



CONFIDENTIAL

P.0791

PRIME MINISTER

Privatisation of British Telecommunications

(E(TP)(82)6, 7, 8 and 9)

BACKGROUND

At its previous meeting on 22 April the Sub-Committee agreed to reconsider the Secretary of State for Industry's proposal that control of British Telecommunications (BT) should be transferred to the private sector in the light of further work on:

- i. the scope for liberalisation of telecommunications without privatising BT;
 - ii. how telecommunications should be regulated if BT were privatised;
 - iii. what transitional arrangements would be necessary to define the relationship between the Government and BT if it was not possible to sell a majority shareholding in one go, so that there would be a transitional period in which less than half of BT's shares were owned by the private sector.
2. E(TP)(82)6 and 7, both reports by the Official Committee on Telecommunications Policy (TP(0)) respectively discuss regulation and interim arrangements. The Sub-Committee will ready have discussed liberalisation as the first subject on the agenda. The views of the CPRS on these issues are set out in E(TP)(82)9.
3. In E(TP)(82)8 the Secretary of State for Industry restates his case for privatising BT. He proposes that the Government should introduce legislation in the next Session of Parliament to make this possible, with a first sale of shares as soon as possible after the next General Election; that he should make an early statement to Parliament outlining the Government's intentions for BT; and should begin appropriate consultations as soon as possible thereafter.



CONFIDENTIAL

MAIN ISSUES

4. The main issues are:

i. whether BT should be privatised, notwithstanding the fact that new regulatory arrangements for telecommunications will need to be introduced, and that provision will have to be made for an interim regime for the Government's relations with the new company during the period when less than half the shares might be owned by the private sector;

If so

ii. what should be the nature of the regulatory arrangements;

iii. what should be the method and timing of the sale of shares, and the interim regime;

iv. what should be the timing of the legislation, and the steps leading up to that.

5. If the Sub-Committee concludes that BT should not be privatised, or at least that there should not be legislation to this end in the next Session of Parliament, there may still be a case for a Telecommunications Bill in 1982-83 to make the detailed legislative changes to facilitate liberalisation to which the Secretary of State refers in E(TP(82)5 and to reform the Telegraph Acts; and perhaps to change the arrangements for regulating telecommunications. But you will not want at this meeting to get into the question of what if any telecommunications legislation should be introduced in this Parliament if the decision goes against privatisation; that can be pursued later.

Should BT be privatised?

6. The Secretary of State for Industry gives three arguments for privatising BT:

a. Transfer to the private sector would in itself increase BT's efficiency and the quality of its decisions.



CONFIDENTIAL

b. The amount of investment in telecommunications would be determined by the market and not constrained by the PSBR and by the Government's policies on public expenditure.

c. A private sector successor to BT might be able to reduce telecommunications charges in real terms by financing less of its investment from retained earnings than BT is now obliged to.

7. Against this it might be argued as follows:

a. Privatisation of BT can only bring limited benefits in incentives to efficiency and changed attitudes since telecommunications will remain a regulated market.

b. It will be several years before a majority of the shares can be sold and BT's external borrowing can be freed from Government control.

e. The management effort involved, and the union opposition which may be provoked, may make further progress towards liberalisation more difficult, although this may in any event be constrained for other reasons.

8. The Sub-Committee will wish to weigh these conflicting considerations and also the Government's general predisposition in favour of privatisation. There is no doubt that privatisation of BT will be a much more extensive and complex undertaking than any privatisation which the Government has yet attempted. The legislation will be substantial and will raise some difficult issues about the best way to regulate a very large private sector monopoly. The benefits may be thought somewhat speculative and attainable only over a very long period. Nevertheless the considerable detailed work which has been done since the proposal was first put forward by the Secretary of State for Industry in March suggests that there are no insuperable problems in going ahead, if Ministers think it advantageous to do so.

