Leadership Challenges for a Complex World

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Simon Henry became Chief Financial Officer of Royal Dutch Shell in May, 2009 and an Executive Director the same month.

He is responsible for finance and information technology management and for global business strategy development at Shell. He also has oversight responsibility within the Executive Committee for Shell’s business activities in the Asia Pacific region.

Simon has a first-class degree in Mathematics from the University of Cambridge, UK. He joined Shell in 1982 as an engineer at the Stanlow refinery in the UK. He qualified as a member of the Chartered Institute of Management Accountants in 1989 and went on to hold various finance posts, including Finance Manager of Marketing in Egypt, controller for the Upstream business in Egypt, Oil Products Finance Advisor for Asia Pacific, Finance Director for the Mekong Cluster and General Manager Finance for the South-East Asian Retail business.

He was appointed Head of Group Investor Relations in 2001. Most recently he was Executive Vice President Finance for Exploration & Production from 2004 until his current appointment.

Simon is a British national born in 1961. He is married with three children.
In a decade that is likely to be characterised by its economic and political uncertainty, Chief Financial Officers (CFOs) will be subject to a broader range of pressures than ever before. The CFO’s traditional job description continues to undergo far-reaching changes. In addition to capital-raising and managing financial processes, they must now spend more time engaging with policymakers, analysing mergers & acquisitions (M&A) deals, and developing corporate strategy. In this speech Simon Henry, CFO of Royal Dutch Shell, describes how the broad trends of the next decade could affect CFOs and explains how he is tackling the challenges in fields including risk management and capital raising.

Introduction
In discussing the leadership challenges facing CFOs over the next decade, I’ll do three things.

First, I’ll set out some of the broad economic and political trends that could shape the next decade. Then I’ll ask what they mean for CFOs. And I’ll finish by describing how I’m tackling some of these challenges at Shell.

So what, broadly, will the next decade look like?

From the late 1970s to fairly recently the world economy experienced what history may show to be a benign environment, with steady growth, low inflation and commodity prices supporting emerging economy growth. Our economists refer to this as a period of “moderation”. That has now changed. We believe greater economic uncertainty and volatility will be the norm.

And the past few weeks have reinforced that political uncertainty will also be one of its defining features. It’s too early to speculate about the likely geopolitical fallout of what is happening in the Middle East and North Africa. And it’s certainly a mug’s game trying to predict where unrest might spring up next. But recent events have sent oil prices sharply higher, and weakened risk appetites among investors.

That is an uncomfortable reminder that political instability will go hand-in-hand with stronger macro-economic volatility. And that energy and commodity prices remain prime drivers of the macro economy.

With respect to the oil supply, OPEC’s current spare capacity is probably more than double what it was during the 2008 price spike. So in that respect, at least, the world is better placed to cope with the current supply disruption.

Even before the recent surge to $120 per barrel of oil, prices had increased sharply as demand recovered after the recession. In 2010, demand increased by 3%. Only twice before has the world experienced such a strong growth rate: in 1976 and 2004. Partly as a result, steel and other metals prices have also rebounded strongly, as have food prices.

That is consistent with the trend of rising long-term energy demand. Over the first half of the century, global demand could double or even triple, on the back of growth in the developing economies and the rising global population. Keeping pace with this demand will be no easy task. According to the IEA, the world must invest some $1 trillion a year in new energy projects to meet demand to 2030.

So, whether because of surging demand or supply disruptions, energy price volatility will be a risk that remains with us throughout this decade and beyond.

To get a sense of the potential impact, you only have to consider that the cost of the European Union’s oil imports grew by $70 billion last year – a figure equal to the combined budget deficits of Greece and Portugal.

There are, of course, several other threats to macroeconomic stability.
For example, to address huge public deficits in the advanced economies, more governments are making deep cuts in expenditure, with uncertain consequences for a fragile recovery.

Inflationary pressures are now building in many countries, not least here in the UK and in the Eurozone. Yet, at the same time, high rates of unemployment and rapid fiscal cuts raise the spectre of deflation. So, in deciding how and when to tighten monetary policy, central banks face some extremely tough calls.

Another key feature of the next decade will be the continuing rise of the emerging economies. They will provide an increasing share of the world’s growth, just as they have provided much of the impetus in the global recovery. The world’s economic centre of gravity is moving inexorably east.

In my own industry, for example, China could account for more than half of the world’s increase in oil demand before 2035, with India driving much of the rest.

While such growth brings enormous opportunities, it also spurs more intense competition as world class companies emerge in China, India, Brazil and elsewhere.

