



FROM: MISS M O'MARA

DATE: 19 April 1984

cc Sir P Middleton
Mr Monck
Mr Burgner
Mr R H Wilson
Mr J Williams

PS/FINANCIAL SECRETARY

BT: CAPITAL STRUCTURE + RPI-X

The Chancellor telephoned Mr Baker this afternoon about the latest state of play in negotiations with BT.

2. The Chancellor said he had been disturbed by reports that DTI Ministers might be moving away from the position of RPI-3. Mr Baker explained that he had had a lengthy negotiation with BT on Tuesday, when Sir George Jefferson had opened discussion by asking for a £500 million debt-equity conversion and RPI-2. BT were clearly concerned that the company could not be sold for less than RPI-2, as were Warburgs. In the course of the negotiations he had offered BT a £250 million debt-equity conversion in the course of the negotiations which would give a saleable gearing ratio but Sir George Jefferson was still not prepared to accept RPI-3 and had said he would be unlikely to recommend the Government's package to his Board next Wednesday. In response, Mr Baker had stressed that this negotiation needed to be completed by Easter and that nothing more was on offer.

3. Mr Baker explained that Sir George had returned yesterday with further proposals on RPI-3. In his view, this was not purely a negotiating ploy; they were also worried about the marketability of the formula and Hoare Govett shared their doubts. Sir George had proposed the inclusion of international calls in the basket of services but Mr Baker had rejected this. Sir George had then pointed out that the RPI-3 formula would be very difficult for BT if inflation fell to 3 per cent or below, because of the very large proportion of fixed costs which the new company would face, without benefit from falling interest rates. Mr Baker said he had discussed this proposal with his Secretary of State who had agreed that the concession could be made if it would secure the Board's endorsement of the package.



4. The Chancellor said that he believed RPI-3 to be perfectly saleable and that BT had in addition been offered an excessively generous capital structure. As he had told DTI Ministers at his earlier meeting, he had only been prepared to concede a debt-equity conversion as large as £250 million if that would clinch the deal. He believed it unnecessary for a successful flotation. BT were bound to press the Government for as many concessions as they could get.

5. Mr Baker explained that he had told BT at a stormy meeting yesterday that he would consider the proposals sympathetically provided it secured the Board's agreement to the whole package. At that stage, Sir George Jefferson had not been proposed to agree and he had therefore threatened postponement of the sale. The Chancellor detected an element of bluff in BT's tactics and stated his firm view that the Government must stick at RPI-3. Mr Baker said that he had warned Sir George at a meeting this morning that the offer to adapt the formula if the annual increase in the RPI fell below 3 per cent was not on the table and that the Chancellor had reservations about it.

6. The Chancellor said that he would be prepared to consider adapting the formula in this way, if as a quid pro quo the debt-equity conversion were reduced from £250 million to £100 million. Mr Baker thought that this would produce an impasse in negotiations. The Chancellor said that in this case RPI-3 must be the final offer. He noted that Kleinworts regarded this as marketable. If BT were concerned about their higher proportion of fixed costs then the flexibility in the formula must be two-way. Mr Baker suggested that the concession he was mooting could be costless. The Chancellor said it would also be meaningless in market terms because the market did not expect inflation to fall below 3 per cent over the next 5 years.

7. Mr Baker then expressed this concern that the Government might be faced with a minute from BT's Board meeting next week, rejecting the Government's proposal. This would be bound to leak. The Chancellor, for his part, expressed concern that if the Government made a further concession now, they would be pressed to make yet another by BT. RPI-X was a critical element in BT's regulatory framework. Mr Baker noted that if the Government stood firm, as the Chancellor was insisting, Sir George Jefferson would carry over the dispute on RPI-3 to the negotiations on resale and interconnect which were in any case likely to be very difficult. There was a real risk that as a result the October/November slot for the flotation could be lost. The Chancellor said that this reinforced his view that



the Government should stand firm. Ministers were privatising a monopoly and had a duty to impose a proper regulatory regime. He was not prepared to make any further concession and believed that the Government had already been pushed far enough. He did not believe any further concessions were necessary to secure a successful flotation. The time table pressures applied just as severely to BT as to the Government.

8. Mr Baker said that he would have to report the Chancellor's view to his Secretary of State.

9. In the light of this discussion, the Chancellor would be grateful to know whether Officials think that the fixed costs problem is a genuine one for BT. If so, he suggests that this implies a different type of formula - perhaps one with a lower limit of 0 and an upper limit of 4. But he has stressed that it should certainly be symmetrical. He would also like to know the position on resale and interconnect.

JS

PP. MISS M O'MARA