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CABINET  
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

BNOC - FUTURE STRUCTURE AND PRIVATE  
SECTOR PARTICIPATION

Memorandum by Secretary of State for Energy

1. The Committee agreed on 11 September (E(79)7th Meeting), that following the decision not to proceed for the time being with BNOC asset disposals, I should bring forward proposals for private sector participation in BNOC's upstream operations.
2. This paper sets out the broad approach I propose to adopt towards such participation. It deals with questions of policy concerning structural relationships between the Government, BNOC's trading operation and its upstream operation. Once these are settled, detailed privatisation plans can be prepared and a start made to prepare legislation for introduction later this session.

Structural relationships

3. My main objectives in a structural re-organisation are:-
  - a. to ensure maximum security of national oil supplies by the best method available;
  - b. to achieve the widest possible spread of ownership by the British public in BNOC's upstream operations, bearing in mind effects on the PSBR (see Annex 1);
  - c. to ensure the continued development of a major British oil company on the UK Continental Shelf, based on BNOC's upstream operations;
  - d. to reduce the public sector.



These objectives require separation of the two operations so that the Government may retain 100% control of the trading side, while relinquishing a part of its stake in the upstream side. The former - BNO (Trading) with a staff of around 50 - will be the existing public corporation; the latter - BNO (Operating) taking the bulk of BNO's 1200 or so staff - almost certainly a Companies Act company, in which any public sector stake would be held by the public corporation. (NB. I give these names for the sake of convenience. BNO (Operating) would of course be given quite a different name e.g. British National Oil Ltd.).

Size of public sector stake in BNO (Operating)

4. I believe there is clear advantage - both in terms of our political commitment to the nation and to ensure commercial and operational efficiency - in BNO (Operating) being a free-standing commercial company unequivocally under private sector management and control. Abnegation of public sector control will also bring substantial benefits to the PSBR in the years of disposal from the proceeds of privatisation although as Annex 1 shows there would be losses to the PSBR in later years.

5. This unequivocal arms length relationship can most simply be achieved by reducing the public sector stake to a level significantly below 51%. I have however considered whether the relationship could be satisfactorily established by means of a clear declaration of the Government's intention not to intervene, while retaining 51%. I do not think this is a satisfactory solution because:-

- (a) the existence of a majority public sector stake would lead to great pressures to intervene;
- (b) with the history of BNO's role as an instrument of the previous Government's policies retention of a shareholding giving Government scope for intervention would not meet our political approach;
- (c) in the case of BNO the existence of a majority Government

stake would be a deterrent to successful private sector participation. A BP-type formula on the lines of the Bradbury/Bridges letters would not sufficiently alter this position, since it is the long history of non-intervention rather than these letters in themselves which engender investor confidence in BP;

- (d) I see no particular reason to retain<sup>a</sup> 51% or more stake without the accompanying control. BNO is likely to be a highly profitable organisation which will not need any support from the Government.

6. I therefore favour retention of a lesser stake. A minimum 25% stake would be needed to block changes in the Memorandum or Articles of Association of the Company. This would enable us to ensure that the company maintains, as a primary objective, exploitation of the UKCS, and thus would remain as a major British presence here. It would be open to us to dispose of further shares at a later stage if we so decided.

Government powers over BNO (Trading) and BNO (Operating)

7. The rationale for retaining BNO (Trading) is to be able to improve the UK's security of oil supplies, and the emphasis should be concentrated on this. The initial activities of BNO (Trading) should be essentially those of an oil trader and as a vehicle for Government to Government deals if appropriate; and holder of the public sector stake in BNO (Operating). Any extension of these activities, upstream or downstream, should not take place without my prior consent, and the powers of consent currently afforded by the Petroleum and Submarine Pipe-lines Act 1975 should be widened accordingly. The Committee should note at Annex 2 certain EEC considerations in this connection.

8. BNO (Trading) will thus be limited as at present to trading in large quantities of oil at small margins in the interests of maintaining our security of supplies, with little opportunity to achieve other than marginal profits and the risk of occasional loss. The cushion of BNO's



upstream profitability which it at present enjoys will be replaced by the dividend on the minority stake in BNOC (Operating).

9. We should take powers to control BNOC (Trading)'s transactions in shares in the upstream subsidiary, in order to maintain its stake in BNOC (Operating) at the level the Government requires.

10. These changes apart, I see no reason to change the Government's relationship with BNOC (Trading) from that prescribed in the 1975 Act, except to sever the connection with the National Oil Account, to abolish the statutory advisory duty and perhaps to remove the statutory obligation to have two Civil Service Members. (I suggest that this should be a discretionary rather than mandatory matter, according to the merits of the case).

11. I do not consider we should retain powers over BNOC (Operating) except indirectly through the exercise by BNOC (Trading) of its rights as shareholder. A Government veto, or the right to appoint directors would be inconsistent with the commercial independence I envisage. But the Government through BNOC (Trading) would appoint the initial board and control its composition prior to privatisation and should ensure that any BNOC (Trading) appointees are subject to Government approval.

#### Scope of BNOC (Operating)'s operations

12. I see no reason to impose any constraints on the scope of this company's operations, apart from ensuring through the Memorandum and Articles of Association that its primary objective is exploitation of the UKCS. There will of course need to be oil options in favour of BNOC (Trading).

#### Private sector participation

13. As indicated in paragraph 6 I favour retention by BNOC (Trading) of a minimum 25% stake in BNOC (Operating), the balance being available

for issue to the general public. An important objective in any such issue should be to achieve the widest possible spread of ownership. On the basis of advice - received from Mr. Phillip Shelbourne, Chairman of Samuel Montagu, acting as a consultant to my Department, I believe

- (i) Private capital should be invited on the basis of an offer for sale of ordinary shares in BNOC (Operating);
- (ii) preference should be given for employees and for small investors;
- (iii) there are means to limit the extent of foreign ownership of shares, but their compatibility with international obligations needs to be studied;
- (iv) if a long term widening of ownership on a significant scale were looked for this would require a major incentive to potential owners which a conventional offer of sale would not provide. A free issue of shares, or units, to the British people along the lines of the British Columbia Scheme is one possibility.

