

ASSESSMENT OF THE BP 2010 ANNUAL REPORT

Overview

While identifying many risks and challenges, BP's Annual Report (AR) generally provides shareholders with an insufficient level of detail to determine how the company's safety and risk management function has been strengthened, how it is being evaluated and managed, how the board will oversee it, and how progress is to be assessed and measured.

The AR reiterates changes that were announced several months ago -- including the intervention powers of the new risk unit, the reorganization of the upstream business, and the appointment of board members with expertise from the chemical and nuclear industry -- yet the AR does not provide substantial new information regarding four key areas of concern:

1. Health and Safety
 - a. Operating Management System
 - b. Recommendations from *The Deepwater Horizon Accident Investigation Report*
 - c. Joint Ventures and Contractor Relationships
 - d. Refining and Marketing
2. Remediation of the Gulf Oil Spill
3. Transition to a Low Carbon Economy
4. Board Oversight

This assessment does not cover BP's Sustainability Review, issued two weeks after the AR, given the AR's function to convey areas of strategic importance to investors.

1. HEALTH AND SAFETY

The disclosure of specific information related to risk assessment and management is critical to investors as a basis for analysis of investment in BP. In light of the devastating human, environmental and financial impacts of the Gulf of Mexico incident, the lack of substantive specific information regarding improved safety and risk practices in the AR is disappointing. The AR represented the company's opportunity to provide shareholders with specific disclosures regarding: the operation of the Safety & Operational Risk (S&OR) unit; the unit's specific goals and objectives; the timelines for implementing the Bly report recommendations; and the frequency of reports to shareholders on the unit's operations. Unfortunately little of this detail is provided in the AR.

a. Operating Management System

Following the Gulf of Mexico incident, the major announcement made by BP was the creation of a new Safety and Operational Risk (S&OR) function with authority to intervene in business lines.

The AR makes frequent reference to enhancements that have been made to the safety and operational risk function; however, without additional detail, it is difficult to know how the Operating Management System (OMS) has been strengthened, how BP's understanding of risk exposure has increased, and what appropriate actions are being taken. The lack of key performance indicators and benchmarks to measure progress towards addressing risk make it difficult to judge the effectiveness of the steps the company has taken to date, or to gauge future preventative measures. Given BP's recent history, this level of detailed information is warranted.

By way of example, in describing BP's OMS, the AR states that BP's system of risk management is comprehensive and supported by "*detailed company practices, as well as other technical guidance materials.*" However the AR does not provide detailed descriptions of and/or links to more specific materials that demonstrate that a thorough and robust system is in place and operating effectively. Further, while Pg. 14 notes that the S&OR function has its own expert staff, the qualifications and number of staff is not provided, nor is an explanation of how that staff is "*embedded in BP's operating units, including exploration projects and refineries.*" It is unclear if new staff has been added to these units to offer a fresh perspective and provide additional expertise or if staff remain in previously held positions but have since been trained to sufficiently and regularly escalate concerns.

Also, while a list of material risks to the company is presented (Pg 27-30), insufficient evidence of the ways in which those risks are being properly managed is provided, which would be of greater value to shareholders.

While the AR states that the OMS "*lays out the steps and safeguards we believe are necessary to maintain socially responsible operations at our projects and operations,*" (Pg. 75) a system for evaluating the effectiveness of its programs in relation to the Gulf of Mexico, including benefits to local communities, opportunities for local suppliers, and preservation of the environment and local cultural heritage appears to be lacking. For example, while the AR notes financial commitments to promote tourism and seafood safety, referred to in the AR as "*two cornerstones of the Gulf Coast economy,*" there is little detail about the program's goals and measures of success by which to judge progress.

b. The Deepwater Horizon Accident Investigation Report

As The National Commission on the Deepwater Horizon Oil Spill and Offshore Oil noted in its review, BP's record suggests "*its approach to managing safety has been on individual worker occupational safety but not on process safety. These incidents and subsequent analyses indicate that the company does not have consistent and reliable risk-management processes -- and thus has been unable to meet its professed commitment to safety.*"

There are numerous references in the AR to the twenty-six recommendations found in The Deepwater Horizon Accident Investigation Report -- also known as "The Bly Report" -- which the company "*accepted and are implementing across our worldwide drilling operations.*" While a general description of the recommendations is provided, a major weakness of the AR is the omission of how the recommendations are being implemented, which have been deemed most critical and require highest prioritization, and the timeframe for implementation.

While the AR does not make clear how frequently reports will be released, shareholders require disclosure, at least annually, on BP's progress towards implementing the recommendations, as well as the challenges being faced and how they will be addressed. It is critical that BP demonstrate its understanding that the spill was not the result of human failure but failure by BP to create adequate systems to prevent it.

