JH 62

Caroline
Pl set up meeting as soon as poss
1630 TUE 26 OCT. Cl. 24/10 1 hour.
M.

cc JV.

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

13 October 1982

(1)

Prime Minister

Please see John Sparrow's and Alan Walters' notes (attached).

The main remaining issue is whether regionalisation would delay privatisation and if so if this is to be borne.

A meeting

Michael Scholar Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1A 0AA

Dear Michael,

Thank you for your letter of 9 September recording the Prime Minister's questions about the scope for breaking up British Telecommunications (BT) into a series of separate regional companies and the impact of the proposed flotation. I enclose a note.

2 My Secretary of State has considered this question carefully. He can see some advantages from breaking up BT into separate companies with separate tariffs and separate published results; this might for example put pressure on local managements to meet special local needs and to attempt to emulate or surpass the performance of other local companies. He thinks, however, that breaking up BT would do nothing to enhance true competition in telecommunications - each local company would continue to be a local monopoly as is the case in America - and could lead to significant increases in telephone bills in rural areas and those areas where Mercury is unlikely to provide competition to BT. He also believes that any attempt to break up BT would delay the flotation and policitise the telecommunications industry to an undesirable extent.

3 In his statement to the House on ~~19~~ Pt 4 July, my Secretary of State announced publicly that the Government intends to privatise BT as a single unit, and the legislation based on this approach is now nearly ready for introduction early in the forthcoming session.

4 I am copying this letter and attachment to John Halliday (Home Office), Margaret O'Mara (Treasury), Richard Hatfield (Cabinet Office) and Gerry Spence (CPRS).

Yours sincerely,
Jonathan Spencer

J P SPENCER
Private Secretary

✓ Mr Jenkin
✓ Mr K Baker
✓ Chancellor
✓ Mr Sparrow
✓ Alan Walters ?

Yes MT

MCS 20/10

THE SCOPE FOR BREAKING UP BRITISH TELECOMMUNICATIONS IN THE LIGHT OF AMERICAN EXPERIENCE

Summary

a) Although there are over 1,600 regional and local telephone companies in the United States, there is no competition between them except in one small area. This state of affairs will not be changed by the Bell antitrust case.

b) Breaking up BT into separate regional companies would damage consumer interests, particularly in rural and remote areas, but there might be some benefits from "emulation" effects.

c) Breaking up BT would be complicated because the network is integrated, (unlike the position in America) but BT is taking internal steps to secure localisation of decision-taking.

d) Breaking up BT into separate companies could not be accomplished for many years, thus delaying flotation, and inclusion in the Telecommunications Bill of a power to break up BT after flotation would create so much uncertainty that flotation would be impossible.

e) Nevertheless, powers will exist under the Fair Trading Act which could be used to break up BT into regional companies if the Government's policies do not work as planned.

American Experience

2 There are over 1,600 regional and local telephone companies in the United States. The largest is American Telephone and Telegraph (ATT or Bell), which controls a number of major regional companies.

General Telephone and Electronics (GTE) and the Continental system both control a smaller number of regional companies. There is also a host of small companies, some of which are active only in individual municipalities. The total number of companies is misleading since the bigger regional companies tend to own separately incorporated subsidiaries in different States; thus the Chesapeake and Potomac company, a regional company in the Bell system, has separate subsidiaries in Washington DC, Virginia and Maryland. Bell also controls the major "long lines" company which links the local and regional companies together.

3 The regional and local companies do not compete with each other; each commands a local monopoly of telephone services in its own area and there is only one case (see below) where there is competition to supply local telephone services. Consequently it is misleading to think in terms of there being "competitive" regional companies in the United States. There is a limited measure of competition in the provision of "long lines" since a small number of companies supply long distance circuits in competition with Bell. One of these long line companies, MCI, has started to supply local telephone services (in the Denver area) in competition with the local monopoly company but only on a small scale. ATT and GTE between them dominate over 90% of the US telephone systems market.