14. I have also considered the timing of disposal of the private sector stake. There would seem some advantage in spreading any resultant PSBR benefits over more than one year. This can be done by making the issue of shares in two stages, at a year or more's interval, or by issuing on a partly paid basis with the balance payable in the next financial year; or a combination of both. Mr. Shelbourne's advice is that a two stage approach will be feasible provided there is a sufficient interval between the two issues and that our intentions are made clear at the outset. I believe that the issue can be so structured that BNOC (Operating) can be excluded from the PSBR, and sales proceeds count to reduce it, from the first issue, even though until the second issue to public sector will have a majority stake. Mr. Shelbourne's full advice on these matters is attached at Annex 3. The Committee will note that for illustrative purposes he has framed his advice on the basis that the public sector



retain 33 1/3% of the equity, though, as noted, in paragraph 6 25% is the significant minimum holding to keep control of the Articles.

15. My basic proposal is therefore to dispose of a majority stake in BNOC (Operating) up to a maximum of 75%, by means of one or more offers for sale. The disposals could be spread over 2 or 3 years and decisions on the precise timing would need to be made in the light of PSBR considerations and of the need to achieve a successful marketing.

16. There would be political attraction in making some part of the disposal in the form of a free distribution on the British Columbia model and Mr. Shelbourne's advice is addressed to this possibility (pages 7 and 8 of Annex 3). But apart from the obvious PSBR disadvantages of such a scheme, I am not yet convinced of its feasibility on such a wide distribution. It would anyway seem more sensible to look at this approach in relation to other disposals of public sector assets generally, with a view to offering the public a stake in an investment vehicle holding shares in a range of public corporations. Any such arrangement would require separate legislation. I hope my colleagues agree that these possibilities should be further investigated, particularly as they might provide a means of making renationalisation by a subsequent Labour administration more difficult.

#### BNOC's position

17. I have discussed these ideas with the BNOC Chairman (Mr. Utiger) and a few of his colleagues. BNOC accepts the need for the creation of a separate subsidiary holding all its upstream assets as a necessary preliminary to introducing private capital to the latter. But is strongly of the view that the management of the two operations should remain integrated on the grounds that the Trading side on its own could not attract management of a suitable calibre and its viability could thereby be impaired. This would call for retention of a minimum 51% stake.

18. While there may be a difficult transition stage while the separate managements are being formed, I believe we can successfully establish the Trading Management we need provided we are prepared to pay the right salaries. And retention of management control of BNOC (Operating) by

BNOC (Trading) could jeopardise the successful sale of shares to the private sector, our policies for reducing the public sector, and our aim of establishing a further free-standing British company on the UKCS.

#### PSBR

19. The PSBR impact of my proposals are set out at Annex 1. These figures are necessarily very speculative, given the uncertainty about oil prices, and the level of BNOC's own capital programme. The proceeds of privatisation are based on a net saleable value of £1500m, which again is a very broad estimate, subject to market conditions at time of sale. But these figures illustrate that while significant PSBR benefits can be secured in early years, the PSBR will lose the benefit of positive cash flows in the future. From the strict PSBR standpoint the issue seems to turn on whether early certain benefits (and the cash which they generate) are preferred to later less certain benefits. But this can only be one element in the wider political context.

#### Conclusions and recommendations

20. On balance I favour complete separation of the management of the two functions and I therefore invite my colleagues to agree to the approach described in this paper, including specifically that:-

- (a) all BNOC's upstream assets should be vested in a separate subsidiary company (BNOC (Operating));
- (b) The public sector through BNOC (Trading) should retain a stake in BNOC (Operating) of a minimum of 25%;
- (c) BNOC (Trading)'s functions should be those provided in the Petroleum and Submarine Pipelines Act 1975, but my consent should be required for upstream operations and for any downstream operations other than crude oil trading;
- (d) BNOC (Operating) should not be subject to any constraints except oil options to BNOC (Trading);



- (e) Government should have no special powers over BNOO (Operating) but should have the power to approve BNOO (Trading)'s appointees;
- (f) The issue to the public could be in two or more stages, a first tranche being offered for sale if possible in late 1980; the precise amounts to be decided in the light of conditions at the time.

#### Legislative implications

21. Legislation will be needed to implement the above proposals. I invite my colleagues to agree that this should be set in hand at once to implement the restructuring and the initial Offer for Sale.

22. In addition to the measures outlined above legislation will be needed to abolish the statutory duty to advise and it will be necessary to reform the National Oil Account so that BNOO's connection with it is completely severed. For the information of my colleagues Annex 4 sets out my initial views on this latter question which I will need to clear with my Treasury and other colleagues. In essence I propose that BNOO (Trading) should have access to PDC and NLF finance; the Government should have powers which ensure that surplus monies are not retained by the Corporation; and a revised statutory funding limit is introduced.

23. As my colleagues already know I also intend to take the opportunity of such legislation to make some tidying-up amendments to the Petroleum and Submarine Pipelines Act 1975 which have been found to be necessary as a result of its operation in the last 4 years.

24. A summary of the legislative provisions thus envisaged is given in Annex 5. I invite my colleagues to agree that these should form the basis of instructions to Parliamentary Counsel, subject to clearance with my Treasury and other colleagues of the proposals for severing BNOO's connection with the NOA.

#### Timetable

25. I would hope to be in a position to introduce the legislation in February: it is likely, however, that its passage will not be completed until the end of the session.

#### Parliamentary announcement

26. My aim will be to make a statement in terms agreed with my colleagues as soon as possible.

D.A.R.H.

