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Distribution considerations

Summary
Following earlier discussions about the near-term advisability of commencing share buybacks, the purpose of this paper is to set out some longer-term considerations in setting distribution policy.

Whilst distribution policy has an important role in messaging and ensuring an appropriately efficient balance sheet, we see little evidence that it drives share value – as opposed to shareholder expectations of underlying cash generation. This view is borne out by BP's experience from 2004 onwards.

Many investors value a secure dividend stream but to be secure it obviously needs to be underpinned by **through-cycle** underlying earnings. It is unclear that the abnormal dividend increases in 2005 and 2008 had any sustained impact on share price but they did leave the Group financially constrained when the oil price fell sharply.

We do believe that share buybacks are a useful and efficient tool to cope with earnings volatility arising from commodity prices by returning surplus cash that is not supported by through-cycle earnings. In determining the quantum and timing of buybacks, we need to be careful to establish that cash is truly "surplus", both in relation to competing growth opportunities and in being surplus to the Group's liquidity requirements. Share buybacks in themselves are value neutral. The current liquidity buffer is not "surplus" cash, both in the sense it has not been generated from operations but largely by borrowing, and as it has been raised deliberately in recognition of the heightened financial risk of the Group following Macondo. We therefore consider it imprudent to spend the cash buffer on buybacks and thereby double up the financial risk of the Group. Clear criteria can be set to identify truly available cash.

Financial framework
The Group amended its financial framework following the Gulf of Mexico incident. The changes were driven by the need to ensure the Group's balance sheet was sufficiently liquid and robust to deal with Gulf of Mexico related liabilities. The changed financial framework was announced as part of the February strategy presentation, when it was outlined that the Group was going to increase its financial strength and flexibility by continuing to maintain a large cash liquidity buffer and reducing its target net debt ratio to 10-20%.

Source of the cash buffer
Table 1, in the appendix, summarizes quarterly cash flow performance for BP since the start of 2Q 2010 through to the end of 1Q 2011. During this period the Group increased its cash reserves by $12 billion to $19 billion.

The data in the appendix demonstrate that the increase in the cash buffer has not been generated from surplus free cash flow. Along with the asset disposal programme, BP's increased liquidity has been generated by raising additional indebtedness, with BP reporting an unprecedented figure for gross debt of $46 billion as at the end of 1Q 2011. In addition, at the end of 1Q 2011 the Group remained outside the 10-20% target range, with a net debt ratio of 21%. Future forecast reductions in gearing are based on timing and success of closing of divestments.

Increasing indebtedness
Current indications are that the level of net debt at the end of 2Q will be in line with the figure for 1Q. The fact that the Group has a net debt target expressed as a gearing ratio range, rather than as an absolute amount, introduces a potential distortion in practice. It presents the impression that, as shareholders' equity grows, indebtedness can be increased without there necessarily being an accompanying increase in underlying cash flow required to service the greater level of gross debt. Should it be deemed appropriate to reduce the cash buffer then, with gross finance debt running at $46 billion, we recommend applying cash to repayment of BP's current record gross indebtedness before increasing distributions to shareholders.

Dividend policy
The February strategy presentation also contained the announcement that the quarterly dividend and related Scrip dividend programme were being resumed. The dividend was reinstated at a level of 7 cents per share, half the level pre-Macondo. This was described as prudent given the continuing obligation to pay $5 billion per annum, until the end of 2013, into the Deepwater Horizon Oil Spill Trust, plus the uncertainties that the Group continues to face.

It was also explained that BP's intention is to grow the dividend over time in line with the improving circumstances of the company. The planned rate of increase in dividends will need to be set at a level that the Group's operating cash flows can comfortably support over the business cycle.

Share buybacks
As is mentioned above, BP has announced to the market that it will look to increase the dividend from its current level as performance improves. Share buybacks should remain an important tool to be considered for use under the appropriate circumstances, such as returning surplus cash which is not needed for investment purposes during a period of high commodity prices.

A share buyback could also provide a means to reverse the dilutive impact of the Scrip dividend programme which has seen approximately 139 million new shares issued to shareholders over the last two interim dividend cycles. Whilst it could be claimed that running a Scrip dividend programme alongside a share buyback is counterintuitive and even inefficient, continuing with the Scrip programme is important as it has proved popular with shareholders. Given the Scrip programme has only recently been introduced, shareholders may appreciate the consistency of continuing with the current programme as the old system for providing an option to receive dividends in the form of shares rather than cash, the DRIP, was withdrawn at the time the Scrip programme was introduced. The only material frictional cost of running both a Scrip programme and a share buyback in parallel is the stamp duty on share purchases - $5m per $1bn share purchased in the London market.