4 The existing arrangement of a number of regional monopoly telephone companies and a dominant "long lines"

company will not be altered by the outcome (whatever that may eventually be) of the antitrust action which is intended to require Bell to divest itself of its regional telephone companies. Each regional company will have the same local monopoly status as before.

Differences Between Britain and America

5 The Department thinks that attention must be paid to the differences between this country and the United States. Here the early local telephone companies gradually evolved under market forces into a nationwide company before being taken over by the Government early this century. America has retained its regional and local companies largely for economic and geographical reasons including the number of genuinely distinct commercial centres and the immense distances between them. The American Federal structure and regulatory environment has meant that the separate companies which evolved in most States were kept distinct from each other and were not permitted to merge as happened in this country. Many of the separate US companies grouped together under the Bell umbrella have been forced to retain separate corporate structures, separate managements and a large measure of separate identity. Consequently it is relatively easy to break up Bell into completely separate local companies but even so the legal and accounting details have already taken some years and look like taking several more.

6 By contrast, the BT system, like most other systems in the world, is a single integrated whole reflecting its history as a centralised Government Department. It has centralised management, centralised purchasing, centralised research etc. BT's local and long distance operations are tightly integrated so that for example a single rack in a telephone exchange may contain equipment handling both local telephone calls and trunk calls. Consequently breaking up BT would be complex; it would be necessary to identify for example which equipment "belongs" to the local company and which to the "long lines" company and the process would take some time; at the end of the day a break up of BT might result in different companies owning different bits of the same building. Whatever solution was adopted the process of separation would take a long time. For example, the separation of BT from the Post Office took a good deal of time even though the postal and telephone business were run separately for some time before separation took place.

Impact on Consumers

7 Against this background the Department does not believe that breaking up British Telecommunications (BT) into a number of regional companies would of itself provide customers with a choice of telephone company; they would still have to go to the local mini-BT to obtain all their telephone services (except in the limited geographical areas where Mercury will operate). Customers in some regions might suffer

positive disadvantages from a break up; different regions generate different amounts of trunk and international calls both of which subsidise local calls. London is the most profitable area and BT's profits there help subsidise the regions and rural areas. So breaking away, say, Scotland from BT could result in Scottish subscribers paying substantially more for telephone calls. The regions which might suffer from BT being broken up are precisely the areas where Mercury (which will aim at the business market) will find it unprofitable to establish operations for many years to come; so customers in areas disadvantaged by breaking up BT could not only suffer a significant increase in prices but would also have little prospect of benefitting from competition.

8 Customers might benefit from a break up of BT only if the "emulation" effects outweighed these disadvantages. Creation of separate regional companies would foster a sense of local identity; management and local staff might set out to make local improvements in service that were frustrated within the present monolithic organisation. This in turn might cause the company in one area to seek to emulate the performance achieved in another area. Consumers might perceive differences in service between areas and press for local improvements in their own area. In management terms, separate local companies could provide an objective yardstick to measure differences of performance. It is highly unlikely that these emulation effects would offset the disadvantages to consumers; emulation effects are already present in

the United States and there is evidence (which is not widely publicised) that many of the smaller companies provide an indifferent service, having been slow to install dialling facilities or to replace out of date equipment. Moreover, it is not necessary to break up BT to secure beneficial emulation effects; these can be secured by internal action.

Internal Decentralisation As An Alternative To Breaking Up BT

9 Whereas breaking up BT into separate companies would be slow, complex and unlikely to promote competition, considerable advantages could be obtained from decentralising decision taking within BT. This could give local managements greater scope for initiative, greater flexibility and a better means of assessing the costs and efficiency of the service they provide than is possible under the present arrangements. The "emulation" effects discussed above would be facilitated. The creation of separate profit centres within BT and the devolution of decision taking to them, if done properly, should improve efficiency, and make the organisation more responsive to customer needs.

