WHAT BP TEACHES US ABOUT ETHICS, RISK, AND BUSINESS MANAGEMENT

The story of the explosion at the BP Deepwater Horizon well and the resulting months of oil spewing into the water and onto the shores of the Gulf states make us wince, but not internalize. We see the "lessons learned" and "take-aways" belonging to the oil industry, engineers, and environmentalists. Distancing ourselves with a facile "Glad I'm not in the oil industry" is a mistake. The newspaper headlines on this story should help with some reflection that can translate for financial leaders:

- "BP Crew Focused on Costs"[1]
- "BP Relied on Cheaper Wells"[2]
- "Safety and Cost Drives Clashed As CEO Hayward Remade BP"[3]
- "The Five Shortcuts That Prioritized Time and Money Over Safety"[4]
- "BP Chose Riskier of Two Options for Well Casing"[5]
- "Unusual Decisions Set Stage for BP Disaster"[6]
- "In BP Record, A History of Boldness and Blunders"[7]
- "Oil Execs: BP Didn't Meet Standards"[8]
- "Members of Past Disaster Panels See Recurring Pattern"[9]
- "Bold Player in Energy Markets: BP Loses Trading Floor Swagger"[10]

Instead of seeing oil rigs and spills and "their problem," we might find that "There but for the grace of God go I" is more appropriate. There are many parallels between what happened out on an oil rig in the Gulf of Mexico and our own companies than we realize.

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A culture that increases risk when cost trumps safety

The headlines above are but a sample of a plethora of similar news stories. The message is clear: BP danced on the edge when it came to decisions on operations, maintenance, and construction. The focus was: What gets the job done fastest and at the least cost? There was little factoring in of the long-term risks associated with such an approach, especially when there are elements of risk (such as mile-deep wells) for which you have no data set. The stories behind these headlines conclude, with ample historical evidence as well as information about Deepwater Horizon, that while BP's management principles, business plan, and code of ethics focused on safety and compliance, something was lost in translation between words and actions. The message in the written materials was not the message that the employees heard or followed. There was a longstanding cultural disconnect between outward appearances and internal behaviors.

This cultural disconnect was evident long before the Deepwater Horizon incident. In fact, now former CEO Tony Hayward was brought in to replace Lord John Browne because of two incidents that had as their root cause costs over safety. One was the burst pipeline at Prudhoe Bay, Alaska, and the other was the explosion at BP's Texas City Refinery that resulted in a loss of 15 lives and injuries to 500 workers. BP employees described Lord Browne as the industry's best cost cutter, who created "a ruthless culture."[11] The cost-cutting was evident in the lead-up to both events.

The Prudhoe Bay pipeline burst in March 2006 and resulted in a spill of 267,000 gallons of oil. The burst was not a surprise. Industry standards require smart pigging every five years. BP had not done smart pigging on the Prudhoe Bay line since 1998. BP had a request from a board member to look into maintenance issues at Prudhoe Bay and indicated that he was concerned about serious corrosion issues. A 2004 internal report written by an external consultant warned the company about accelerated corrosion but BP did not undertake maintenance nor did it develop a plan for testing the pipeline.

The Texas City Refinery operated on the edge. BP had entered into a 2005 agreement with OSHA to fix the safety violations at the plant, but it had failed to do so. At that time, OSHA had found 271 violations at the refinery. The Chemical Safety Board (CSB) Report concluded that cost-cutting played a role in BP's failure to address the ongoing OSHA violations. Beginning in 2002, BP commissioned a series of audits and studies that revealed serious safety problems at the Texas City Refinery, including a lack of necessary preventative maintenance and training. These audits and studies were shared with BP executives in London and were provided to at least one member of the executive board. BP's response was too little and too late. Some additional investments were made, but they did not address the core problems at Texas City. Rather, BP executives in 2004 challenged their refineries to cut yet another 25 percent from their budgets for the following year.[12] The CSB investigation and report were headed by James Baker, former U.S. Secretary of State, who found "instances of a lack of operating discipline, toleration of serious deviations from safe operating practices and apparent complacency toward serious process safety risks at each refinery."[13]

