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ccBG

SECRETARY OF STATE FOR ENERGY
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The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

NBPM.

22 May 1986

Dear Nigel

BGC PRIVATISATION: SELLING AND DISTRIBUTION COMMISSION

Our officials have had a number of discussions with our advisers on the rate of commission to be paid to selling agents (brokers and licensed dealers), intermediaries (eg solicitors and accountants) as well as distribution agents (ie the clearing banks).

We have pressed Rothschilds and Cazenoves very hard to improve on the rates applied in the British Telecom sale. They have done this, as you will see from the enclosed letter jointly from Michael Richardson and Anthony Forbes. They recommend a reduction in the distribution commission for clearing banks from the 2% paid in BT's case to 0.375% for BGC. They further recommend a reduction for the rate to be shared between selling agents and intermediaries from 2% to 1.75%. They calculate that, although the BGC sale could be about twice the size of BT, the likely cost of commissions will be £9.3 million against £11.6 million.

You will note that they advise in very strong terms against a further reduction. Having considered this advice very carefully, I feel bound to accept it. It is vital to motivate all those concerned with the sale, who will have to work much harder for their commission than in the case of BT as:

(a) The BGC sale will be much bigger than BT, not to mention secondary issues such as Cable and Wireless and Britoil;

(b) BGC will intrinsically be a much more difficult stock to market than BT, lacking its high-tech attractions and overshadowed by the fall in oil prices and hence BGC's profits;

(c) Rothschilds and our other advisers are committed to much finer pricing than the BT issue. It would be folly to have to accept a higher premium in the after market because we had demotivated the whole sales campaign;

(d) Market conditions were ideal for the BT sale. Unfortunately we cannot be confident that we will be in a bullish market situation in November;

SECRETARY OF STATE FOR ENERGY

(e) We are trying to expand the number of new shareholders very dramatically, which will involve a great deal of extra effort by all the selling agents and intermediaries.

Your officials have suggested that we should pay rates similar to those offered in recent secondary and tertiary issues. These issues are very much smaller than BGC - less than 10% of the size in the case of Britoil. The stocks are known and have established market prices. Indeed our advisers have questioned whether there was in fact any need to pay such commissions at all in these secondary and tertiary issues. It is therefore not surprising that, as your officials have pointed out, the regional brokers involved have not complained about commission levels in those very different circumstances.

I should add that we have consulted our independent (unpaid) adviser on fees, who helped us obtain such fine rates for Rothschilds and Cazenoves own appointments. He is of the firm opinion that we would all be in danger of being penny wise and pound foolish if we tried to squeeze the 1.75% rate further on this occasion.

I accept that you are concerned to reduce the commission rates not only for BGC but for other future primary privatisations, eg Rolls-Royce and British Airways. Michael Richardson has made the point that many of these are much smaller than the BGC issue and intrinsically more attractive. Moreover, having successfully reduced the rates for BGC it should be easier to reduce the rates further on future occasions.

There will be a major meeting of regional brokers at the Salters Hall on 27 May. It is very important to be in a position to tell them the rates at that meeting. It would get the whole marketing campaign off to a very bad start if we are unable to do so. It would almost certainly get into the Press. I therefore propose to authorise Rothschilds to announce the rates set out in the joint letter from Rothschilds and Cazenoves at that meeting.

I am sending a copy of this letter and enclosure to the Prime Minister.

Yours

PETER WALKER

RR3.85

ccBG

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

23 May 1986

G S Dart Esq
Principal Private Secretary to the
Secretary of State for Energy

DW - to note o/r.

NBPM

Dear Geoff,

BGC PRIVATISATION: SELLING COMMISSIONS

The Chancellor has seen your Secretary of State's letter of 22 May.

In the Chancellor's view, the City case is arguable, but he is prepared to accept your Secretary of State's judgement.

I am copying this letter to David Norgrove (No.10).

Yours ever
Rachel

MRS R LOMAX
Principal Private Secretary

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J. R. S. Guinness, CB,
Department of Energy,
Thames House South,
Millbank,
London SW1P 4QJ.

21st May, 1986

Dear John,

Selling and Distribution Commissions

We have, in conjunction with Cazenove's, given further consideration to the levels of selling and distribution commissions we would recommend.

This matter has now become a matter of utmost urgency in view of the regional co-ordinators briefing on Tuesday 27th May, 1986 where we are committed to divulging details of selling and distribution commissions. It is now too late to postpone this briefing and we are concerned that our inability to provide the expected information will become public knowledge, result in adverse comment and stunt the whole thrust of the marketing campaign at its inception.

Selling Commission

When considering selling commissions it is important to differentiate between the element retained by the selling agent and the element reallowed to the intermediary. In each of the four previous privatisations, where selling commissions have been paid, the element retained by the selling agent has been fixed at 0.75 per cent. The element which has varied is the amount reallowed to the intermediary which was 1.25 per cent. in the case of British Telecom and 0.5 per cent. in the case of the three recent secondary and tertiary issues. I think it is worth touching separately on both elements.

