PRIME MINISTER

You saw the DTI letter about the BT regulatory regime over the weekend. As the Policy Unit note attached explains this essentially comes down to a disagreement between the Chancellor and Mr. Tebbit on the DT pricing formula. Mr. Tebbit will presumably seek to persuade you tomorrow to accept his rather than the Treasury's views. Unfortunately the Chancellor is not in the country at the moment and I understand that John Moore, who will be seeing the papers tomorrow morning, is unlikely to feel able to shift from the Chancellor's position. In these circumstances the Policy Unit advise that you should not agree to Mr. Tebbit's proposal without the agreement of the Chancellor. Mr. Tebbit is likely to say that further delay will lose the privatisation in October or November: hence the need for agreement to BT's suggestions before their Board meeting tomorrow afternoon.

As the Policy Unit imply this would normally be a matter for DTI and the Treasury to sort out and agree advice to you. The essential point for your decision is whether the circumstances (and Mr. Tebbit's case) are strong enough to override the normal process of consultation and agreement.

DT

24 April 1984

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MR TURNBULL 24 April 1984

BRITISH TELECOM CAPITAL STRUCTURE AND REGULATORY REGIME

Mr Lansley's letter to Andrew Turnbull representing Norman Tebbit and Ken Baker's views on BT privatisation attempts to speed up a deal with BT on the pricing formula.

The Treasury, who have not been consulted on this latest proposal, started the bidding at wanting RPI-5% as the formula governing future price increases for the agreed basket of telephone calls. They have been dragged down to RPI-3%. The case in favour of a high value for X is:

1. It makes the privatisation of BT much better news for the customer: it guarantees that on the major monopoly services, prices will go up very slowly. Under the original RPI-5% formula, it would have been possible to say that on this year's inflation rate, there would be no price increase for telephone calls at all.

2. The original 5% figure had the virtue of being equivalent to the projected efficiency improvements BT could generate from improving technology each year.

3. A side effect of having a high value for X is to lower the future profits of the business and therefore to lower the market valuation of the business to be sold. Whilst this is bad news on strict Treasury criteria of wanting to maximise sale proceeds, it is good news in that it eases the problem of sale to the stock market. The DTI letter does not mention this consequence of a higher value of X.

4. The views of the advisers to BT are probably heavily influenced by the view of BT itself. Of course, BT wants to minimise the value of X, thereby leaving itself greater freedom to put up prices and maximise returns. It does not mean this is the best policy for the Government to follow.

The argument concerning the balance sheet is more evenly balanced. If more pressure is put on price increases and profits are consequently reduced, there is a stronger case for reducing the amount of debt relative to the amount of equity. The letter as set out, however, conceals the relatively low gearing of BT. The 49% gearing figure represents debt as a percentage of shareholders' funds (according to Mr Lansley in my telephone conversation with him). This means borrowing as a percentage of total capital is around 30%, very much in line with many corporations. The £1.3 billion of new borrowing by 1989 is for the five-year period. £260 million a year of extra borrowing is quite modest for a group the size of BT, and would lower the

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gearing on the figures given me, somewhat uncertainly, by Mr Lansley.

They are:

1985	Shareholders	£6.25 billion
	Borrowings	£3.1 billion
	Gearing	49%
1989	Est.Shareholders	£9.25 billion
	Est.Borrowing	£4.4 billion
	Gearing	47%

We recommend that:

i. The Prime Minister does not agreed without consulting the Treasury view.

ii. When settling the RPI-X formula, due weight be given to the customer interest.

iii. It should be remembered that by limiting price increases, future profits will be constrained, but that there is a price for everything in the stock market. This does not necessarily make it more difficult to sell.

JOHN REDWOOD

MINACN

Treasury Chambers, Parliament Street, SW1P 3AG

Tim Flescher Esq
Private Secretary to the Prime Minister
10 Downing Street
LONDON
SW1A

25 April 1984

Dear Tim

BRITISH TELECOM: CAPITAL STRUCTURE AND REGULATORY REGIME

Both the Chancellor and the Financial Secretary have been closely involved in the process of reaching agreement with the chairman of BT on the future capital structure for the p.l.c. and the coverage and size of the RPI-X price control formula. These are on the point of being settled but BT are still pressing for further last-minute concessions on RPI-X.

The Financial Secretary thinks it is important that in advance of seeing Mr Tebbit this morning, the Prime Minister should be aware of the substantial concessions the Treasury has already agreed. These are:

1. We have agreed that the liability to meet the pension fund deficit inherited from the Post Office should be left with Government. This was a point of enormous importance to BT.

2. We have agreed to a massive re-profiling of BT's existing £4 billion debt obligations to Government so that they will not have to re-pay these until much later this century. This also is of considerable help to BT but in the short-run will mean that the PSBR will benefit less than it would otherwise have done from BT's debt and interest payments.

3. We have agreed to BT writing down the value of its assets by nearly £1 billion in its accounts;

4. We have further accepted the inclusion in BT's balancesheet of £750 million of preference shares not redeemable for over 30 years;

5. We have reluctantly also agreed that £250 million of BT's debt should be written off and, although some of this may be recouped in a higher value for the equity that is sold, it is unlikely to be more than partially recouped this way - there are equivalent direct costs to the PSBR. It is an awkward

precedent for other privatisations.

6. As regards RPI-X, we have acceded to pressure to reduce from our basic view that this should be RPI-5 to RPI-3, but only on the understanding no further concessions would be made.

7. We have accepted the broad inland services coverage for the formula which gives BT added flexibility.

8. We have accepted a generous scheme for employee share purchase preference - likely cost to Government £50 million.

9. We have accepted in principle the need for substantial government-financed inducements to investment in BT shares by the wider public -potential cost £90-100 million.

