

Avoiding Environmental Pitfalls in Board Governance

By George Pilko, Chairman

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I have been looking forward to visiting with you this morning. I'll spend half our time reviewing some key concepts and then will facilitate a discussion for the remainder of our session.

All of you know the story of military generals who are experts at "fighting the last war." You also know how successful this approach is for these generals.

The Directors at many energy companies have fallen into the same trap.

Their industry is facing major environmental, health and safety challenges in the 21st century. The problem is too many Directors are addressing these issues as if we were still in the 1980's.

They seem to believe their primary concern should be compliance with EPA and OSHA regulations. Regulations haven't changed much in the last ten years, but the "battlefield" for energy companies has changed dramatically.

During the next fifteen minutes, I will describe why and how Directors should change their approach to EHS Governance.

Let's start with an overview. For the last few years, we've used a concept called the "Three Buckets" with clients.

The Big Picture



Each Bucket Impacts Shareholder Value

I would contend that companies need to look beyond the traditional Risks and Liabilities Bucket, which only contains a snapshot of the current situation.

The Governance Bucket goes further to look at what systems are in place to proactively manage Environmental issues and drive overall performance.

I'll have more to say about this Bucket in a few moments.

The third bucket, Emerging Issues, speaks to how well you are addressing subjects like sustainable development and global climate change.

Bottom line- all three Buckets impact Shareholder Value and should be of concern to Outside Directors.

Before I forget, for the sake of simplicity this morning, I will use the terms "Environmental," "EHS" and "Environmental, Health and Safety" interchangeably.

We will touch on four topics –

First, we'll look at examples of the "Good, the really Bad, and the incredibly Ugly" for Environmental Governance.

Second, I'll talk about key trends which should drive how Directors address these issues.

Third, I'll review some common misconceptions Directors have that stand in the way of better Governance.

And finally, I'll provide some recommendations for Directors.

Here's my favorite example of brilliant Governance. Pegasus Capital, a private equity firm with enlightened leadership, bought Coffeyville Resources out of bankruptcy about five years ago. Coffeyville consists of an older refinery in Kansas and an adjoining fertilizer facility.

Coming out of bankruptcy, Coffeyville was out of compliance, had no Management Systems or Governance Processes and was clearly struggling.

Their new CEO, Phil Rinaldi, dedicated the money, time and personnel to fix their EHS shortcomings and develop robust governance systems. Fifteen months later they sold the company to Goldman Sachs and Kelso for an astronomical return on their investment.

And then there's the other end of the spectrum, aptly represented by BP. As you know, their Texas City incident in March, 2005 caused 15 deaths and more than 170 injuries.

What you may not realize is that BP has had a \$50+ billion drop in market capitalization relative to their peer, Royal Dutch Shell, since this incident.

The Baker Panel identified serious deficiencies not just at BP's Texas City refinery, but at their other domestic refineries. Given the well documented state of their equipment, their maintenance, their staffing and their training, this incident should have come as no surprise.

You would have to assume that BP's directors didn't know beforehand the extent of the risks their company was incurring. The question remains – "Why not?"

And finally we come to...

"The Incredibly Ugly"



The incredibly Ugly. This nameless company was also bought out of bankruptcy by investment groups who were hopeful of duplicating Coffeyville's financial returns.

While the company is now profitable, their compliance problems continue, and worse, they have no systems in place to fix them. When the investors tried to sell the company recently, they found no buyers – partly because all three of their Buckets looked like sieves.

Now, let's turn to ongoing changes in the energy industry:

* Stakeholder expectations continue to rise. Energy companies are expected to cause no harm to the environment, no harm to people, and no harm to the community, regardless of where they operate and regardless of what local regulations require.

Moreover, energy companies are expected to have thoughtful strategies to deal with issues like climate change and sustainable development.

* As you know, much of our energy infrastructure is stressed today. Our industry consists in large part of older assets that are often being pushed to their limits to maximize production. This applies to both upstream and downstream operations.

As you recall, the downstream industry had been only marginally profitable for more than a decade, and a lot of these operations had not been aggressively maintained during this period or updated with new technology. BP learned in Texas City that it's challenging to maximize production in older facilities which have not been particularly well run.

* All of this creates a growing need for companies to focus on Operational Excellence, that is, keeping facilities operating reliably with no impact on people, the environment or local communities. The major stumbling blocks in actually achieving Operational Excellence at many companies are four widespread misconceptions. And believe me, I've heard these repeatedly from Directors of major companies!

Misconception #1 is:

* We have an EHS Board Committee for that!