Department of Energy  
21 November 1979



PSBR EFFECTS OF ALTERNATIVE CASES

1. BNOC Status Quo

	£m. outturn				
	<u>1980/1</u>	<u>81/2</u>	<u>82/3</u>	<u>83/4</u>	<u>84/5</u>
A. Net Cash Flow to BNOC (after tax and dividend)	75	335	285	185	240
B. Dividend	-	25	70	110	125
C. Tax (PRT)	-	-	195	425	475
D. Total Public Sector Take (A+B+C)	75	360	550	720	840
E. Total Public Sector Take less tax (A+B)	75	360	355	295	365

The figures shown under line A are affected significantly by the size of the capital programme assumed. Those shown above are based on BNOC's capital expenditure programme as agreed by Ministers for the PES White Paper. BNOC has however recently reviewed its capital expenditure projections and on the assumption that its future programme is limited to upstream operations on existing licences, it now foresees a reduced programme of expenditure. If this forecast is realised the total public sector take less tax (line E) would be:

	£m. outturn				
	<u>1980/1</u>	<u>81/2</u>	<u>82/3</u>	<u>83/4</u>	<u>84/5</u>
	175	480	445	375	485

At 1979/80 survey prices the equivalent figures are:

	£m. (1979/80 survey prices)				
	<u>1980/81</u>	<u>81/2</u>	<u>82/3</u>	<u>83/4</u>	<u>84/5</u>
Public Sector Take (less tax) assuming:					
(a) PES Capital Expenditure Programme	59	254	226	169	192
(b) New BNOC Programme	138	339	283	215	255



2. BNOC (Operating) 25% Publicly Owned and counted as Private Sector Body

Public sector would lose BNOC net cash flow (line A in the Table shown under option 1) and 75% of the dividend payments (line B), which would be paid to the private sector. PRT take (line C) would be unaffected. Against this, the public sector would receive the proceeds of privatisation. Assuming proceeds of £1125m<sup>(outturn)</sup> spread over 1980/81 and 1981/2 the total public sector take (excluding tax) at survey prices and on the PES capital expenditure programme would be:

	£m. (1979/80 survey prices)				
	<u>1980/1</u>	<u>81/2</u>	<u>82/3</u>	<u>83/4</u>	<u>84/5</u>
Public Sector Take (less Tax) from Operations	-	4	11	16	16
Proceeds of Privatisation	<u>445</u>	<u>400</u>	<u>-</u>	<u>-</u>	<u>-</u>
	<u>445</u>	<u>404</u>	<u>11</u>	<u>16</u>	<u>16</u>

3. BNOC (Operating) 51% Publicly Owned and counted as a Public Sector Body

Here total BNOC net cash flow (A above) would be counted as public sector revenue. The public sector would lose 49% of dividend payments which would be made to the private sector. PSBR would not benefit from the proceeds of privatisation.

The public sector take (excluding tax) at survey prices and on the PES capital programme would be:

	£m. (1979/80 survey prices)				
	<u>1980/1</u>	<u>81/2</u>	<u>82/3</u>	<u>83/4</u>	<u>84/5</u>
Public Sector Take (excluding tax) from Operations	59	245	205	138	160
Privatisation Proceeds	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>160</u>
Total	<u>59</u>	<u>245</u>	<u>204</u>	<u>138</u>	<u>160</u>

Notes

The table is based on the following assumptions:

- (i) oil prices at \$28.50/bbl in April 1980 rising at 10% each January thereafter; \$2.10 = £1; UK inflation falling from 14% to 9% a year over the period;
- (ii) BNOC estimates of PRT (these are in line with, though a little higher than Inland Revenue forecasts);
- (iii) Dividends based on  $\frac{2}{3}$  of post-tax profits as forecast by BNOC. Assumed that dividends are not paid out until April/May of the year after the profit figures to which they relate;
- (iv) The need to repay BNOC's BritOil finance during this period is neutral in terms of the PSBR;
- (v) No detailed figures for public sector take are available beyond 1984/5 and much will depend on the size of the agreed capital programme. However, on the assumption of a capital programme which remained constant in real terms from 1984/5, increases in oil prices of 10% a year and UK inflation of 9% it is estimated that the net cash flow to BNOC (A in option 1) would remain roughly constant for 1985/6 and 1986/7. Dividends in 1985/6 could be around £35m. (1979/80 survey prices).



EEC IMPLICATIONS

The establishment of BNOC and its subsequent access to large quantities of oil, derived through both its participation and equity interests, has enabled a substantial proportion of these supplies to be disposed of in accordance with HMG's own inclinations. This has been achieved by the close relationship between the two bodies, although in strict legal terms not only is the Government, apart from Article 36 (public security), precluded by Article 34 of the Treaty of Rome from imposing restrictions on exports to Member States, or measures having equivalent effect, but also, under Article 37, it may not use BNOC (as a body through which it may exercise powers of control) to influence such exports, whether directly or indirectly.

Under the new proposals, participation interests will be retained by BNOC (as BNOC (Trading)) and even with the transfer of the upstream equity interests to BNOC (Operating), a majority at least of oil from this source will none the less be secured to BNOC (Trading) by means of options, so that ostensibly at least, the position under the Treaty should be little different from that prevailing hitherto notwithstanding the new arrangements. Indeed, the position should be somewhat stronger since the severance of the link between the Corporation and the National Oil Account and the introduction of a separate financial structure could be taken as a demonstration of the greater independence of BNOC (Trading). However, the radical restructuring of BNOC may serve to focus renewed attention on the Corporation's activities and in any event the more restricted scope of these activities may serve to expose them more readily to scrutiny, so that there may be a greater



risk of successful challenge to the Corporation's disposal policies under this head and also under the further head described below.

Further grounds for challenge to the participation interests exist as a result of Articles 85 and 86. The risk of challenge under Article 86 (abuse of a dominant position) should not be materially increased by the proposals since the share of the market will not be increased as a result of them. With regard to Article 85 (which prohibits constraints on competition), the fact that under the new proposals oil supplies from the existing equity interests will be secured by options between BNOC (Operating) and BNOC (Trading) will place these supplies in an equivalent position to those derived from participation sources. This will mean that these arrangements will be at risk for the same reason, whereas the risk is largely absent at present since of course BNOC exercises control over its equity interests by virtue of ownership and not by way of agreement.

This risk could be reduced to some extent by conferring on BNOC (Trading) an express duty to carry out oil acquisition and disposal operations for the Government, to enable the Corporation, should a challenge be mounted, to claim the benefit of Article 90 which in respect of "undertakings entrusted with the operation of services of general economic interest" allows for the possibility of a limited exception from the provisions of Articles 85 and 86.

THE BRITISH NATIONAL OIL CORPORATION

PRIVATISATION : AN INTERIM REPORT

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THE BRITISH NATIONAL OIL CORPORATION ("BNOC")

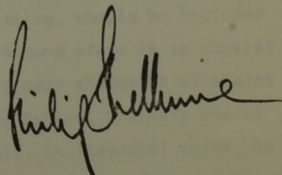
PRIVATISATION : AN INTERIM REPORT

I have been retained by the Secretary of State for Energy to advise him on the means ("privatisation") by which BNOC's interests in the exploration, development and exploitation of oil fields on the United Kingdom Continental Shelf ("UKCS") may be removed from the public sector. As the Secretary of State is aware, I am being assisted by some of my colleagues.

