

THE NEWSLETTER OF THE BDO NATURAL RESOURCES PRACTICE

NATURAL RESOURCES RECORD



BOARD COMPENSATION ON THE RISE IN THE OIL AND GAS INDUSTRY

By Lance Froelich, BDO USA, Houston

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

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AN UPDATE ON OFFSHORE GULF OF MEXICO DRILLING ACTIVITY

By Greg Stowe, BDO Valuation Advisors

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

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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.

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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 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

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industry standards and competitive trends, rather than on pre-conceived – and possibly mistaken – notions.

One of the standard practices that is being re-examined 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.

About the author

Lance Froelich is a senior director in the compensation and benefits practice at BDO in Houston. He is also the compensation and benefits leader for the firm's natural resources industry practice. BDO is the world's fifth-largest accounting and consulting organization.



For more information on executive and director compensation in the oil and gas industry, please contact Lance Froelich at lfroelich@bdo.com.

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OFFSHORE GULF OF MEXICO DRILLING

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

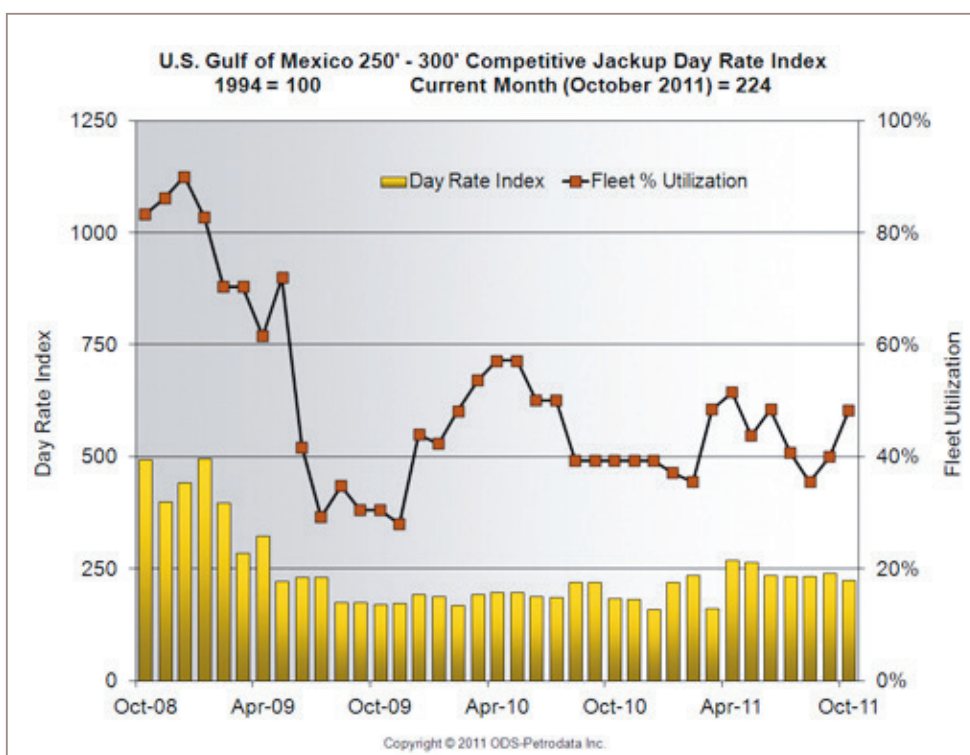
The moratorium for shallow water drilling was lifted in June 2010. As illustrated in the chart below, this did little to improve shallow water drilling activity and there was no positive impact for almost nine months. The chart shows the historical day rate index (left scale) and the fleet utilization (right scale) for the U.S. Gulf of Mexico 250 foot to 300 foot jackup 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



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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.

▶ DEEPWATER DRILLING

The offshore rig market is divided into two main types of rigs; floaters and jackups. 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.

