Changing Drill:
How Shell's Move To Revamp Culture Ended in Scandal

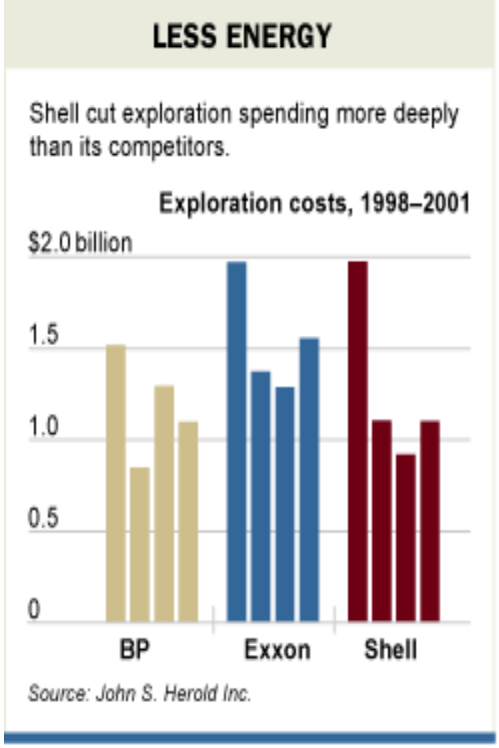
By Chip Cummins and Almar Latour

Wall Street Journal
November 2, 2004

In late 2000, the head of the Dutch exploration unit at Royal Dutch/Shell Group asked his planners to deliver five-minute skits pitching ideas for discovering oil and gas.

In one skit, a naked employee ran on stage to catch the boss's attention, say two people who attended. Another featured a mock episode of the Jerry Springer show, the incendiary daytime TV talk program. A third, after a bit of fun and games, promised to extract large quantities of natural gas cheaply from seemingly declining Dutch fields.

Long known for its sober geological expertise and conservative image, the Anglo-Dutch energy giant in the 1990s embraced New Age management. At other meetings, managers were told to shake their arms up and down in "energizer" exercises or stare into the eyes of colleagues while confiding their innermost thoughts, say attendees.



This cultural revolution ultimately led Shell into one of the worst crises in its history as the company turned to accounting maneuvers to hide its failures in finding energy. This year it admitted that it dramatically overstated its oil and gas reserves.

Last week, Shell said it plans to consolidate its Dutch and British parents under a single board and a U.S.-style chief executive -- ending a dual structure that dated to 1907 and was long criticized as opaque. The current chief executive, Jeroen van der Veer, says he is committed to reform. His predecessor, Sir Philip Watts, and Shell's exploration chief were ousted earlier in the year, and a company investigation placed much of the blame for the reserves overstatements on the two men.

The root of the problem, however, goes significantly further back than Sir Philip's reign, which began in 2001. The skits in 2000 were an illustration of how Shell had increasingly discarded its traditional modus operandi in the 1990s as it adapted to the seemingly permanent fall in oil prices. Some of the new management stunts might have appeared relatively harmless. But the push for unconventional thinking also undermined discipline in Shell's core business of finding oil and gas. A bonus system prodded some managers to make rosy forecasts that they couldn't necessarily meet. Sound estimation of reserves often went out the window in favor of accounting maneuvers.

These deeper roots are significant because the company has yet to make a full break with its past. Mr. van der Veer is a longtime Shell executive who sat on the committee that received -- and dallied over -- warnings about the accounting problems. He says he was aware of potential reserves problems but didn't know about improper bookings. Sir Mark Moody-Stuart, chairman from 1998 to 2001, remains on the board of Shell's English parent although he is set to step down when the reorganization is complete next year. He declined to comment about reserves issues.

And Shell still can't seem to get a handle on its reserves. After assurances earlier this year that it had finished cleaning up its accounts, Shell said last week that it may have to slice reserves by another 6%, or the equivalent of 900 million barrels of oil. Standard & Poor's announced Friday that it will review Shell's double-A-plus credit rating for possible downgrade.