* **But** – Who's your expert on EHS governance? Many times there's nobody on the Board who has first-hand, current knowledge of best practices for EHS governance or Operational Excellence.

In some cases, the director designated as Board "expert" had their most recent operational experience a decade ago in a third quartile company with a poor EHS record.

Misconception #2 is:

* We have a management system!

* **But** – Is it the equivalent of a new BMW or a Ford Edsel?

People tend to think that if they have a management system, they're protected – but that's like saying that Enron was protected because they had an accounting system!

We've seen systems at large, multinational companies which are poorly designed and/or poorly implemented.

Every director seems to believe that their management system is "above average" – sort of like the children in Lake Wobegon. That's what their management tells them.

So – an equally important question is "How do you really know how your company stacks up?"

A management system is not something that you can install and walk away from – to do its job well, it must be in a continual state of dynamic renewal to conform to changing business processes. Think of it as the business equivalent of yardwork – it's never totally finished, and it always needs attention.

Misconception #3 is:

* We do audits, and we're in compliance!

* **But** – are you effectively managing your biggest risks? Audits and compliance are necessary, but not sufficient. Keep in mind that BP was conducting regular audits before their Texas City disaster.

Surely, BP's Directors would have acted, if they understood the actual state of the equipment, the training and the Management Systems at Texas City. Their audits, however, apparently did not provide them those insights.

The final misconception is:

* We reviewed the Baker Panel Report!

* **But** – have you made the right changes as a result of this review? This leads to the next topic, Operational Excellence; but before I go there, I want to compare the current state of financial governance to EHS governance in the energy industry.

Here's a quick comparison of where the energy industry stands with financial governance versus EHS governance.

There are clearly some dramatic differences. For example –

Sarbanes Oxley dictates that internal financial management systems have to be robust in the way they are designed and the way they are implemented. In contrast, Environmental Management Systems in the energy industry vary greatly – there are a few companies with robust systems, many with mediocre ones, and no small number with totally ineffective systems.

Qualifications for Audit Committee members are well defined under Sarbanes Oxley, while undefined for Environmental Board Committees. As we discussed, few Boards have anyone with strong qualifications in Environmental governance.

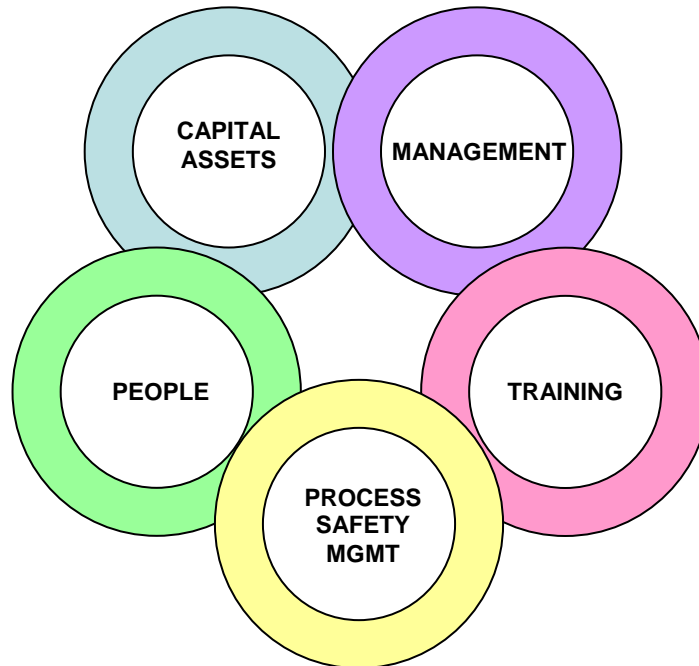
External auditors are required under Sarbanes Oxley for financial issues but seldom, if ever, used at the Board level for EHS matters.

In summary, the overall quality of governance is now excellent on the financial side, but remains highly variable on the EHS side. We are beginning to see some improvements, but the pace needs to speed up.

So, how should an energy company approach EHS governance?

We believe one answer is added focus on Operational Excellence, which we see as a holistic and balanced approach to driving EHS performance. As we discussed, a key objective of Operational Excellence is “keeping facilities operating reliably with no impact on people, the environment or local communities”

A Balanced Approach to Operational Excellence



This graphic shows the five elements that comprise Operational Excellence:

Capital Assets – refers to the equipment in use and how well it is being maintained.

People – includes leadership, staffing and roles & responsibilities.

Processes – includes management systems, audits and the building of a culture of continuous improvement.

