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Natural Resources RECORD

Board Compensation on the Rise in the Oil and Gas Industry

Board compensation in the oil and gas industry has seen something of a resurgence over the past two years. Spurred by U.S. economic recovery early on, compensation packages for board members grew six percent in 2010 with total compensation averaging $139,930 – making oil and gas the second highest paid industry for directors behind technology. The increase is predicted to be even higher in 2011. Sensitive to the losses incurred by the industry and shareholders during the economic downturn, board members had accepted little-to-no growth in compensation in 2009. However, according to data collected and analyzed in the annual *BDO 600: Survey of Board Compensation Practices of 600 Mid-Market Companies*, increasing demands on board members' time and expertise have led to meaningful pay increases. Directors have taken note, and more than two thirds (69%) believe their compensation is now commensurate with their responsibilities, according to the *2011 BDO Board Survey*, conducted in August. However, this also means that 31% still feel that their compensation has not caught up to the heavier workload.

Increased Responsibilities Mean Increased Pay

A major impetus behind these compensation changes is the fact that guiding companies through challenging times is simply harder work. In the course of a "normal" year, board members usually meet about half a dozen times, perhaps more often if they are also assigned to a particularly busy committee. But in the past few years, the average number of meetings has jumped significantly. For example, members of the BP board met 25 times in 2010 to manage the fallout from the Deepwater Horizon explosion and subsequent oil spill.

Even in the absence of such disasters, directors have found it necessary to meet more often to address issues such as financial restructuring, mergers, and acquisitions. These types of deals and organizational shifts take months of careful and time-consuming analysis on the part of directors – something that cannot be done in only six meetings a year.

Regulatory changes, including the Sarbanes-Oxley Act, the Dodd-Frank Wall Street Reform and the Consumer Protection Act have also had an impact on the shifting role of executive board members, requiring directors to assume greater responsibility and increasingly time consuming duties. During the 2011 proxy season, a number of provisions from the 2010 Dodd-Frank Act - aimed at broader disclosure of executive compensation practices - became effective. In order to address the American public's concerns about unfair or outsized executive compensation packages, the Act now requires directors to give shareholders a "say on pay."

Directors are already skeptical of the new rules and more than three-quarters (78%) do not believe Dodd-Frank's "Say-on-Pay" disclosures will help them better manage the compensation of their key executives. In fact, just one-fifth (22%) describe the rules as helpful. Directors who serve as members of their board's compensation committee were even more likely (91%) to say the new rules will not help manage executive pay, according to the *BDO Board Survey*.

The Liability Issue

Along with ensuring that their companies are properly governed, directors are also concerned about their own personal liability. The oil and gas industry in particular exposes directors to significant personal risk in relation to not only governance and business risk issues but also environmental issues and operational hazards. A recent BDO analysis of

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risk factors as reported in 10K filings of the 100 largest E&P companies found that some of the top risks include operational hazards including vessels sinking or colliding, blowouts, spills, personal injury, and loss of life.

While companies have insurance to cover these risks, there are certain instances in which directors can be held personally liable. Facing the possibility of such lawsuits, it is not surprising that the best board director candidates expect that their compensation will reflect the risk associated with their good faith efforts to be of service to shareholders.

Compensation: Determining the Right Value and Structure

The question that oil and gas companies now face is how to appropriately compensate board directors for their time commitment to their organizations? While our data has shown that many companies are already offering competitive pay increases for their directors, many other companies remain uncertain about how to structure the amount and method of payment of their compensation programs. Pay practices advocated by proxy advisory groups often emphasize immediate pay-for-performance tie-ins, but performance does not always manifest itself on a yearly basis. There needs to be consideration for making smart investments, strategic shifts and other moves that do not lead to immediate measurable returns.

Independent analyses offer the best solution for companies concerned about putting together attractive compensation programs without going overboard. A benchmark comparison against other companies of comparable size and with similar business lines, conducted by an independent expert, can offer organizations great insight on setting appropriate compensation values. Such studies also help to ensure that companies are making compensation decisions based on industry standards and competitive trends, rather than on pre-conceived – and possibly mistaken – notions.