The critical role of selling agents, and regional co-ordinators in particular, in informing and educating potential investors and intermediaries should not be under-estimated. Given the desire to attract a much larger number of applicants than was the case in British Telecom it is imperative that selling agents are strongly motivated and thereby generate a large and favourable response. It must be remembered that regional co-ordinators are not receiving a fee and the extent to which their expenses will be reimbursed is limited to £7,500 which is only a proportion of their anticipated total marketing expenditure.

The variation in the amounts reallowable to intermediaries reflects the very different circumstances surrounding the marketing of a primary issue such as British Telecom and the marketing of a further tranche of an already listed security as was the case in the other three issues. It is important to recognise that an intermediary, in his role as financial adviser, is required to exercise a much greater degree of judgement in a primary issue as there is no market price to act as a benchmark against which to evaluate the offer for sale price.

We are concerned, therefore, that there must be a suitable incentive for intermediaries so as to persuade them to set aside the required time to analyse BGC and evaluate its suitability as an investment to recommend to their clients. The intermediaries initial reaction to the level of commission will be critical in determining their support. We believe this reaction will be based partly on a comparison with the rates of commission paid in British Telecom (rather than the levels in the three other issues) and also by comparison with commissions payable on other investments such as unit trusts, i.e. up to 3 per cent. Therefore we must ensure that the commission rates declared do not disappoint intermediaries - this is particularly important given that HMG's allocation policy has resulted in relatively small allocations and therefore restricted amounts of commission per application.

However, we recognise HMG's desire to reduce costs where this is cost effective and therefore we have sought to establish the minimum acceptable level of selling commissions to ensure getting the issue away without prejudicing the success of the flotation. We believe that with careful presentation selling commissions can be reduced from the British Telecom levels and our recommendation is a rate of 1.75 per cent. of which 1.0 per cent. is reallowable to the intermediaries on allocations up to £10,000 - the 1.0 per cent. payable to intermediaries has the benefit, from a marketing perspective, of being an easily ascertainable figure.

At your request we have considered whether we could recommend a figure below 1.75 per cent. but we have concluded that the risk associated with any further reduction is not justified by the consequent cost saving. As you know we have always stressed that the key to a successful flotation lies in generating a strong retail demand. With such a demand we believe it may be possible to persuade U.K. institutions to pay a premium price for their firm allocation and, in addition, to persuade overseas investment houses to take shares at the same price as U.K. institutions. We are anxious to maximise this premium and believe it would be foolish to jeopardise it for a relatively small saving on selling commissions.

Treasury officials yesterday suggested certain ways of reducing or restructuring the level of proposed commissions without affecting the motivation of intermediaries and selling agents. They have proposed three ideas in particular and we have considered each in turn:-

1) To reduce selling commissions from 1.75 per cent. to 1.25 per cent. and compensate regional co-ordinators by increasing their expenses from £7,500 to a figure of, say, £12,000 to £15,000. The proposed level of expenses is likely to be only a relatively small portion of the expenses incurred by regional co-ordinators - it would still not cover the advertising expenditure of the actual example of one regional broker's expenses set out in Appendix III. More importantly however it is essential for the success of the offer that all selling agents are fully motivated. Therefore we would have serious reservations concerning any scheme which attempts to compensate regional co-ordinators for a reduction in selling commissions but does not extend to other selling agents. Accordingly, it is our belief that the level of selling commissions must be set at a level which motivates a wide range of selling agents - we would draw your attention to the fact that 76 per cent. of total commissions in British Telecom were paid to firms who were not regional co-ordinators - in Cable & Wireless this figure was 65 per cent. Furthermore this Treasury proposal does nothing for selling agents who bring much of the business to the brokers. Whilst any increase in the levels of expenses would be beneficial it is our view that the additional expenses incurred by regional co-ordinators are compensated for partly by the amount reimbursed and partly by their positioning in the offer.

2) To review the whole concept of selling commissions and, in particular, that of reallowance. The proposals envisage selling commission being paid directly to the

intermediary rather than, as present, the intermediary receiving a portion of the commission by way of reallowance. We have already made clear the importance we attach to the role selling agents play in informing and educating intermediaries. A critical part of their task is to combat the inertia of intermediaries who are by and large very conservative - this is achieved in various ways but the most important are through the provision of professional investment advice and logistical support to ensure accurate and timely submission of applications. Furthermore most solicitors and accountants will want to rely on the professional market assessments of the brokers. They would be imprudent not to do so and HMG should think very carefully about encouraging, say, solicitors to offer market advice without consulting brokers.

The Treasury's proposed structure would, as a minimum, eliminate the incentive for selling agents to involve intermediaries. This would not only have a serious impact on retail demand but would undermine the concept of roadshows aimed at intermediaries as the regional co-ordinator, who is charged with promoting the roadshow, would have no interest in involving intermediaries.