10 Largely on his own initiative but also spurred on by liberalisation, Sir George Jefferson has started on the process of introducing devolved management and accounting arrangements within BT. He has been in office for only a short period and has had to introduce the new internal structure virtually from

scratch. BT is therefore in the midst of moving towards a local management structure which should, when it is in place, create a sense of local identity within BT, provide managers with many of the tools of successful management which are lacking in BT at present and ensure that "emulation" effects can occur.

Impact Of A Break Up On Privatisation

11 There is no doubt that any move towards a break up of BT would postpone flotation for many years. The essential problem is that the mechanics of hiving off companies are complex and inevitably take time even in well managed private sector companies. In the case of BT it would be necessary first to decide the overall structure of the successor companies, taking account in BT's case of long term national telecommunication and defence requirements. Second, it would be necessary to identify the assets and liabilities to be allocated to each company, which in BT's case is complicated by the fact that Sir George Jefferson found no asset registers on his arrival. Third, it would be necessary to establish the necessary legal arrangements for the transfer. These measures could not be completed for many years.

12 If it were wished to break up BT before the flotation (which would then be of several separate companies), the flotation would be delayed, probably

until around 1988 to permit the creation of several successor companies and the transfer of assets between them. To secure such a break up it would be necessary to include compulsory powers to achieve this in the Telecommunications Bill. This would add greatly to its complexity and it is already long and complicated. Such a provision would also stir up controversy; both the BT management (whose goodwill is essential to the success of privatisation) and the BT unions (who have scope for inflicting serious industrial damage) would resist the Bill and we would run the risk of making the telephone system, which is an essential national service, into a political football like the steel industry.

13 The alternative to flotation after breaking up BT would be to float BT as a single entity and to take formal powers to break it up at some future date. The Department considers that such a step would jeopardise the flotation. Investors will need to be confident about the company they are buying and this means a stable outlook, particularly when the concept of a privatised telecommunications company is itself novel. The introduction of a power to break up BT would undermine confidence and stability. At its simplest BT's profits and hence its ability to pay a dividend depend on its long line and international businesses which generate sufficient profits to fund the local services which make a loss at present: investors will not want to take up shares in an integrated profitable company like BT if the Government could convert their shares at some unspecified future date into shares in a series of local, unprofitable

companies. The problem of adding to the complexity and controversiality of the Telecommunications Bill would remain.

Possible Break Up of BT In The Future

14 These objections apply to the inclusion of a power to break up BT in the Bill. The Department does not, however, rule out breaking up BT for all time. The Department believes that the combination of liberalisation, competition from Mercury, decentralised accounting and management within BT, and the market disciplines arising from private ownership will transform BT's performance. It will take a few years to test this. If, however, towards the end of the decade BT plc remains a sluggish, inefficient monopolist, the Government will retain the option of asking the MMC whether BT's monopoly operates in the public interest. If the MMC considered that it did not operate in the public interest the Government would then have order making powers which might be used to require BT plc to sell off regional companies. This option is available in the case of any monopoly company. Moreover, action to break up BT at the end of the decade would be much easier than now because Sir George Jefferson's new decentralised management structure, which by then would be in place and operating, should have brought about a substantial degree of regionalisation.

T2
DEPARTMENT OF INDUSTRY
11 October 1982

cc

3 pps

CONFIDENTIAL

Qa 06101

To: MICHAEL SCHOLAR 18 October 1982

From: JOHN SPARROW

Telecommunications Bill

1. I have seen a copy of Jonathan Spencer's letter of 13 October to you setting out Patrick Jenkin's views on the break up of BT into separate regional companies. The CPRS has also been considering the advantages of regionalisation more broadly in our study of the State Monopolies, and have had a meeting with David Young, as suggested by the Prime Minister (in your minute of 6 September).