In this paper, we give, in an interim report, our views and recommendations on the Secretary of State's present proposals for achieving privatisation. I emphasize that it is outside my brief to comment upon those aspects of the proposals which depend upon decisions of a specifically political nature.

It is, however, the basis of this paper that, as a necessary condition for privatisation, BNOC will be reconstructed so that its trading activities remain, through the medium of a public corporation or Companies Act company ("Trading"), wholly within the public sector, and its other activities, in the exploration, development and exploitation of UKCS oil fields, are carried on by a separate company ("Operating"), in which private sector interests and a continuing interest, via Trading, by HMG will be held.

In Part I of this paper, the current proposals for privatisation are set out and our views and recommendations on these proposals are summarized. The proposals and our conclusions are examined in detail in Part II. The three Appendices contain information on disinvestment by private investors in the U.K., on the distribution and value of the major U.K. savings instruments and on the free distribution to residents of British Columbia of shares in British Columbia Resources Investment Corporation ("BCRIC").



Philip Shelbourne

16th November, 1979



Current Proposals for Privatisation

The Secretary of State's current proposals are that:

(i) The public sector should divest itself of one third of the value of Operating by means of an Offer for Sale on the London market in the financial year 1980/81;

(ii) A further one third of Operating's value should be disposed of by gift to the British people or by means of a further Offer for Sale in the financial year 1981/82;

(iii) One third of Operating's value should be retained, via Trading, by HMG, but so that the rights attaching to HMG's interest in Operating should, from the date of the first Offer for Sale, be so circumscribed as to remove Operating from the public sector.

Summary of Views and Recommendations

Our views and recommendations on the current proposals are:

(i) The securities of Operating to be offered for sale should consist of Ordinary shares;

(ii) Flotation of Operating by means of an issue of Ordinary shares is, in principle, feasible and could, provided that market conditions were not notably unfavourable, be effected in 1980/81;

(iii) If it is to be part of the proposals that divestment by HMG should be effected in two stages, the first stage should precede the second by at least twelve months, and a clear statement to that effect, and of HMG's future stance towards Operating, should be included in the initial prospectus. If, however, the second stage is to consist exclusively of a free distribution either of Ordinary shares or of shares of a different class ranking *pari passu* with, or behind, Ordinary shares (collectively referred to as "shares"), there would, in financial terms, be no particular merit in providing for a substantial passage of time between the stages;

(iv) Wide public participation in Operating, extending beyond that small proportion of the U.K. population which directly holds listed securities, may most effectively be secured by a free distribution of securities of Operating;

(v) If it is decided that divestment should incorporate a free distribution of securities, the timing of that distribution should depend upon the nature of the securities so distributed. If they are to be shares, the distribution should succeed an Offer for Sale; if they are to confer rights to participate in the equity of Operating more broadly defined, through a preferential charge on Operating's oil revenues embodied, for instance, in an oil production stock, the distribution should precede the Offer for Sale;

(vi) If the proposal to effect divestment in two stages partly reflects a wish by HMG to reserve its right to offer further Ordinary shares for sale in the second stage, so that receipts from the two Offers for Sale fall in different financial years, the object of spreading receipts might equally (and more cheaply) be achieved by providing that settlement by allottees on the first Offer for Sale should be made in two instalments bridging the end of a financial year;

(vii) Removal of Operating from the public sector could be achieved by providing in its Articles of Association that, with effect from the first Offer for Sale, the votes attaching to HMG's holding should not count as more than, say, 25 per cent. of the total of votes cast on a poll;

(viii) We consider that the maximisation of receipts from the Offer for Sale will best be achieved if potential investors perceive that Operating is to be independent of HMG. We recommend, therefore, that the rights attaching to HMG's holding and the level of Trading's options over Operating's UKCS oil should be set at the minima consistent with the national interest;

(ix) If it is HMG's policy that control of Operating should not pass out of British hands, a safeguard could (provided that it did not contravene international law) be constituted by clauses in Operating's



Articles of Association under which HMG, via Trading, could, provided that it held not less than, say, 25 per cent. of the issued Ordinary shares of Operating, have the right to appoint two directors of Operating and such directors would be vested with a power of veto in the event that, say, 30 per cent. of Operating's Ordinary shares came to be held by non-residents;

(x) From a preliminary assessment of the value of the gross assets of Operating, we consider that the total flotation value of Operating could, in current prices, be in the region of £1.5bn. Independent expert advice would be required before a definitive valuation, nearer to the time of flotation, was undertaken.

After the proposed Initial Offer for Sale, as to whether the second stage should consist exclusively of a free Distribution of securities of Operating or partly of a free distribution and partly of a further Offer for Sale, there is much to be said, in our view, so as to avoid distribution of the value of shares initially offered for sale that the prospectus could conceivably create that HMG was contemplating a further issue, but that no such issue would be made before the expiry of at least two months. As to a free Distribution is concerned, we consider that such a Distribution should succeed the Initial Offer for Sale if the distribution is to consist of shares, since this order of events would allow a market in shares to be provided. That consideration would not, however, apply if the distribution to the people were to consist of securities ranking in priority to ordinary shares. If, for instance, it was decided that it would be more appropriate that the people should participate in Operating's revenues through all production stage units (that) it would be necessary for the distribution to precede an Initial Offer for Sale because it would not be open to HMG to procure thereafter the flotation of securities of Operating whose holders would be entitled to participate in Operating's revenues in priority to holders of ordinary shares. Thus, while the retention of two stages would leave HMG with room to make its own choice upon the completion of the second stage, it would inevitably entail the loss of an opportunity to effect free distribution of shares in the form of shares.

PART II

In this Part of the paper, we examine certain aspects of the proposals in detail and amplify our recommendations.