In light of the failings consistently identified by the independent expert in implementing the recommendations of the BP US Refineries Independent Safety Review Panel, shareholders would benefit from the appointment by the board of an independent expert, as was done in Texas City, to ensure timely and thorough implementation of the recommendations from the Bly Report.

We note the publication by the company on March 21, 2011 of a document entitled "*Responsible Investor Briefing.*" This document is stated to be issued in response to "*several requests for*

information from the investor community, keen to understand our response to the Bly report recommendations.” It sets out certain information regarding the methodology for implementing the recommendations and tracking the progress of such implementation. The publication of this document, while welcome, evidences the lack of adequate disclosure on these specific issues in the AR. It is disappointing that such disclosures were only made available in response to specific requests from shareholders rather than being provided unprompted in the AR. While the briefing provides some useful information to shareholders, it also serves to highlight the lack of specific timelines for implementing certain recommendations and the lack of external independent audit of progress as opposed to internal audit by the S&OR and Internal Audit departments of the company.

c. Joint Ventures and Subcontractor Relationship

While BP acknowledges the potential risks associated with contractor relationships and has clearly suffered from insufficient oversight of these relationships based on the fatalities in The Gulf and in Texas City, there is inadequate disclosure in the AR to demonstrate how the company oversees, manages, coordinates and trains its contractors, sub-contractors, and joint venture partners.

The AR notes that for many of its major projects and operations, risk allocation and management is shared with third parties and is conducted through joint ventures or associates and through contracting and sub-contracting arrangements, whereby BP may not have full operational control (Pg. 30). While the AR acknowledges the *“complex risk allocation and decision making processes and indemnification arrangements,”* (Pg. 32) it states only that its OMS, *“formalizes standards and recommended practices for selecting and working with contractors. This includes assessing the contractor’s safety performance as part of the selection process, and defining safety requirements in contracts.”*

While the Chairman’s letter notes that the board is *“reviewing how best to provide consistent and effective contractor oversight,”* (Pg. 71) and shareholders welcome this approach, there is no further information about the extent of the review, how it is being conducted, and when results will be provided to shareholders. Further, there is reference to contractor management and a new safety incentive system in the AR but no additional detail is provided about the system, how compensation might be impacted, and how BP employees might be incented based on contractor performance. It is assumed that a review of contractors would benefit Texas City operations, where the fatalities in 2005 involved contractors.

On January 14, 2011, BP announced a joint Arctic exploration operation with Russian state-controlled Rosneft. The deal has since been challenged by the Alfa-Access-Renova consortium, which represents the group in control of the Russian part of BP’s Russian partnership, TNK-BP. While the AR mentions the injunction from TNK-BP, little detail is provided as to the board’s role in analyzing the transaction and verifying that the political, environmental, regulatory and financial risks are managed successfully. It is unclear what input the board provided and how it exercised its judgement in granting its approval and in overseeing the company’s new strategy of joint ventures in oil and gas exploration with national oil companies announced by CEO Bob Dudley on the earnings call on February 1, 2011.

In light of the joint venture with Rosneft, the \$7-billion joint venture with India’s Reliance (announced March 4, 2011), and the relevance of a lack of direct operational oversight to the Gulf of Mexico incident, it is disappointing that the AR does not provide detailed information about the way in which joint ventures are managed and how BP exercises sufficient operational oversight over joint venture operations. Shareholders would benefit from an explanation as to why a broader

review of joint venture projects where BP does not have operational control was not considered beneficial.

Given the acknowledged failures of risk assessment, risk management and oversight as significant contributing factors to the Gulf of Mexico incident, it is disappointing that the AR does not provide further information as to whether any other risk assessments previously carried out by BP (most particularly on joint venture projects such as the Sunrise Project) have been reviewed in light of the Gulf of Mexico incident.

Of great concern is the AR's mention of remedial work to the ACG oil & gas platform in Azerbaijan following the blowout in September 2008, the seriousness of which was not adequately reported to investors as was revealed via Wikileaks. The leak led to a full evacuation of the platform and was clearly a near fatal accident. In light of the Wikileaks cable, the Gulf oil spill, and the plan for better communication with shareholders, there is an expectation of a broader discussion of this incident, and investors look to BP to provide information as to the steps that the company has taken to ensure the prevention of another blowout at its Azerbaijan and other operations, including a thorough assessment of the way in which cement is tested and utilized, particularly given the catastrophe in the Gulf, caused in part by faulty cement. The situation in Azerbaijan indicates that CEO Bob Dudley's assessment of the Gulf as a "*very, very low probability*" (Pg. 10) may not be precise and calls into question the company's risk management standards and review of contractor practices.