2. Breaking up BT into independent operating units would involve the formation of a number of regional companies, and separate companies for the other activities - "long lines" trunk telecommunications, international telecommunications, research and development (Martlesham) and miscellaneous services (BT Enterprises). The regional and international operations would remain monopolies. Mercury would provide some competition to the trunk company. The other activities would operate in a more competitive environment, making it possible to compare their efficiency, though they would not actually be competing unless perhaps in limited areas at the margin.

3. The formation of independent regional companies with a local monopoly of telephone services seems to us to have a number of advantages:-

(a) it would be easier to manage because the units would be smaller;

(b) it should result in greater attention being given to consumers' interests and complaints than is likely with the large national organisation;

(c) this would facilitate comparison between the regions and, if performance measures are compared and the results highlighted, this should encourage competition between managers and greater consumer pressure for change;

CONFIDENTIAL

(d) the centralised control and single culture, which are typical of the national monopolies, would be removed, thus creating a climate in which individual regional innovation and initiatives could take place;

(e) if coupled with the introduction of franchising, whereby licences are granted to the local telephone companies for a fixed term, this should result in "competition for the field" even if "competition in the field" is not possible;

(f) it would facilitate regulation by the Office of Telecommunications because of the comparisons available, and would be less likely to result in "agency capture" because there would be more than one organisation being regulated;

(g) it would be likely to lead to regional wage bargaining and local productivity schemes, thus bringing pay more in line with local conditions;

(h) it could lead to a reduction of national union power and of the likelihood of national disputes and disruption;

(i) it would eliminate the present monopsony purchasing position, which has arguably made the telecommunications manufacturing industry less competitive internationally.

4. Sir George Jefferson is embarking on a programme of internal decentralisation which will bring benefits as outlined in the DOI note. This should have the advantages at (a) to (c) above. However, unless decentralisation is coupled with the creation of independent regional companies not under common ownership and control, it is unlikely that the benefits described in (d) to (i) above will materialise.

5. It has been suggested that breaking up BT into separate regional companies would damage consumer interests in rural and remote areas. Regionalisation might tend to cause telephone charges to fall in urban

areas and rise in rural areas; this is because tariffs would reflect more closely the cost of providing the services. At present hidden cross-subsidisation takes place between trunk and local calls and between urban and rural users so that the major users, typically the large businesses in urban areas, are discriminated against. Regionalisation would bring these issues out into the open, so that decisions to subsidise rural subscribers and social services could be taken with the financial implications made explicit.

6. The major disadvantage of regionalisation concerns the timing. BT is a highly centralised organisation. It will take some years before separate commercial relationships can develop between the regions and the other companies, and before separate accounting and costing systems can be introduced. There is the related problem of common facilities such as the same premises housing both local and trunk equipment. We do not dissent therefore from the DOI view that privatisation would be delayed for some time, possibly until 1988.

7. There may be further difficulties of the kind put forward by the Home Office over the licensing of Mercury. But the main decision for Ministers, given the present public commitment to privatising BT, is whether the prospect of delay outweighs the benefits that regionalisation could bring. If so, then we recommend that support and encouragement should be given to Sir George Jefferson's plans for a decentralised organisation, with increasing devolution to secure so far as possible the benefits of regionalisation. If we were starting now, my own preference would be to regionalise (and regulate) first, before privatisation - but I recognise that a lot of water has already gone under the bridge.

8. I am sending a copy of this minute to Sir Robert Armstrong.

JS.

cc Mr. Mount
Mr. Vereker

MR. SCHOLAR

BRITISH TELECOM

The letter from the Private Secretary at the Department of Industry of 13 October in answer to the Prime Minister's question about the possibility of having a number of local telephone companies instead of one national monopoly, pursued arguments which are, I think, false.

Breaking up BT would enhance true competition in telecommunications even though each local company would act as a local monopoly as in the case of America. The main point is that you can avoid a local monopoly by moving. To avoid a national monopoly, however, you have to flee the country. There is much less monopoly in a local than a national organisation.

