen had in mind reviews of the Materials Division; the fleet of heavy good vehicles; and the cadre of network executives.

9. I provided Mr Macklen with a copy of the Notes of Guidance for scrutiny examining officers.* We agreed to remain in touch. We both thought that a half-day exchange of experience after the holiday period when Mr Macklen had got more review experience under his belt would be helpful. I offered to put Mr Phillips in touch with him in connection with his interests in both stores and transport economy.

SP

C PRIESTLEY

22 September 1982

* Also of the Management Guidelines for transport etc