Timing

(i) General Considerations

We assume that the proposal that the privatisation of Operating should be effected in two stages is intended to confer on HMG some latitude in determining the time and the form of the second stage. If HMG wishes to reserve its decision, until after the proposed initial Offer for Sale, as to whether the second stage should consist exclusively of a free distribution of securities of Operating or partly of a free distribution and partly of a further Offer for Sale, then it would be necessary, in our view, so as to avoid depression of the value of shares initially offered for sale that the prospectus should unequivocally state that HMG was contemplating a further issue, but that no such issue would be made before the expiry of at least twelve months. So far as free distribution is concerned, we consider that such a distribution should succeed the initial Offer for Sale if the distribution is to consist of shares, since this order of events would allow a market in shares given to the people to be provided. That consideration would not, however, apply if the distribution to the people were to consist of securities ranking in priority to Ordinary shares. If, for instance, it was decided that it would be more appropriate that the people should participate in Operating's revenue through oil production stock units (Ops), it would be necessary for the distribution to precede an initial Offer for Sale because it would not be open to HMG to procure thereafter the creation of securities of Operating whose holders would be entitled to participate in Operating's revenues in priority to holders of Ordinary shares. Thus, while the retention of two stages would leave HMG with room to decide in due course upon the composition of the second stage, it would implicitly entail the loss of an opportunity to effect free distribution other than in the form of shares.



(ii) PSBR Considerations and Part Payment Arrangements

If privatisation in two stages is proposed partly because HMG may wish, if the second stage is to include a further Offer for Sale, to spread its receipts between two financial years, we consider that that object might equally be achieved if a single Offer for Sale were made but payments for Ordinary shares allotted were made at two dates falling in successive financial years. A single Offer for Sale would be considerably cheaper because the costs of printing a prospectus and of compiling the formidable amount of information required to be included in it would be incurred once, not twice, while an advantage of part payment arrangements would be that underwriting commission would be payable only in respect of the first instalment. As against this, the longer the period between the two instalments, the greater would be the risk that the market price of Operating's Ordinary shares (taking the second instalment into account) would fall below the subscription price and hence that investors, particularly small investors, might fail to make the second payment due, thus rendering shares allotted to them forfeitable. In addition, we recognise that the element of flexibility conferred by divestment in two stages would be surrendered if a single Offer for Sale were made.

If the decision were made before the first Offer for Sale that the second stage of the proposals should be implemented exclusively by a free distribution of shares, we would see no particular merit in providing for the passage of as long a period as twelve months between the two stages.

(iii) Timing of Initial Offer for Sale

We have been informed that it is unlikely that the legislative process necessary to permit partial divestment by HMG of its interest in BNOC will enable the first Offer for Sale of Ordinary shares in Operating to be made before the Autumn of 1980. We do not consider that timing is a factor crucial to the success of Operating's flotation, although our view is subject to the normal caveat that we would not recommend proceeding with an issue in notably adverse market conditions.

Some concern has been expressed that, in the Autumn of 1980, there would be a temporary glut in world oil supplies which would swing to a shortfall in 1981. So far as receipts from an Offer for Sale are concerned, it can be argued that the presence of a glut could entail a

widening of the discount on Operating's absolute value. Per contra, it may also be argued that the market broadly discounts events twelve to eighteen months in advance and that the success of an issue in the Autumn of 1980 would, therefore, turn on expectations about future, not present, oil supplies. On balance, we do not conclude that there is at present any argument of great substance in favour of deferring the initial Offer for Sale beyond the Autumn of 1980.

A public issue of the value envisaged could have some implications for the PSBR funding programme. We recommend, therefore, that an announcement of its approximate size and timing should be made in advance, in particular so as to facilitate the planning of institutional cash flows. We also note that, under Stock Exchange regulations, listing for new securities will not normally be granted if the latest financial period on which accountants report in the prospectus ended more than six months before its date.

## 2. Wide Public Participation

Appendix I sets out evidence of the behaviour of subscribers to two recent substantial new issues and of the contraction in the number of shareholders of I.C.I. and J. Sainsbury. Appendix II contains information on the distribution and value of investment in the major U.K. savings instruments.

A conventional Offer for Sale is likely to leave a large part of Operating's shares in professional investors', and particularly institutional, hands, even if preference is given to small applicants and employees of Operating. The proportion of the U.K. population directly holding securities listed on The Stock Exchange is small and the increasing dominance of the institutions well documented; the two B.P. issues, despite wide publicity, attracted in each case not more than 200,000 applications. The evidence of recent flotations is that the number of shareholders diminishes significantly within a relatively short period after the date of issue, which suggests that those individuals who do apply for new issues are not long term holders. The technicalities and transaction costs of dealing in securities on The Stock Exchange are perceived as



forbidding and fluctuations in value as unpredictable. Thus, while we recommend that, on the Offer for Sale, shares should be reserved for employees of Operating and preference should be given to small applicants, we do not consider that an Offer for Sale would achieve anything approaching a wide distribution of Operating's Ordinary shares.

The evidence of the free issue in British Columbia of shares in BCRIC, which is analysed in Appendix III, suggests that applications will be attracted from a high proportion of those eligible if securities are available at no cost. The evidence also suggests that a wide distribution of holders, by number although not by value, is likely to be maintained after a free issue. It is not possible, in the absence of evidence, to predict to what extent distribution would be narrower if shares were offered not free but at a discount. A priori, however, we feel that the level of applications would be more sensitive to the existence of a price, however small, than to gradations in the price itself. In addition, unless the issue of securities at a price were accompanied by an upward shift in the savings ratio, applications could well be financed in a counter-productive fashion through the encashment of National Savings Certificates and similar widely held instruments.

A separate working party, on which we are represented, has been established at the Department of Energy to consider means whereby wide public participation may be achieved. It is recognised by the working party that distribution to the public in any form is subject to substantial administrative difficulties. Our tentative views at this stage are that, if it is intended that the people's interest in Operating should be represented by shares, it may be possible to resolve some of the administrative difficulties by providing that the people will hold their interest not directly in the form of shares but indirectly in the form of units in a trust which would be the registered holder of the people's shares in Operating; the voting rights attaching to the people's holding would be exercisable by the trustees of the trust, an arrangement which would ensure effective British ownership of a large minority stake in Operating and thus possibly lead to a reduction in the required size of HMG's residual holding.

As an alternative to this route, we consider that there are certain attractions in the issue to the people of Ops of Operating on terms that the Ops should combine certainty of monetary value and minimum yield with the speculative prospect of appreciation in real terms. Whether this method commends itself depends, to some extent, upon whether it is conceived that ownership by the people should necessarily embrace the exercise of voting rights by them or on their behalf.