Strategic rationale for share buybacks
If we were to announce a share buyback at the current time then it will be open to be interpreted in a variety of ways by analysts, investors (both equity and debt) and other stakeholders. For instance, there is a widely held belief that BP is undertaking its divestment programme to help cover the cost of our Gulf of Mexico commitments. Whilst some investors and commentators will welcome BP increasing shareholder distributions as a sign that the Group has sufficient confidence over the magnitude of its liabilities in the US, others may perceive a buyback, alongside a divestment programme, as a sign that BP been unable to pursue growth opportunities and has instead decided to return cash to investors as surplus capital. If the Group is to undertake a share buyback, the reasons for doing so would need to be clearly explained to investors and other stakeholders.

Signalling impacts and long term shareholder value
In most circumstances share buybacks should be value neutral and should not have a profound impact on a company's long term share price. In the short term they can be looked on favourably by investors as a signal that management are confident in future prospects, disciplined in investment decisions and managing cash flow. Increasing shareholder distributions by way of dividends or share buybacks can have a positive impact on the share price if they are underpinned by a confident expectation of sustainable, improved cash flow being generated from underlying assets. However, the acts of increasing dividends or starting a share buyback, in themselves, with no linkage to underlying improved cash flow generation, is unlikely to enhance a company's share price sustainably.

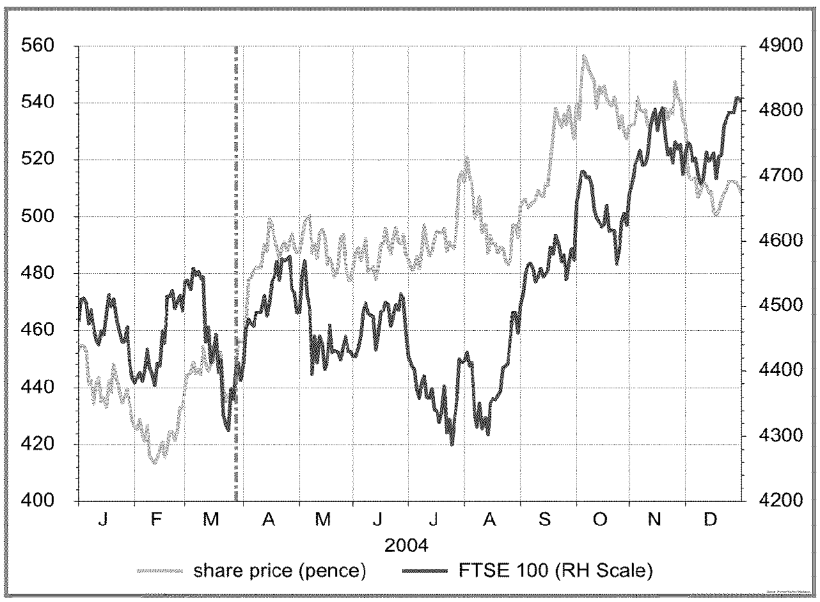
Impacts of recent changes in BP's distribution policy
Changes in BP's distribution policy over the last few years provide empirical support for these views.

i) Share buybacks
Firstly, in 2004 BP announced in its strategy update that it was going to focus on growth and enhancing cash returns. The guidance given was:
- Production growth would be 5% *per annum* between 2003 and 2008;
- The progressive dividend policy was going to be maintained; and

* Shareholders would receive 100% of free cash flow in excess of operating and dividend needs, generally when the price of oil was above $20 a barrel.

The share buyback announcement was extremely very well received by investors as it was regarded as a signal that BP was entering a new phase of delivering sustainable levels of extra cash to its shareholders whilst at the same time growing production and long-term returns. The press made much of the CEO's guidance on the level of cash that shareholders could expect under different oil price scenarios. At $20 per barrel, shareholders would receive $19.5 billion in dividends and buybacks. That figure would rise to $26.4 billion at $25 per barrel and $33 billion at $30 per barrel. As can be seen in Figure 1 below, the share price performed strongly following the strategy announcement made on the afternoon of 29 March. The share price by the close of 30 March was 4.9% higher than the closing price the day before the announcement.

Figure 1: BP share price following 2004 strategy update



BP's share price continued to perform strongly for a period of time after the strategy announcement but by the end of 2004 had fallen back in line with the wider market. Analysts highlighted that increasing capex costs would reduce cash available for dividends and share buybacks and was contrary to guidance given in the March strategy update.

