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Prime Minister

To note (please also see Alan Walters's note on this, attached). MCS 8/11

PRIME MINISTER

PRIVATISATION OF BRITISH TELECOMMUNICATIONS

When E(TP) agreed my proposals for the regulation of British Telecommunications plc at their meeting on 30 June (E(TP)(82)2nd Meeting), we decided to investigate further the question of how to prevent BT exploiting the dominant position it will continue to hold in important parts of the telecommunications market by overcharging subscribers or tolerating inefficiencies. I was invited to arrange for officials to consider the respective merits of imposing in BT's licence a single maximum rate of return, a two-tier maximum rate of return and a profits tax.

2 These issues have been considered by a working group of officials drawn from the Department of Industry, the Treasury, the Department of Trade and the CPRS in order to fulfil the remit from E(TP). Kleinwort Benson, my merchant bank advisers, also participated. I had hoped that Alan Walters (or his nominee from the Policy Unit) could also join the study, but I understand that this did not prove possible. I therefore had a long meeting with Alan myself last month. Paragraph 4 below reports the outcome.

3 Officials and Kleinworts agreed that a two-tier maximum rate of return procedure would be appropriate. Under this BT would be allowed to earn up to a previously specified rate of return,

say 6% per annum on a CCA basis, and would pay back a major part of any excess over the limit as a rebate to subscribers, the rebate being fixed on a sliding scale so as to avoid 100% marginal rates of tax. In addition the Director General of Telecommunications would be able to agree with BT some relaxation in the limit (so that BT for example might retain all its earnings up to a maximum of 6.6%) in return for meeting a series of previously agreed performance targets. This would give BT an incentive to increase its efficiency and its quality of service whilst ensuring that the consumer did not pay excessive prices. I am satisfied that arrangements on these lines would provide a practical and acceptable solution to the problem which concerned us. Kleinworts advise that such a system would be accepted by the market.

4 Alan Walters, however, told me that he still considers that we would be much better advised to go for an output-related tax, the amount of which would <u>decrease</u> the more BT <u>increased</u> its output above a previously agreed level. At our meeting, he explained that owing to pressure of other work he had not had time to develop his ideas in full detail. I am, however, attracted by many aspects of his proposal and, after a lengthy discussion, I suggested that, whilst I should go ahead with introduction of the Telecommunications Bill on the basis of the proposed two-tier control on BT's maximum rate of return, I should commission an independent economist to develop Alan's ideas and compare their strengths and weaknesses with the

proposals put forward by officials. With Alan's agreement, I have asked Professor Littlechild of the University of Birmingham to carry out this study which will be completed in time for me to amend the Bill during its passage through Parliament if we decide that this would be desirable. I should perhaps add that Kleinworts feel that the novelty of such an output-related tax could confuse the market and so make privatisation more difficult. However, I will report further to E(TP) Committee when I have received Professor Littlechild's study.

5 E(TP) also asked me to reach agreement with the Treasury on the relationship between BT plc and the Government in any interim period after the first sale of shares during which BT plc might remain in the public sector. The Chancellor and I have now agreed that it would be best to deal with this problem by including a suitable provision in the Articles of Association of BT plc, underpinned by a short clause in the Bill.

6 This I think deals with both the points which we left outstanding after our discussion in E(TP).

7 Copies of this minute go to members of E(TP) Committee, John Sparrow and Sir Robert Armstrong.

PJ

P J

8 November 1982

Department of Industry

CONFIDENTIAL

MR. SCHOLAR

PRIVATISATION OF BRITISH TELECOM: SECRETARY OF STATE'S MEMORANDUM OF 8 NOVEMBER 1982

One reform in the Secretary of State's memorandum is that now they have eliminated the 100% marginal rate of tax. This at least helps a bit. But, as you can see in paragraph 3, there is still the requirement to have efficiency audits by the bureaucracy and almost certainly tariff control - but the Secretary of State does not talk about that. I would expect Kleinwort's to advise that such a system would be accepted by the market. After all, it is broadly the same system that is used in America, with the most enormous bureaucratic regulation system behind it in many industries. It is also more or less the same as the system we use to control the nationalised industries - such as railways and electricity. It has resulted in railways and the electricity industry raising their tariffs during the slump in order to cover their costs and achieve a cash target. In electricity, for example, tariffs have been raised much above costs because of the low loading of expensive electricity equipment. This is the opposite of what we want to see.

In paragraph 4, he mis-states my suggestion. The amount would not decrease the more BT increased its output. The whole point is that the percentage scale of profits tax would decrease the more BT increased its output. It is not an output-related tax as such, its an output-related percentage tax.

It is true I have not had the opportunity to develop my ideas in detail. It requires both an analytical treatment and probably also a computer modelling of the implications. And I agreed that Littlechild of Birmingham was one, of a list of three, who would be suitable for doing this job.

Littlechild came to see me this afternoon. He has not yet got his terms of reference from the Department of Industry. He had, however, seen Kleinworts and had a standard list of problems. They were easily dealt with.

I would like to emphasise that I do not know whether my idea is the best that could be thought up. What I do know, however, is that the drift of the DoI suggestions, is both familiar and bad. This we

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know from experience. It seems to be a case of pursuing the known failure rather than the unknown, but possible success. One can easily see if we pursue the known failure route then nobody can be criticised.

It is perfectly true that my suggested solution is a radical one. It is designed not to nullify the profit motive, but to magnify it. Since we have been busily muting or stifling the profit motive for so long, it is understandable that any suggestion that would magnify it comes as a shock. But there it is. Somehow we must break out of this lethargy and the path of familiar failure.

8 November 1982 (Dictated but not seen by AAW) ALAN WALTERS