Following the Texas City explosion, the OSHA investigation found a total of 439 "willful and egregious" violations, a finding that resulted in the largest fine in OSHA's history, $87 million. The Texas City tragedy and the Prudhoe Bay spill were so public and resulted in such negative publicity that the BP board made its change in the company's leadership. Mr. Hayward, a reserved geologist, was expected to help the company turn the corner on its safety and prudence issues. However, Mr. Hayward was not able to make the cultural corrections the board hoped would happen. A 2007 internal report, issued one year into Mr. Hayward's tenure, concluded that there had been "unprecedented" levels of issues and accidents at BP and that there was a culture of pervasive unwillingness to stop work when something was clearly wrong.[14]

On-the-surface observations presented a puzzling scenario of ubiquitous safety messages surrounded by contradictory behaviors. All BP facilities had reminders for employees to hold the banister while using stairs, walk only in marked areas, and never walk with hot coffee. Employees who drove on the job had to take defensive driving courses and all employees were reminded of Mr. Hayward's singular message, "Safety is our first priority."[15] But as the safety program was continued in earnest, there were increasing problems with both the decisions about and the conduct on off-shore rigs.

In fact, there was a precursor event to the Deepwater Horizon explosion and spill. Almost two years after Texas City and Prudhoe and nearly two years before the Deepwater Horizon spill, BP had the June 5, 2008, 193-barrel oil spill at BP's Atlantis rig (also in the Gulf of Mexico). The internal report on what went wrong and why included the following information:

> "[Managers] put off repairing the pump in the context of a tight cost budget."
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> "Leadership did not clearly question the safety impact of the delay in repair."
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> A BP safety officer told company investigators, "You only ever got questioned on why you couldn't spend less."[16]

During this period of ongoing safety lapses and resulting casualties, BP continued its stellar financial performance. In 2007, BP's shares were at $77. Its debt/equity ratio was .31, its dividend rate 15 percent, a 20 percent ROE, with gross margins of 27 percent and net margins of 7.47 percent. EPS growth in 2008 was at 64 percent. That financial performance will not be repeated any time soon.

In April 2010, the Deepwater Horizon explosion resulted in the deaths of 11 BP workers on the rig. As much as 60,000 barrels per day gushed from the burst well for almost 90 days. The evidence that has emerged so far reveals decision-making that followed the patterns in place at the refinery and other rigs. A whistle-blower allegation that had emerged early in 2010 has resurfaced, as it were, through the release of e-mails related to government investigations. The e-mails express concern about whether crucial engineering drawings and paperwork necessary prior to operation of off-shore rigs had been completed. The e-mails also reveal that engineers who asked for an additional 10 hours in the critical path to address their concerns about the well by installing 21 centralizers instead of just six were dismissed by the lead engineer with "I do not like this."[17]

At hearings before the House of Representatives, other oil company CEOs testified that BP did not follow appropriate design standards in drilling the well.[18] A *Wall Street Journal* study found that BP used a risky design that was cheaper for one of three of its deep-water wells. The so-called "long string" design is one that uses a single pipe for bringing the oil to the surface. Experts indicate that the result of using one long pipe is that natural gas accumulates around the pipe and can rise unchecked. Most experts recommend its use only in low-pressure wells, not wells such as Deepwater Horizon. They also note that long-string drilling would not be appropriate when a company does not know the area, something that was true about this well for BP. The cost theme has already emerged as a causal factor in the Deepwater Horizon spill.

