Wait for Tsy Energy comments

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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
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25 January 1980

Dear Geoffrey

BNOC: FUTURE FINANCIAL STRUCTURE

In paragraph 22 of E(79)67 I indicated that I would be coming forward to interested colleagues with my proposals for severing BNOC's connection with the NOA and providing it with a more normal capital structure. Annex 4 to that paper set out my thinking at that time.

My officials have now had detailed discussions with the Treasury and BNOC on this question, and the attached paper sets out their recommendations. Broadly these are that:

(a) BNOC should be funded by a mixture of NLF loans and public dividend capital (pdc);

(b) I should have the ultimate power to determine the level of dividends on pdc, and to transfer surplus cash from BNOC to the Exchequer;

(c) there should be a redefinition of the borrowing limits and BNOC's obligation to obtain consents to lend money, and to buy or sell company securities should be modified.

I understand that Treasury officials are unwilling to support a case for pdc for BNOC, and believe that the Corporation can and should be funded entirely from debt; although there should be a power to receive grants to meet unrecoverable trading losses. The paper sets out the arguments on both sides. I think it is right to be extremely selective about the use of pdc, and guidelines such as those in Command 7131 are desirable. But I believe that it is totally unrealistic to provide an organisation which is dependent for its profits on a dividend flow from a single investment, and on what is basically a major jobbing operation, subject to the constraints of participation agreements, with one hundred per cent debt capital. And I do not think that the ability to give grants to cover losses is a satisfactory substitute. With pdc there is the prospect of remuneration in due course, and as profits grow remuneration above the NLF rate. With grants there is no prospect of remuneration whatsoever. The knowledge that grants are available also severely undermines the proper financial disciplines to which management should be subject.

If however you see difficulty in accepting now the appropriateness of pdc for BNOC, I suggest that we include in the Bill powers to provide NLF, pdc and grants, leaving open for later decision whether pdc will be provided. This has the added advantage of giving us flexibility to deal with any problems arising out of the transition to the new structure, or out of privatisation which we have not yet identified. This is a highly complex matter which we are having to deal with at great speed in order to meet the Parliamentary timetable. We have identified a number of financial problems which we are satisfied our proposed new structure will cope with, but as we look at the privatisation process in more detail others may emerge, and the flexibility provided by the approach I am suggesting should minimise the need for changes during the drafting of the Bill, or for amendments during its passage.

I should be grateful therefore for your agreement that we proceed to take the powers summarised in para 16 of the attached paper; I should be glad also to know whether you are willing to agree in principle at this stage that some part of BNOC's funding from the Government should be in the form of pdc.

I am copying this letter to the Prime Minister, John Nott, Keith Joseph, John Biffen, and Sir Robert Armstrong.

Yours ever

D A R HOWELL

David

BNOC : FINANCIAL STRUCTURE

Background

1. On the assumption that BNOC (Trading) is to be the vehicle for the Government shareholding in BNOC (Operating) its financial structure must satisfy the following requirements:

(i) Oil trading. Trading will act principally as a jobber in large quantities of oil secured largely under participation agreements. As an oil trader the Corporation will have the prospect of a high turnover combined, in normal circumstances, with relatively small profits or losses. It will have no significant fixed assets and will require little medium or long-term capital to finance its trading assets (but see (v) below). Given, however, that the trading operation entails by its nature a significant exposure to loss, the financing arrangements must provide a flexible means of funding of last resort. They must also ensure that BNOC can finance a relatively large requirement for working capital for normal day-to-day operations;

(ii) Shareholding in BNOC (Operating). Here there are two main requirements:

(a) a mechanism for ensuring the transfer of dividend income from Operating through Trading to HMG;

(b) a means of financing Trading's subscriptions to future rights issues by Operating (this might be needed, for example, to maintain the Government shareholding at an agreed level);

(iii) Forward oil sales. Trading may carry some of the liability to meet supply obligations under the forward oil sales recently negotiated. The prospect of Trading involvement in the unwinding of forward oil sales is in any case certain if the existing sales are rolled forward into 1981-2;

(iv) Proceeds of privatisation. Unless the existing NOA arrangements remain in force until after privatisation has been completed (which is unlikely to be practicable) Trading will be the initial recipient of the proceeds of privatisation. New financial arrangements must ensure that these proceeds are passed directly to HMG;

(v) Other activities. Although the activities of Trading will be restricted for the foreseeable future to oil trading, the Corporation will have the same powers to broaden its activities as the existing BNOC. The financial structure must be formed in such a way as to allow for some of the powers (e.g. the power to go downstream) to be exercised in the longer-term.