3) To introduce negotiable rates of reallowance. We believe that the introduction of negotiable commissions will only serve to complicate the offer and that given the limited time available for the submission of applications we should strive to keep the system as simple as possible. The emphasis in the selling period must be to maximise the selling effort to produce a successful subscription and this will not be served by introducing a whole series of negotiations between selling agents and intermediaries.

Accordingly, we do not believe these methods enable us to recommend a reduction in the rate of the minimum selling commission and we would reiterate our opinion that selling commissions are essential in generating a retail bandwagon with all its consequent impact on institutional and overseas demand.

We have also reconsidered the level of selling commissions on applications over £10,000. I think we are all agreed that we should encourage applications in excess of £10,000 and that this will not be easy given the widely held view on HMG's allocation policy. Whilst we may be able to make noises that larger applications are worthwhile we believe that the selling commissions must be made suitably attractive to persuade selling agents and financial intermediaries to recommend sizeable applications to their clients. Accordingly, we would stand by our earlier recommendation that selling commissions on allocations over £10,000 should be at a rate of 1.75 per cent. on the first £10,000 and 0.5 per cent. on the balance. However, we do believe that it would be appropriate to introduce a maximum commission for each application so long as the maximum represented a sufficient incentive. We would suggest a cap of £375 which, on the above format, would be effective on any application over £50,000.

Distribution commissions

We have also reconsidered our earlier recommendations on the level of selling commissions and believe that the rate of 0.375 per cent. applicable in the recent Britoil and Cable and Wireless issues should be retained.

However, we recognise that the clearing banks through their role as distributors of prospectuses are not as influential as the selling agents in determining the size of applications. Accordingly, we believe that it would be acceptable to cap the distribution commission at £37.50 per application - being 0.375 per cent. on £10,000. Accordingly we would recommend a distribution commission of 0.375 per cent. or £37.50 whichever is the lower.

Summary

We have summarised the proposals in the attached Appendix I.

Finally, we have compared the possible cost of the commission structure we are proposing with the actual cost for British Telecom. This comparison is obviously heavily dependent on certain assumptions, notably the size of the offer, the portion available to the U.K. public, the number of forms actually stamped and the impact of any customer share scheme. However, based on the assumptions set out in the attached Appendix II, we believe the likely cost may well be below that of British Telecom even though the size of the offer is significantly increased. This is partly the result of the reduced level of selling commissions (1.75 per cent. from 2 per cent.) and partly because of the changed treatment for the clearing banks (0.375 distribution commission compared to 1.5 per cent. selling commission).

We have also obtained a breakdown of the commissions received and reallowed by one of the regional co-ordinators in the British Telecom issue. These are set out in Appendix III and they are informative not only for giving an indication of the return, net of expenses, for regional co-ordinators but also for indicating the number of intermediaries involved and their average level of commissions - £73.

As we agreed, this letter represents the joint views of ourselves and Cazenoves and therefore both Anthony Forbes and I have signed this letter. It has also been discussed with both Kleinwort, Benson and Hoare Govett who are in agreement.

Yours sincerely,

Michael Richardson

Michael Richardson

Yours sincerely,

Anthony Forbes

Anthony Forbes
Cazenove & Co.

Attachment

Appendix I

Selling and Distribution Commissions

SUMMARY

Selling Commissions

	Total	Re-allowable
0 - £10,000	1.75%	1.00%
above £10,000	1.75% on first £10,000 and 0.5% on the balance subject to a maximum of £375.	1.00% on first £10,000 and 0.25% on the balance subject to a maximum of £200.00.

Distribution Commissions

The lower of 0.375% or £37.50

Appendix II

Selling and Distribution Commissions

Assumptions

1. £6 billion equity offering.

2. 30 per cent. allocated to U.K. public.

3. 40 per cent. of U.K. public applications stamped (compared to 41 per cent. in BT).

4. Of stamped forms 1/3rd are stamped by banks, 2/3rd's by selling agents (compared to 34.5 per cent. banks and 65.5 per cent. others in BT).

5. No allocations over £10,000.

Commissions paid/payable

B.T.	- actual	£11.6 million	(0.77 per cent. of the public issue)
BGC	- estimate	£9.3 million	(0.52 per cent. of the public issue)

Note: No account has been taken of a possible customer share scheme and its impact on the number/amount of applications which are stampable.

Appendix III

Selling Commission from British Telecom issue

1. Split of Gross Selling Commission

		%	£
Amount retained	-	69	69,000
Amount reallowed	-	31	31,000
Total		100	£100,000

2. Brokers' income/expenditure

		£
Retained commission		69,000
Fees/expenses reimbursed		15,000
		84,000
Less expenses incurred:		
Direct advertising	18,400	
Printing	10,000	
Travel	4,000	
Mailing	9,600	
		43,000
Surplus		£41,000

3. Intermediaries

425 intermediaries introduced 9,900 applications representing an average of 23 applications each and commission of £73 per intermediary.

Note: All figures supplied by a regional co-ordinator with the exception of the amount of gross selling commission which is in accordance with the approximate figure indicated at the meeting on 14th May, 1986.