The costs

BP has taught us in a painful manner that there are financial risks that accompany poor decisions in any company and at any level. Following the spill, which is the largest in history, BP lost $30 billion, or 16 percent, of its market value.[19] Prior to the Deepwater Horizon explosion and spill, BP's share price was at $62. By July, the share price was $38, a loss of 33 percent. The reputational damage will last for years. BP certainly has displaced Exxon and its Valdez as the bad poster child for oil companies. Retail sales at BP stations are down 8 to 10 percent since the time of the spill.[20]

The costs, in terms of cash outlays, continue for BP. Since the time of the explosion, BP has spent $7 million per day trying to contain the spill, something that was not accomplished until July 2010. The daily costs have not abated because clean-up efforts are ongoing. BP was given an ultimatum by the Obama administration, and shortly after a White House meeting BP pledged to place $20 billion in an escrow account for the United States government to distribute to those in the Gulf states who have been harmed by the spill. BP has sold off $7 billion in assets to cover the expenses and the down payment of the $20 billion and it anticipates selling off another $3 billion by the end of 2010.[21] BP took a $32 billion charge in July 2010 for the Gulf oil spill costs and added the following about it losses in its July 27, 2010, SEC filing:

> "The costs and charges involved in meeting our commitments in responding to the Gulf of Mexico oil spill are very significant and this $17 billion reported loss reflects that. However, outside the Gulf it is very encouraging that BP's global business has delivered another strong underlying performance, which means that the company is in robust shape to meet its responsibilities in dealing with the human tragedy and oil spill in the Gulf of Mexico."[22]

BP's assets remain, but as one of its traders commented, he has his running shoes on because the financial future for the company remains uncertain.[23] Even the industry itself is grappling with uncertainty as the legal battle over a U.S. moratorium on off-shore drilling remains in litigation and rig owners face decisions on whether to move or stay. The oil industry now grapples with the uncertainty of off-shore drilling in the future.

The lessons

When a company emphasizes low-cost operations, no safety program can trump that focus on financial results. When those financial results and goals are a component of employee performance evaluations, the safety considerations take a back seat to results. Decisions on drilling, designs, timing, and equipment should be examined in light of organizational behavior factors such as incentive plans, bonuses, and performance evaluations. Numbers results are the business measurements managers use to gauge company and employee performance. However, they are not reflecting on what a numbers culture can do to the quality of decisions, especially when it comes to decisions that involve work shutdowns or additional time in a construction or production schedule. There were at least five critical points in BP's construction of Deepwater Horizon where there was a decision made on the basis of quicker, faster, and cheaper rather than on the basis of safety, long-term production, and industry standards.[24] For example, BP chose the far riskier single line for Deepwater Horizon, a decision that others in the industry have testified was not appropriate for a well that deep. The risk was far too great in terms of its failure, and the accumulation of gas around such a single line posed a safety risk for those who worked on the rig. Furthermore, the decisions workers made that day focused on keeping the well going, not on the risk that continued operations posed.[25] In other words, the patterns of Texas City and Prudhoe Bay had continued in BP employees and operations.

BP had not reformed following what should have been cathartic moments for the company in terms of its numbers culture and assessment of risk. Rather, BP developed a blind adherence to the standard type of industrial and occupational safety program. BP had bench-marked its safety program, right down to the banisters and hot-coffee precautions. BP not only implemented the safety program, it was also measuring the impact of its safety program with the usual forms of data tracking; reportable injuries, missed-work-day injuries, etc. BP's data on these factors marked them as a stellar performer. In fact, Deepwater Horizon had been presented with an award by the U.S. government for its safety record. BP was entitled to recognition for meeting their safety goals. However, there are problems with blind adherence to these dashboard types of programs and measures of safety. These forms of safety programs and monitoring do not provide managers with the information about far more risky safety issues. BP was not measuring risk accurately, it was measuring safety events only.

Companies often fall into this trap of facile measurements, whether in safety programs or compliance and ethics. The program components and the measurables look great and a sense of confidence results because the numbers look terrific, but they do not reflect the real risks or the levels of that risk. Pursuing a deepwater off-shore drilling model presents greater risk factors than the usual off-shore rig with its much shallower placement. Couple this decision process on how to drill the off-shore rig and operate it with the emphasis on performance and employees will make risky decisions to achieve their results. For example, safety reportables data will not reveal the underlying financial pressures in the company that are driving important decisions on company operations and exploration. The reportables do not disclose whether there has been detached analysis on the construction of a rig or the decision to avoid a fix on the rig construction so as not to add 9 hours to the critical path. Yet, the damage to the company from critical engineering decisions that are not thought through very carefully is far greater.

