



Meeting the Legal Challenges in the Energy Industry

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Beat Hess became Legal Director of Royal Dutch Shell plc in 2003. In this post, he has coordinated the company's legal response to the challenges that arose for Shell following the reserves crisis in 2004, leading to successful settlements with various regulators. He also oversaw the legal work for the unification of Shell's former parent companies, Shell Transport and Trading and Royal Dutch Petroleum Company, a significant improvement of the Shell Group's governance structure. Shell's legal function comprises some 1200 persons, including almost 800 lawyers and IP professionals. Shell's compliance office is also part of the legal function.

Before joining Shell in 2003, Beat was Senior Group Officer, General Counsel and Secretary at ABB Ltd, and General Counsel at BBC Brown Boveri Ltd, having started his career as a Swiss civil servant.

He is Chairman of the Planning Committee of the European Chief Legal Officers Roundtable and a Member of the International Panel of Distinguished Neutrals (Arbitrators).

Beat has Law degrees from the University of Geneva, Switzerland, and the University of Miami, United States of America. He holds a Law Doctorate (PhD) from the University of Fribourg in Switzerland.

Beat was born in Lucerne in Switzerland, in 1949, and is married to his wife Liny with two children.

Developments in the energy sector will bring a host of new legal challenges. Dealing with new technology, increased regulation, litigation surrounding carbon emissions and increasing ‘resource nationalism’ are just a few of these challenges. Beat Hess discusses what is asked of corporate lawyers to meet them. Maximising the business opportunities while mitigating legal risk will depend on how well international energy companies prepare their in-house and external lawyers and structure their services.

The Energy Industry

In the autumn of 2005, Hurricanes Katrina and Rita damaged many platforms, refineries, power plants and power distribution equipment in and around the Gulf of Mexico, shutting about a quarter of US domestic hydrocarbon production. On the Friday after Hurricane Rita, there was no power at any of the refineries in a region covering the entire state of Louisiana and part of Texas; it was impossible to pump oil through the pipelines. Fortunately, technicians managed to restore emergency power over the weekend. If they had failed, imagine what could have happened: there might well have been panic buying at gas stations across the entire Southeast, spreading north to New York and other parts of the country.

The hurricanes reminded us of the serious effect a local supply disruption can have when global spare production capacity is limited and the geopolitical situation is tense. Between 2000 and 2005 the supply situation had become increasingly tight because of rapid energy demand growth in China and India, and increased demand for fuel in the United States, reflecting, not the least, the increased number of SUVs in the US car fleet. On the supply side, we felt the effect of relatively low levels of investment in the 1990s.

Despite the relatively high oil prices today, worldwide demand is expected to remain high in the coming decades. The International Energy Agency believes energy demand could increase by 50 per cent between now and 2030. World energy consumption by the middle of this century could be double today’s levels. Huge investments will be required to make sure sufficient energy can be supplied. The International Energy Agency speaks of a cumulative

investment of around 20 trillion dollars (in 2005 dollars) over the period 2005 to 2030 for the combined electric power, oil and gas sectors.

But supply and demand are only two dimensions of the energy industry picture. A third dimension concerns the emission of greenhouse gases, especially carbon dioxide. It is estimated carbon emissions could rise by 55 percent in the period from 2004 to 2030 – that is 1.7 percent per year. Increased use of coal, especially in China and India, explains why carbon emissions are rising even faster than overall energy demand.

So the question will be how to produce more energy *and* less carbon dioxide. Shell believes that technical innovation will prove vital. Only through innovation will we be able to unlock more energy resources, produce and consume energy more efficiently and substitute conventional fossil energy with alternative sources, such as wind, solar and biofuels.

But we still have very far to go to reach a clean, ‘fossil-free’ energy future. Today, the share of fossil fuels used in the overall energy consumption worldwide is 80 percent. Unless we take stringent measures across a large number of countries, in 25 years’ time this percentage will be the same, due to the surging overall demand.

Legal Challenges

Developments in the energy sector will bring a host of new legal challenges. Dealing with new technology, increased regulation, litigation surrounding carbon emissions and increasing ‘resource nationalism’ are just a few of these challenges.