Shallow Permits to Drill

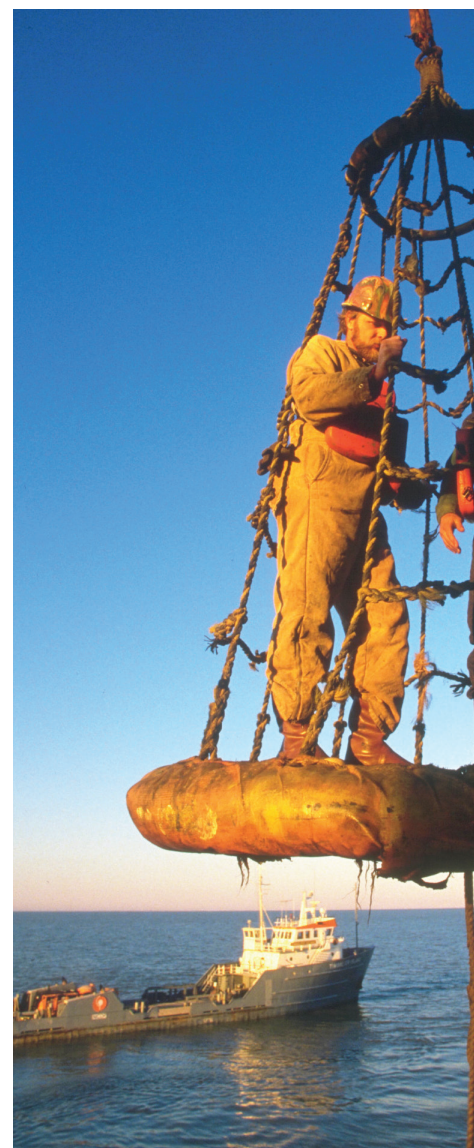
Water Depth Less than or equal to 500 feet

Permit Type	Submitted prior to June 8, 2010	Submitted since June 8, 2010	Returned	Withdrawn	Pending	Approved since June 8, 2010
New Well	13	89	11	5	11	75
Revised New Well	9	129		3		135
Bypass		35			3	32
Revised Bypass		24				24
Sidetrack	17	114	6	5	6	114
Revised Sidetrack	6	127	1		1	

