

Out in the Cold

Serious concerns for shareholders identified by U.S. Department of the Interior review

April 2013

Background

Shell's 2012 Alaskan Arctic programme descended into a series of setbacks. These include a failure to secure timely certification of its containment ship, the Arctic Challenger, the failure in testing of vital spill containment equipment, air permit violations and anchor dragging of one of its rigs, the Noble Discoverer, culminating in a failure to secure permission to drill for hydro-carbons. In December, matters degenerated further with the running aground on New Year's Eve of its other drilling rig, the Kulluk.¹

On 8th January, 2013 the U.S. Interior Secretary, Ken Salazar, announced a 60 day review of Shell's 2012 Alaskan Arctic offshore drilling programme *"to review practices and identify challenges as well as lessons learned."* The review was to *"look at Shell's safety management systems, its oversight of contracted services, and its ability to meet the strict standards in place for Arctic development."*²

On 27th February Shell announced that it was 'pausing' its 2013 Arctic drilling programme *"to prepare equipment and plans for a resumption of activity at a later stage."*³

On 8th March, 2013 the U.S. Department of the Interior review (the "Review") was published.⁴

On 22nd March, 2013 it was reported that David Lawrence, executive vice president responsible for exploration activity in the Americas, is to leave Shell mid-year.

This briefing sets out key extracts from the Review highlighting issues which should be of concern to Shell shareholders including a lack of contractor oversight. This briefing will also highlight the differences between Shell's own reporting of its 2012 Arctic operations in its annual report on the one hand and the Review on the other. Finally, it suggests some questions for shareholders to ask of Shell.

The Review

The Review is highly critical of Shell. It identifies 7 key principles and prerequisites for safe and responsible offshore drilling in the Alaskan Arctic of which 5 apply to industry. The report finds that Shell fell short on all but one of those five principles.

Lack of Preparation

Shell entered the drilling season not fully prepared in terms of fabricating and testing certain critical systems (including its spill containment systems) and establishing the scope of its operational plans.

Examples

Even though Shell committed to building and deploying a sub-sea containment system in mid-2010, work on designing and fabricating this system did not begin until late 2011, *less than nine months* before the intended drilling season.

It was not until March 2012 – *only four months before* the planned start of the Arctic drilling season – that the Arctic Challenger was moved to Washington for essential works.

The Review states on page 23: *“In submissions to the Department of the Interior, Shell consistently underestimated the length of time required to complete each step of its drilling operations. The timelines provided by Shell proved to be unrealistic and did not account for complications and delays that should be budgeted for when operating in the Arctic.”*

The Review on page 19 identifies the following factors as contributing to Shell’s inability to obtain certification of the Arctic Challenger in time:

- (a) the selection of a vessel in need of significant retrofitting;
- (b) the late start of design and construction operations, all contributing to unrealizable timelines for construction, testing, and obtaining Federal approvals;
- (c) insufficient engagement by Shell management and technical personnel;
- and
- (d) turnover of certain contractor staff.

Contractor oversight

There were *“significant problems with contractors on which Shell relied for critical aspects of its programme”*⁵. This is an issue that requires further examination. Lack of contractor oversight was, after all, one of the root causes of the Deepwater Horizon disaster. The Review describes the problems with contractor management and oversight as *“the most significant shortcomings in Shell’s management systems.”*⁶ It is also worth noting that the need for stricter monitoring of contractors carrying out remediation works has been identified as an issue requiring attention at Shell’s Nigerian subsidiary in a recent International Union for the Conservation of Nature report.⁷

Superior Energy Services (Superior).

Shell contracted with Superior to design, fabricate, own and operate the Arctic Containment System (ACS). The ACS is a containment system designed to capture oil and gas from a capping stack or from a containment dome. The ship, The Arctic Challenger was chosen as the surface support vessel for the ACS.

Shell was not actively involved in overseeing Superior’s progress, and in developing solutions to emerging problems, during most of the refurbishment and classification process for the Arctic Challenger. Shell did not have naval or marine engineering expertise to advise on the Arctic Challenger refurbishment and to identify and troubleshoot problems alongside Superior. The Review states that Shell personnel described Superior’s work on the ACS during late 2011 and the first half of 2012 as a *‘black box.’*

It was not until June 2012 that Shell engaged directly and at a high level on the problems with the Arctic Challenger.

“ *The most significant shortcomings in Shell’s management systems were in the area of contractor management and oversight.*”

*U.S. Department of the Interior Review
p.31*

By the time certification was received, the drilling window had closed.

