



Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
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22 March 1983

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Whitehall SW1

2

Prime Minister

A further ~~an~~ attempt to
explain BT's £568 m
undershoot. M/L 23/3

Dear Geoffrey, *Nat Ind: Policy Pt 7*

I was asked by E(NI) on 7 December to circulate a breakdown of BT's undershoot for 1982-83 and to indicate the action proposed to remedy the causes of the undershoot. I have delayed writing until Leon Brittan and I had reached agreement on the BT EFL for 1983-84 since clearly a main piece of remedial action would have indeed to be the setting of a more realistic EFL for the coming year.

2 I now attach a table which gives the factors BT have advanced in explanation for the shortfall of £568 million which, as E(NI)(83)6 recorded, was thought last month to be the likely size of the undershoot. (It now seems that it may be somewhat larger still.) You will see that some of the factors reflect credit on BT (lower expenditure on accommodation, and certain current cost improvements), some reflect changed circumstances outside BT's control (lower prices, lower demand for investment, delays because of planning problems, lower interest payments, and, in the opposite direction, reduced turnover); and some cause concern about BT's performance and forecasting ability (late delivery of equipment and the shortfall on working capital).

3 There are, I suggest, three pieces of action that must be taken, all of which are in hand.

4 First BT's internal estimating and accounting system must improve. I have had a presentation from BT's consultants on this which gives a measure of reassurance: it is a huge and lengthy task to prise BT out of its civil service past into the commercial world into which we are to launch it, but the task is now being tackled with spirit.

5 Secondly, even though the sum of money involved may have been modest, the story of delays in delivery of equipment needed for modernisation must not continue. I am glad that Sir George

Nat Ind: Policy Pt 9

M/L

cc N/O



Jefferson took the opportunity of the annual dinner of the manufacturers' trade association last week to take them to task on this subject (although I would not maintain that BT themselves are blameless here). The delays were not to System X equipment. But what really matters in achieving the modernisation of the network is satisfactory progress with System X: Plessey now have the development under control and the first fully digital exchanges will be delivered next year. I am satisfied that there is no more we need to do on this matter.

6 Thirdly, we must ourselves set a financial regime for BT sufficient to place them under pressure to limit costs and such that, if successful in this, BT do not massively undershoot their EFL. I believe that a combination of the EFL of minus £100 million, the financial objective of a real return of 6.5% on net assets and the BT price undertaking (not to increase prices in 1983-84 by more than the average of 3.3% involved in the proposals BT put forward for implementation in November 1982, which have been postponed until at least July) do apply this element of discipline. E(NI) will have the chance of seeing how the position is developing in the context of the BT Corporate Plan in the early summer.

7 I am copying this letter to the Prime Minister and other members of E(NI) and also to Sir Robert Armstrong. I would of course be content for there to be a discussion of it in E(NI) if colleagues wish it.

You are
Patel



ANNEX 1

BREAKDOWN OF BT FORECAST UNDERSHOOT FOR 1982/3

ITEM	DEVIATION FROM BUDGET (£ million)
<u>Fixed Capital Shortfall</u>	
Reduction in prices	120
Reduction in expenditure on accommodation for training and service centres	70
Late delivery, mainly of exchange equipment	80
Reduced demand due to recession (mainly local line plant)	30
Other (including delays to CTO site and third earth station site because of planning problems)	73
<u>Total Fixed Asset Shortfall</u>	<u>373</u>
<u>Working Capital Shortfall</u>	<u>108</u>
<u>Total Shortfall on Capital Requirements</u>	<u>481</u>
 <u>Increase in Internal Resources</u>	
Lower than forecast staff costs	84
Other current account improvements	107
Reduction in interest payments	67
Capital receipts and adjustments	8
offset by	
reduction in turnover	179
<u>Total increase in internal resources</u>	<u>87</u>
<u>Total forecast undershoot</u>	<u>568</u>

Post & Taxation
Future of Pt 6.

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Prime Minister ⁽²⁾

Mrs 6/12

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Secretary of State for Industry

6 December 1982

Rt Hon Leon Brittan MP
Chief Secretary
HM Treasury
Parliament Street
London SW1

mt

Dear Chief Secretary,

BRITISH TELECOM: 1982-83 UNDERSHOOT

Thank you for your letter of 29 November.

2 I attach a table giving the BT explanation of the forecast underspend of £520m.

3 We did, of course, already know that the underspend would be of the order of £320m and suspected it might be higher, but I do agree that the shortfall on the BT estimate is now pretty glaring.

4 You mentioned that until recently you were prepared to accept that the underspend was due to creditable factors such as lower prices and some progress in making real cost savings. I would urge you to agree that that is no less true now and that a number of the items in the list are very much to BT's credit - eg securing lower prices from their suppliers, and making savings on accommodation. Other items are outwith BT's control - eg reduced demand due to the recession. On the other hand, BT themselves are most disturbed at the late delivery of exchange equipment in view of the priority they give to the need to improve the network and they are discussing with suppliers why the delays have arisen and how to avoid them in future.