2. In our view the new capital structure for Trading should resemble more that of the other state corporations. The following criteria seem essential:

(i) provision for formal capital which imposes a proper financial discipline;

(ii) ability for the Corporation to control its cash and working capital without reference to the Department;

(iii) flexibility to deal with the transactionscovered in paragraph 1;

In addition

(iv) the Government must be able to obtain early access to suprlus cash.

3. The starting point for our consideration has been that Trading's long-term requirements should be funded from Government sources by means of NLF loans or public dividend capital; and that its short-term working capital requirements could be obtained from the banking system. The key questions we have had to consider are:

(a) how should remuneration of Government funds be decided? Can Trading be funded entirely from the NLF, or is some element of pdc needed?

(b) what modifications are needed to the conventional arrangements to deal with Trading's special problems?

4. The remuneration that Trading / is called upon to pay on Government funds will primarily effect its profitability, and will be the main financial discipline imposed on the Corporation. It is essential to provide it with a proper commercial discipline, which at the same time avoids prejudicing its financial viability. An examination of Trading's likely assets and the revenues flowing from them will give the best guide to how those assets should be financed. Taking the 5 categories of activity referred to in paragraph 1 the following considerations are relevant:

(i) Oil trading. What capital is needed will be to finance any losses. It would be unrealistic to assume that BNOC would be able to remunerate such capital by fixed interest payments - equity therefore seems appropriate.

(ii) Shareholding in BNOC (Operating) and (iv) Proceeds of Privatisation. Prior to privatisation this will be on BNOC (Trading)'s balance sheet at book value, financed by corresponding amount of capital; as shares are sold the proceeds can be applied to repay capital pro-rata, and distributed as capital profit. BNOC (Trading) will not be able to remunerate 100% debt in respect of these shares out of initial dividends which will take some time to build up, either before or after privatisation; the logical solution would be to finance the share stake by means of equity, but it would be feasible to contemplate a mix of equity and debt.

(iii) Forward oil sales. Any outstanding forward commitment to supply oil in respect of payments already received would need to be shown in the balance sheet as a liability, matched by a corresponding asset of some sort. This could be handled by the proceeds of any forward sale being deposited with the Government until such time as the obligation to deliver arose. The extent of any Government remuneration of such deposits would be decided by the need to ensure that BNOC (Trading) made no loss as a result of such deals.

(iv) Other activities. The argument for equity rather than debt finance in respect of new activities is less clear cut and decisions would have to be taken ad hoc. But it is possible that such investment might be heavily front end loaded and with the prospect of positive cash flow and profitability only in the longer term. Such a possibility would be best catered for by equity finance.

5. The conclusion from this analysis is that pdc is an essential element in any funds provided to Trading by the Government.

6. The provision of equity finance for Trading would provide a convenient basis for the transfer of dividend income from Operating to HMG. We envisage that SOS would have the power to determine the level of dividends on the equity in the light of Trading's profits and cash requirements. He would also have the power to require the payment of interim dividends so as to ensure the prompt transfer to Government of dividends received by Trading. This latter power could be backed up, if necessary, by a specific power to transfer cash surpluses from the Corporation after appropriate consultation.

7. Privatisation proceeds would be channelled to HMG by means of capital repayments to the Exchequer corresponding to the book value of the shares sold with any excess cash from the sale after capital gains tax being used to provide a capital dividend to HMG. There would have to be a special provision in the legislation to ensure that SOS could insist on the payment of such a dividend, with a safety net provided by the power to transfer cash surpluses from Trading suggested in paragraph 6 above.

8. Our preferred scheme for Trading thus comprises the following elements:

(i) Trading may be funded by NLF debt or pdc (at the discretion of the SOS);

(ii) short-term working capital will be sought from the banks;

(iii) privatisation proceeds will be used to repay opening capital, and as capital dividend on pdc;

(iv) dividends from BNOC (Operating) and trading profits can flow through as dividends on pdc - with the SOS having power to set the level of dividend;

(v) the SOS will have the power to remove surplus cash from the Corporation;

(vi) proceeds of forward sales of oil will be deposited with the NLF, and drawn down as the delivery obligations mature.