New technologies, such as the extraction of heavy oil from oil sands, are increasingly vital for competitive edge. Protecting intellectual property

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rights while respecting the rights of others is essential to minimise legal risks, such as patent and trademark infringement, disclosure of confidential information, know-how contamination and know-how leakage. These risks are compounded by such factors as multiple contract parties and jurisdictions, highly complex business structures, and inconsistent or non-existent laws and enforcement procedures.

The matter of CO₂ emissions is equally challenging. Mitigating the legal risks associated with carbon trading regimes – an area that is currently comprised of ad hoc, localised regimes with little coordination – is fraught with uncertainty. If we purchase certificates for emissions today for a market that has yet to develop, what will the legal framework be? When we incur capital expenditures to meet anticipated regulatory obligations, what is our recourse when the anticipated legal framework does not materialise?

Typically, energy companies invest against a time horizon of at least 15 to 20 years. Should investors in the United States anticipate the creation of an emissions trading system similar to that of the European Union, and can investors in the EU count on the trading system remaining in place beyond 2012?

Add to this the effects of growing resource nationalism, as national governments increase their participation in the industry, the number and frequency of energy-related business transactions with them increase. The legal framework for these transactions can be uncertain and the rights of energy companies can be difficult to enforce.

We need to think carefully about how to protect our assets and minimise legal risk while maximising the opportunities in less than ideal investment environments. Local legal instability is perhaps the biggest challenge the energy industry will have to face over the next plan period. The Roman law principle *pacta sunt servanda* appears no longer to be carved in stone. The contractual bedrock upon which multi-billion dollar investments are made is becoming

fractured. In the United States, we face increasingly dubious litigation.

Unfortunately, litigation is seen by some as the solution to all of society's problems, including global warming. As a conservative, born in the heart of the Swiss Alps, I find the prospect of being sued for hurricane damage – on the grounds that hurricanes are the result of global warming, which is allegedly caused by the energy industry – a difficult pill to swallow. Industry players would have no choice but to defend themselves vigorously from such frivolous accusations, in what undoubtedly would become a long and arduous fight.

Issues like global warming are not for the courtroom, but rather for the governments of the world, for industry – including national oil companies – and for consumers. I mention consumers, because, for them, many options in energy efficiency already exist. Meeting the energy challenge is our collective responsibility. Shell will continue to take its share of the responsibility, but we can only develop a healthy, sustainable business in an environment of good faith conduct, reliable partners and respect for the rule of law.

Legal Services in the Energy Industry

Maximising the business opportunities while mitigating legal risk will depend on how well we have prepared our lawyers and structured our services. And so I ask myself, do my lawyers, both in-house and external, have what it takes to meet these legal challenges? Will they tomorrow? How can I ensure they do?

The mandate of Shell Legal is to provide and procure top quality and fit-for-purpose legal and IP services to Shell Companies in a proactive, timely, cost-effective and professional manner. One can only fulfil such a mandate by focusing in first instance on the basics: structure and reporting, core competencies, relationships with external counsel, and a certain personal style. The rest will follow.

I am a firm believer in the value of a well-structured law department with

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clear lines of responsibility and clear accountabilities. A proper structure contributes both to the overall professional quality of the law department and to the quality of the specific legal advice rendered to the business. Among other things, it reduces duplication, increases timeliness of responses, maximises cost-effectiveness and is easier to manage. With over 700 lawyers in Shell Legal, our ability to add value and fulfil our mandate would be severely restricted without our structure and the harmonisation of roles and responsibilities within it.

The structure of the Shell Legal function is a mirror of the Shell business organisation. The lawyers and IP professionals are located and work hand-in-hand with their business clients, but have clear, solid reporting lines within the department. They are geographically decentralised but work within a number of defined minimum standards, such as a global legal budget, risk assessment policies, performance and development goals and targets, leadership guidance and a talent development plan. These minimum standards are contained in the Shell Legal and IP Frameworks, applicable to all Shell Legal staff and regularly updated on our Shell Legal homepages. A common, uniform approach towards a number of well-defined minimum standards, written in plain, understandable language is, in my view, the glue that holds a large legal community together, and provides the basis for a distinct, and distinguished, professional culture. Within such a structure mature, experienced lawyers who can delegate their own responsibilities within their areas of competence, and who have the ability to look beyond the day-to-day legal issues should be leaders at the top. They should be complemented by lawyers who concentrate on the core legal competencies required to respond to the needs of the business they support.