One of the standard practices that is being reexamined right now is the practice of paying meeting fees to directors for attendance at board or committee meetings in addition to the annual cash retainer. In recent years, there has been a trend toward setting a fixed annual retainer for service on the board and paying no fees for meeting attendance. Given the increased workload by some committees and the chairs of those committees, there is some evidence that this trend is beginning to stall. We expect to see a reversion to the practice of paying meeting fees in order to reflect the reality that some directors are required to commit more time than others to their roles based on their committee assignments.

Director compensation has risen to reflect new accountabilities, as oil and gas companies are pressed to recruit and retain the best and brightest candidates, and to attract those individuals with the right management, financial and industry experiences needed to provide sound leadership. While the components that make an attractive compensation package can vary from company to company, and sector to sector, there is broad recognition among companies of the need to rethink the compensation for services rendered by their board members. Compensation programs that have not been recently updated may not reflect the commitment required by directors in today's environment and economy. By properly analyzing trends and their implications, companies can make better decisions about the elements of a fair and appropriate director compensation program. *Lance Froelich is a senior director in the natural resources industry practice in BDO's Houston office. He can be reached at lfroelich@bdo.com.*

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An Update on Offshore Gulf of Mexico Drilling Activity

On April 20, 2010, the Deepwater Horizon was drilling the Macondo prospect for BP approximately 48 miles off the coast of Louisiana when the rig was consumed in a massive explosion, ultimately spewing 4.9 million barrels of oil. In May 2010 following the spill, Ken Salazar, secretary of the Department of the Interior, announced an immediate moratorium on the approval of all offshore oil and gas drilling permits until the completion of an offshore safety review. This was later revised to allow for shallow water drilling operations in 500 feet of water or less where the blowout preventer is located above the water's surface. However, a few weeks later, the Interior Department issued a safety notice to lessees that imposed stronger safety requirements to be met before any new shallow water drilling operations would be permitted.

The deepwater moratorium was officially lifted on October 12, 2010, ahead of the original date of November 30, 2010. Since then, a slew of regulatory issues, economic and geopolitical conditions have all had a significant impact both the shallow and deepwater drilling activity on the Gulf of Mexico and the industry overall. While the moratorium has certainly impacted activity in the gulf, these other factors may be just as responsible, if not more so, for the decrease in rig count and permitting.

Shallow Water Drilling

The moratorium for shallow water drilling was lifted in June 2010. As illustrated in the chart below, this did little to improve shallow water drilling activity and there was no positive impact for almost nine months. The chart shows the historical day rate index (left scale) and the fleet utilization (right scale) for the U.S. Gulf of Mexico 250 foot to 300 foot jack-up rigs. These rigs are typically hired by independent exploration companies and are generally used in exploring for natural gas in the shallow water Gulf of Mexico. When natural gas prices peaked in 2008 so did the utilization and day rates. However, as soon as the economy started to turn south in late 2008 and early 2009, utilization and day rates plummeted. When the economy started to improve in 2009 and early 2010, rates stayed low but utilization picked back up to nearly 60 percent. Then, the moratorium hit and utilization dropped down to 40 percent.

You might ask why the utilization rate didn't drop to zero given the moratorium. Some rigs were being paid for, just to keep them in place and ready to work when the moratorium was lifted while others were used for other, less risky purposes such as water injection.

Based on recent statistics from the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE (now the Bureau of Safety and Environmental Enforcement (BSEE)), there have been 89 shallow water applications submitted since the new safety and environmental standards were issue on June 8, 2010 and 75 have been approved. The approval rate has been about seven per month since fall 2010, compared to an average of about 8 permits per month in 2009.

Another factor that is impacting the shallow water drilling is the expanding production of natural gas from the significant shale plays in the continental U.S. The production increases from these areas are having a significant impact on keeping natural gas prices low and making it uneconomical to drill in the more expensive offshore prospects. Day rates for land-based rigs are generally less expensive and the permitting process is much easier. And so while the moratorium may have had an impact on the shallow water rigs, there appears to be more of an impact from alternatives to drilling offshore; namely the onshore shale gas production.

