Financial Framework Refresh

The Group's Financial Framework was restated in 3Q 2010 after the Deepwater Horizon incident to define the standard required for a more resilient capital structure, particularly in the light of the accident and on-going litigation risks. The Financial Framework followed the model of our existing Financial Framework with 4 explicit public statements but backing it up with 3 further more sharply internal statements and 6 financial parameters. The progress of the Group towards this structure has been monitored by the GFRC.

Having used the framework for 18 months, the following refinements to the Framework are now recommended. The attached Financial Framework Dashboard has been adjusted to reflect these changes:

- **Review of financial parameters/metrics:** We currently track the both the "key financial parameters" and a slightly expanded set of "key metrics". It is recommended that this is simplified to one set of "key financial parameters" with the following modifications:
  - **Funds from Operations/Expanded debt:** This is the most critical financial ratio used by the rating agencies. Our chosen measure is based on S&P methodology. The current framework targets a 70% ratio. S&P indicate a through cycle ratio of >60% is adequate to support a AA ratio. The original target was set at 70% to provide a cushion but it currently looks unrealistic and unnecessarily prudent. It is therefore proposed to drop the target to >60%.
  - **Replace "Adjusted gearing" (%) with "Net Debt" ($M):** Our key parameters currently include both "adjusted gearing" and "net book gearing". As a metric "gearing" has significant limitations and is potentially misleading where capital employed grows rapidly but cash generation remains flat. "Net book gearing" is one of the public targets of our Financial Framework and therefore needs to be retained. "Adjusted gearing" is little used and the impacts of "expanded debt" are reflected in the more useful ratio above of FFO/expanded debt.
  - **Definition of "Net Capex":** It is recommended that this parameter is defined as the current year's planned capex (organic plus inorganic less disposals). Currently this is a critical measure in managing the Group's financial risk.
  - **Remove additional financial metrics "EBIT/interest cover" and "Cash:ST Debt" :** These are two additional metrics. The "EBIT/interest cover" ratio is easily met currently and to reduce the number of metrics, it is recommended that it is removed. "Cash: ST Debt" is unrealistically tight at >2 times and is inconsistent with our cash buffer target of $10bn. Given debt maturities each year of up to $6bn and around $3bn of average other short term debt in the Group, this would imply the need to hold a cash buffer of $18bn rather than $10bn. Given the Group's strategic priorities and financial position, this level of cash holding is neither likely to be achievable nor is it clear it is required or optimal given the negative arbitrage costs of holding cash.
  - **Managing the Cash buffer:** Previously we have used a variety of definitions for measuring the cash buffer including total cash, an S&P definition of cash and our own definition of "Treasury Cash" which is the most conservative. Going forward

we will standardise on "Treasury Cash". Recognising that this is a conservative approach, we will manage Treasury cash within a range of $8bn to $12bn. We will also taking into account known future cash flows. If there are large planned outflows we will aim to be at the top of the range. Conversely, if there are large known inflows or we are at the bottom of a defined cash cycle, we will be at the bottom of the range. This will be supported by the Group's cash forecasting and stress testing processes. Falling below the range will cause us to review interventions including working capital management and emergency funding options.

  - **"Rollover risk" of CP:** BP needs to retain a rolling balance of around $1bn CP to maintain a presence in the market. In periods of liquidity tightening, one of the levers that Treasury uses to boost cash is to issue additional long-dated CP. This provides additional breathing space but the short-dated nature of CP increases rollover risk. To flag the increased risk of CP funding it is recommended that the target cash buffer is increased to match any CP financing over $1bn with less than 3 months to maturity.

- **Governance**: The governance structure around the Group's Financial Framework has not been explicitly stated. The following accountabilities are proposed:
  - External statements concerning the Group's framework are "owned" by the ETM.
  - The internal statements underpinning the Framework and the accompanying financial parameters are "owned" by the Group CFO.
  - The GFRC will support the Group CFO by monitoring performance against the Financial Framework using data provided by Finance (Treasury Finance) based on GFO data.
  - Accountability to review and recommend changes to the Financial Framework rests with the Group Treasurer

BP Treasury
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