Secondly, as is well known from American experience, the local monopoly is subject much more to local control. An individual consumer can have very little effect on a national British Telecoms, but he may well have much more influence on his local telephone company. That must respond to local needs and local demands and be subject to a local censure.

Thirdly, local companies would have both incentives and opportunities to innovate and try new techniques. Such new innovations may very well be adapted to local circumstances. We know, however, from experience that national organisations, even though subject to considerable competition like British Rail for example, tend to standardise and not innovate. (The British Railway sandwich, for example, is the same unpalatable mess wherever you eat it.)

Fourthly, there would be standards of competition and comparison. British Telecom West Midlands could compare itself with British Telecom East Midlands. Any fall from competitive grace would be a stimulant to great local pressure - as happens at present in some other local monopolies.

Fifthly, I believe there is some evidence of diseconomies of scale in Telecoms. The largest size does not give rise to efficiency, but inefficiency, as bureaucracies become out of touch and coordination becomes more and more difficult.

/The letter of

The letter of 13 October raises the bugaboo of increased charges for rural customers. This is the familiar bogey that is paraded to frighten away any suggestions of change. But the whole point of having any control mechanism, and certainly the control mechanisms which I have been concerned with, is to ensure that the local companies, just as the national company, would have an incentive to provide rural services at low prices. This is a matter which is very largely independent of whether one has a national or local company. It is certainly no argument for a national company as such.

I can well believe, however, that an attempt to break up BT might delay the flotation. This argument might well be correct. I have no evidence on which to make a judgement.

As a footnote, I would add that Hull apparently operates its own telephones under licence from British Telephone. They apparently have charges which are below those of BT. Perhaps there is a lesson in Hull.

Finally, there is a general point. This letter from the Department of Industry reflects still the underlying ethos of the merger mania, bigger is better, integrate and become more efficient, - views which were common and very influential some 10-20 years ago. But the Germans, Japanese and indeed the Americans have shown that size is no substitute for and often inimical to sense. It is worrying but perhaps understandable that the same ethos still persists in the Department.

14 October 1982

ALAN WALTERS

CONFIDENTIAL

Asst Secs Sec
Dr. Vereker

10 DOWNING STREET

From the Private Secretary

9 September 1982

Telecommunications Bill

As I mentioned to you on the telephone yesterday, the Prime Minister has asked me whether it might be possible for the Telecommunications Bill to allow an arrangement like that in the United States where there could be a number of regions providing competitive telecommunications services. The Prime Minister understands that the Department of Industry view is that if the Government took powers in the Bill to enable it to break up BT plc into separate regional companies, this would have a serious impact on privatising telecommunications: if BT were broken up before flotation took place, the mechanics would take several years, thereby postponing privatisation probably until towards the end of the next Parliament; on the other hand, if the Government attempted to float BT plc as a single unit whilst retaining in the Bill the power to break it up at some future date, the flotation itself would be jeopardised.

The Prime Minister would be grateful for a note on this whole issue. In particular, she has asked why it would take several years to break up BT into several regional companies, thus postponing privatisation until towards the end of the next Parliament.

I am sending a copy of this letter to Peter Jenkins (HM Treasury), Richard Hatfield (Cabinet Office) and Gerry Spence (CPRS).

M. C. SCHOLAR

Jonathan Spencer, Esq.,
Department of Industry.

CONFIDENTIAL

cc JV

CONFIDENTIAL

Qa 06058

To: MICHAEL SCHOLAR

From: JOHN SPARROW

8 September 1982

Telecommunications Bill

1. Thank you for your minute of 6 September, conveying the Prime Minister's suggestion that we should talk to David Young on this subject. This is a good idea, but I have a little personal difficulty in that I am going on leave this weekend (apart from putting in an appearance on Monday evening). I am therefore asking Alan Bailey to open up a discussion with David Young so that I can pick the matter up again on my return.