5 For the rest there are two separate respects in which the BT performance is seriously deficient. First, they still do not possess adequate accounting systems to assess what is happening within the business - BT have made no secret with us of their deficiencies here and of the fact that despite all their efforts it will take years rather than months to put this to rights. We have a draft of Coopers & Lybrand's long form report prepared in the context of the bond issue which demonstrates how much remains to be done; and Sir George Jefferson has just told me that he is



seeking to accelerate the development of better systems.

6 Second, BT's forecasting, on the basis of the last two years, has contained too much fat. BT having been rebuked for exceeding their limit by a small margin in 1980-81, regard their EFL very literally as a limit and not in any way as a target. I am taking this up with them, but I confess to having some sympathy with their view that an undershoot is in principle less serious than an overshoot.

7 Sir George Jefferson is already seeking additional specific capital investment which would be of long term benefit to the business and which could be implemented this year. I have written to him welcoming these efforts. I have also asked him to consider a lower EFL next year in the light of the evidence of inadequate forecasting in the past.

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

Yours sincerely,

Jonathan Spencer

MP. PATRICK JENKIN

(approved by the Secretary of State
and signed in his absence)

BREAKDOWN OF BT FORECAST UNDERSHOOT FOR 1982/3

ITEM	DEVIATION FROM BUDGET (£ million)
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Fixed Capital shortfall

Reduction in prices	90
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Reduced expenditure on accommodation for training and service centres	65
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Late delivery, mainly of exchange equipment	80
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Reduced demand due to recession (mainly local line plant)	20
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Other (including delays to CTO site and third earth station site because of planning problems)	85
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<u>Total Fixed asset shortfall</u>	340
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Working Capital shortfall	100
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<u>Total shortfall on capital requirements</u>	440
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Increase in internal resources

Lower than forecast staff costs	80
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other current account improvements	70
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Reduction in interest payments	60
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offset by

reduction in turnover	(130)
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<u>Total increase in internal resources</u>	80
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<u>Total forecast undershoot</u>	520
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Post - Telecom : Future of Pt 6

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6 DEC 1982

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gfr
Prime Minister (2)

This will take

some answering.

Treasury Chambers, Parliament Street, SW1P 3AG

MCS 29/11

Rt Hon Patrick Jenkin MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1E 6RB

29 November 1982

R. Patrice *mb*
BRITISH TELECOM: 1982-83 UNDERSHOOT

We shall be discussing the Quarterly Monitoring Returns for the nationalised industries as a whole at E(NI) shortly. They are dominated by the extremely large undershoot by BT of its EFL. This amounts to £520 million.

Geoffrey Howe wrote to you on 20 April last proposing a mid-term review of BT's ambitious capital plans and I assume that these figures stem from that. Certainly it is useful to have had the information about underspend earlier this year than last. But it is a pity that we were not able to take account of it in our public expenditure discussions last month. We knew then that there was likely to be some underspend, as indeed we have suspected throughout the year, but these figures show that it is likely to be several hundred million higher than we thought.

I was prepared to accept, in relation to the earlier figures that, in part at least, the underspend was attributable to creditable factors such as lower prices and some progress in making real cost savings. However, the overall shortfall on fixed asset expenditure is now glaring. The EFL was based on an increase in fixed asset expenditure of 28 per cent (on BT's new accounting policies). But the estimated outturn is only 9 per cent and even this depends on a halving of the variance from budget in the second half of the year, so there may well be further underspend to come. We cannot ignore the implications of this, nor indeed of the other factors which have led to the undershoot. For instance next year's EFL is based on assumed capital expenditure of £2,012 million, some 22 per cent higher than the outturn now anticipated for this year.

It would be extremely helpful in advance of the E(NI) meeting to have a more detailed explanation of this year's undershoot, drawing on the results of the review which the Chancellor requested. In particular, we need to know what faults in BT's management systems

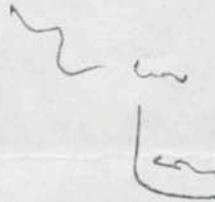
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have led to the persistent overfunding; what is being done to correct them urgently; and what size of cash surplus BT is now generating as a result.

Secondly, I must now reopen with you the question of the £96 million external financing provision for BT for next year. On grounds of investment realism alone, it looks as though this should now be negative, but there are other factors such as the continuing under-estimation of profitability which need also to be taken into account. I would be grateful if you would consider this and let me have your proposals.

There may be wider issues which I shall need to take up with you, in the light of your response. But in the first instance we need an urgent analysis of the situation and your proposals on next year's EFL.

I am sending copies of this letter to the Prime Minister and to Sir Robert Armstrong.



LEON BRITTAN

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Post Office, Pay Negotiations, April 1980.

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U.S. POST OFFICE
WASHINGTON, D.C.