A positive NPV Training Center

CA FINAL

RISK MANAGEMENT

IN-HOUSE

CASE STUDY SERIES

-By Sanjay Saraf Sir

Case Study 6 Question

Powered By -

ULURN
KNOWLEDGE IN DEPTH

SSEI QFORUM

Petromex

Petromex is one of the world's largest petrochemical companies. It is based in Sunland and is responsible alone for 10% of Sunland's total stock market value. It employs 120,000 people in many countries and has an especially strong presence in Denland because of Denland's very large consumption of oil and gas products and its large oil reserves. Petromex is organized, like most petrochemical companies, into three vertically integrated business units: the exploration and extraction division; the processing and refining division; and the distribution and retailing division.

Because of the risks and the capital investment demands, 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. A joint venture is a shared equity arrangement for a particular project where control is shared between the JV partners. In each of its JVs, Petromex is the largest partner, although operations on each rig are divided between the JV member companies and the benefits are distributed according to the share of the JV.

As a highly visible company, Petromex has long prided itself on its safety record and its ethical reputation. It believes both to be essential in supporting shareholder value. Its corporate code of ethics, published some years ago, pledges its commitment to the 'highest standards' of ethical performance in the following areas: full compliance with regulation in all jurisdictions; safety and care of employees; transparency and communication with stakeholders; social contribution; and environmental responsibility. In addition, Petromex has usually provided a lot of voluntary disclosure in its annual report and on its website. It says that it has a wide range of stakeholders and so needs to provide a great deal of information.

One of the consequences of dividing up the different responsibilities and operations on an oil or gas rig is that Petromex does not have direct influence over some important operational controls. 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. Given that Petromex has JV interests in hundreds of deep-water oil and gas rigs all over the world, some observers have said that this could be a problem should an accident ever occur.

This issue was tragically highlighted when one of its deep-water rigs, the Denland Coastal Deep Rig, had an explosion earlier this year. It was caused by the failure of a valve at the 'well-head' on the sea floor. The valve was the responsibility of Safe Services, a minor partner in the JV. 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, a situation that should have been prevented had the valve been fully operational. It was soon established that Safe Services' staff failed to inspect the valve before placing it at the well-head at the time of installation, as was required by the company's normal control systems. In addition, 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. The sea bed was 1,000 metres deep and the connecting part was intended for use to a depth of up to 300 metres. There was a suggestion that the need to keep costs down was a key reason for the use of the connecting part with the inferior specification.

Reports in the media on the following day said that the accident had happened on a rig 'belonging to Petromex' when in fact, Petromex was technically only a major partner in the joint venture. Furthermore, there was no mention that the accident had been caused by a part belonging to Safe Services. A journalist did discover, however, that both companies had operated a more lax safety culture on the deep-water rigs than was the case at facilities on land (the 'land-side'). He said there was a culture of 'out of sight, out of mind' on some offshore facilities and that this meant that several other controls were inoperative in addition to the ones that led to the accident. Information systems reporting back to the 'land-side' were in place but it was the responsibility of management on each individual rig to enforce all internal controls and the 'land-side' would only be informed of a problem if it was judged to be 'an exceptional risk' by the rig's manager.

The accident triggered a large internal argument between Petromex and Safe Services about liability and this meant that there was no public statement from Petromex for seven days while the arguments continued. Lawyers on both sides pointed out that liability was contractually ambiguous because the documentation on responsibilities was far too complex and unclear. And in any case, nobody expected anything to go wrong. In the absence of any official statement from Petromex for those seven days, the media had no doubts who was to blame: Petromex was strongly criticised in Denland with the criticism growing stronger as oil from the ruptured valve was shown spilling directly into the sea off the Denland coast. 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. Images of seabirds covered in crude oil were frequently broadcast on television and thousands of businesses on the coast reported that the polluted water would disrupt their business over the vital tourist season. Public statements from Petromex that it was not responsible for the ruptured valve were seemingly not believed by the Denland public. Senior legislators in Denland said that the accident happened on 'a rig belonging to Petromex' so it must be Petromex's fault.

A review by the Petromex board highlighted several areas where risk management systems might be tightened to reduce the possibility of a similar accident happening again. Finance director, Som Parekh, suggested that the company should disclose this new information to shareholders as it would be value-relevant to them. In particular, she said that a far more detailed voluntary statement on environmental risk would be material to the shareholders. The annual report would, she believed, be a suitable vehicle for this disclosure.

Because of the high media profile of the event, politicians from Denland involved themselves in the situation. Senator George's constituency on the coast nearest the rig was badly affected by the oil spill and many of his constituents suffered economic loss as a result. He angrily retorted in a newspaper interview that Petromex's CEO, Kamala Sahu, 'should have known this was going to happen', such was the poor state of some of the internal controls on the Denland Coastal Deep Rig.

As the oil spill continued and the media interest in the events intensified, CEO Mrs Sahu was summoned to appear before a special committee of the Denland national legislature 'to explain herself to the citizens of Denland'. The Petromex board agreed that this would be a good opportunity for Mrs Sahu to address a number of issues in detail and attempt to repair some of the company's damaged reputation. The board agreed that Mrs Sahu should provide as full a statement as possible on the internal control failures to the special committee.

SSEI
Sanjay Saraf Educational Institute Pvt. Ltd.
A positive NPV Training Center

Multiple Choice Questions

1. **Which of the following is not an example of operational risk?**

   A. Inadequate/malfunctioning computer systems

   B. Circumvention of issued regulations and guidelines

   C. Occurrence of a natural disaster, such as a tornado

   D. An increase in the price of gas

2. **The following scenarios describe conflict of interests in risk management. Which one does not?**

   A. The risk manager whose remuneration package includes stock options may overlook some risks inherent in a project with an eye on higher earnings when the stock price rises.

   B. Lenders wish to see the company invest in less risky projects while shareholders support more risky ones.

   C. The risk manager deliberately avoids riskier investments in favor of less risky ones to reduce chances of business failure and, therefore, safeguard their job security.

   D. The risk manager sidelines environmentally harmful project in order to safeguard the company's reputation and brand value.

3. **The risk manager of a certain public company is in the process of appraising several projects before giving recommendations to shareholders. He realizes that a few projects may put the company on a collision course with the Food and Drug administration because of ethical issues and human safety violations. Under such circumstances, which major type of risk is the company facing?**

   A. Operational risk

   B. Reputation risk

   C. Legal and regulatory risk

   D. Strategic risk

4. **At the center of every financial institution's focus lies the need to instill confidence in all stakeholders including customers, lenders, shareholders and others. Each party should feel that its interests are safeguarded. Which type of risk do companies face in this regard?**

   A. Legal and regulatory risk

   B. Reputation risk

   C. Specific risk

   D. Operational risk

5. **In considering the major classes of risks, which risk would best describe an entity with weak internal controls that could easily be circumvented with a lack of segregation of duties?**

   A. Business risk

   B. Legal and regulatory risk

   C. Operational risk

   D. Strategic risk

Descriptive Questions

6. **Identify the major category of risks involved in the above case.**

7. In preparing to appear before the special committee of the Denland national legislature, CEO Mrs Sahu has been informed that she will be asked to explain the causes of the accident and to establish whether she can give assurances that an accident of this type will not re-occur.

   Prepare a statement for Mrs Sahu to present before the committee that explains the following:

   'Health and safety' risk and the factors that can increase this risk in an organization.