Deepwater Permits to Drill

Water Depth Greater than 500 feet

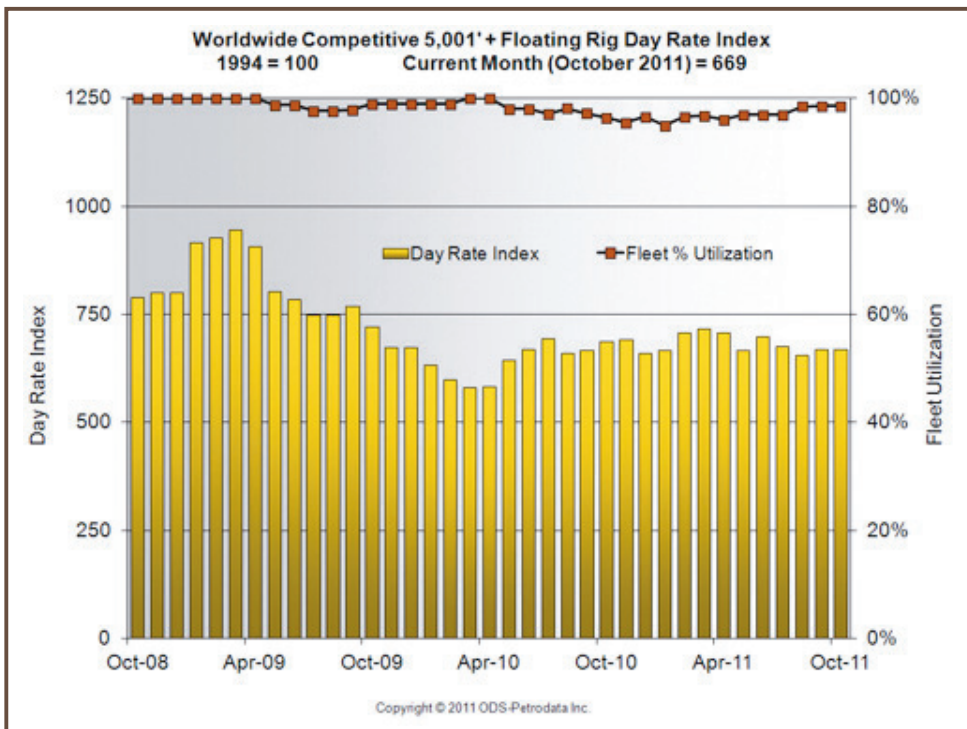
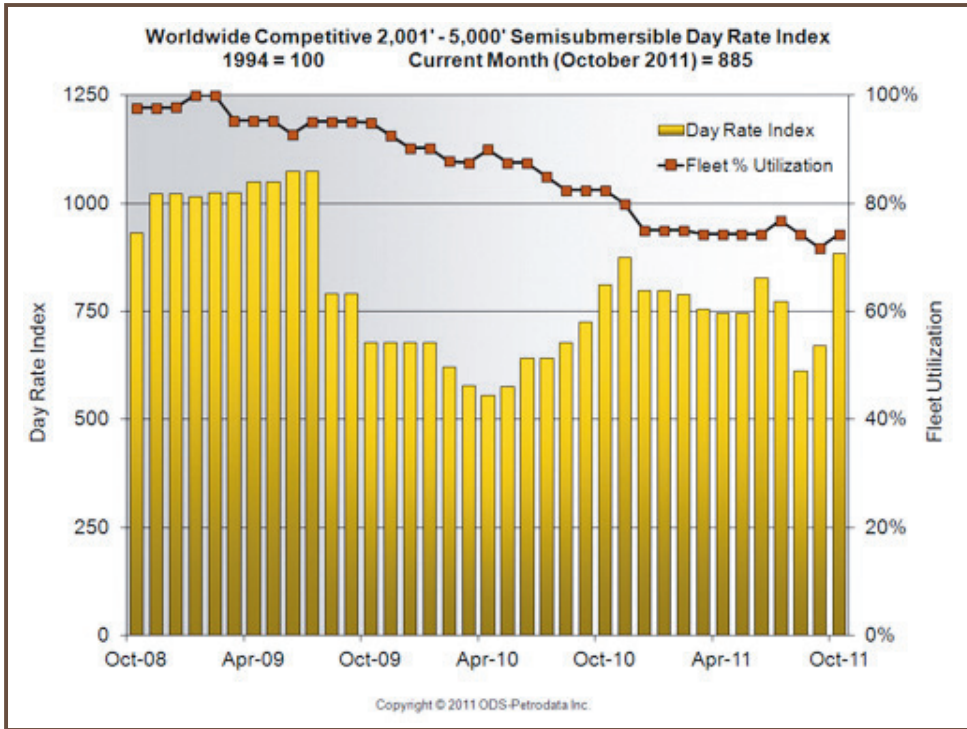
Permit Type	Submitted prior to Oct. 12, 2010	Submitted since Oct. 12, 2010	Returned	Withdrawn	Pending	Approved since Oct. 12, 2010
New Well	15	35	11	3	13	23
Revised New Well	2	87	3	3	6	77
Bypass		14				14
Revised Bypass	1	21		2		20
Sidetrack	4	16	2	1	5	12
Revised Sidetrack	4	30		1	3	30



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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.

About the author

Gregory Stowe is a Senior Vice President at BDO Valuation Advisors in Dallas. He has more than 15 years of experience in the valuation of businesses and business assets. BDO Valuation Advisors, LLC is a separate legal entity and is affiliated with BDO USA, LLP, a Delaware limited liability partnership and national professional services firm.



For more information on oil and gas industry valuations, please contact Greg Stowe of BDO Valuation Advisors at gstowe@bdovaluation.us.com.

BDO SPOTLIGHT:

Q&A with Rocky Horvath, Assurance Partner, Houston



What led you to work with the BDO Natural Resources Practice?

My career has always been based in Houston, where oil and gas is a major focus. My first job was in the Houston office of Coopers & Lybrand (now PriceWaterhouseCoopers), where I began my career auditing both public and private oil and gas companies. In 1992, I became an independent consultant and was first exposed to BDO. By 2003, the introduction of Sarbanes-Oxley compliance legislation meant that nearly 100% of my work was with BDO, helping clients navigate the new reporting requirements. In July 2007, I joined the firm full-time as a partner in the Natural Resources practice, focusing almost exclusively on work with clients in the E&P sector.

What experience helped shape your career?