Other lessons include spending the time necessary to investigate even the most minor lapses and then implementing the appropriate changes. BP's decision to investigate the Atlantis accident was a good one. The problem was its failure to investigate whether the conclusions and findings on that rig could be applied to the other rigs the company was operating. Know thy operations and thy people, not just their safety stats. What they are doing may be more important than a solid set of safety measurables.

Conclusion

The story of the Deepwater Horizon explosion is a tragic one, made more vividly tragic because the root cause goes back to the same thing we find for any company that experiences problems:

"What were they thinking?" In BP's case with this oil spill, the answer is the same as it has been for the failed Wall Street firms, the failed companies of the dot-com era, and the defunct subprime mortgage lenders. They were not really thinking about the long term and risk as carefully as they should have. They were focused on fast and uninterrupted results, with no setbacks. That strategy is risky. Numbers should be placed in perspective with ongoing evaluation of this question: "How are we achieving these results and what decisions are employees making to stay there?" Whether in drilling at oil companies or reporting numbers for financial reports, that answer is critical if a company really wants to understand where it is in reality and the risks it faces. ■

NOTES

1 *Wall Street Journal*, June 15, 2010, p. A1.
2 *Wall Street Journal*, June 19-20, 2010, p. A1.
3 *Wall Street Journal*, June 30, 2010, p. A1.
4 *Wall Street Journal*, June 16, 2010, p. A4.
5 *Wall Street Journal*, May 27, 2010, p. A1.
6 Ibid.
7 *New York Times*, July 13, 2010, p. A1.
8 *USA Today*, June 16, 2010, p. 1B.
9 Op. cit. Note 4, p. A4.
10 *New York Times*, June 28, 2010, p. A1.
11 Jon Birger, "What Pipeline Problem?" *Fortune*, September 4, 2006, 23–24.
12 Sheila McNulty, "BP Safety Culture under Attack," *Financial Times*, March 20, 2007, p. 15. The report recommended that BP comply with 29 CFR 1910.119, Process Safety Management of Highly Hazardous Chemicals and implement an effective means of process safety management.
13 Ibid.
14 Guy Chazan, Benoit Faucon, and Ben Casselman, "Safety and Cost Drives Clashed as CEO Hayward Remade BP," *Wall Street Journal*, June 30, 2010, p. A1.
15 Sarah Lyall, Clifford Kraus, and Jad Mouawad, "In BP's Record, A History of Boldness and Blunders," *New York Times*, July 13, 2010, p. A1.
16 Op. cit. Note 14.
17 Neil King Jr. and Russell Gold, "BP Crew Focused on Costs: Congress," *Wall Street Journal*, June 15, 2010, p. A1, A5.
18 Julie Schmit, "Oil Execs: BP Didn't Meet Standards," *USA Today*, June 16, 2010, p. 1B.
19 Peter Coy and Stanley Reed, "Lessons of the Spill," *Bloomberg BusinessWeek*, May 10-May 16, 2010, p. 48.
20 Naureen S. Malik, "Protests Target BP But Hit Independents," *Wall Street Journal*, June 16, 2010, p. A4.
21 Guy Chazak and Gina Chona, "BP Sells $7 Billion in Assets to Fund Clean-up," *Wall Street Journal*, July 21, 2010, p. A7.
22 www.secgov/ EdGAR Datea base, BP 8-k July 27, 2010. Accessed: August 22, 2010.
23 Sarah Lyall, Clifford Kraus, and Jad Mouawad, "Bold Player in Energy Markets: BP Loses Trading Floor Swagger "*New York Times*, June 28, 2010, p. A1.
24 Ben Casselman and Russell Gold, "Unusual Decisions Set Stage for BP Disaster," *Wall Street Journal*, May 27, 2010, p. A4.
25 Russell Gold and Neil King, Jr., "Rig Ignored Red Flags," *Wall Street Journal*, May 13, 2010, p. A1.