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Deepwater Drilling

The offshore rig market is divided into two main types of rigs; floaters and jack-ups. There are approximately 277 floaters operating in the world market today. Floaters typically operate in two distinct markets; mid-water (2,000 feet to 5,000 feet) and deepwater (5,001+ feet). Of the 277 floaters, there are 37 that operate in the Gulf of Mexico and are made up of six mid-water rigs and 31 deepwater rigs. Currently only two of the mid-water rigs are under contract while 28 of the deepwater rigs are working. Prior to the Macondo blowout, there were approximately 47 floaters working in the Gulf. In the weeks after the deepwater moratorium was put in place, the number dropped down to 11 in July 2010.

On February 28, 2011, BOEMRE issued its first deepwater permit since the moratorium was lifted. This permit, issued to Noble Energy, will allow the company to resume work on a well that it had already drilled to 13,000 feet when they were ordered to suspend operations. On March 11, 2011, the second permit reapproved by BOEMRE went to BHP Billiton to continue drilling its well in Green Canyon block 653. On March 28, 2011 the third reissue permit was granted to ATP Oil & Gas at its well to begin production. On March 22, ExxonMobil received its reissue permit to begin drilling operations on the first new well in a Keathley Canyon block. Moving forward to September 2011, BOEMRE has issued 23 new well permits while it has returned 11 for further documentation, particularly for information regarding containment.

While the drilling moratorium did have an impact on drilling in the Gulf of Mexico market, it had little or no impact in the global floater market. As the following charts show, the mid-water day rates dropped significantly in October 2009 but actually increased during the moratorium while utilization has continued to decline. The deepwater floaters have seen their day rates decline as well but utilization has remained high at nearly 100 percent.

Conclusion

While there has been a decline in drilling activity in the Gulf of Mexico, the reason for this is still open to debate. Some believe that the decline is due to the moratorium, while others believe it is more a function of economic issues. Shallow water drilling activity has been much more impacted by the general economy, lower gas prices and easier access to drilling locations on land more than anything else. Deepwater drilling has seen a slowdown in the permitting process, but there has not been a mass exodus of rigs to other locations that many believed would happen.

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Did You Know...

The Russian Arctic, one of the last undeveloped drilling locations in the world, was opened to development on August 30th when Exxon and Russian oil company Rosneft signed a deal. *Source: Thompson Reuters*

A report from the *U.S. Energy Information Administration* forecasts a 13% decrease in U.S. offshore oil production from 2010. Most of the decreased production comes from the Gulf of Mexico.

The recently launched "Power in Cooperation" campaign from ConocoPhillips aims to emphasize natural gas as a source of clean energy and an engine for job creation. *Source: The Wall Street Journal*

Global energy demand is expected to increase by 35% between 2008 and 2035, with China and India responsible for half of that growth, according to the *U.S. Department of Energy.*

According to a report by *OPEC*, Venezuela now has more oil reserves than Saudi Arabia, propelling the South American country to the top of OPEC's list of reserve holders and adding to the growing influence of the Americas in the oil industry.

Deutsche Bahn, the national railroad system of Germany, released a statement in August outlining its plans to be carbon-free by 2050. By 2014, the railroad expects 28% of the energy used to power its trains to come from wind, hydro, or solar sources.

According to the *International Energy Agency*, subsidies for global fossil fuel consumption are expected to reach $660 billion by 2020 – the equivalent of 0.7% of global gross domestic product.

Analysis by *Bloomberg* shows that the U.S. is experiencing a record year for exports of gasoline cargoes. In the first three quarters of 2011, shipments are up 24% from 2010, putting freight rates at a three year high.

Natural Resources Record is provided by GBQ's Oil & Gas Team for our clients and other interested persons upon request. Since technical information is presented in generalized fashion, no final conclusion on these topics should be made without further review.

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