It appears from the Department's projections of Operating's cash flows that it is unlikely that the annual dividend on a holding of shares directly distributed will exceed 50p in the early years of Operating's life as a listed company (on the assumption that one third of Operating's value is given to the British people in the form of shares distributed free to each member of the adult U.K. population, which consists of some 40m persons). The administrative cost of making such payments might well be disproportionate to the benefit conferred. The working party is, therefore, examining methods by which income could be accumulated: it appears that it would be feasible to incorporate provisions for accumulation in either of the two routes mentioned.

### Type and Method of Flotation

#### (i) Type

The opportunities available to U.K. investors to invest directly in U.K. oil production are limited, principally because the U.K. oil production interests of the U.K. listed oil companies are diluted by downstream activities, oil production interests outside the U.K. and diversification. Of the general range of securities listed on The Stock Exchange, those which provide a deferred equity entitlement, in the form, for example, of convertible loan stocks or convertible preference shares, are by their nature specialist instruments and are significantly exceeded, in terms of market value, by Ordinary shares; while of new non-public sector securities issues, the great majority consists of Ordinary shares with full voting rights. In our view, the size of issue contemplated in the case of Operating, the opportunity which the issue would provide for direct investment in U.K. oil production and considerations of simplicity (and thence of appeal to the widest possible range of portfolio tastes)



and of subsequent financing requirements suggest unequivocally that the flotation of Operating should follow the conventional pattern and be confined to Ordinary shares. In our view, the issue of a convertible stock of Operating would not enhance its overall value or HMG's receipts from flotation and would result in a fragmentation of the market in Operating's securities, which we regard as undesirable. It has, further, been impressed upon us that, were there to be an issue of securities in Operating which constituted a close substitute for government stock, the financing of the PSBR might be affected, whereas an equity issue would meet institutional portfolio preferences.

(ii) Method

In practical terms, an equity issue of the size contemplated may only be made either by an underwritten Offer for Sale at a fixed price or by an invitation to tender. The tender method has, historically, been employed in small equity issues where the absence of comparable listed securities has made valuation by the issuing house difficult. Issues of Treasury Bills and of various fixed coupon securities are, of course, regularly made by tender both in the U.K. and the U.S.; institutional procedures, however, vary in that they depend on whether the issuing authority sets, implicitly or explicitly, a reserve price, wishes to allot the whole amount for which tenders are invited, aims at a spread of holders or accepts offers at their actual values in descending order or at a single striking price which clears the market. In our view, the merits of a tender issue in the case of Operating, where HMG had declared its intention to divest itself of a specified proportion of Operating's Ordinary share capital, would be outweighed by those of an Offer for Sale. A tender issue could well fail to achieve a satisfactory balance between the two important (and potentially conflicting) objectives of maximising receipts and maximising the spread of holders. In addition, there could be no certainty that proceeds from a tender would exceed those from an Offer for Sale, while the risk of setting a reserve price which resulted in the issue being undersubscribed would be unacceptable. In any event, it has been a matter of general experience that the aftermarket in shares issued by tender has been less firm than that succeeding an Offer for Sale at a fixed price.

The arrangements for substantial issues of government stock (and, indeed, for the recent Offer for Sale of B.P. shares) often provide for payment by instalments. We consider that, while these arrangements are open to the objection that they may confer on "stags" a geared endowment to any profit implicit in a fixed price offer, that objection is outweighed by the enhancement of the attractions, and value, of an issue accruing from part payment arrangements, by the greater, and important, assurance that a substantial secondary market will develop and by the minimisation of disruption to the PSBR funding programme.

The exact timing of the initial Offer for Sale would, in view of the size contemplated, be the subject of a joint decision by H.M. Treasury, the Bank of England and the Government Broker.

#### 4. Independence of Operating

An extremely important feature of the flotation of Operating will be the restrictions, if any, imposed upon the company as to both the manner and extent of its future operations and the degree of control which HMG may be perceived as exercising over its activities. The retention by HMG of voting control would be of concern to potential investors, who would fear that Operating might be required, in the national interest, to undertake non-commercial ventures. Furthermore, such control might well inhibit the company's ability to expand internationally, since it would be regarded as a creature of HMG.

BP may be cited as a case in which HMG's majority holding has not appeared to influence the operations of the company, and it may, therefore, be argued that a similar *modus operandi* in the case of Operating should not give rise to anxiety among investors. Our view, however, is that the B.P. position is accepted by investors because of the long history of apparent non-intervention. It could not be inferred from the instance of B.P. that Operating would be perceived as being independent of HMG. Although we recommend that a firm indication of HMG's stance towards Operating should be contained in the prospectus, we do not consider that this or a Bradbury/Bridges commitment would persuade investors that Operating would remain free from Governmental interference, particularly since there could be no assurance that the bi-partisan approach to B.P. would be repeated in the case of Operating. As a result, we conclude that the retention of control over Operating by HMG would reduce Operating's flotation value.



It would, however, be consonant with HMG's proposals and with the maximisation of receipts from an Offer for Sale if a provision were included in Operating's Articles of Association limiting, from the date of the Offer for Sale, the voting rights attributable to HMG's holding in Operating to 25 per cent. of the votes actually cast on a poll of Operating's shareholders. We do not consider that the retention by HMG of a holding carrying voting rights of 25 per cent. would have any significant effect upon the flotation value.

We also understand that consideration is being given to the level of Trading's options over Operating's UKCS oil. We consider, in general terms, that access by Trading to Operating's oil should be set at the minimum level consistent with the national interest. If access to 100 per cent. were retained, some reduction, possibly of up to 10 per cent. in the flotation value of Operating, would, in our view, follow. We recommend, therefore, that Operating should be liable to surrender only the 51 per cent. normal in the case of its competitors.

We also understand that HMG would like to ensure that Operating remained under British control although no specific safeguard has yet been determined. We believe that it would be extremely difficult to enforce restrictions embodied in the Articles of Association which were based either on the size of the holding or the nationality of the holder because it would be open to an ingenious holder to fragment his interests through intermediaries, a technique of exploiting "the corporate veil" to which the Home Secretary recently referred in the case of casinos.