Shell agreed in August to pay about $150 million in fines to the U.S. Securities and Exchange Commission and British regulators to settle charges that it misled investors about its reserves, without admitting or denying wrongdoing.

Shell's accounting problems stemmed from an industry-wide struggle to find energy in a world increasingly picked over or closed off to exploration. When oil prices were low in the 1990s, many companies cut back on exploration spending because they thought it wouldn't bring a return sufficient to satisfy investors. That contributed to today's soaring price of oil -- which, in a twist, may prove to be Shell's rescuer. Shell is confident prices will stay high, so its explorers are again well-funded.

But to find oil and gas effectively, they'll have to restore the standards that made Shell's exploration-and-production unit -- or E&P -- the elite of the industry. Among its feats was the discovery of huge oil and gas reserves in the North Sea in the 1970s.

Until the mid-1990s, a cadre of senior executives known as the "peetvaders," Dutch for godfathers, groomed young executives. The peetvaders sent promising people to the toughest jobs in Shell's empire -- places like Nigeria -- before granting them lofty titles at headquarters.

That started to change under Cor Herkstroeter, a Dutch finance expert who became Shell's top executive in 1993. He began to phase out the peetvader system and let employees apply for openings. "The practical consequence was that the most talented

people no longer went to places where we needed them the most," says one current Shell executive. Mr. van der Veer, Shell's current chief executive, says in an interview that Shell wound up with "gifted amateurs" in key jobs. Mr. Herkstroeter also introduced bonuses to better align pay with performance -- a system that several current and former Shell employees believe encouraged short-term maneuvers to boost results.

Two controversies in 1995 had further distracted management. Protests by environmentalists forced Shell to abort a plan to scrap an old oil platform by sinking it in the ocean. Later, Nigeria executed Ken Saro-Wiwa, who had campaigned against Shell's operations in the Niger River delta.

Mr. Herkstroeter and his heir apparent, Sir Mark, hired consultants and mapped out a campaign to improve Shell's image. Executives were sent out to demonstrate Shell's sense of social responsibility.

Paddy Briggs, a retired Shell communications executive, recalls one event where he and about 40 executives were issued shovels and pick-axes and dispatched to a Dutch village to help it restore an old playground. The oilmen gave up around lunchtime amid heavy rain. Such gimmicks became the butt of jokes, "but nobody said, 'Hey, have we lost our minds here?'" says Mr. Briggs.

Mr. Herkstroeter, now independent chairman of Dutch insurance giant ING Groep NV, declined to comment about the culture changes.

In 1998, Sir Mark, who had led the E&P division, took over from Mr. Herkstroeter as Shell's top executive and redoubled efforts to mend Shell's reputation. In one incident, masked environmentalists hoisted a sign that read "Murderers" on his country home. Sir Mark and his wife served the protesters -- some still wearing masks -- coffee and tea on the lawn. As Shell's image softened, he won a knighthood in 2000 from Queen Elizabeth II.

Sir Mark took a more defensive approach to Shell's core business. The Asian economic crisis sent oil prices tumbling, and he clamped down harder than rivals on spending. He also sat out the merger frenzy in which BP bought Amoco and Exxon took over Mobil. Such mergers replenished rivals' exploration prospects and smoothed the way for cost-cutting, but Sir Mark insisted he could slash fat at Shell without a merger. He also wanted

The new style of management was on display in 2001, when a team gathered at the Golden Tulip, a lakeside business resort in northern Holland, to map out a drilling plan for a Dutch gas field. For a week, managers gave motivational speeches to accountants and geologists, pumping them up during breaks by playing loud rock music, according to one person who attended.

A prominent feature of the meeting was the "fishbowl." Participants sat in a circle, with an empty chair in the middle facing the leader. Anyone who wanted to speak out against a plan by the group had to take the empty chair. The setup was designed to nurture

consensus by discouraging "blockers," people resistant to bold moves, according to executives familiar with the method.