Regulation

9. The report by the Official Committee (E(TP)(82)6) argues that special regulatory arrangements will be necessary to prevent BT abusing its dominant market

CONFIDENTIAL

position to hinder competition, charge excessive prices to its customers (either to generate monopoly profits or to permit inefficiency) or to put unreasonable pressure on its suppliers. In paragraph 5 of E(TP)(82)8 the Secretary of State for Industry accepts that there should be such arrangements. In E(TP)(82)9 the CPRS urges that a regulatory body should be established as soon as possible. It is unlikely that any member of the Sub-Committee will dissent; it would seem difficult to justify letting loose a monopoly like BT without adequate powers to prevent it from overcharging consumers or keeping out competitors.

10. The following paragraphs discuss the detailed questions on regulation on which an early decision is necessary and which are listed in paragraph 27 of E(TP)(82)6.

11. There is likely to be general agreement that:

a. as a Companies Act company, BT should cease to enjoy its present statutory privileges and powers to license and approve equipment and should need a licence, like other operators:

b. that licences should contain conditions designed to reduce the chances of anti-competitive behaviour (paragraph 12 of E(TP)(82)6 gives examples of the sort of conditions which might be attached); this would be underpinned by reference to the MMC of prima facie anti-competitive behaviour of types not specified in the relevant licence.

12. The report by TP(0) suggests that licences should specify a maximum real rate of return to prevent excessive charges to BTL's customers. The Secretary of State for Industry agrees. He envisages that the rate of return would be set by the Government according to criteria contained in BT's licence. The maximum rate would be reviewed from time to time, perhaps by the MMC, to take account of technological developments, BTL's efficiency and changes in rates of return generally.

13. In his minute of 23 June to Mr Scholar, Professor Walters argues that:

a. setting a maximum rate of return will lead to over investment;

b. it is equivalent to proposing a tax with a 100 per cent marginal rate which would remove incentives to efficiency.

CONFIDENTIAL

He advocates instead a graduated tax on BTL's profits designed to enable the company to retain a significant proportion of its efficiency gains. In this latter respect, Professor Walters' proposal has something in common with the proposal tentatively aired in the officials' paper and supported by the CPRS for a two-tier maximum rate of return, allowing BTL to keep some of the benefits between the lower maximum and the upper maximum. The problem of encouraging over-investment was recognised in the officials' paper as something which would have to be tackled through powers to investigate efficiency.

14. This is a difficult issue on which Ministers need not take a detailed decision at present. It would be sufficient for Ministers to agree on the principle of restricting BTL's profits, while trying to find the best ways of retaining incentives to efficiency. Further work could then be done by officials, taking account of Professor Walters' ideas and other variants.

15. So far as the responsibility for the new regulatory arrangements is concerned, there is likely to be general agreement that the Secretary of State for Industry should be responsible for licensing (subject to powers to delegate) but that monitoring performance against licence conditions would be better entrusted to a body not under direct Ministerial control.

16. On the choice of regulatory body there are two questions to consider.

a. Should existing bodies (in practice the Office of Fair Trading and MMC) be used or should a new organisation be set up?

b. If a new authority is chosen should it be a non-departmental body (a body corporate, headed by a board, staffed by non-civil servants - like the Civil Aviation Authority) or a non-Ministerial Department (headed by an officer appointed by the Secretary of State for Industry, staffed by civil servants - like the OFT)?

17. The Secretary of State for Industry endorses the Official Committee's that it would be better to set up a new agency to regulate telecommunications given the technical difficulty of the work and the possibility that it would unbalance the OFT and MMC's other functions; although he suggests that in time it might be



CONFIDENTIAL

possible to unite the new body with the OFT.

18. The Secretary of State parts company with the majority view in the TP(0) report in preferring the new body to take the form of a non-Ministerial Department rather than a non-departmental body. He argues that:

a. Licence conditions could be drawn tightly; the regulatory body's discretion would therefore be limited and an independent board would not be necessary.

b. Control should not be surrendered entirely in this area to a totally independent body.

The CPRS, on the other hand, favours a non-departmental body on the grounds that the agency should be distanced from Government and will need to be staffed by experts.