Total ownership by non-residents would obviously be precluded if HMG were to retain a holding of 25 per cent. or more, and voting rights of 25 per cent., in Operating and we consider that HMG's position would act as a serious deterrent to potential acquirers. No-one is likely to wish to acquire a majority holding in opposition to HMG and the various regulatory powers open to it. While such powers may not be conclusive on their own, in concert they would give rise to substantial commercial influence and could result in a massive investment being subjected to considerable and prolonged uncertainty. As an example of these powers, a holder in excess of 25 per cent. could be made the subject of a reference to the Monopolies and Mergers Commission.

Despite this, if a holder or a party of holders, acquired 50 per cent. or, possibly, less of Operating's shares, it could have the power to restructure the Board with its own nominees. This could clearly result in the commercial posture of Operating being changed. If it were considered essential to provide against this eventuality an effective safeguard could be constructed by stipulating that, for so long as Trading held not less than, say, 20 per cent. of Operating's Ordinary shares, it should have the right to appoint two directors to the Board and that those two directors should have the right to veto any resolution of the Board or of a committee thereof in the event that Trading became aware that, say, 30 per cent. or more of the Ordinary shares was held by non-resident individuals, corporations or nominees; for these purposes, non-resident corporations would be deemed to include U.K. corporations under foreign control, foreign nominees would be deemed foreign and U.K. nominees would also be deemed to be foreign unless the beneficial ownership of shares held by such nominees was disclosed to be in resident hands by response to the powers of inquiry contained in the Companies Act 1976. These two rights would be conferred by clauses in Operating's Articles of Association. We are not, however, qualified to judge whether such clauses would have consequences in international law: such consequences are a matter for discussion between our lawyers and the Department's.



New issue statistics

Set out below is a summary of the effects on the share register in the case of two large public issues.

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<u>I.M.I.</u> (£68m)	<u>000's</u>
Number of shareholders at December 1976	12
Number of new allottees arising from ICI offer for sale in November 1977	71
	—
	83
Number of shareholders at February 1978 (earliest balancing date after offer)	76
	—
Net fall during December-February after offer (10%)	7
	==

<u>B.P.</u> (£564m)	
Issue in June 1977	
Number of shareholders before issue	100
Number of allottees	200
	—
	300
Number of shareholders on first balance of register after issue	170
	—
Net fall after issue (65%)	130
	==

NB: Multiple applications were not rejected.

Disinvestment by the small investor

<u>Company</u>	<u>Size of holding</u> (Number of shares)	<u>Number of shareholders</u>		
		<u>December</u> <u>1974</u>	<u>December</u> <u>1976</u>	<u>December</u> <u>1978</u>
<u>I.C.I.</u>	Under 1,000	535,000	488,000	439,000
	Over 1,000	59,000	66,000	59,000
		<u>March</u> <u>1975</u>	<u>March</u> <u>1977</u>	<u>March</u> <u>1979</u>
<u>J. Sainsbury</u>	Under 1,000	27,000	24,000	20,000
	Over 1,000	1,500	1,400	1,600

The above table indicates the trend (established in the Diamond Commission Report) among private investors away from direct investment in shares.



Major Savings Media

	<u>Number of Holders</u> million	<u>Total Holdings</u> £ million	<u>Average Holding</u> £	<u>Maximum Holding</u> £
<u>National Savings Movement</u>				
Premium Bonds	25	1,410	56	3,000
National Savings Certificates	8	6,000	750	1,500/3,000 (depending on issue terms)
British Savings Bonds	1	758	758	10,000
National Savings Bank:				
(i) Ordinary A/c's	14	1,420	101	10,000
(ii) Investment A/C's	1.3	1,860	1,430	50,000
SAYE (index linked)	0.7	315	477	1,200 (£20 per month)
<u>Trust Investment</u>				
Direct investment	1½	3,000	2,400	
Indirect investment (via equity-linked policies etc.)	½	1,100	1,500	
<u>Building Society Movement</u>				
Share accounts (joint accounts treated as single holders)	18	41,000	2,300 (maximum £15,000)	
<u>National Savings Stock Register of Gilts</u>				
Post Office sales	0.3	388	1,300 (maximum £5,000 per day)	
TSP promoted sales	0.15	308	2,100	

B.C. RESOURCES INVESTMENT CORP.OWNERSHIP PROFILEPURPOSE OF ISSUE

The purpose of the issue was to distribute the assets of B.C. Resources amongst the population of British Columbia. British Columbian citizens were entitled to apply for 5 free shares and up to 5,000 at a price of C\$6.00 which was paid into the company to enhance its further development.

The issue was open to all Canadian citizens provided they had been residents of the province for at least twelve months.

OWNERSHIP

(No institutions were allowed to participate in the original offering, although purchases in the after market were permitted.)

In total 96.2 million shares were issued. Shareholders who were allotted less than 100 shares held these in bearer form, whilst those with 100 or more shares were registered shareholders.

As a result, the breakdown of ownership was as follows:-

12.3m. Bearer Shares

83.9m. Registered Shares

Actual distribution of the shares was approximately as follows:-

	<u>Shares</u>
2,000,000 shareholders who applied for 5 shares	10.0m.
of the above 70,000 applied for additional shares (applying for an average of 32.8 shares each)	2.3m.
130,000 people applied for registered shares and, in total, received an average of 645 shares per application at a cost of C\$3840	83.9m.
	<u>96.2m.</u>

400,000, or 16.6%, of the eligible population of 2.4 million did not apply.

On the assumption that 80% of the 130,000, or 100,000, were four person family groups who applied for free shares as well, then these family groups ended up with 90% of the issue. This indicates that 30% of the eligible population had 90% of this issue, and 70% had 10%.



Although the actual figures are not available, the number of bearer shares subsequent to the issue, has declined marginally whilst actual institutional ownership has risen to an estimated 7½% of the total capitalisation. This suggests that selling where it has occurred, has been in the area of significant excess applications whilst nearly all the shares given out free have been held.

The assumption here is that the purchaser of bearer shares would, on buying 100, convert these into registered shares which is permitted by the company. Since the issue, only 400,000 shares have been so converted - suggesting that only 6% of those given free shares have actually sold them.

Finally, the number of owners of the registered shares has, since the issue, only contracted by 2,000 although it is likely that these sold very much more than 645 average shares per person to account for the high turnover in shares subsequent to the issue. In essence, these were probably "the stags".

