

CA FINAL

RISK MANAGEMENT

IN-HOUSE

CASE STUDY SERIES

-By Sanjay Saraf Sir

Case Study 6 Answer

Lecture Note 4

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Petromex

Multiple Choice Questions

1. **D is correct.**

Operational risk refers to the possibility of incurring losses resulting from operational breakdowns, caused by either internal or external factors.

2. **D is correct.**

A conflict of interest occurs when the interests of one party are in direct collision with those of another party within the business environment. Such conflicts usually manifest in form of objectives that are at variance with the desires of some other stakeholder in the organization. While choices A, B, and clearly outline possible conflicts of interests, an attempt to avoid environmenally harmful projects does not constitute a conflict of interest. In fact, it bodes well with the interests of goverment and the community in general.

3. **C is correct.**

Legal and regulatory risk entails going against stipulated laws, rules, and regulations. The government, through designated regulatory bodies, enforces these rules to safeguard the safety of consumers and ensure fair competition among businesses in the same industry.

4. **B is correct.**

Reputation risk concerns itself with the need to fulfill promises made to counterparties and creditors and adherence to fair and ethical business practices. Departure from these things can damage the reputation of the company and reduce its brand value.

5. **C is correct.**

Weak internal controls and lack of segregation of duties would represent a nonfinancial risk and be best described as an operational risk. Business risk focuses on the income statement (i.e., revenues too low and expenses too high). Legal and regulatory risk focuses on the risk of an entity being sued or the risk of unfavorable changes in the rules and laws that the entity must follow. Strategic risk focuses on significant new business investments or significant changes in an entity's business strategy.

Descriptive Questions

6. **The major category of risks involved in case of Petromex were as follows :**

1. Strategic Risk – Let's understand what Strategic Risk is all about. Strategic Risk refers to the current and prospective impact on earnings, capital, reputation or good standing of an organization arising from its poor business decisions, improper implementation of decisions or lack of response to industry, economic or technological changes. Failure of strategies will adversely impact the business objectives and attainment of the goals.

Petromex is organized into three vertically integrated business units: the exploration and extraction division; the processing and refining division; and the distribution and retailing division. A single miscommunication or a slightest hint of a lack of cooperation, amongst the divisions might lead to huge financial as well as reputational disruption to the company.

Secondly, Petromex has joint venture (JV) agreements in place for many of its extraction operations (i.e. its oil and gas rigs), especially those in the deep-water seas. It is questionable as to how come Petromex relies upon its JV partners.

2. Country Risk – Let's understand Country Risk.

Country risk refers to the uncertainty associated with investing in a particular country, and more specifically the degree to which that uncertainty could lead to losses for investors. This uncertainty can come from any number of factors including political, economic, exchange-rate, or technological influences.

The firm is really big and doing business in multiple countries and therefore, subject to the risk of Regulatory mishaps and Regulatory Changes in those countries.

- 3. Operational Risk** – Operational Risk refers to the risk associated with the operations of an organization. It is the risk of loss resulting from failure of people employed in the organization, internal process, systems or external factors acting upon it to the detriment of the organization. Operational risk includes legal risk and excludes strategic and reputational risk since they are not quantifiable.

In each of Petromex's JVs, operations on each rig are divided between the JV member companies and the benefits are distributed according to the share of the JV. One consequence of doing the same is that Petromex doesn't have direct influence on some important Operational Controls, despite it being the largest partner in each of the JVs.

The failure of Safe Services, a minor Partner in the JV, at inspecting a valve at the "well head" on the sea floor, before placing it at the well head during installation, exposed the workers at the rig to a huge Safety Risk, which resulted in an explosion at one of its deep water rig, the Denland Costal Deep Rig.

Furthermore, the valve was attached to a connecting part that did not meet the required technical specification for the water depth at which it was operating. This was a case of sheer Operational as well as Governance failure.

- 4. Legal Risk** – Legal Risk arises from the uncertainty due to legal actions or uncertainty in the application, interpretation of contracts, laws or regulations.

In case of Petromex, the contractual arrangements on any given oil rig can be very complex and there have often been disagreements between JV partners on some individual legal agreements and responsibilities for health and safety controls.

Moreover, after the explosion, the liability triggered on both Petromex and Safe Services was contractually ambiguous, because, documentation on responsibilities were far to complex and unclear.

- 5. Safety Risk** – Safety Risks are the are the most common and will be present in most workplaces at one time or another. They include unsafe conditions that can cause injury, illness and death.

