

# Chairman's letter to Shareholders

7 November 2014



Dear fellow shareholders,

The Carnarvon Petroleum Limited Annual General Meeting (AGM) will be held on Friday 14 November 2014 and I'm looking forward to welcoming all those shareholders who are able to join us at the meeting.

At the AGM, four resolutions are to be voted upon, all of which are important to the governance and future growth and direction of the Company.

I am writing to alert you to the fact that a number of proxy advisors, who advise institutional investors, are expressing concern with Resolutions 1, 2 and 3.

Let me start by saying that Carnarvon Petroleum enjoys a very positive and open relationship with its institutional shareholders and they are supportive of the business.

In the wake of our recent discovery at Phoenix South we have not been afforded the opportunity to consider the position of the proxy advisors. Nor have we had the opportunity to address the concerns of some of our new institutional shareholders in the lead up to this year's AGM. In a sense, our recent success has elevated our profile beyond that of a small exploration company, and we must accept and deal with this new reality going forward.

I accept that as we continue to raise our profile with institutional investors we will have to meet higher expectations of transparency over governance and remuneration practices, and the Carnarvon board intends to engage and consult with our major shareholders and seek advice from proxy advisory firms on best practice in regards to our Employee Share Plan, Board independence and governance and Executive Remuneration policies, and to have those practices thoroughly considered and addressed before our 2015 AGM.

However there are times like this when the proxy advisors' approach is inappropriate and needs to be brought to the attention of the wider shareholder base of the Company.

Accordingly I would like to explain why Carnarvon respectfully disagrees with some of the positions taken by the proxy advisors and is seeking support from our shareholders to ensure our Resolutions are passed by a strong majority.

### **Resolution 1: Re-election of Mr Ted Jacobson as a Director of the Company.**

Ideally the Board of a public listed company should comprise a majority of independent non-executive directors. Your Board agrees with this principle. Your Board has also been cognisant of the merits of filling the position vacated when Mr Neil Fearis retired. However we believed the contribution required from a new non-executive director would be influenced by the outcome of the Phoenix South-1 well and accordingly considered it prudent to defer making an appointment until the result was known.

In any event, whether the Board is currently independent turns on whether Ted Jacobson is considered an independent non-executive director. The proxy advisors consider this not to be the case because he drew a relatively modest consultancy fee during the previous financial year for technical work he undertook for the Company. For this reason they take issue with his re-election.

The Board elected to engage Ted's specialist expertise to assist with geotechnical work for which he is uniquely qualified and experienced to perform, owing to his many years of exploration and geotechnical experience in the North West Shelf.

The alternative was to employ new staff when the Company was seeking to manage its costs.

Now that business conditions have improved and we have strengthened the technical team, Ted no longer draws the same fees.

Due to Ted drawing this consultancy fee, combined with his shareholding level and previous role as CEO, the proxy advisors do not deem him to be independent and therefore have formed the view that the Board does not have a majority of independent directors.

I would argue that the drawing of a consultancy fee in these specific and exceptional circumstances does not invalidate Ted's capacity to act independently in the interests of all shareholders.

It is our belief that voting against the re-election of Ted at this time makes no sense in that he is a strong advocate for all shareholder interests, his knowledge is important to the ongoing success of the business and he would in all likelihood step away from the business if not re-elected.

***I strongly encourage all shareholders to vote in Favour of the re-election of Ted Jacobson as a director of Carnarvon Petroleum.***

### **Resolution 3: Issue of securities to Mr Adrian Cook under the Employee Share Plan**

The proxy advisors also had concerns with Carnarvon Petroleum's Employee Share Plan vesting period being too short.

The Company implemented the Employee Share Plan ("ESP") following shareholder approval at the 1997 AGM. It has been approved by shareholders every three years since then and it was last updated and ratified by over 92% of shareholders at the Company's 2012 AGM.

The purpose of the ESP is to attract, retain and motivate those employees who have been invited by the Board to participate in the plan. The plan is also intended to align employee interests with all other shareholders by encouraging performance that increases shareholder wealth over an appropriate period of time.

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We consider this plan to be an effective incentive scheme for the size and nature of the Company. The plan only rewards share price growth, rather than relative performance, meaning no value arises if the share price falls. In addition, the plan does not incur a tax liability on issue of the shares, unlike some options, therefore encouraging longer term holdings and avoiding employees having to sell shares to pay tax liabilities.

According to proxy advisors, the Carnarvon ESP vesting period is too short in that they recommend 50% or more of an ESP issue vest in a period of three years or more. The current vesting periods were presented to and approved by over 92% of shareholders at the 2012 AGM such that one third vest after the first anniversary of their issue, another third vest after the second anniversary and the final third vest after the third anniversary.

The Board feels that the current vesting period is relevant to the shorter-term focus of an exploration focused company like Carnarvon when compared to the longer term strategies of larger, producing companies such as Woodside. We also consider the current ESP to be a very effective way to align the objectives of management with the interests of shareholders.

***I strongly encourage all shareholders to vote in favour of the issue of securities to Mr Adrian Cook***

#### **Resolution 2: Adoption of the Remuneration Report for Year Ended 30 June 2014**

The proxy advisor's objection to the Remuneration Report pertains to the previous rationale behind the decision to have a shorter vesting period for the Carnarvon Employee Share Plan and the payment of consulting fees to Ted Jacobson.

I also note one other concern around the Board's decision not to disclose in advance the exact nature of the performance hurdles for the short term incentive scheme. This was the case because:

- a) The nature of our operations can not be readily benchmarked; Carnarvon is growth-oriented through its exploration initiatives and therefore has less emphasis on industrial style metrics like earnings; and
- b) The performance metrics used are typically commercially sensitive and confidential. For this reason it makes no commercial sense to disclose such hurdles in advance and if we did so they'd potentially be detrimental to shareholder interests. However, they are reported on a look back basis through the Annual Report and we feel the incentives paid this year were based on robust business and personal performances.

***I strongly encourage all shareholders to vote in favour of the resolution to adopt the Remuneration Report for the Year Ended 30 June 2014.***

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The Board's position is that when running a company with the focus, size and business strategy of Carnarvon, a pragmatic and practical approach is sometimes preferable and more appropriate. Your Board feels that these specific concerns raised by proxy advisors are not appropriate to our current business, however we acknowledge that we will engage with our institutional shareholders over the coming year to consider their respective positions on the types of matters outlined above.

As a shareholder, I ask you to consider the Board's rationale for seeking your support for these resolutions at our upcoming AGM.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'P. Leonhardt', with a large, sweeping flourish extending to the right.

**Peter Leonhardt**

**Chairman**

**Carnarvon Petroleum Limited**

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