



# Shell's strategy to fuel the future

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IMD CEO Roundtable, Lausanne  
November 11th, 2005



Jeroen van der Veer is Chief Executive of Royal Dutch Shell plc. He was a Managing Director of Royal Dutch Petroleum from 1997 until the unification under Royal Dutch Shell in July 2005.

He joined Shell in 1971 and worked in manufacturing and marketing in the Netherlands, Curaçao and the United Kingdom. In 1984, he returned to Shell Nederland as manager of Corporate Planning, and then of Pernis Refinery. After an assignment in Shell International, looking after Africa and Canada, he became a managing director of Shell Nederland in 1992. Four years later he became president and chief executive of the Shell Chemical Company in the United States.

He was born in Utrecht in the Netherlands, and is married with three daughters. He has two degrees – one in mechanical engineering from Delft University and another in economics from Rotterdam University. In 2005 he was awarded an honorary doctorate from the University of Port Harcourt in Nigeria.

He is a non-executive director of Unilever, serving as a member of the Nomination and Remuneration Committees.

Global energy needs are expanding and changing rapidly. Energy markets are volatile. Developing new supplies presents increasing challenges, and we must find ways of dealing with carbon dioxide emissions. Energy companies require stronger capabilities. The recent creation of Royal Dutch Shell plc provides clear, simple, efficient and accountable governance for the Shell Group. Business organisations have been globalised. Shell strategy is 'more upstream and profitable downstream'. More upstream means focusing investment on long-term, high-return projects to develop oil and gas resources, and grow Shell's leading liquefied natural gas business. Downstream it means generating more cash by reshaping an integrated oil products and petrochemicals portfolio to enhance operations and focus on growth markets, particularly in Asia.

The international energy business has never been other than very demanding. But it's getting even tougher. Energy needs are expanding and changing rapidly. Markets are more volatile. Developing new supplies presents increasing challenges. And we must find ways of dealing with carbon dioxide emissions.

But this offers business opportunities for energy companies, if they have the necessary capabilities. In Shell we have a clear strategy for realising these opportunities.

I will start by outlining the business challenges and Shell's journey of renewal and restructuring. Then I will discuss this strategy – which can be expressed simply as 'more upstream and profitable downstream' – with some examples. I will end by suggesting some key requirements for success.

#### *What challenges?*

Global energy markets are being transformed, with demand growing rapidly, particularly in major emerging economies.

China's energy consumption grew by more than 15% last year, and India's by 7%. But there was growth elsewhere as well – US oil demand grew by nearly 3% and EU gas demand by 3.5%.

Overall world demand grew by over 4%, exceeding 10 billion tonnes oil equivalent for the first time. That's twice what it was when I started my career in the early 1970s.

According to International Energy Agency projections, world energy consumption could increase by more than half over the next quarter century.

Most of this growth will be in developing and transition economies.

The energy mix is also changing. But the world will still depend on fossil fuels for most of its energy, with gas gaining an increasing share, mainly at the expense of coal.

High energy prices reflect tight supply, with little cushion for interruptions, such as the recent hurricane damage in the US. This tightness is no longer from OPEC constraints, but from unprecedented demand growth.

Flows of speculative funds make prices more volatile. Some \$28 billion has entered the forward market for West Texas Intermediate crude this year. Of course, this money can go as quickly. Concern about the impact of high prices on demand may already be altering bullish perceptions.

The global economy has weathered the impact of high energy prices reasonably well so far. Will this continue? I don't know. But the risks are clearly increasing.

What does all this mean for energy companies? It means we need stronger capabilities.

Energy supplies are not tight because of a lack of resources. There's still plenty to bring into production. But they are increasingly difficult to develop. What matters is being able to apply new technology and undertake more demanding projects, as well as having the commercial conditions to justify large and long-term investments.

And this is not just one multi-billion dollar project at a time. Today we're working on three such 'elephant'

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projects. By 2015 it could be 10. So we need to be able to manage the business risks of these long-term investments, including:

- uncertain geology,
- frontier conditions,
- new technology,
- environmental and social expectations,
- regulatory and fiscal changes, and
- volatile prices and margins.

Today’s prices provide the cash flows to invest in developing new supplies, although there has been a corresponding sharp rise in the cost of project materials, equipment and services.