2. It so happens that I met George Jefferson at Farnborough on Monday, and I got the impression that regionalisation in some form is also part of his thinking. He is very anxious not to disturb his relationship with Patrick Jenkin, but would nonetheless welcome an opportunity to meet the Prime Minister in order to talk to her about what he is seeking to achieve and how he is setting about it. I can see considerable advantage in such a discussion if it can be arranged, and I wonder, if the Prime Minister likes the idea, if an invitation might not be conveyed by way of Patrick Jenkin. But my ideas on protocol are still a little hazy.

3. I am sending a copy of this minute to Sir Robert Armstrong.

B.

Note/ Discussed with Mr Sparrow and told him that I thought it would be a bad idea for the PM to see Sir G Jefferson — ~~repetition~~ (this was Jonathan Spencer's / Mr Jenkin's private advice to me). Jefferson had already floated this idea with Mr Jenkin, who had turned it down. PA

MCS 9/9

CONFIDENTIAL

file

JR

bc: Mr. Vickers
Post + Tele

10 DOWNING STREET

From the Private Secretary

CONFIDENTIAL

MR. SPARROW

TELECOMMUNICATIONS BILL

Thank you for your minute of 3 September to Robin Butler.

We showed this to the Prime Minister over the weekend. She has asked why it would take several years to break up BT into separate regional companies, thus postponing privatisation probably until towards the end of the next Parliament. The Prime Minister has suggested that you should have a talk with Mr. David Young some time; the Prime Minister knows that he has a number of ideas on this subject, from his days in the Department of Industry.

I am sending a copy of this minute to Richard Hatfield in the Cabinet Office.

MCS

6 September 1982

DSS

Would you have a word with David Young? Prime Minister mentioned this. We have no. 1 item from his DOI days. MT

WR 3/9

Qa 06053

To: ROBIN BUTLER

From: JOHN SPARROW

3 September 1982

Telecommunications Bill

1. We have made enquiries of the Department of Industry about the specific point on the Telecommunications Bill raised by the Prime Minister and set out in your minute of 1 September.

2. The Prime Minister's understanding is correct. In accordance with the decision, taken collectively by Ministers and announced, that BT would remain as one entity, the Bill is being drafted to provide for the transfer of assets from BT to a single successor, BT plc. Theoretically the Government could take powers in the Bill to enable it to break up BT plc into separate regional companies. In the view of Department of Industry officials, this would have a serious impact on privatising telecommunications. On the one hand, if BT were broken up before flotations took place, the mechanics would take several years, thereby postponing privatisation probably until towards the end of the next Parliament. On the other, if the Government attempted to float BT plc as a single unit whilst retaining in the Bill the power to break it up at some future date, it is highly unlikely that the City would invest in an institution whose future structure was so uncertain. Of the two, my personal preference would be for the first, but we would need first to decide whether or not regionalisation is the best course of action.

why? why?

3. Ministers would retain the option to break BT up into regional companies after flotation without specific powers in this Bill, but only by new legislation or by an order under the Fair Trading Act following an MMC investigation which concluded that the continuation of BT plc as a single entity was contrary to the public interest.

4. On licensing the situation is simpler. Under the Bill the Secretary of State for Industry will have a power to license which could be used, if Ministers so decided, for local companies or further Mercuries. For the time being it is intended that licences be restricted to BT, Hull and Mercury.

5. I am sending a copy of this minute to Sir Robert Armstrong.

JB.

CONFIDENTIAL

FILE

HL

Post & Tel

10 DOWNING STREET

From the Principal Private Secretary

MR. SPARROW

Telecommunications Bill

This minute records a specific point which the Prime Minister discussed with you yesterday during your general discussion with her about the CPRS work programme.

The Prime Minister said that her understanding was that the Telecommunications Bill would prescribe a monopoly telecommunications company and would prevent an arrangement like that of the United States where there could be a number of regions providing competitive services.

You agreed that the CPRS would look quickly into this and let the Prime Minister know what the position is.

E. E. R. BUTLER

1 September 1982

CONFIDENTIAL