As a young staff member, I dove headfirst into a few public client accounts that dealt with highly specialized oil and gas industry reporting requirements. I soon learned that a clear understanding and command of these reporting requirements was in high demand. By focusing my work in this area early in my career, I had the opportunity to gain a valuable knowledge base that would become an asset to future oil and gas industry clients.

In your opinion, what are some of the biggest challenges facing the industry today?

Regulatory restrictions are a major challenge facing the industry, as reflected in both our Risk Factor report and CFO studies. Industry leaders are particularly concerned with the risk of increased regulations on hydraulic fracturing, which could have a significant impact on the cost of doing business in the industry. A second major regulatory issue is taxation, specifically the removal of the accelerated deductibility of IDC (intangible

drilling cost), a necessary deduction that gives oil and gas companies the incentive to drill wells even though some of those wells may not ultimately find producible oil and gas deposits. The trickle down effect of such tax legislation could reduce the value of a company's oil and gas reserves and, ultimately, limit their ability to raise capital.

In addition, the 2008/2009 credit freeze is still top of mind for many oil and gas CFOs. The underlying issues facing the banking industry have not been completely solved and CFO's are proceeding with caution given the volatile economy and the credit problems faced by both the Eurozone and the U.S. Any repeat of such a credit freeze could abruptly affect the value of their reserves and ability to raise capital necessary to carry out their business plans.

What are some of the industry's greatest strengths in the face of economic uncertainty?

At the end of the day, oil and natural gas are physical commodities. This means that even in a tough economic environment, they may represent a more sound investment choice – especially when compared to investments in many other industries. Because of this, the industry is garnering a great deal of investor interest, which translates into growth and increased opportunities for oil and gas companies. Part of this interest is also due to improved technology. Oil and gas companies are able to enter zones and shale plays that were considered impossible as little as two or three years ago. This is very exciting for the industry and could potentially lead to job creation and further business development, making the oil and gas industry one of the few bright spots in our economy.

What lies ahead for the BDO Natural Resources industry practice?

I see a lot of growth. Our practice has experienced a great deal of upward movement this past year, mainly from existing private clients interested in taking some or all of their assets public. In general, there seems to be a great deal of interest from the investment community in oil and gas companies, especially those in the commodities extraction (exploration and production) business, an area where we have significant experience. This knowledge and understanding of the industry, along with a depth and breadth of partners and managers in the Houston, Dallas and Austin offices, allows us to provide attentive service to clients with knowledgeable personnel at all levels. This means our clients don't have to train their auditor each year, something that CFOs truly appreciate and a factor that has contributed to several of our recent client wins.

For more information on how the BDO Natural Resources practice can help companies navigate challenges and take advantage of growth opportunities in the industry, please contact Rocky Horvath at rhorvath@bdo.com.

2011 CALENDAR

The following is a list of upcoming natural resources conferences and seminars:

NOVEMBER 2011

November 1-3

9th Annual Deepwater Operations Conference & Exhibition

Moody Gardens Hotel & Convention Center
Galveston, TX

November 7

Climate Insights: Financial Opportunities 2011

Thomson Reuters Headquarters
New York, NY

November 10-12

IPAA Annual Meeting

La Quinta Resort & Club
La Quinta, CA

November 15-17

DUG: Developing Unconventional Gas East

David L. Lawrence Convention Center
Pittsburgh, PA

DECEMBER 2011

December 6-7

The Dodd Frank Act: Implementation and Compliance for the Energy Industry

Courtyard Marriott Houston
Houston, TX

December 12-15

PIRA Understanding Natural Gas Markets PIRA Understanding Global Oil Markets

Hilton New York
New York, NY

December 12-15

Subsea Survey RIM 2011

Marriott Westchase
Houston, TX

JANUARY 2011

January 16-17

Platts 10th Annual Gas Storage Outlook

JW Marriott Hotel
Houston, TX

January 18-19

3rd Annual Pipe Tech Americas Summit 2012

Sugar Land Marriott Town Square
Houston, TX

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BDO's Natural Resources industry practice provides assurance, tax and advisory services to emerging and established businesses in the United States and all over the world who are involved in both the traditional and alternative energy industries. Our clients often operate across borders either raising capital or making acquisitions abroad. Our extensive industry knowledge is supported by our international network of 1,082 offices in 119 countries, allowing us to provide a consistently high level of service wherever our clients do business.

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