For example, the national oil companies of a number of emerging economies are becoming leaner and more technologically savvy. For Shell the enhanced competition raises the bar higher.

Our ability to build thriving partnerships with resource holders, and thus to win important business opportunities, is in large part rooted in our technological prowess.

Simultaneously, western governments seem intent on introducing swathes of new regulations that will affect businesses. After the internet bubble and the events of 2008, this is perhaps understandable. But all too often prescriptive legislation simply aims to punish the drivers of the last crisis, rather than preventing the next one. For example, a lesson from Sarbanes Oxley is that it added to complexity and cost for businesses, but failed to even identify let alone prevent the credit crunch.

And lastly, events of the past year in the Gulf of Mexico in our own industry have shown how reputational damage can have a far greater impact on a business than perhaps its underlying economic impact.

So, looking forward, we face much greater macroeconomic volatility, a shift in economic power and competitive positioning, western governments that cannot afford their programmes but are keen to restrict their own business organisations. And an environment where the general loss of trust in businesses has brought so many new challenges to our collective reputation.

Ladies and gentlemen, our job just got tougher.

**Raised internal expectations for CFOs – delivering on more fronts**

This is an outlook that carries profound implications for CFOs.

Their core tasks of accountancy and capital-raising are already more challenging. And CFOs will also have to deliver on a much broader range of fronts, as their job descriptions continue their rapid evolution.

A decade ago, the overwhelming focus of most CFOs was on getting the basic financial processes and control frameworks right, and ensuring the businesses had access to capital. Most spent relatively little time developing corporate strategy and M&A deals, or dealing with the media and government policymakers.

Fast forward a decade and CFOs face sharply raised expectations among their colleagues. As well as their traditional responsibilities, many must now oversee more proactive and rigorous risk management, while ensuring that strategic decisions create

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lasting value, not least in the emerging markets. In short, they must impose the professional rigour of the finance department across all areas of business activity.

It’s hardly surprising, then, that CFOs must also grapple with a new set of boardroom dynamics. For example, while maintaining a strong relationship with their chief executives, some must also meet the new boardroom expectations that they, as CFOs, are answerable for ensuring that their bosses maintain appropriate risk management and financial discipline.

**External pressures**

External expectations are also mounting.

In the wake of the financial crisis, accounting standards face a prolonged period of upheaval, with far reaching consequences. We’ve already seen the backlash against “fair value” or “mark-to-market” accounting, where financial instruments like derivatives, are valued according to their current market price, rather than their historic cost.

There’s also pressure to change accounting standards in other areas, including pensions, leases and revenue accounting.

All of which will add to the complexity of company accounts and financial statements. And widen the gap between financial accounting and the information that actually supports sound business decision making. So CFOs must spend even more time explaining complicated accounting standards to their business colleagues, investors and others.

The regulatory landscape will be equally unforgiving.

In the USA, for example, the passing of the Dodd-Frank Act last July heralded the biggest shake-up of financial services in 80 years. This will affect a host of areas, from the supervision of systemic risk to consumer protection, and from the trading and clearing of “over the counter” – or OTC derivatives – to investment fund management.

Given fragile public confidence in the business sector, this is understandable. But complying with complex new regulations could produce many thousands of hours of work for finance departments. That, at least, was a lesson of Sarbanes-Oxley.

The wave of financial regulation also means that CFOs must spend more time engaging with policymakers.

This is needed to ensure that legislation produces real improvements, rather than unintended consequences.

The provisions of the Dodd-Frank Act relating to revenue transparency are a case in point.

When implemented, the Act will oblige Shell and other companies to report all payments that we make to foreign governments in the course of our work. By project, by country, by type of payment.

It is not just that this would require us to revamp our financial systems and processes, raising costs. Much more troubling is that we would be obliged to disclose this information even if it violated the laws of the foreign governments concerned. In other words, companies would be forced to choose which country’s laws to observe and which to violate.

But engaging with policymakers and NGOs on such sensitive issues is tough. In this particular case, we have promoted the cause of voluntary transparency through the Extractive Industries Transparency Initiative, believing that it will produce far better results by bringing together governments, industry and civil society and respecting host countries’ sovereignty.

But, in the eyes of many, companies like Shell tread a fine line between acting in the public interest on these issues, and protecting our own narrow concerns.

For CFOs, this involvement will deepen as governments press on with ambitious financial reforms.

So in all these ways, CFOs must
deliver on a broader range of fronts, and against a more complex backdrop.

So how am I tackling these challenges at Shell? And what are some of my priorities?

