

Working at the edge

Lessons from the Deepwater disaster

Introduction

On 20 April 2010, the “Deepwater Horizon” offshore oil drilling platform leased by BP plc caught fire and sank, killing 11 men. The resulting oil spill became the largest accidental spill in history. In addition to the tragic loss of life, the incident has had a devastating impact on the environment, the livelihoods of thousands of Americans, the share price of BP plc and the income of shareholders. While investor focus in the immediate aftermath of the Deepwater disaster has understandably centred on the preparedness of oil companies for the risks of offshore deep water drilling, it is vital that this increased investor scrutiny of oil companies’ operations is not limited to an isolated area of activity.

Investors must consider whether the failures of risk assessment and management and of disaster response evidenced in the Gulf of Mexico provide warning signs for other frontier and unconventional oil projects carrying potentially catastrophic environmental and financial impacts.

Over the next 50 years, climate change mitigation (to move the world towards the Copenhagen-endorsed 450 ppm target) is likely to pose one of the biggest challenges to oil companies due to destruction of oil demand and/or increased costs. Investors need to engage with oil companies to ensure that they have adequately assessed the transformational risks posed by climate change - or regulations to mitigate it - and that they are developing appropriate business and risk mitigation strategies.

FINANCIAL IMPACT OF THE DEEPWATER DISASTER

- Closing ordinary share price on 20 April 2010: £655.4;
Closing ordinary share price on 24 August 2010: £377.5.¹
- On 16 June 2010 BP plc announced the cancellation of the payment of the previously declared first quarter dividend, and announced there will be no dividends declared for the second and third quarters of 2010.²
- \$20 billion compensation fund established.³
- Over \$4billion spent as at 24 August 2010 including:⁴
 - \$100 million unemployed rig workers’ fund.
 - \$500 million establishing Gulf Coast Research Institute.
 - \$389 million paid to claimants.

Lessons from Deepwater Horizon for all frontier oil projects

While investigations are continuing into the precise cause of the explosion on the Deepwater Horizon rig, it is clear that warning signs of an unacceptable pattern of behaviour with respect to BP's health and safety culture existed but were not acted upon. Perhaps the most striking warning was the October 2009 proposal by the US Occupational Safety and Health Administration (OSHA) to levy a fine of \$87million against BP for alleged failures to rectify already identified safety violations and for 439 additional citations (post Texas refinery explosion) for alleged new wilful violations of health and safety standards.⁵ It seems that the warning represented by this 2009 OSHA inspection and announcement was not acted upon, either by investors or by the company, in such a way as to sufficiently improve BP's health and safety culture. This is despite former BP CEO Tony Hayward's promise to "focus like a laser" on safety and reliability.⁶

Investors have reacted to the obviously insufficient response plans of BP and other oil companies⁷ for incidents such as Deepwater by increasing engagement on such issues. A recently announced collaborative investor initiative seeking greater disclosure from energy companies about their spill prevention and response plans for offshore drilling is a welcome development.⁸ However, in this context of previously missed warning signals both oil companies and their shareholders must consider whether Deepwater holds lessons far beyond the Gulf of Mexico for other risky frontier oil projects so that, to the extent possible, disasters can be prevented rather than simply reacted to.

Within the portfolio of frontier oil projects, Canadian oil sands have a public profile comparable to post-Deepwater offshore drilling. They represent some of the most contentious industrial projects in the world and were the focus of shareholder resolutions and extensive investor engagement earlier this year at both BP and Royal Dutch Shell plc. As the effects of the Deepwater disaster became clear, Canadian oil sands were touted as the safe alternative to risky offshore drilling.⁹

This attitude raises concerns that the correct lessons are not being learnt from Deepwater. Taking BP as an example, we can see parallels between their Deepwater Horizon operation and their proposed Sunrise/Toledo oil sands project. In both cases, day to day operating control remains with a third party - Transocean in the case of Deepwater Horizon, Husky Energy at Sunrise¹⁰ - and questions exist over their worst-case scenario risk assessment.¹¹ If investors are to learn the lessons of the Deepwater disaster, it is necessary that they assess the similar risks inherent in other frontier oil projects rather than see the issue as being specific to one area of oil exploration.

“ We are seeing in the oil industry the same corporate indifference to risk as caused the collapse on Wall Street. ”

- Chairman Waxman,
Chair of the House
Energy and Commerce
Committee, 17 June 2010

DISCLOSURES REQUIRED FROM OIL SANDS OPERATORS

- Their assessment of the risks (both operational and macro-economic) of their oil sands projects and, where those assessments differ from independent or peer reviewed studies, clarification as to why the company regards its assessment as more accurate.
- Their prevention and response plans for such risks.
- The extent of reliance being placed on technologies not yet tested operationally and/or at a commercial scale and the estimated costs of such technology failing.
- The degree of oversight being exercised over the day to day decisions of operating partners.
- The degree of board oversight on specific projects.

The threat of climate change

Aside from evidencing the operational risks of a range of frontier oil projects, Deepwater also provides a backdrop for investors to consider whether oil companies are similarly unprepared for the far greater challenge presented to the industry by climate change and regulations intended to tackle it.