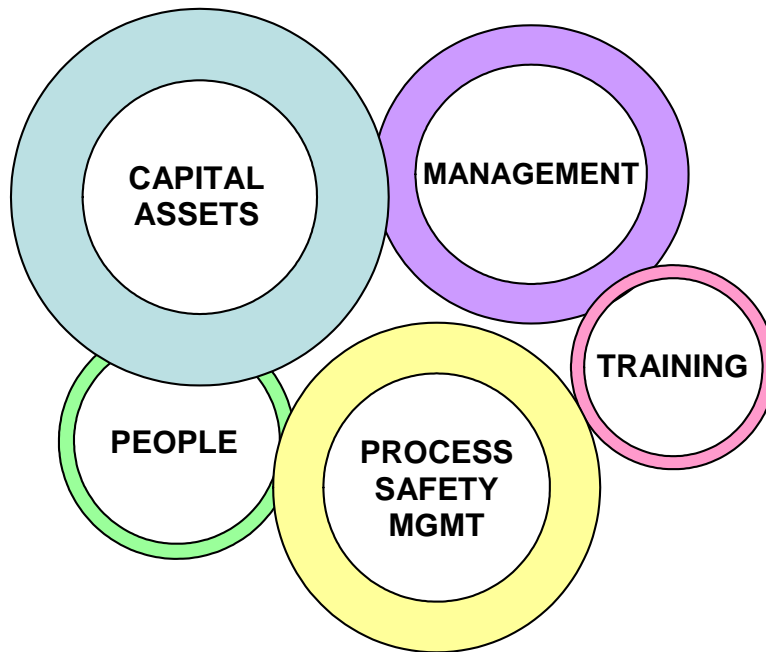
Training – relates to networks for transferring Best Practices throughout the organization.

Management – speaks to the way you execute all of the other elements. This means good leadership throughout the organization, clear goals, effective prioritization, and ultimately, the mitigation of business risks.

The key point in this slide goes beyond the nitty gritty of each element – it’s about approaching all of them in a balanced way.

Too often this is what we see. Executives read the Baker Panel Report and throw money and resources at the problem. So they really beef up selected activities, but ignore other keys for effective Operational Excellence.

Only as Strong as the Weakest Link



Keep in mind, these elements are like links in a chain, and a chain is only as strong as its weakest link. Your company may have fabulous process safety systems and great assets, but if you don't have the right people and train them appropriately, you could have some nasty surprises.

Directors must ensure that their company is taking a balanced approach to Operational Excellence.

There are three points that I would like you to take away from this session:

* First, overcome any false sense of security you may have. As we saw in our three examples, this issue can have a major impact on shareholder value. Energy companies simply need all three of their Buckets to be watertight.

* Next, ask the hard questions.

What are the qualifications of your directors to provide oversight for EHS governance?

What is the Board's relationship with your company's operations and EHS staff? If all you get is a one-hour quarterly presentation from the VP of EHS, that is not even close to enough. You should have a dynamic ongoing relationship with these individuals.

Finally, what is the quality of Board oversight? Do you know how your company stacks up against Best in Class energy companies? Would you know if you had a problem?

I've summarized some Best Practices for EHS Board Governance – you are welcome to pick up a copy during the break. [document attached, please see following page]

* Finally, consider independent assessments of your EHS governance practices – these assessments are always insightful and can provide the perspective you need to protect shareholder value.

We believe that during the next five years all energy company Boards will have outside EHS advisors – just as they now have outside financial and compensation advisors.

I'll close this morning by returning to our Three Buckets. Remember –

* In the first Bucket, your company should go beyond compliance and superficial audits to aggressively managing risks to avoid things that go boom in the night.

* In the Governance Bucket, you want to take a balanced approach to all five elements of Operational Excellence.

* And in emerging issues, you want to stay ahead of the curve on such issues as climate change and sustainable development, not only because it's good for our planet, but also because it may be critical for your business.

Summary



Thanks very much for your time today. Now I'd be happy to answer any questions.

Best Practices for EHS Board Governance at Energy and Chemical Companies

1. Have a Board Committee with a primary focus on EHS matters.
2. Have at least one member on this Committee with in-depth knowledge of operations and Best Practices for EHS.
3. Have an annual review of the biggest EHS Risks facing the company and plans to mitigate these risks.
4. Ensure a strong focus on Operational Excellence which will drive EHS performance.
5. Ensure that the company has a robust EHS Management System, preferably integrated with an Operations Management System.
6. Have an annual in-depth review of lagging and leading indicators for EHS performance.
7. Have an annual private session with the head of the EHS Audits.
8. Have an annual full day visit of a major company facility.
9. Ensure Committee Members receive annual training on evolving Best Practices for EHS Governance.
10. Have an Independent Assessment of your overall EHS Governance every four years.