As a result of the explosion at Denland Costal Deep Rig, Eight workers were killed on the rig from the high pressure released after the valve failure, and oil gushed into the sea from the well-head.

The culture of having a lax attitude on deep sea water rigs than the land-side, pushed the deep water workers to more of a safety risk.

- 6. Governance Risk** – Governance Risk refers to in-effective, un-ethical management of a company by its executives and managerial levels.

The valve at the Deland Costal Deep Rig, being connected to an inferior connecting part which was intended to be used for a Sea Water depth of 300 meters, the actual depth being 1000 meters, was a prime trigger for the tragic explosion. The need to keep costs down being cited as the reason, was a case of Governance Risk.

As discovered by the journalist, that both Petromex and Safe Servicers had operated a more lax safety culture on the deep-water rigs than was the case at facilities on land (the 'land-side'). There was a culture of 'out of sight, out of mind' on some offshore facilities which meant that several other controls were inoperative in addition to the ones that led to the accident. The same, in-turn triggered more and more safety risk.

- 7. Reputation Risk** – Reputational Risk refers to adverse publicity regarding an entity's practices will lead to a loss of revenue or litigation. Any event which affects the name or brand image of the entity is Reputational Risk. Any adverse publicity, news coverage, comments etc. has the ability to dent the trust created by the entity and becomes detrimental to the business of the entity.

Petromex was strongly criticised in Denland, where it once had a prominent presence, with the criticism growing stronger as oil from the ruptured valve was shown spilling directly into the sea off the Denland coast. Every effort of Petromex for pleading innocence were futile, as the Denland Public were not in a position to believe a single word.

Politicians like Senator Gregory and his constituency on the coast nearest to the rig was badly affected by the oil spill and many of his constituents suffered economic loss. The Senator's angry retortion to the newspaper interview disrupted the image of Petromex even further.

8. Business Continuity Risk – Business Continuity Risk refers to the risk arising from inability to restore operations immediately in the event of an incident / disaster.

With no contingency plan for a deep-water well-head rupture in place, the ruptured valve took several months to repair, meaning that many thousands of tonnes of crude oil polluted the sea off Denland.

7. Health and safety risk

The board of Petromex was deeply saddened to hear of the loss of life on the Denland Petromex Rig. As a petrochemical company involved in each stage of the extraction, processing and distribution of oil products, we are naturally very aware of the health and safety risks that we face. These are risks to individuals, employees or others, arising from any failure in our operations giving rise to compromised human welfare.

Health and safety risk, and particularly the probability of a given health and safety risk materializing, is generally increased by a number of factors. The first is a lack of a health and safety policy. In some industries, including petrochemicals, large parts of this policy are underpinned by legislation, depending on jurisdiction, but it is also in the interests of a business to ensure that robust policies are in place covering all aspects of health and safety and indeed this was the case on the oil platform in question. The second is a lack of emergency procedures or a failure to deal with hazards that arise. Once identified, a new hazard or impact must be addressed with a policy or a way of dealing with it. Ineffective operational controls, such as was the case on the Denland Petromex Deep Rig, contribute to this failure. Third, a poor health and safety culture can undermine an otherwise good policy if management and staff are lax towards health and safety, or believe it to be unimportant. There is some evidence that this was sadly the case on the rig.

Considering the above factors, the board of Petromex has decided to take the following measures :

- Petromex, being the largest partner in the JV will have reasonable control as well as monitoring over the Operation of each and every single rig, be it on the land-side or in deep waters, to prevent any such event from happening in the near future.
- Petromex will have thorough scrutinization on it's further JV operations.
- Petromex will conduct periodic internal audit checks on each production rig to check upon the efficacy of the systems being used in the process of exploration. Technical specifications will be respected and won't be diluted for cost savings.
- The company plans to provide reasonable compensation to the families of the injured and deceased workers and all affected by the tragic accident.
- Governance System on part of the company will be strengthened with the focus being more on Stakeholder value maximization, than shareholder value maximization.
- The company will focus on the transparency of it's further contractual terms and conditions, so that the liability of each party is well defined and clear to understand.
- The company plans to have a robust Business Continuity Plan (BCP) and Disaster Recovery Plan (DRP) in order to minimize the severity of such an accident, if one were to happen in the future.

Last, but not the least, the company will take every measure possible to win back the trust and confidence of people of Denland in no time.