BP downplayed the risk of a spill at Deepwater Horizon and was, by its own admission, totally unprepared to deal with the consequences.¹³ There are worrying signs that BP (and other oil companies) may prove similarly unprepared to deal with the human, environmental and financial challenges that climate change will increasingly present, and are not preparing for the necessary transition to a low carbon economy.

BP and the reference scenario: leading us to the edge of climate chaos

In their official published response to the shareholder resolution on oil sands,¹⁵ BP stated “World energy demand is projected to increase by around 40% between 2007 and 2030 with fossil fuels still satisfying as much as 80% of that demand by the end of that period”. This projection was again stated verbally by BP’s chairman at this year’s AGM. This projection is also referred to in the BP Annual Review 2009¹⁶ and in the 2009 Annual Report and Accounts.¹⁷

This projection appears to provide comfort to shareholders concerned about future oil demand. It is taken from a scenario developed by the International Energy Agency (IEA) called the Reference Scenario which again would seem to reassure investors. However, to understand and assess the suitability of its use as a base for strategic decision making, one must understand the assumptions underlying this scenario:

“

Rep Mike Doyle (D): *We asked your representatives who were the Senior BP Executives responsible for the Macondo well. They told us it was Andy Ingles, the Chief Executive for exploration and Doug Suttles, the Chief Operating Officer for exploration. Can you tell me was Andy Ingles involved in this decision?*

Tony Hayward: *I’m afraid I can’t answer that question. I genuinely don’t know. I would be very surprised.*¹²

”

“

It is unlikely that an accidental surface or subsurface oil spill would occur from the proposed activities.”

- Initial Exploration Plan February 2009 for Mississippi Canyon Block 252¹⁴

”

THE REFERENCE SCENARIO

- It is a baseline picture of how energy markets will develop if governments make no changes to their existing policies and measures to deal with climate change.
- According to the IEA, this scenario “puts us on a course for doubling the concentration of those gases [GHGs] in the atmosphere to around 1000 parts per million (ppm) of CO₂-equivalent by the end of this century”.¹⁸
- It would lead to an eventual global average temperature increase of up to 6°C,¹⁹ resulting in catastrophic climate change.

As was pointed out to BP earlier this year, it is not acceptable to so completely discount the threat posed to an oil company’s business strategy by climate change or regulations to tackle it. As BP itself notes in its Annual Report, “it is likely that policy responses to climate change, energy security and energy poverty will profoundly affect future outcomes”.²⁰ It appears from the continued use of the Reference Scenario that BP’s strategic decision making is based on a scenario which - in light of the Copenhagen agreement - the international community is committed to ensuring never comes to pass. Indeed the use of the Reference Scenario would also appear to be incompatible with BP’s own public statements on the need to tackle climate change.

Furthermore, while the Reference Scenario may be good news for oil demand, its coming to pass would carry significant economic risks for the oil industry and the economy as a whole. Despite quoting the Reference Scenario to appease investor concerns regarding oil demand, BP has not set out its plans to deal with the corresponding impacts such as increased severe weather events, damaged infrastructure and conflicts. For investors with diversified holdings, dependent on the performance of the economy as a whole rather than on any one sector or stock, the Reference Scenario could put at risk GDP growth and therefore the performance of their portfolio as a whole.

Investors have already suffered the consequences of BP’s failure adequately to assess and manage risk and must scrutinise more closely claims by oil companies regarding future oil demand. Investors must challenge BP on its continued use of an unacceptable energy demand scenario to downplay future risks.

DISCLOSURES REQUIRED FROM BP

- An explanation as to why, if as it claims it takes climate change seriously, it is projecting oil demand on the basis that there will be no government action on climate change and a six degree global temperature increase, which would entail catastrophic climate change with severe economic, environmental and human impacts.
- The implications of such a scenario coming to pass for BP’s business and how the company is mitigating those risks e.g. extreme weather events and infrastructure damage.
- Confirmation as to the actual oil demand projections being relied upon by BP, if it is not developing its business strategy on the basis of the Reference Scenario.

“ BP has a decade-long track record of advocating and taking precautionary action to address climate change. ”

- BP Plc Website²¹

“ What is undoubtedly true is that we did not have the tools you would want in your tool-kit. ”

- Tony Hayward in an interview with the Financial Times²²

The oil industry and the transition to a low carbon economy

It is accepted that the necessary transition to a low carbon economy will require an explosive pace of industrial transformation²³ to transform our use of energy. Despite making public statements about the importance of tackling climate change, there is little evidence that oil companies are actually working towards that required transformation, instead pursuing strategies which are in direct contradiction with transitioning to a low carbon economy.

For example, companies such as BP and Shell have invested significantly in the carbon-intensive Canadian oil sands, which Shell acknowledges fits within its Scramble Scenario (a scenario in which policy makers pay little attention to more efficient energy use until supplies are tight and greenhouse gas emissions are not seriously addressed until there are major climate shocks).²⁴

A public collaborative investor initiative to engage with oil companies to ensure that they are developing business strategies consistent with achieving the internationally agreed goal to limit global temperature increase to two degrees would be a welcome development. In the meantime, investors must determine whether oil companies are correctly assessing the risks posed by climate change and developing appropriate risk mitigation strategies.