19. This is a finely balanced issue. It may well be the kind of point on which the Government would be prepared to fall in with the preferences of outside opinion when these become known. If however Ministers opt in favour of a non-Ministerial department, they should bear in mind that its staff (which could well number 50 or more) would count as an addition to the civil service.

Method and timing of a possible sale of shares; and interim regime

20. These issues are linked. Special interim arrangements between the Government and a partly privatised BT, only a minority of whose shares had been sold to the private sector, would only be necessary if it were impossible to sell a majority shareholding in BT in one go. The feasibility of any interim arrangements (and indeed the prospects for a successful sale) also depend on the timing of the sale: in particular it would seem very difficult to arrange the successful sale of a first tranche of say 25 per cent of BT's equity during the present Parliament: it seems likely that if a successful sale were to take place before the next General Election, it would have to involve a controlling interest in BT.

21. Paragraph 16 of E(TP(82)7, which lists the questions requiring early decision in this area, therefore begins by asking:

CONFIDENTIAL



CONFIDENTIAL

- i. whether Ministers wish to keep open the option of privatising BT by a single issue of shares;
- ii. whether Ministers wish to keep open the option of such a sale in the autumn of 1983;
- iii. whether legislation to privatise BT should in any case provide for the possibility of a sale in more than one tranche and for an appropriate interim regime;
- iv. whether if the sale is to be in more than one tranche a first flotation before the next General Election should be ruled out because it would have to take place in conditions of political uncertainty?

22. The Secretary of State for Industry's answers are:

- i. the possibility of a single sale of a majority shareholding in BT should be further explored; but
- ii. it would be both technically difficult and politically risky to try to force through a single sale before the next General Election;
- iii. the most likely outcome is that a sale will have to take place in two stages and legislation will therefore need to provide for an appropriate interim regime;
- iv. a first tranche of shares could not be sold before the General Election.

23. The CPRS agrees on the timing and also on the desirability of exploring further the scope for a single sale. It may possibly be suggested that the size of BT is such that there is no chance of a single sale of half its shares except by devices whose effects would be to depress the proceeds of sale. On the other hand the Secretary of State for Industry might wish to argue that some of the approaches suggested by merchant banks and which TP(0) considered could be more feasible in a single post Election sale than in the peculiar circumstances of a single sale before the Election.



CONFIDENTIAL

24. The major difficulty in devising satisfactory arrangements for the interim period when the Government would be the majority but not the only shareholder in BT is of reconciling:

- a. the need to maintain a proper control over BT's finances so long as it remains in Government control and in the public sector; and
- b. the need to allow BT sufficient commercial freedom even in this interim period to make it an attractive proposition to purchasers and allow the Government to get a good price for its shares.

The CPRS questions the need for the requirement at a. but the Treasury is likely to argue strongly in favour of it.

25. Drawing on merchant bank advice, the TP(0) report on this subject (E(TP)(82)7) suggests that the interim regime might have the following features:

- a. assurances that, subject to the need to ensure that BTL's external financing adequately takes account of the Government's policies for public expenditure and public sector borrowing, the Government will not use its powers as major shareholder and creditor to prevent BTL from acting commercially;
- b. reliance on the new regulatory arrangements discussed in E(TP)(82)6 to deal with competition, efficiency, return on assets and pricing matters;
- c. the setting of external financing figures for each year of the public expenditure planning period, which would be set out for the information of investors in the prospectus for the initial sale of shares;
- d. retention of the Government's existing powers in the British Telecommunications Act 1981 to control BTL's borrowing, suitably modified, until the Government had disposed of 50 per cent of BTL's shares;
- e. arrangements between the Government and BTL providing for BTL to supply information about its future investment plans and internal resources as a basis for the Government's exercise of its powers over borrowing; and for

CONFIDENTIAL

the Government to call for such other information about BTL's financial plans and progress as it thinks fit.