By the end of the week, the group decided new investment could double the estimated gas reserves in the field, according to one participant. The forecast won the group coveted funding from headquarters. But after spending about $125 million drilling, engineers didn't find new gas, says this participant. He calls the whole process an example of how Shell's new management culture undermined the checks and balances that underlay traditional planning.

Current and former Shell employees say another feature of such meetings was the "energizer" exercise, in which managers held the hands of their colleagues and rapidly shook their arms up and down. On at least one occasion, employees were told to hold the hands of a colleague and reveal their innermost thoughts. A male employee recalls finding the exercise awkward when he was paired with an attractive Italian female colleague.

"If I look back, there was a bit of ... the 'dot-com' culture," says Mr. van der Veer, the current chief executive, in an interview. Describing Shell's euphoria at the time, he says, "Everyone thought that trees would grow into heaven."

Veteran engineers began trading grim jokes about falling standards, according to current and former employees. New hires were called "Nintendo" engineers, a jibe at a generation more familiar with computer modeling than field experience. E&P at Shell, went another line, stood for Excel and PowerPoint.

In the summer of 2000, E&P planners met in The Hague. The participants concluded that Shell's way of allocating capital to projects "appears to be flawed with overstatements of key parameters to secure funds," according to briefing papers from the meetings.

By 2001, Shell was replacing only 74% of the oil and gas it depleted. At Exxon and BP, this "reserve-replacement ratio" was above 100%, according to a February 2002 memo prepared for Shell's Committee of Managing Directors, at the time the company's top executive body.

In addition to its ambitious plans to discover new oil and gas cheaply, Shell under Sir Mark was redefining how it counted existing reserves. These are defined as oil and gas in the ground that a company expects to pump and sell. Oil companies have long had to report reserves to the SEC but have wide discretion over assumptions behind the calculations.

Sir Mark's point man was Sir Philip, an Englishman who once donned a space suit at a meeting in Maastricht, Netherlands, in 1998 to pump up his troops. In a June 1998 memo, Sir Philip declared that he would bring Shell's reserves accounting "more in line with industry practice." People familiar with the situation say this meant matching what Shell saw as more aggressive reserves booking by Exxon and others in mature fields. At the

same time, according to an SEC investigation released in August 2004, Shell kept its existing booking method for young fields, which was more aggressive than others. Sir Philip has said he depended on internal and external auditors to assure him that reserves were solid. Through his lawyer, he declined repeated requests for an interview.

By the end of 2001, the revised accounting procedures boosted Shell's reserves by 1.2 billion barrels of oil equivalent, according to internal estimates contained in Shell briefing notes in 2002. That equaled some 6% of Shell's reserves. The SEC this year determined that Shell failed to justify the new bookings with adequate analysis, though it isn't clear how much of those bookings were inappropriate by SEC standards.

Although regulators have focused much of their fire on the 1998 change, it explains only a fraction of the over-booking problem, which has totaled 4.47 billion barrels so far according to Shell. In many cases, according to Shell employees and internal documents, it was zealous E&P managers at Shell units around the world who boosted reserves estimates -- not necessarily by using new rules but by applying their own discretion to revise numbers upward. They were egged on in some instances by a new culture that rewarded what was perceived as risk-taking and unconventional thinking.

The new numbers made Sir Philip look like a star. In 2001, he was rewarded with the top job, succeeding Sir Mark. But Shell's internal reserves auditor, Anton Barendregt, was raising red flags. Mr. Barendregt's job was to review Shell's annual submission to the SEC. In an audit report in January 2001 filed to Sir Philip and other E&P bosses, Mr. Barendregt concluded that engineers felt pressure to book reserves aggressively in part because they were tied to bonuses. In at least one instance, Mr. Barendregt found such pressures led engineers to produce an "extremely marginal reserves booking" for a Shell field in Angola.

Shell's Angola staff had booked new reserves equal to 74 million barrels of oil, Mr. Barendregt wrote. He met with the Angola staff late in 2000 and encouraged them to craft a development plan to justify the booking as economically realistic. In his year-end audit report, however, Mr. Barendregt wrote that while a plan was submitted, the planners made it clear they were doing so only to get the new reserves counted. He signed off on the booking as "only just supportable" -- an example of his reluctance to rock the boat, which later led the SEC to criticize Mr. Barendregt as insufficiently independent from Shell.