The Review, in analysing problems with another component of the ACS, the containment dome, refers on page 19 to the *“significant communication problems between Shell and Superior.”* It also states that during the testing of the containment dome on the Arctic Challenger, officials *“observed the absence of clear lines of authority on the vessel.”*

The Review finds that the delays in the completion of the Arctic Challenger and the failure of the containment dome arose from Shell’s *“lack of rigorous and direct contractor oversight.”*⁸

The Review on page 31 criticises Shell’s selection of Superior as a contractor. It notes that the selection appears to have been based on a long-term relationship rather than informed *“by a robust analysis of the scope and risks of the ACS project specifically.”*

Noble Corporation (Noble)

Noble is the owner of one of Shell’s drilling rigs, the Noble Discoverer. In July 2012, the Noble Discoverer dragged its anchor in Dutch Harbor. On 27th December 2012, it was announced that the U.S. Coast Guard had highlighted ‘deficiencies’ and ‘maintenance issues’ on one of Shell’s two Alaskan drilling rigs, the Noble Discoverer.⁹ On 4th January 2013, CBS News reported that the U.S. Coast Guard had called in their criminal investigation team to investigate whether federal laws had been broken.¹⁰

The Review states that these failings can be attributed, in part, to Shell’s failure to adequately monitor Noble’s compliance with the appropriate management systems on-board the vessel.

Review’s Recommendations

The Review states the prior to resuming its drilling programme in the Alaskan Arctic, Shell should: (1) submit a comprehensive, integrated operation plan and commission; and (2) complete a full third-party audit of its management systems.

Shell’s Annual Report

8th March also saw the publication of Shell’s annual report.¹¹ Shell sets out its summary of its Alaskan Arctic programme on page 49. It is important to note that Shell’s summary makes no reference to:

1. The fact that the U.S. Department of the Interior was conducting its review;
2. contractors; or
3. the multiple problems with the drilling rig the Noble Discoverer.

To highlight our concerns about Shell’s reporting of its 2012 Arctic operations we offer the following example: Shell in its annual report claims that it has *‘developed a thorough oil spill response capability that includes capping and containment equipment, and oil spill response vessels’*,¹² which is in stark contrast to the Review which states in its third paragraph: *‘Shell entered the drilling season not fully prepared in terms of fabricating and testing certain critical systems and establishing the scope of its operational plans.’*

“Shell entered the drilling season not fully prepared.”

U.S. Department of the Interior Review
p.1

Questions for Shell

Contractor oversight at the Shell Group has been identified as an issue in both the Review and at its Nigerian operations. What specific steps is Royal Dutch Shell taking to ensure adequate contractor monitoring across the Shell group?

At what point did *the board* of Royal Dutch Shell become aware of the problems with Superior and Noble?

Royal Dutch Shell held a number of individual and group meetings with investors to discuss progress and setbacks in its Alaskan Arctic operations during 2012. Why were the issues with contractors never highlighted by the company?

Has Shell reviewed its processes for contractor selection in light of the criticisms in the Review of the company's selection of Superior who lacked appropriate certification for ship design and build work?

What lessons from its Alaskan experience and which recommendations from the Review does Shell intend to apply to its Russian Arctic ventures particularly given the recent announcement of a deal with Gazprom?

What changes have been made to internal reporting structures to address the obvious disconnect between the operational reality of ill-preparedness on the one hand and the confident statements by Royal Dutch Shell board members including the Chairman and CEO about the company's ability to carry out its 2012 Arctic plans on the other?

Does Shell feel its reporting of its Alaskan Arctic operations in its annual report present a fair and balanced account in light of the findings of the Review?

Why did Shell not disclose specific information in its Annual Report's Arctic summary regarding contractor failings given that contractor risk is specifically identified as a risk factor in the general risk factor section?

Conclusion

The US Interior Department report is sobering reading for investors. Shell's inadequate preparations, lack of contractor oversight and late response to problems that arose in its Arctic drilling operations has uncomfortable echoes of the root causes of the Deepwater Horizon oil spill. Shareholders need to press the company urgently on its plans to address the multiple deficiencies in its operations before even considering recommencing its Alaskan Arctic project.

About ShareAction

ShareAction (formerly FairPensions) is a registered charity that promotes responsible investment practices by pension providers and fund managers. ShareAction champions greater transparency and accountability to the millions of people whose long-term savings are managed by institutional investors and other professional agents. ShareAction believes that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

ShareAction is supported financially by a number of leading charitable foundations and counts amongst our member organisations a growing number of globally recognised NGOs and trade unions. Over 8,000 individuals support our work both by taking action directly to advance responsible investment and through personal donations.

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The opinions expressed in this publication are based on the documents specified in the end notes. We encourage readers to read those documents.

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ENDNOTES

1. ShareAction, Platform, Greenpeace. Out in the Cold. Repeated Misadventures: Key questions for Shell on its Alaskan Arctic Programme. 01.13 http://www.shareaction.org/sites/default/files/uploaded_files/investorresources/ArcticBriefingKeyQuestions0113.pdf all links accessed on 16.04.13 unless otherwise stated
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12. Ibid. p.49