



10 DOWNING STREET

From the Private Secretary

28 July 1982

Dear Jonathan,

SYSTEM X

The Prime Minister held a meeting with Ministers to discuss your Secretary of State's minute of 23 July about System X. Apart from your Secretary of State, the Minister of State for Industry (Mr. Baker), the Minister of State, Treasury (Mr. Wakeham) and Mr. Sparrow were also present.

Your Secretary of State said that the UK telecommunications industry was no longer world-class. It had too long enjoyed a cosy relationship with British Telecommunications (BT). System X showed many signs of being a commercial failure, particularly overseas. Half a dozen rival systems were already being sold in export markets, and without major export orders BT's own procurement would not be nearly enough to provide for the three British companies the minimum production levels for competitive international pricing. The present situation was very stark. Neither the Government nor the industry had the luxury of doing nothing, not least because the freedom to procure in the most competitive markets which a privatised BT would have would further point up the essential weakness of the industry. There was no doubt about the technical merits of System X. But could it be produced on time and at the right price? It was certain that, however the industry was organised, far less labour would be required for System X than for earlier telecommunications systems. Technological innovation was leading to a sharp decline in equipment costs so that by 1990 BT's annual public switching procurement would have fallen to a total about 80% of GEC or Plessey's current switching orders. If therefore the three companies were to maintain their present order books, exports would need to rise by £300 million a year. This would be a huge task.

Your Secretary of State went on to say that there were now signs that the industry were beginning to recognise the starkness of the position. Lord Weinstock had told Mr. Baker privately that GEC would be prepared to separate off its public switching and transmission activities and merge them with Plessey's public switching business to form a 50:50 controlled company. Plessey's initial reaction was one of disinclination to enter any such arrangement. It was difficult to see what role STC would have. It was essential that the relationship between BT and the companies be redefined: the companies must be free to design and develop at their own risk and in competition:

/ BT



BT should specify only functional requirements and then procure competitively from the companies. Your Secretary of State said that he had concluded that a one-company solution was not politically acceptable. The companies must themselves put together a deal, with BT. He proposed that Mr. Jeffrey Sterling should assist in this process, acting as an honest broker between GEC, Plessey and BT, in an attempt to overcome the mutual distrust between the two companies.

Mr. Baker said that in a recent conversation with him, Lord Weinstock had strongly attacked the privatisation of BT, which he had said would do great damage to GEC. He had made three proposals. First, the part-merger with Plessey which the Secretary of State had described. Second, he had canvassed the idea of selling 50 per cent of the GEC telecommunications business to BT, lending BT the money to make this purchase, in exchange for BT's shares after privatisation. Third, he had suggested that GEC might purchase a large stake in BT, in order to influence or control its procurement. There was no doubt that Plessey were some way ahead of GEC in this area, in both research and production capability. Neither Plessey nor GEC saw any role for STC. It would be necessary for BT to find some alternative work to allot to STC if they were to be eased out of the System X business altogether.

The Prime Minister said that she saw disadvantage in either a one-company or a two-company solution. Both solutions involved inadequate competition. Mr. Sparrow said that BT should be allowed to arrive at an industrial solution to what was an industrial problem. When BT's view was clear, Ministers could decide whether there was a need to intervene on political grounds; but at that stage it would be necessary to remember that any solution to the problem which had been outlined would require rationalisation and the shedding of labour.

Summing up the discussion, the Prime Minister said that she agreed that it would be politically very difficult to assign sole responsibility for System X development and production to any single company at this time. The Department of Industry should proceed as your Secretary of State had proposed in attempting to assist the industry, together with BT, to restructure itself in order to improve its capacity to meet the challenges ahead. But, in her view, the responsibility for these changes lay with the industry and with BT; and the manner of the Government's intervention should take full account of that view.

I am sending copies of this letter to John Kerr (HM Treasury), Neil McMillan (Minister of State's Office, Industry), Peter Michael (Minister of State's Office, HM Treasury), John Rhodes (Department of Trade), Gerry Spence (CPRS) and David Wright (Cabinet Office).

*Yours sincerely,*

*Michael Scholes*

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Department of Industry.