We’re investing \$15 billion this year, 13% of our capital employed. Our future spending plans will have to reflect both those higher costs and the new opportunities we’re developing.

But we don’t forget that within the last decade the price of a barrel of Brent crude has been as low as \$13 over a year, and has averaged only \$27 a barrel. Refining margins are as volatile. That’s why the clamour for windfall taxes is so short sighted. The world depends on this industry’s ability to sustain high-levels of investment.

International companies face increasing competition in gaining access to potential resources, including from the national companies of emerging markets. We have to show resource holders that our technology, capabilities and long-term commitment add real value.

#### *How organised?*

How should we organise ourselves to meet these challenges? This is something we have had to think very hard about in Shell over the past few years.

Despite our complex governance, we have a long record of business success. Our country-based organisation kept us close to customers and to the governments who control resources, although it left a legacy of diverse systems and processes.

We introduced far-reaching changes over the past decade. But we didn’t act quickly or decisively enough in responding to a new world of connected

markets and instant communications.

The crisis over the reporting of our proved reserves – which is not the same as the much larger resource base we are working to develop – was the catalyst for the necessary decisive action.

This included unifying our parent companies under Royal Dutch Shell plc – one company, with one board, a chief executive, and a single headquarters – providing clear, simple, efficient and accountable governance.

As chief executive, I am directly accountable for the performance of our business and the delivery of our strategy to a single board – with a non-executive chairman – elected by one shareholder body. This won’t sound revolutionary to many of you. But it was a major change for us, and has had a huge impact on the culture at the top of the organisation.

It has also given us the financial flexibility enjoyed by our more straightforwardly organised competitors.

At the same time we have globalised our business organisations – to ensure clearer direction, integrated operations, standardised processes and faster exchange of learning.

By globalisation I don’t mean becoming more distant from our customers and stakeholders. Rather I mean cutting out that organisational complexity – doing business with ourselves – so that we serve them better.

We are rationalising our many IT systems, creating a common infrastructure, with standard applications and shared services in lower cost areas.

Of course, it’s not just how we’re organised that matters. It’s how we work together.

I emphasise discipline and teamwork. That means scrupulous attention to compliance, with legal requirements as well as Shell principles and policies. It means focusing on what’s good for the business as a whole, not individual parts. Our pay now reflects a single Shell scorecard for everybody. And it means greater professionalism.

My determination to ensure longer job tenures has not been popular with everyone. Gaining wide experience has

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value. But I have no doubt it is better to take time to master jobs and take responsibility for the outcomes of decisions.

I talked earlier about the challenges of developing technology, gaining access to resources and managing much more complex projects. Shell has a strong record in all these areas. But we need the highest standards in everything we do.

So we have established Commercial and Project academies to ensure that lessons from our own successes – as well as those of others – are systematically applied everywhere. And we recently appointed Chief Scientists to act as internal and external ambassadors for key technical disciplines.

Finally, of course, we need to recruit more talent to meet the increasing opportunities. This year we have already recruited over a thousand new technical professionals around the world.

But, while I am on that subject, I'm increasingly worried about the decline in science graduates in Europe and the US. Perhaps you share my concerns. I have no doubt that our ability to compete economically, and to help make the world a better and safer place, will depend above all on our technological capabilities.

#### *What direction?*

What do we mean by our strategy of 'more upstream and profitable downstream'?

More upstream is about focusing our investment – over three quarters of the total – on finding and developing oil and gas, and growing our LNG business.

This is where we have the capabilities to make long-term, high-return investments, focusing on three growth areas:

- developing new material oil resources, such as the major Bonga deepwater field in Nigeria which we are bringing on stream shortly,
- integrating the gas delivery chain from reservoir to customers,
- and bringing unconventional resources, such as from Canadian oil sands, to market.

We also make incremental investment in our existing assets to maintain production and respond to today's high prices.

Profitable downstream is about generating more cash by reshaping our integrated oil products and petrochemicals portfolio, enhancing our operations and focusing on growth markets, particularly in Asia.

There are four key drivers of our strategy:

- portfolio renewal, with \$13 billion dollars of completed divestments since 2004,
- integration across the businesses – contrary to what some may think being an integrated oil and gas company is an increasing strength,
- applying technology,
- and harnessing the global strength of the Shell brand.

I will give three examples of our strategy in action, starting with 'integrated gas'.