While outside of the AR's reporting period, information is lacking regarding a leak that was discovered on January 8, 2011 in the Trans-Alaska pipeline system. BP is the largest shareholder in Alyeska Pipeline Service, the company which runs the pipeline. Since other events of importance falling outside of the reporting period were included in the AR, such as Rosneft, shareholders had expected additional information on the leak, especially given the press coverage and the proximity to the Gulf oil spill.

In the section titled "Progress in 2010 - Process Safety - Oil Spills and Loss of primary containment," a sharp increase in the volume of oil unrecovered (in thousand litres) excluding the Gulf was noted, from 222 (2009) to 758 (2010), without a detailed explanation (Pg. 70). Further, disclosure is lacking as to the severity and location of the spills, which would provide investors with a better understanding than the number of incidences, and ways in which it is addressing and strengthening its efforts to decrease the volume of unrecovered oil.

d. Refining and Marketing

In March 2005, an explosion at BP's Texas City refinery resulted in 15 deaths and 170 injuries. In 2007, Duane Wilson was appointed by the board, per the recommendation of the U. S. Chemical Safety and Hazard Investigation Board, as an Independent Expert to provide an objective assessment of BP's progress in implementing the recommendations of the BP US Refineries Independent Safety Review Panel. It is concerning that six years after the explosion, the company still lacks consistent and reliable risk-management processes and has been unable to meet its professed commitment to safety.

While improvements have been made implementing many of the recommendations of the Panel and progress has been reported, findings from the Third (released in 2009) and Fourth report (released in 2010) of the Independent Expert reveal a host of outstanding problems that raise key questions for investors regarding the pace of and progress toward implementation. For example, the Third Report notes BP's difficulty in effectively managing safety at the plant in a timely fashion and warns that BP "*must demonstrate improved capability for systematic management of these*

systems, processes, standards, and practices so it can accelerate the overall pace of implementing the 10 Panel recommendations.” The Fourth Report also identified areas that warranted special attention, including the finding that *“overdue process safety action items were not being reported to executive management and to the board, as recommended by the Panel”* (Pg. 70).

Although BP has announced its intention to sell Texas City, a buyer has not yet been identified nor is it known the timeframe in which one will be found. The frequent references by Mr. Wilson to improvements that are needed suggest a greater commitment by the board is needed and increased information provided to shareholders to demonstrate strict levels of oversight.

Regarding 2010 performance, Refining and Marketing experienced increased losses of primary containment (up 12% from 2009), an increase in spills greater than one barrel (132 in 2010 compared to 113 in 2009), a slightly higher recordable injury frequency (0.35 vs 0.32), and an increase in vehicle accidents (77 vs. 71). Sales also decreased in 2010. Given the performance of the division and the continuing safety issues at Texas City, shareholders must question the performance criteria that entitled Head of Refining Iain Conn to receive a bonus of £310,500, “after he met or exceeded targets in his division.” (Pg.114)

2. REMEDIATION OF THE GULF OF MEXICO OIL SPILL

The AR states: *“BP’s comprehensive response focused on three strategic fronts: stopping the flow of hydrocarbons at the source; working to capture, contain, and remove oil offshore and near the shore; and cleaning and restoring impacted shorelines and beaches along the Gulf Coast.”* (Pg. 34). Beyond demonstrating that significant effort was undertaken, investors are not given enough information to evaluate progress and measure success.

For example, while statistics are provided on the barrels of oil collected, flared, skimmed and removed in remediation efforts (Pg. 34), 1.92 million barrels, collectively, it is difficult to assess this result without knowing the amount of oil spilled, which was not provided in the AR. In another instance, the AR cites 468,869 claimants to the Gulf Coast Claims Facility (GCCF) (Pg. 34), but the number of claims rejected, paid, and pending, as well as the median payout, is not provided.

In numerous instances, substantial data and information is provided related to BP’s efforts and activity to address the Gulf of Mexico oil spill without appropriate objectives, evaluative context, or external assessments to help investors understand the level of progress being made. A case in point is the \$100 million fund established by BP for unemployed rig workers (Pg. 35). Beyond mentioning its creation, it difficult to judge the effectiveness of the program without knowing the number of applicants, the number of workers that received assistance, or the type of assistance that was provided. In addition, a brief description of various short- and long-term commitments to furthering research and study of the Gulf of Mexico is included but without functional discussion of the objectives or implications of that research for the region.

Further, little information is provided on issues with significant reputational and financial implications, such as the short- and long-term toxicity concerns related to BP’s substantial dispersant use, efforts to revive the Gulf Coast economy, and backlogs for claimants in the GCCF.

Finally, as previously stated, one cannot help but notice the absence—at least as described in this report—of any structured independent oversight and assessment. An undertaking as large as the Gulf Coast recovery effort should surely require the type of oversight and attention given the Texas City refinery explosion. Investors must question why the board has not commissioned an independent oversight process.