9. The only outstanding difficulty with these proposals stems from the use of pdc. The White Paper on the Nationalised Industries, Cmnd 7131, set out two requirements to govern the use of pdc, first that it should be applied to essentially viable organisations, ie. issued on the assumption that the prospect of dividends was no worse than the return on NLF loans; and second that pdc was intended for industries in which profitability was cyclical. At official level, the Treasury have doubts that both these conditions would be met by BNOC (Trading). They also argue that the funds needed to finance the BNOC (Trading)'s shareholding in BNOC (Operating) can be properly met by NLF loans and that any losses from its activities can and should be met by voted grants. In our view the criteria for pdc can be met:

(a) because Trading's main source of revenues (the dividend from Operating) while not necessarily cyclical is completely outside its control; and its basic trading operation is essentially fluctuating;

(b) there is a long term prospect that as the dividends from operating build up, Trading will be able to pay dividends on its pdc equivalent to the interest that would have been payable on NLF debt.

Further we and BNOC would strongly prefer not to see losses being met from grants, since this would militate against normal commercial disciplines.

10. We would therefore advocate a choice in favour of a mixture of pdc and debt to be covered in the Bill. It would however be possible to include provisions in the Bill covering pdc, debt and grants so that options between our and Treasury's views can be kept open, with decisions as to whether pdc should in fact be provided being taken when the new Corporation comes into being.

TRANSITIONAL ARRANGEMENTS

11. We propose that the Bill should provide for the SOS to specify a date when Trading's connection with the National Oil Account is to be terminated and the new structure set up. No decision needs to be taken yet what this date will be. Provision will be needed to establish the funding of Trading's assets at the specified date, to convert any receipts from forward oil sales into deposits with HMG, and to ensure that Trading has adequate cash balances and access to working capital to meet its needs from the moment when the NOA ceases to operate.

BORROWING LIMITS

12. We are currently reviewing with the Treasury the terms of the Corporation's statutory borrowing limit. It is agreed however that the limit should be applied to all sources of funding by the Corporation (including pdc it it is used), guarantees and indemnities and any further arrangements along the lines of the Britoil arrangement. It is for consideration however whether the limit should apply to the funding necessary to finance BNOC (Trading)'s shareholding in BNOC (Operating). The funding associated with the shareholding will start at a high level in the period when BNOC (Trading) holds all the shares in BNOC (Operating). As shares are sold however, the funding necessary to finance the shareholding will fall substantially. A further rights issue in BNOC (Operating) would of course increase the finance necessary. Inclusion of funding for this purpose would thus result in major fluctuations in the total, and to be effective any statutory

funding limit would have to be varied accordingly. Such an artificial arrangement might be better circumvented by specifically excluding the shareholding from the limit, though this course would hold its own presentational problems.

MISCELLANEOUS

13. Under Sec 2(4)(c) of the Act, BNOC must seek the SOS consent to purchase or sell company securities. This control is unsatisfactory because it does not cover all the possible ways in which BNOC may extend the scope of its operations, and it involves the SOS in scrutiny of the structure of acquisition deals rather than the substance and blurs the Corporation's responsibility for the detailed arrangements. We therefore propose to repeal 2(4)(c), and instead place on BNOC a duty to seek the SOS's prior approval to any substantial commitment of funds on capital account, the threshold to be set from time to time by the SOS with the approval of the Treasury.

14. We propose however that the SOS should have the power to control the size of Trading's stake in BNOC (Operating).

15. Sec 2(4)(d) of the Act requires BNOC to seek SOS's consent to lend or borrow money. To bring BNOC's position more into line with other nationalised industries and to reflect the Government's policy of a more armslength relationship, we propose to repeal the provision in 2(4)(d) relating to lending by the Corporation.

CONCLUSIONS

16. The new financial structure should allow for Trading to be funded from the Government either by NLF loans or by pdc; if agreement to pdc cannot be obtained now, then the provisions in the Bill should cover NLF, pdc and grants, in order to keep options open. Specific provisions are recommended as follows:

(i) severance of connection with NOA;

(ii) ability to borrow from the NLF;

(iii) ability to receive pdc from money voted by Parliament; and to repay pdc;

(iv) power for the SOS to make grants out of money voted by Parliament;

(v) power of the SOS to determine dividends, after consultation with BNOC;

(vi) power of the SOS to remove surplus cash (after consultation with BNOC);

(vii) power of SOS to establish the capital at outset needed to finance existing assets;

(viii) a revised definition of the borrowing limit;

(ix) amendments to controls over purchases and sales of securities;

(x) freedom to lend money without consent of SOS;

(xi) the date on which these provisions come into force to be specified by order.

25 JAN 1980