The world wants much more gas because of its efficiency and cleanliness. This has to be delivered over increasing distances, by pipeline or as liquefied natural gas (LNG).

The challenge is to put together the complex and costly delivery chains from reservoir to customer in dynamic and competitive markets. That doesn't necessarily mean investing in the whole chain, but choosing where we can open strategic options.

We are determined to maintain Shell leadership in the LNG business and target 14% growth in equity capacity over the next five years – slightly faster than over the past five – from projects already underway. We expect further significant growth from new projects early next decade.

The LNG plant we are constructing on Sakhalin Island in Russia will have capacity equal to around 8% of today's Pacific basin demand. We have secured long-term sales for over 70% of this from our traditional Asian customers and by developing North American import capacity. Sakhalin is perhaps the largest and most complex integrated oil

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and gas project yet developed. Although we face significant cost pressures, it remains a very attractive project.

Once greenfield LNG plants are in operation, it is much cheaper to expand them. The Nigeria LNG plant started production in 2000 with two trains. The fourth will be completed this year, a fifth and sixth are under construction, and two more are being discussed. Expansion has been driven by Shell's ability to develop new import capacity and markets in North America.

Developing new business opportunities in emerging energy markets is a priority. Let me give an idea of what we are doing in the largest, China. Our history in China goes back more than a hundred years and we re-entered the country in the early 1970s.

Our approach is to pursue wide-ranging opportunities in all our core businesses. This includes:

- applying advanced technology to produce gas for delivery to customers in Beijing,
- developing a major retail joint venture in Jiangsu province,
- blending and marketing high-quality lubricants,
- investing in the \$4.3 billion Nanhai petrochemical plant, which is now being commissioned,
- applying our coal gasification technology to help use China's coal more efficiently and cleanly,
- and pursuing the potential of our new technology to produce oil from shales.

We are doing this in partnerships with a range of Chinese companies, including all three major oil and gas companies.

And we're building a strong Shell China to take the business forward. We now employ 1,500 people, more than 90% are Chinese nationals.

This is helped by two strengths:

- the reservoir of experienced, Chinese speaking Shell managers and technical professionals from our major operations in south-east Asia, and

- our established system for assigning people to gain experience in other Shell operations around the world, 80 Chinese staff are doing this at present.

Finally, let me look at our strategy of offering differentiated fuels with better qualities – power, cleanliness and economy – for which our customers are prepared to pay more. This rejects the common assumption that fuels are inevitably commodities.

We produce these fuels in three ways:

- bespoke refining, which requires a highly efficient supply chain to deliver base fuel from our own refineries rather than relying on swaps with other refiners,
- proprietary additives, and
- by including synthetic components made from gas.

The last reflects our leadership in Gas to Liquids technology to produce high-quality, ultra-clean fuels, which can be used in existing cars and also supports the development of better engines.

We recently launched V-Power diesel – which includes the Gas to Liquids component as well as an advanced additives package – here in Switzerland.

Our differentiated fuel strategy – launched in 40 countries – has been very successful and underpins our retail profitability.

Looking forward, I think that Shell is unique in having positions in all the major areas of fuel development – synthetic fuels from gas, coal and biomass, biofuels and hydrogen.

I hope these three examples give you an idea of how we are realising our strategy of 'more upstream and profitable downstream'.

#### *What learning?*

But having a clear strategy is just half of it. What matters is how we execute it. We need to bring clarity and simplicity to this too.

I believe our success will depend on three things.

First, we need to be benchmarked in the top quartile in all our operations. We

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know where we don’t achieve this and have plans – which I monitor very carefully – for getting there.

Second, we need to be able to deliver all projects on time, on budget and to the required technical standard. This is a priority and I have mentioned some of the things we are doing to achieve it.

Third, we need to make the right choices in an industry with such high requirements for capital and skills.

I believe our simpler governance enables us to do this better and quicker.

Business success has always depended on being able to respond to new conditions and opportunities.

Change today is faster and the pressures more intense – from customers, regulators, NGOs, competitors and shareholders.

I believe that achieving success depends on four things

- clarity of understanding, strategy, choices and communications,
- simplicity in less complex, faster and more flexible organisations,
- efficiency of processes, learning and innovation,
- and accountability throughout the organisation but most clearly for Chief Executives.

That’s what makes our job worthwhile.

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