The more senior lawyers also need to cooperate and integrate with top management of the businesses and of the Shell Group. Given the complexities

of the energy industry, the ability of lawyers to understand all of the drivers and pressures on the business is key to assessing, advising and mitigating the legal risks, while maximising opportunities for the business to move ahead. Lawyers also need to be able to distinguish between important and essential matters and those that are simply nice to have. And just as importantly, they need to be able to coach and mentor their juniors to develop these same skills.

The focus on essential matters is particularly close to my heart. For example, we could hire a lawyer to review the legal risks of selling hot dogs at our 45,000 gas stations, and I'm sure one could find a way to fill one's time examining all the associated legal angles. However the obvious question is, of course, do we have a serious legal issue with selling hot-dogs? Probably not. A risk-based approach is how we make the selection between the gold-plated Rolls-Royce and the perfectly useful Volkswagen. No doubt, we could do with fewer lawyers and less cost if everyone throughout our organisation – particularly the leaders – possessed this valuable skill which, in my view, distinguishes the good from the average: the ability to step back, to spot relevant risks, current and future, and to guide our business people calmly through the choppy waters of today's hazardous environment.

We all look for high calibre, intelligent, good, solid lawyers, but lawyers also need to have a high emotional quotient or 'EQ'. This enables them to communicate, interact and deal with others without friction. These "others" not only include our business people, but also board members, shareholders, regulatory agencies, NGOs, government officials, other lawyers, etc. In a global business such as ours, there are already enough linguistic, cultural and other differences with which to contend without having to worry about whether or not our lawyers will even recognise them. I also value lawyers with a minimum of manners –

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not overly friendly – simply friendly. It helps and costs nothing.

Backbone, determination and good judgment round out the core competencies of an in-house lawyer. Backbone and determination to take a position and enforce our rights when required, and good judgment to know when this may not be possible, even in the face of clear rights.

Finally, a word or two about the role of lawyers in the area of compliance. The energy industry as well as many others operate in an ever-increasing regulatory environment. Lawyers can play a large part in providing proactive advice to avoid regulatory issues altogether, at least where the rule of law prevails and even sometimes when it doesn't.

We have considerably strengthened our internal compliance framework because I believe that this will be an area of increased focus in the years ahead of us. The range of issues is wide: from antitrust to health, safety and environment. One particularly illustrative example of the increasing regulatory environment is the complexity of disclosure rules where, often within minutes, we have to give advice as to whether or not immediate disclosure of an event is mandatory, with potentially far-reaching consequences.

Relationships with External Counsel

In-house lawyers are only part of the legal profession supporting the energy industry; external counsel is the other. Maximising the business opportunities while minimising legal risk often requires that these two parts work hand-in-hand and I believe there should be a good balance between the work done internally and externally. Approximately half of our total legal spend goes to outside counsel.

In my view, the basic principles for good cooperation between 'in-house' and 'outside' lawyers are trust, availability and efficiency. We place a lot of trust in external counsel to provide an assessment of the potential risks and to anticipate issues.

In a dynamic and global industry such as ours, the ability of external counsel to foresee, prevent or at least mitigate against future issues is invaluable. We trust that our advisers have done their due diligence and applied their best minds to our difficult issues. This doesn't mean we expect to be advised of the safest course of action, but rather that the risks and potential rewards have been properly considered and assessed, both with regard to the issue at hand and as part of the bigger picture. I, for one, choose my outside advisers based on the individuals in the first place. The name of the firm, while not unimportant, comes second.

External counsel must also be available – this means proper staffing, coverage during off-hours and absence of conflicts. It goes without saying that responsiveness is key. With operations around the globe, our workday never really comes to an end.

Efficiency is another foundation for good cooperation between internal and external counsel. Costs are a never-ending pressure and we look to external counsel to optimise resources and provide productive, competent and capable lawyers. There appears to be a constant struggle not to 'over lawyer' a file and I encourage my lawyers and external counsel to keep a critical eye as to what is actually required.

We also trust our external counsel to be professional and to work with our business colleagues in a focused manner, avoiding too much 'legalese' and jargon and providing pragmatic solutions.

The above captures some of my views on the challenges in the energy industry and how we are preparing ourselves to face them.

Of course, other industries too will face such challenges, as the nations and economies of the world continue to develop. I expect that most business lawyers in the world today, whether they are in-house or external counsel, are already tackling these challenges, and many more, and I look forward to doing the same.

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