

## HOW TOP SHELL EXECs FOUND THEMSELVES OVER A BARREL

**Following Shell's disclosure in January 2004 that it had miscategorised 3.9 billion barrels of oil equivalent (boe) of its "proved" reserves, the group appointed law firm Davis Polk & Wardwell to conduct an independent investigation.**

The firm delivered a 463-page report to the General Audit Committee (GAC) in March, which has been accepted in full by the Shell board. An executive summary was made available on Shell's website in April.

Walter van de Vijver succeeded Sir Philip Watts as CEO of Shell's Exploration & Production (EP) business in 2001. He told Davis Polk that, soon after he took office, he noticed that "the health of the EP business was not as robust as the company-determined performance targets set under the former EP CEO [Sir Philip]. In fact, it was in a far worse state... than was portrayed by my predecessor to senior management..."

Van de Vijver claimed repeatedly over the years that reserves booked during Sir Philip's tenure were "premature" or "aggressive", and did not comply with Shell guidelines, hence, were also in violation of SEC requirements. He added that the premature booking of reserves had frustrated his ability to meet business targets.

Davis Polk concluded that the reserves problem was seen as "a serious and immediate business question but not, equally, as a regulatory and disclosure failing", even though from 2001 onwards there was a "growing recognition" within Shell that the reserve data was not fully compliant with SEC

rules. In February 2002, van de Vijver sent a note to the Committee of Managing Directors (CMD) pointing out that recent SEC clarifications "make it apparent that the [Shell] guidelines for booking proved reserves are no longer fully aligned with the SEC rules." He added that some 2.3 million boe may be "exposed" as a result.

Sir Philip called for van de Vijver to submit a second report to the CMD, forewarning him in May 2002 that he must leave "no stone unturned" to effectively make the reserve problem go away.

Van de Vijver's second report in July 2002 made no mention of the SEC non-compliance. The strategy, Davis Polk says, was to play for time, hoping that circumstances would improve to allow improperly booked reserves to ultimately qualify.

### Fooling the market

But business conditions did not improve enough to justify historic bookings. In September 2002, van de Vijver wrote to the CMD (and CFO Judy Boynton) that "the market can only be fooled" if credibility in Shell remained high, portfolio replenishment was high enough and other KPIs were showing positive trends: "Unfortunately... we are struggling on all key criteria."

Following further conversations with Sir Philip, van de Vijver replied in October 2002: "I must admit that I become sick and tired about arguing about the hard facts and also cannot perform miracles given where we are today. If I was interpreting the disclosure requirements literally (Sarbanes [sic]-Oxley Act etc), we would have a real problem."

In a note regarding the business plan circulated to EP staff, van de Vijver made clear that the only reason for submitting this plan was "to protect the group reputation externally (promises made)" and because it was not possible to be "honest about past failures (... disconnect from reality... reserves manipulation)."

Similar discussions took place through 2003 until, at the end of the year, troublesome reserve audits and a draft memorandum containing legal advice to EP prompted the process that resulted in the January 2004 revelations. A "script" sent to van de Vijver by EP staff warned that the report proved reserves were "materially wrong" to the tune of about 2.3 billion boe and that disclosure of this fact could not wait until publication of the annual report in April 2004.

Van de Vijver responded to one of the authors – the EP CFO – saying: "This is absolute dynamite, not at all what I expected and needs to be destroyed." The CFO consulted a number of people and, in fact, retained the document. But van de Vijver deleted the email from his CFO.

### Disclosure

As the reserve review process – project Rockford – got underway, van de Vijver wanted to make clear that "the problem was created in the 90s and foremost in 97-00 and any clean-up must reflect that. I will not accept that it was OK then but not OK with the better understanding of SEC rules now, and that it took us 2 1/2 years to come to the right answer."

But at the press conference in January, van de Vijver said that the

catalyst for the disclosure was a recent review of particular oil fields, which "immediately sort of triggered the process to look at the whole globe". Sir Philip added: "We've always believed – and I've always believed – that Shell in aggregate was materially compliant... we relied on audits... [When] it came to my attention, it was a matter of all hands on deck. And I remember writing down the words, 'Get the facts and do the right thing.'"

### Lessons and observations

- The internal reserves audit function was undertrained.
- The Shell guidelines were slow to incorporate SEC interpretations.
- CFO Judy Boynton took no action on the aggressive reserves, relying instead on financial auditors.
- Until recently, none of the business unit CFOs reported to Boynton. "For this and other reasons, on the issue of reserves, it may be that her responsibility exceeded her authority," the Davis Polk report says.
- The General Audit Committee was not provided with the information that would have allowed them to identify the issue.
- Van de Vijver blamed the corporate culture and said Sir Philip and Boynton frustrated his efforts to have the reserves problem disclosed.
- "It is critical that Shell enforce a culture of compliance," concludes the report. "Management and employees must recognise that their conduct is required to be in accord with the highest ethical and legal standards."

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