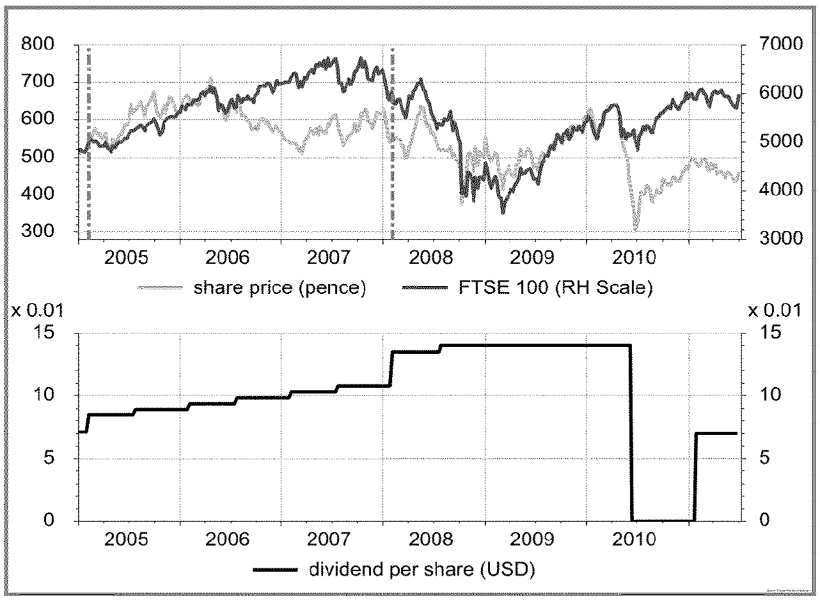
ii) Dividends – step change increases

Subsequent to 2004 there have also been two large increases in BP's quarterly dividend. In each case, it can be claimed that investors did not perceive this as being linked to an improvement in underlying operational cash flows; 2005 saw the quarterly dividend increased by 19.7% from 7.1 to 8.5 cents per share. In

2008 there was a further step-change increase of 24.9% with the dividend jumping from 10.825 to 13.525 cents per share.

Figure 2 below shows the history of BP's dividend per share since 2005 along with the share price over the same period. The dashed vertical red line on the upper share price chart marks the announcements of dividend increases in 2005 and 2008. In the case of the 2005 increase it is possible to see an increase in the share price following the announcement, although this was not sustained in the long term. However, it is hard to discern any positive reaction to the 2008 increase announcement.

Figure 2: BP share price and dividend per share since 2005



Conclusion

The Group should determine the appropriate level of shareholder returns and their apportionment between dividend and share buyback, with regard to the Group's financial risk profile and its business strategy, as these will determine investment requirements and likely levels of underlying cash generation from the Group's assets.

The level of the dividend should be grown only to an extent that does not restrict the Group's ability to undertake attractive investment opportunities: there is a balance between investing for growth and using cash for dividends or buybacks. The February presentation to the investment community set out an intention to target growth from the lower base that would follow our divestment programme. Clearly, any cash used for shareholder distributions becomes unavailable for incremental organic or inorganic investment opportunities.

Share buybacks will not in themselves create value, although they remain an important tool to use as a means to return truly surplus capital to investors when the operating environment and broad context support it. However, given the continuing uncertainty over the level of Gulf of Mexico liabilities, which necessitates keeping the cash buffer intact for the time being, we recommend establishing a set of strategic criteria that need to be in place before we recommence a share buyback.

As discussed previously, we recommend criteria along following lines:

1. **Gearing**. Bringing our position into the lower part of the 10-20% gearing band.
2. **Material completion of the divestment programme** to remove the risks that cash proceeds will be delayed or not delivered.
3. **Potential final costs from Macondo** should be known with greater clarity.

BP Treasury
July 2011

APPENDIX

Table 1: Quarterly Summary of Cash Flow for BP

	2Q '10 to 1Q '11	**1Q 2011**	**4Q 2010**	**3Q 2010**	**2Q 2010**		**1Q 2010**
$ million							
Operating cash flow	**8,327**	2,404	(178)	(652)	6,753		7,693
memo: GoM cash outflow	***(18,800)***	*(2,800)*	*(5,400)*	*(9,100)*	*(1,500)*		*n/a*
Cash from (used in) investing activity	**(4,618)**	(4,871)	2,155	2,832	(4,734)		(4,213)
Cash from (used in) financing activity	**8,183**	2,442	3,947	3,182	(1,388)		(4,901)
FX differences	**(7)**	195	(171)	131	(162)		(77)
Increase in cash during period	**11,885**	170	5,753	5,493	469		(1,498)
Cash at beginning of period	**6,841**	18,556	12,803	7,310	6,841		8,339
Cash at end of period	**18,726**	18,726	18,556	12,803	7,310		6,841

Source: BP p.l.c. Quarterly Results Announcements

Table 2: Net Debt Ratio

	1Q 2011	**4Q 2010**	**3Q 2010**	**2Q 2010**	**1Q 2010**
$ million					
Gross Debt	46,232	44,420	39,182	30,527	32,001
Cash	(18,726)	(18,556)	(12,803)	(7,310)	(6,841)
Net debt	27,506	25,864	26,379	23,217	25,160
Equity	103,183	95,891	90,366	86,362	104,978
Net debt ratio	21%	21%	23%	21%	19%

Source: BP p.l.c. Quarterly Results Announcements