#### CONCLUSION

The ownership of B.C. Resources was, and remains, concentrated in the hand of individuals. Perhaps the most important point to note is that most of the original applicants for free shares have held, despite the increase in the share price which has been as high as C\$8½.

Proposals for revised Financial Structure to replace connection with National Oil AccountBackground

Under the present arrangements BNOC is required to pay all its receipts into the National Oil Account (NOA) and money is released from the NOA on a day to day basis to meet any expenditure requirements. The Account is under the control of the Secretary of State. The NOA also receives royalty payments from UKCS Licence holders, and this money is available for release to BNOC to meet its expenditure requirements. There is no provision for BNOC to remunerate money advanced to it from the NOA.

2. The proposals in the main paper for restructuring BNOC will leave the statutory corporation as an organisation with one main function (Trading in oil which it buys at market prices under participation agreements), and with the State stake in BNOC (Operating). Any new capital structure must be designed to meet this corporation's special needs, while giving its management a recognisable commercial framework within which to operate.

3. The main net flows of money into the company will be dividend receipts from BNOC (Operating) and the proceeds of privatisation. Its own profits are likely to be very small and, in the nature of the business of a jobber, could sometimes be negative. It will require working capital and may need funds to maintain its stake in BNOC (Operating).

Forward Oil Sales

4. The recent advancing into 1979/80 of receipts for oil to be delivered



in 1980/81, will result in BNOC needing corresponding sums in 1980/81 when the oil is delivered. Future deals of this sort, or the rolling forward for a further year of the current one, will involve major cash flows in future years.

#### Proposed Structure

5. The structure proposed to deal with these flows is as follows:-

- (i) BNOC (Trading) to have access to Public Dividend Capital and NLF loans. The former will allow for flexibility in remuneration - reflecting the fact that the main source of profit will be dividends from BNOC (Operating);
- (ii) Secretary of State to have the power to fix dividends remunerating the P.D.C. (This will ensure that BNOC does not retain surplus cash);
- (iii) Secretary of State to have specific power to transfer the proceeds of privatisation from BNOC to the Consolidated Fund;
- (iv) The proceeds of any advance oil sale to be passed on to the Exchequer in the form of a temporary loan or deposit;
- (v) Working capital requirements to be handled through the clearing banks;
- (vii) The statutory borrowing limit to be redefined to be a limit on BNOC's cumulative net external financing.

In addition to the above changes it is proposed that the requirement for

BNOC to seek Secretary of State's consent to purchasing or selling of securities is modified to bring it into line with the practice for other public corporations.

PP3


19 November 1979.



BNOC RESTRUCTURING : SUMMARY OF LEGISLATIVE PROVISIONS REQUIRED

- (i) BNOC (Trading) is to be empowered :
- (a) to convert an existing subsidiary company into or create a new subsidiary company as BNOC (Operating);
  - (b) to provide BNOC (Operating) with the requisite powers (see paragraph 12);
  - (c) to transfer the relevant assets to BNOC (Operating);
  - (d) to dispose of some or all of its shares in BNOC (Operating) to outside investors;
  - (e) to transfer the proceeds from the sale of the shares to HMG (subject to determination of BNOC (Trading)'s future financial structure - (see paragraph (iii) below).
- (ii) The Secretary of State is to have power to ensure that BNOC (Trading) :-
- (a) performs the tasks specified in paragraph (i) above;
  - (b) maintains an appropriate shareholding in BNOC (Operating) - (see paragraph 9);
  - (c) in respect of companies in which by virtue of its shareholding it may appoint directors, to appoint only those directors which have the approval of the Secretary of State - (see paragraph 11);
  - (d) is not able to operate upstream or downstream without the Secretary of State's consent - (see paragraph 7).




- 
- (iii) BNO (Trading) is to have its finances severed from the National Oil Account and other financial arrangements substituted. (Proposals which are summarized in Annex 5 will be cleared with Treasury and other interested colleagues).
- (iv) The obligation to appoint civil servant members of BNO (Trading) is to be abolished.
- (v) BNO (Trading)'s statutory advisory function is to be abolished.
- (vi) The scope of Section 2(4)(b) (constraints over the power of BNO (Trading) to operate downstream without the consent of the Secretary of State) is to be clarified.

N.B. It may be necessary to make further legislative adjustments in connection with privatisation. The position will be clearer once more detailed proposals on this aspect have been settled.

AMENDMENTS AND ADDITIONS TO OFFSHORE PETROLEUM LEGISLATION

- (vii) Existing provisions of the Petroleum and Submarine Pipelines Act 1975 are to be amended to:-
- (a) extend the Secretary of State's powers regarding compulsory increase of pipeline capacity and acquisition of rights by third parties and to simplify the procedure for the authorization of minor offshore pipelines;
- (b) modify the Secretary of State's powers to make regulations concerning the construction and safe operation of pipelines;
- (c) make provision for receipts and payments in connection with petroleum licences; which are presently handled through the National Oil Account;

- 
- (d) improve the arrangements for the calculation and payment of petroleum revenues to Northern Ireland and the Isle of Man;
- (e) remove the Secretary of State's powers concerning payments to petroleum licence holders in respect of participation agreements;
- (f) give the Secretary of State power to make royalty refunds in cash irrespective of whether royalty is collected in cash or kind;
- (g) clarify certain of the arrangements for the calculation and payment of royalty and delivery of royalty in kind;
- (h) simplify the method of calculating gas/oil equivalence;
- (i) give the Secretary of State power to issue mutually agreed variations to development programme consents;
- (viii) The definition of Inland Waters in the Mineral Workings (offshore Installations) Act 1971 is to be clarified to remove doubt as to the Act's application to tidal inland waters.
- (ix) New provisions are to be made to :-
- (a) enable the Secretary of State to regulate the offshore storage of gas;
- (b) enable UK civil and safety laws to be applied to all installations and their surrounding safety zones servicing petroleum fields which extend into sectors of the continental shelf appertaining to other States;



- (c) extend the Secretary of State's powers relating to the establishment and operation of safety zones;
- (d) extend the powers conferred on Constables in relation to installations to cover the area of the surrounding safety zones;
- (e) abolish the need to lay Statutory Instruments relating to the establishment of safety zones (they would still be subject to scrutiny by the Joint Committee on Statutory Instruments);
- (f) give powers for the revocation of Designation Orders for the purpose of consolidation.

PP3

Department of Energy

21 November 1979