A competitive finance function
My first and most obvious priority has been to build a competitive and smooth-running finance function.

In an era of uncertainty, businesses need confidence in the integrity of their financial information, controls and transaction processing. And with a swathe of new financial regulations on the way our compliance procedures will be tested, as will our ability to adapt to changing accounting standards and enhanced reporting requirements.

Moreover, without a smooth running function, I would be unable to satisfy the growing demands on my diary. For example, I spend over one-third of my time on external engagements, meeting investors, customers and other key stakeholders.

That would be impossible without the transformation of Shell’s finance function over the past five years.

Back in 2005, our financial operations were spread across more than 100 countries, all with their own processes and controls. As much as two-thirds of the finance department’s costs were generated by basic processes like reporting controls and providing management information. And less than 10% of staff were located in dedicated operations centres.

So we adopted an ambitious plan to transform the function by the end of 2010. Among our goals were a 40% reduction in costs – the equivalent of some $800 million - the shifting of half of our roles to operations centres by 2010, and the setting of well-defined targets for our business support activities.

I’m delighted to say that we brought the plan to an official close at the end of last year having delivered on our major targets.

We are now placing a stronger emphasis on talent development, to reflect the challenges of the next decade. In particular, this means equipping our staff with the broader range of skills they need to generate value across all areas of business activity.

In November we piloted a week long course with IMD Business School, Switzerland, to help prepare around 25 of our emerging leaders to play a more prominent role in day-to-day business operations such as deal planning, appraisal, and capital project delivery.

I contributed to the course’s content, which included tough business cases drawn from Shell’s operations. And then joined the participants for more than half a day, answering questions and discussing the issues.

A particular focus of the course was developing finance professionals’ powers of persuasion, negotiation and influence, as well as other “softer” skills. That’s because it will take more than our professional skills to carve out an influential voice in business units run, for example, by more technically focussed engineers or in joint ventures where Shell lacks a controlling interest.

Another session compared how different companies create value, and explored the relationship between growth and profitability. To this end, it analysed the financial impact of business decision-making in a number of areas, including pricing, the use of assets and performance management.

The course was a great success, and we are now developing a version for our more junior finance professionals.

So these are just some of the ways in which I am preparing Shell’s finance function for the challenges of the next decade.

Capital raising and financial strategy
A second area of focus is access to capital markets, which will remain an urgent priority for some time to come.
Despite the financial crisis, the underlying goal remains unchanged: striking the right balance between debt and equity, at competitive rates, while offering a competitive return on both.

Because of Shell’s long-term investment horizons, what constitutes the right return and the appropriate balance changes over time, as our investments, portfolio and exposure to risk shift and fluctuate.

What is clearer now is that the pricing of risk can now be transformed in an instant, thanks to the pace at which political and economic events – and rumours about them – reverberate through the financial markets. Vast amounts of capital move quickly. Billions can be wiped off a company’s value in minutes, with potentially devastating consequences in the most extreme cases.

Higher levels of volatility also make it more difficult to judge what makes an attractive return for investors, as the markets constantly recalculate the balance between risk and reward, drawing on an avalanche of information – much of it outside my control or unrelated to Shell’s operations.

But I am fortunate to be the CFO of an large and successful international oil company, benefitting from relatively open access to the world’s capital markets. Amid all the disruption of recent years, there have been very few days when the markets have been closed to issuers like Shell.

So from my point of view, in this context the major challenge of the next decade will be balancing the risks and returns to Shell’s equity and debt holders, as we invest for long-term growth. But I fully appreciate the challenges some companies are now seeing in access to capital, and this affects all businesses indirectly.

We must balance heavy investment – up to $30 billion every year until at least 2014 – with a prudent financial framework, generating cash to repay debt and providing shareholders with an attractive return.

The nature of that return is changing, mainly because the time horizons of our investments have broadened. As access to resources gets harder, more of our projects are based on new technologies and innovative project models, whose risk parameters are, as yet, unclear.

In turn, our investors have lengthened their time horizons, acknowledging that Shell’s new projects will produce higher rewards over the longer term.

That’s why last year, for the first time, we offered our shareholders a choice to receive dividends in cash or in shares through a scrip dividend programme. This offers investors looking for growth a straightforward way to forego cash and reinvest in future share appreciation.

Shell can then put this cash to work in the projects that will deliver long-term growth.

As for the current political uncertainty in the Middle East, this may raise the cost of capital in our industry, although we expect to be relatively well insulated from any significant increases in the cost of capital.

And amid all the current upheavals, we must not forget there’s also a positive story to be told about the next decade, with the liberalisation of Asia’s capital markets.