The Official Committee left open the questions whether the Government should in addition retain its statutory powers to call for information from BT; and (though this need not be decided now) whether the Government should retain the freedom on public expenditure grounds to restrict BT's external finance to a greater degree than envisaged in the external financing figures that would be included in the prospectus.

26. In E(TP(82)8 the Secretary of State for Industry says that he sees no objection to retaining powers to control BT's borrowing in the interim period (d. above); appears to be content with a., b., c. and e. above (although it would be desirable to establish his views on c. in particular); and agrees that it is not necessary to decide now the extent to which the Government will be able to cut back projected borrowing in the interests of restraining public expenditure: that will be for discussion, in the first instance between Department of Industry and Treasury Ministers, nearer the time when shares are sold. Other Ministers present are likely to be content on these points.

27. The Secretary of State for Industry does not say whether in his view the Government should in addition keep its statutory powers to call for information from BT, though this is a point that would have to be covered in legislation. The Chief Secretary, Treasury is likely to be the main advocate of this idea: unless agreement on it can be reached quickly, he and the Secretary of State for Industry might be invited to try and sort the point out outside the Sub-Committee.

Timing and procedure

28. The Secretary of State for Industry proposes a Telecommunications Bill in the next Session of Parliament to permit the conversion of BT into a Companies Act company and the sale of its shares. Even if Ministers were to decide to postpone the flotation until after the Election, there would still be merit in getting the legislation through beforehand. It is clear that such legislation will be contentious and complex. Whether it could be got through Parliament in the next Session would seem to depend in part on how soon legislation could be introduced. You will therefore probably want to explore how soon, realistically, it will be

possible for the Department of Industry to prepare instructions to Counsel and for Parliamentary Counsel to draft the Bill. There would have to be consultation with BT, the unions and other interested parties about the detailed provisions of the legislation. There must be some doubt about the chances of having a Bill ready for introduction at the beginning of the next Session. If major issues were left unresolved at this meeting, the chances of having the legislation ready in time would be negligible.

29. If the Sub-Committee decides that legislation should be introduced in the 1982-83 Session, it would seem appropriate for the Secretary of State for Industry to make an early statement to Parliament outlining the Government's plans and to begin formal consultations as soon as possible thereafter, as he suggests. If it is thought that legislation would not be appropriate in the next Session it seems largely a matter of political judgement whether Ministers should announce soon that the Government wishes to transfer BT to the private sector or, for example, include such a proposal in the Conservative Party manifesto for the next General Election.

HANDLING

30. When the Secretary of State for Industry has introduced E(TP(82)8 it would be best to work through the main issues in the order in which they are discussed above, ie:

- i. Should BT be privatised?
- ii. If so, what regulatory arrangements should there be?
- iii. How and when might a majority shareholding be sold and what arrangements would there be during an interim period in which the Government remained the majority shareholder in BT?
- iv. Should legislation be included in the 1982-83 Session?

31. Any of those present may wish to comment on the questions at issue and especially their political aspects. In particular the Secretary of State for Trade will want to comment on regulation, The Chief Secretary, Treasury on the sale of



CONFIDENTIAL

shares and interim arrangements; and the Lord President on the Parliamentary aspects. You will probably want to invite comments from Mr Sparrow.

CONCLUSIONS

32. You will want to reach conclusions on the following issues:

a. should it be the Government's policy to privatise BT?

b. if so, should the necessary legislation be introduced in the 1982-83 Session of Parliament; or should any legislation be put off until the next Parliament?

c. should the Secretary of State for Industry make an early statement to Parliament of the Government's intentions for BT's future; and begin formal consultations as soon as possible thereafter with the Board of BT, the unions and other interested parties about the detailed provisions to be included in legislation?

d. on regulation, what are the Sub-Committee's views on the issues set out in para 27 i. to vi. of E(TP(82)6?

e. on the sale of shares and the interim regime, what are the sub-Committee's views on the issues set out in para 16 i. to vi. of E(TP(82)7)?

PLG

P L GREGSON

28 June 1982