10. We also face exceptionally large costs for brokerage and other expenses in order to achieve the maximum possible coverage for the BT sale here and overseas - potential cost £140 million.

11. Finally we have accepted that the Government will undertake not to market further tranches of BT equity for at least 3 years (no previous privatisation has included a commitment beyond 2 years); or to market our holdings of BT debentures for more than 5 years and then only after consultation with BT.

The Financial Secretary would like the Prime Minister to know that he strongly shares the Chancellor's view that this already represents an extremely generous package of concessions to Sir George Jefferson. He doubts the need or the justification for going further.

I am copying this to Andrew Lansley (PS/Secretary of State for Trade and Industry, and to Richard Hatfield (PS/Sir Robert Armstrong).

yours sincerely

FP Bogan

MISS F P BOGAN
Assistant Private Secretary

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PS/Secretary of State for Trade and Industry

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19 April 1984

Andrew Turnbull Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A

Prime Minister

Mr Tebbit would like a word with you about this on Wednesday. He has not yet consulted the Chancellor.

Dub 20/4

Dear Andrew,

BT CAPITAL STRUCTURE AND REGULATORY REGIME

A difficulty has arisen in connection with the current negotiations with BT over the future capital structure and regulatory regime for the company which, after consultation with my Secretary of State (who is at present out of the office), he wishes to have brought to the Prime Minister's attention. I have not had an opportunity to show this letter to my Secretary of State.

2 BT have naturally been pressing for as loose a regulatory regime under the "RPI-X" formula as possible, and as much headroom within the capital structure to allow the borrowing they perceive as necessary for future expansion into a major IT company. This process culminated in a long negotiating session between Mr Kenneth Baker and Sir George Jefferson on 17 April, and two short meetings yesterday and today. Sir George was particularly concerned at the high gearing ratio and borrowing requirements the PLC would have to have, and argued strongly that, while the Government had been helpful in offering a conversion of £750 million debt into redeemable preference shares, a moratorium on debt repayments for five years and waiving of the first year's dividend payment, this still left the PLC with a requirement for new borrowing of £1.3 billion in 1989, and gearing at 49 per cent in March 1985. He argued that the only way in which the PLC would be able to operate with any headroom to withstand market reversals or industrial action would be by a conversion of £500 million debt into equity and a price regulation formula allowing prices to rise at 2 per cent below the RPI.

3 Mr Baker continued to insist on a formula of RPI-3. In an attempt to clinch the deal, he offered a conversion of £250 million debt into equity, on condition that BT accepted a price regulation

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of RPI-3. The response to this was encouraging but still negative, and the advice of Warburgs, BT's merchant bankers, was that a formula of RPI-3 would represent an insuperable barrier to a successful flotation of the company. Our advisers, Kleinwort Benson and Hoare Govett were less pessimistic on this point but still felt that it would be a handicap.

4 When Mr Baker saw Sir George yesterday, Sir George said that BT were content with the capital structure, and would be prepared to accept RPI-3 if they could add international call charges to the basket of services covered by the formula. This would give them more flexibility to carry out the necessary restructuring of their tariffs while retaining the RPI-3 figure. Mr Baker, with my Secretary of State's agreement, rejected the proposal since the price of international calls is dropping in real terms already and what was proposed would have the effect of bringing the formula down to around RPI-2½.

5 In discussion it was suggested that in order to meet BT's concerns about the credibility of RPI-3 to potential underwriters of the issue, and in recognition of considerable fixed costs which BT would have to bear (including £3 billion fixed coupon Government debentures) the Government might consider a reduction in the formula to RPI-2 if inflation falls to 3 per cent or below. At any level above this, the formula would remain at RPI-3. Mr Baker discussed this with my Secretary of State and told BT that he was willing to put this to colleagues.

6 Sir George saw Mr Baker again this morning to say that, on this basis, he was willing to recommend this package to his Board, who would be meeting on Wednesday, 25 April. It is clear that Sir George, while playing down the significance of the concession on RPI-3, views it also as integral to his agreement to proceed in this way. BT's concerns on this point reflect a similar apprehension expressed earlier in the week by our stockbrokers, Hoare Govett. Without the concession, the package would be likely to be rejected. My Secretary of State is strongly of the view that we must now strike this deal with BT or certainly lose the privatization in October or November. He regrets that the progress of negotiations did not allow prior consultation with Treasury.

7 My Secretary of State would wish to point out that what is now additionally proposed would not affect the income from the sale of BT and, if the argument that it has strong presentational advantages is correct, would tend to increase the proceeds. The proposal does not incur a cost for Government and would have no effect on the regulatory regime unless the RPI were to fall below 3 per cent over the next five years.

8 My Secretary of State would wish to stress that RPI-X was initiated by this Department, following the Littlechild Report, as

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a way of safeguarding the consumer in those areas where BT's activities would not be subject to significant competition in the first five years after privatization. He therefore views it as ultimately for DTI to administer. He is very conscious of the Treasury's important interest in regard to the sale of BT but feels it is for this Department to judge what is necessary and, in this respect, acceptable in order to achieve the successful sale of BT.

9 My Secretary of State hopes to speak to the Prime Minister on the morning of Wednesday, 25 April, and afterwards discuss the issue with the Chancellor, prior to the BT Board that afternoon.

10 I am copying this to Margaret O'Mara (PS/Chancellor) and to Richard Hatfield (PS/Sir Robert Armstrong).

yours ever,

Andrew Lansley

ANDREW D LANSLEY
Private Secretary

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