In 2002, Mr. Barendregt warned top executives at E&P that problems persisted. The SEC in 2001 had issued clearer guidance about booking reserves but some executives weren't familiar with it, he wrote. In February 2002, the new E&P chief, Walter van de Vijver, warned Sir Philip and other managing directors that about one billion barrels of reserves -- about 5% of Shell's total at the time -- might run afoul of the SEC's guidelines.

In another memo to top management that July, Mr. van de Vijver discussed Shell's problems finding new oil and gas and suggested ways to deal with the problem, including a simple accounting maneuver. At the time, Shell was considering partially removing a

Russian affiliate from its books for unrelated business reasons. By holding off on the move, Mr. van de Vijver suggested, Shell could maximize its reserve bookings from the affiliate in years to come.

"This would serve only to temporarily mask our underlying problem," he wrote. But the impact of keeping the affiliate fully on the books "whilst essentially being a 'paper' gain would in effect solve our reserves replacement issues at least until the end of 2004." Ultimately the unit was kept on the books, but Shell has also disclosed the effect of such deconsolidations.

In correspondence made public by Shell in April, Mr. van de Vijver increasingly made clear his frustration about the problems at E&P to his boss, Sir Philip. In an e-mail dated Nov. 9, 2003, he told Sir Philip: "I am becoming sick and tired about lying about the extent of our reserves issues and the downward revisions that need to be done because of far too aggressive/optimistic bookings."

On Jan. 9, 2004, Shell announced it would erase about a fifth of its reserve bookings, sparking U.S. and British regulatory probes. Its dual boards ousted Sir Philip and Mr. van de Vijver in March. Both men deny wrongdoing. Mr. van de Vijver, who declined requests for an interview, has said he acted aggressively to flag problems internally. Shell later cut its reserve bookings three more times.

Shell is now trying to regroup. It is retraining its 3,000 petroleum engineers and technicians in SEC compliance. In a frank speech to Shell's top brass in May, Mr. van der Veer said Shell under his leadership will set achievable targets, lengthen job tenures and reduce reliance on consultants. Shell, he said, will have "no new gurus. We will do it ourselves."

SCANDAL AND OVERHAUL

Milestones for Shell as it went through an accounting scandal and moved to rework a 97-year-old corporate structure.

• **1890:** Royal Dutch Petroleum Co. founded.

• **1907:** Royal Dutch combines operations with Shell Transport & Trading Co.

• **1970s:** Several big oil discoveries in North Sea.

• **1993:** Cor Herkstroeter appointed chairman.

• **1995:** Environmental activists force a reversal on Shell plans to sink an old oil platform, Brent Spar.

• **1998:** Mark Moody-Stuart named chairman.

• **1998:** BP-Amoco and Exxon-Mobil announce mergers.

• **Jan. 30, 2001:** Internal auditor Anton Barendregt warns that bonuses may be encouraging

inflated reserve booking.

• **July 1, 2001:** Philip Watts becomes chairman.

• **Jan. 30, 2002:** Mr. Barendregt warns some Shell booking guidelines may be "too lenient."

• **Nov. 9, 2003:** Exploration chief Walter van de Vijver writes Sir Philip in an e-mail that he is "sick and tired about lying" on reserves issues.

• **Jan. 9, 2004:** Shell says it will recategorize its reserve filings. It later removes 4.47 billion barrels of oil equivalent from its books, about 23% of the total.

• **March 3, 2004:** Shell's twin boards oust Sir Philip and Mr. van de Vijver.

• **Aug. 24, 2004:** Shell settles with U.S. and British authorities over accounting issues, agreeing to pay fines of some $150 million.

• **Oct. 28, 2004:** Shell announces a corporate overhaul, combining its two parent companies to form Royal Dutch Shell PLC. It says it may have to reduce its reserves estimate again.

Source: *WSJ research*