3. TRANSITION TO A LOW CARBON ECONOMY

The AR states that lower-carbon resources are central to BP's long-term strategy but provides investors little information as to how a transition to a low-carbon economy will be accomplished or what initiatives the company will undertake to help catalyze the transition. The company's joint ventures with Rosneft for Arctic exploration and its entry into oil sands production suggest a contradiction between BP's strategy and its public statements about climate change.

In discussing long-term oil demand, the AR states that energy demand is projected to increase by around 40% between 2010 and 2030 and that fossil fuels are expected to satisfy as much as 80% of the world's energy needs in 2030. The AR does not disclose that there are three different oil demand scenarios prepared by the International Energy Agency and does not provide shareholders with information as to which of these scenarios it is using in developing long-term strategy. The AR does not state BP's preferred scenario and the steps the company is taking to lead the energy sector in that direction.

While the company cites future regulation of carbon (Pg. 27) as a material risk, BP does not set out the risks arising from the environmental, social and political impacts (infrastructure damage, severe weather events and conflicts as examples) which would result if fossil fuels are in fact satisfying 80% of world energy demands in 2030. The IEA itself has highlighted that if this comes to pass it will lead to a global average temperature increase of up to 6 degrees.

The company notes that it is committed to tracking the transition to a lower-carbon economy in 2030, yet little information is provided as to how this will be accomplished. While the AR states on p.18 that a more diverse mix of energy will be required to meet world energy demand, information is not disclosed regarding the financial commitment BP intends to make in the short- and long-term for solar, wind and biofuels, as well as anticipation of the megawatts generated and the growth expected over time. The report also neglects to disclose future greenhouse gas emission reduction targets and goals, in both the short- and long-term. It is difficult to ascertain the impact of the company's greenhouse gas emissions given the exclusion of the Gulf oil spill and clean-up efforts and the exclusion of GHG emissions from TNK-BP.

While the board makes an effective case for the need for the company to transition to a low carbon economy, little detail is provided as to the board's role in overseeing this process and as highlighted above, the company's strategy and long-term outlook on oil demand appear to be in direct contradiction to a successful transition to a low carbon economy.

4. BOARD OVERSIGHT

Throughout this assessment of BP's AR, numerous instances are highlighted of the need for the board to better communicate with investors its role in overseeing the company's risk management and safety function, the company's role in and preparedness for the transition to a low-carbon economy, and the management of the relationships with contractors and joint venture partners.

The AR represents a lost opportunity for the board to explain how it is successfully addressing its main objectives (Pg. 90):

"Our main areas of focus are:

- *Active consideration of long-term strategy.*
- *Monitoring executive management and the performance of the company.*

- *Obtaining assurances that material risks to BP are identified and that systems of risk management and internal control are in place to manage such risks.*
- *Board and executive management succession.”*

The AR does not sufficiently disclose to investors adequate information to demonstrate that the board is closely monitoring and providing strategic advice to management to ensure that there is a complete overhaul of safety and risk management. While the AR mentions internal board initiatives that have started following the accident, neither sufficient detail nor a timeframe is provided for implementation, except to note that some are “*still ongoing and will conclude in the course of 2011.*” (Pg. 90) It is clear that impacts of the Gulf disaster are far reaching and will be experienced for many years. The board must create and implement long-term initiatives that are robust and substantive, with regular and consistent public reporting that enables shareholders to benchmark progress and assess performance.

While a new safety incentive system was announced for select staff as well as a review of employee reward frameworks designed to increase the focus on performance in safety, compliance, and operational risk management, (Pg. 74) less clear is how safety and risk management will be integrated into executive compensation moving forward.

It is also unclear what steps the board will take in the short- and long-term to help restore BP’s reputation from the Gulf of Mexico oil spill and to oversee management’s efforts to bring the company back to prominence. The risks to BP’s reputation are noted throughout the AR (for example, Pgs. 7, 27, 29, 39) yet little detail is provided as to the sustained role the board will play to ensure that investors, stakeholders, partners, and the public believe in the competency of BP staff.

Investors need to feel confident that in the wake of Deepwater the board is deeply committed to actively managing a change in corporate culture and will be providing continuous and timely updates to shareholders so that it is clear that the lessons from Deepwater are fully incorporated into operations around the globe.

Conclusion

While annual reports are traditionally backward looking, given the reputational damage, cancellation of past dividends and loss in shareholder value due to the Gulf spill, investors had a fair expectation of robust and substantive disclosure on the way in which risks are and will be managed. Investors also expected more detailed information about the company’s strategy, including both short- and long-term goals and objectives, relating to BP’s role in averting catastrophic climate change. BP’s 2010 Annual Report must be viewed as incomplete in these respects.