DISCLOSURES REQUIRED FROM OIL COMPANIES

- Confirmation that they are prepared for the transition to a low carbon economy by disclosing how their current business models are consistent with achieving the internationally agreed goal to limit global temperature increase to two degrees.
- Or, if oil companies are not prepared for such a transition, disclosure of how they are planning to manage the impacts of unmitigated climate change.

Further information:

Louise Rouse | Director of Investor Engagement
louise.rouse@fairpensions.org.uk | 020 7403 7812

References

1. <http://www.bp.com/extendedsectiongenericarticle.do?categoryId=9026517&contentId=7048504> accessed 25th August 2010
2. <http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=7062966> accessed 24th August 2010
3. ibid
4. <http://www.bp.com/extendedsectiongenericarticle.do?categoryId=9034427&contentId=7063885> accessed 24th August 2010
5. US Department of Labor's Occupation Safety and Health Administration (OSHA) <http://www.osha.gov/dep/bp/bphistory.html> accessed 25th August 2010. On August 12th it was announced that BP would be fined \$50.6million, still the highest ever fine issued by OSHA and paid by an employer. BP has not accepted responsibility in paying the fine. <http://www.ft.com/cms/s/0/e878cca6-a63f-11df-8767-00144feabdc0.html>
6. <http://www.telegraph.co.uk/finance/newsbysector/energy/oilandgas/7911546/BP-oil-spill-the-rise-and-fall-of-Tony-Hayward.html> accessed 24th August 2010
7. Testimony of executives from Exxon Mobil, Chevron, ConocoPhillips and the American arms of BP and Shell at a hearing of the House Energy and Environment Subcommittee in Washington on 15th June 2010 <http://www.nytimes.com/2010/06/16/business/16oil.html>
8. <http://www.ft.com/cms/s/0/b7aaf88c-9ff1-11df-8cc5-00144feabdc0.html> accessed 25th August 2010
9. <http://www.ottawacitizen.com/business/Canada+oilsands+blessing/2996800/story.html> accessed 24th August 2010
10. BP confirmed verbally in a meeting with NGOs on 9th February 2010 that they estimate only 4 staff at the extraction site in Alberta will be direct BP employees.
11. See the Initial Exploration Plan dated February 2009 for Mississippi Canyon Block 252 available at <http://www.scribd.com/doc/35728155/29977-BP-Initial-Exploration-Plan-Mississippi-Canyon-Block-252-OCS-G-32306> accessed 25th August 2010; for concerns regarding BP's assessment of the carbon intensity of its Sunrise/ Toledo project see p.2 of FairPensions' Oil Sands Briefing available at http://fairpensions.org.uk/sites/default/files/uploaded_files/tarsands/Investor_Briefing_OilSandsResolutions.pdf
12. Tony Hayward's testimony before the US Subcommittee on Oversight and Investigations, of the Energy and Commerce Committee 17th June 2010
13. Op cited no. 11 and Tony Hayward's interview with the Financial Times at <http://www.ft.com/cms/s/0/e1e0e21c-6e53-11df-ab79-00144feabdc0.html> accessed 25th August 2010
14. Ibid. p.14-3
15. http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/set_branch/set_investors/STAGING/local_assets/downloads/pdf/IC_AGM_oil_sands_resolution.pdf accessed 25th August 2010
16. http://www.bp.com/assets/bp_internet/globalbp/globalbp_uk_english/set_branch/STAGING/common_assets/downloads/pdf/BP_Annual_Review_2009.pdf accessed 25th August 2010
17. http://www.bp.com/assets/bp_internet/globalbp/globalbp_uk_english/set_branch/STAGING/common_assets/downloads/pdf/BP_Annual_Report_and_Accounts_2009.pdf accessed 25th August 2010
18. International Energy Agency World Energy Outlook 2009 Fact Sheet http://www.iea.org/weo/docs/weo2009/fact_sheets_WEO_2009.pdf
19. Ibid
20. http://www.bp.com/assets/bp_internet/globalbp/globalbp_uk_english/set_branch/STAGING/common_assets/downloads/pdf/BP_Annual_Review_2009.pdf p. 9
21. <http://www.bp.com/sectiongenericarticle.do?categoryId=9032939&contentId=7060399> accessed 25th August 2010
22. <http://www.ft.com/cms/s/0/e1e0e21c-6e53-11df-ab79-00144feabdc0.html> accessed 24th August 2010
23. Shell Energy Scenarios to 2050, p.37 . Available at http://www-static.shell.com/static/public/downloads/brochures/corporate_pkg/scenarios/shell_energy_scenarios_2050.pdf
24. Ibid, p.20.

FairPensions™  

Produced by Fairshare Educational Foundation (FairPensions), a company limited by guarantee registered in England and Wales number 05013662 (registered address Unit TR.G.04 The Leather Market, Weston Street London SE1 3ER) and a registered charity number 1117244 and Greenpeace, Canonbury Villas, London, N1 2PN, registered in London number 1314381, VAT registration number 625951426. Design by ThirdActMedia.co.uk