Most important, the Chinese government has encouraged the growth of the offshore Renminbi market in Hong Kong. And it has signalled that it may, in time, open up the mainland’s capital markets, too. All of which would offer a wealth of new opportunities to Chinese companies and investors, as well as foreign companies. Thus expanding – and indeed potentially transforming – the global financial system.

**Risk management**

A third and related challenge for CFOs is meeting raised expectations on risk management.

There is much I could talk about here, from our relentless focus on safety to

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delivering multi-billion dollar projects on-time and on-budget.

But after the recession, many CFOs will be under pressure from sceptical board members and investors to ensure that growth plans deliver long-term value and capital efficiency. If the global financial crisis highlighted anything, it’s the risk of pursuing plans that are financially unsustainable.

To meet raised expectations here, CFOs need to engage more deeply in developing strategy, beyond simply providing the capital to fund it.

I was fortunate to assume responsibility for Shell’s strategy development in 2009 as part of our company-wide reorganisation.

I also chair our strategy and growth forum, which oversees the development of strategy across Shell’s businesses, and assesses the big picture risks and opportunities.

With our growth plans spanning the globe and the emerging markets, including China and Brazil, this is a critical activity.

It allows my team to ensure that strategic decisions, including M&A opportunities, are well-timed, financially sound and consistent with the business’s growth strategy. In other words, that they deliver long-term value.

This matters because last year we made some $9 billion worth of acquisitions, and because we are investing more in the world’s growth markets.

Earlier, I mentioned that our ability to deliver value in these markets will be determined by our ability to create healthy and long-term relationships with local partners, based on our technology. So we have pursued opportunities that help us to do exactly that.

Take, for example, our acquisition of Arrow Energy, an Australian gas company, which we purchased jointly with Petrochina for some $3.2 billion. The JV will develop and operate

unconventional gas production for export to China.

While there’s no doubt this is a great business opportunity, it does demonstrate the range of risks we face in our business. The technical and economic risks may be clear, but this deal highlights the political, environmental and governance risks that we must also identify and manage.

China has similar unconventional resources within its borders. And is understandably keen to tap them in support of its policy to boost the share of natural gas in its energy mix. That’s why China’s national oil companies are keen to build long-term partnerships with companies, like Shell, which have strong expertise in gas production and distribution.

Becoming more closely involved in strategy development can also help CFOs to maintain capital efficiency across their companies – another requirement for financially sustainable growth plans.

We are currently selling many of our more marginal – or “non-core” – assets, to ensure that we focus our financial and management resources on our most promising markets.

We have recently sold assets in African and Europe for well over $1 billion. That follows 2010, when we made $9 billion of sales, matching our $9 billion of acquisitions.

Risks of course come in many other forms in addition to those directly related to the business portfolio. I have only covered a small portion of those we collectively face. Suffice to say our job title does usually now also encompasses the term “chief risk officer”.

Boardroom relationships

Which is a good segue into a final word on boardroom relationships.

Increased formal requirements on directors such as the Combined Code on Corporate Governance have, I believe,
changed the nature of the discussions in boardrooms over the past decade. From personal experience, I have seen a significant improvement in the understanding of business risks and revenue streams. This encompasses all aspects of the business from financial controls through environmental performance to corporate social responsibility. Clearly, this a positive development, which benefits shareholders.

It has placed even greater demands on the CFO, who is increasingly seen as an independent "counterweight" to the CEO and other executive directors, particularly in terms of risk management and assurance processes. The relationship between Audit Committee and CFO, and also the existence of transparent and direct communication between CFO and Chairman are key to good governance.

This afternoon I will join our audit committee in considering the operation of our control framework in 2010, ahead of filing our annual report and 20F returns to the stock exchanges next week. Given the potential consequences of the signatures on those documents, you can imagine it is a sharper and more challenging discussion than it once was.

But again the increased accountability for all directors is one way we can help to recreate some of the trust in businesses that has been lost in recent years.

**Conclusion**

I will draw to a close there. Clearly, there are many other issues that I could touch on, from IT to the challenges of recruitment in the emerging markets. And perhaps we can talk about some of those in the discussion.

While the next decade will be stretching, we must also remember that there has never been such an exciting or stimulating time to be a CFO.

We have the opportunity to use our full array of skills – in financial analysis and strategy, in risk management, and in information technology – to help our businesses achieve sustainable growth in an era of historic change and uncertainty. And that, for all the challenges, is surely a prize worth striving for.

*Thank you for your attention.*

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