



# Black Swan or Blind Spot?

## Why organizations mismanage critical risks and what can be done about it

**BP's Deepwater Horizon tragedy has been described as a so-called "Black Swan": an unlikely but high impact, game-changing event. However, it may actually bring to light a phenomenon no less real and just as important - the "Blind Spot": a source of risk that an organization could see if it only looked in its direction, but for one reason or other, fails to do so.**

We all know the story well by now: a blowout preventer fails on BP's Deepwater Horizon rig on April 20, 2010, methane gas shoots up from the well, igniting and causing the rig to explode, killing 11 workers. Oil gushes from the well at a rate of 40,000 barrels per day for months, creating the most severe environmental disaster in the history of the United States. BP loses approximately \$100 billion in market cap and faces potential liabilities of up to \$40 billion. The President of the United States at one point wants to know "whose ass to kick" and CEO Tony Hayward resigns.

This event has all the classic hallmarks of what in risk management parlance is called a "Black Swan" event, and has been described as such by many observers. "Black Swan" is a term coined by Nassim Nicholas Taleb to describe high-impact, hard-to-predict events. Black Swans are events few saw coming and include the Internet, the Harry Potter phenomenon, World Wars I and II, and the 9/11 terrorist attacks. Before the discovery of Australia, the world assumed all swans were white; a single observation of a black swan there negated thousands of years of observations that had

reinforced the misconception that all swans were white.

Many events faced by organizations are increasingly described as Black Swans. This is often the case with political, environmental and social risks that may manifest – the Deepwater Horizon being one of the many latest. However, much of this characterization is false. Many of these events are not Black Swans at all; rather, they are "Blind Spots" – areas of risk that many organizations could see if they only looked, but for one reason or another, have escaped the organization's vision. Many of these risks lie outside the core competency of the organization. For companies in the extractive sectors (i.e., oil and gas and mining), the above-ground risk environment is littered with potential blind spots.

### **Black Swan or Blind Spot?**

Was the Deepwater Horizon disaster a Black Swan or a Blind Spot? While it may not have been possible to predict every aspect of the disaster, and while we may not know the final answer to this question for some time, a number of details have emerged which would suggest that the event was far from a pure Black Swan:



- US authorities investigating the spill found 20 anomalies in the well's behaviour and a list of safety protocols that weren't followed.
- Hours before the blowout occurred, there were indications, based on high pressure levels and fluid leakage, that BP and Transocean (the company that owned the rig) workers were losing control, but failed to act.
- There are documented disagreements between BP and Transocean employees about the seriousness of the situation.
- The well only had one blind shear ram – the piece of equipment that caused the failure of the blowout preventer – when most rigs currently have two blind shear rams for contingency purposes.

In terms of the impact of the spill, we knew the following about the above-ground risk environment facing BP and other companies before it occurred:

- Other major corporate crises, from the Exxon Valdez tanker spill, the Piper Alpha explosion, to cases of product contamination or community opposition to major projects, involve business and legal costs far greater than what may be stipulated in legislation. In this sense, BP would have been well aware that the \$75 million liability cap under US law may have been comforting legislative theory, but in the real world pure fantasy in terms of real costs it would bear in the event of a spill in the Gulf of Mexico.
- Outrage (sometimes based on fact, sometimes on fiction, or more euphemistically, perception) from a range of stakeholders – communities, politicians, NGOs – can raise significant costs to oil companies over environmental and social performance in almost all operating environments.
- The spill occurred at a time when the US government is more interventionist with corporate activity than any other time in its recent history – witness Wall Street and GM bailouts, political pressure on Toyota, financial reform and so on. In short, if there was a time when the political risks associated with a spill of this magnitude in the USA would be greatest, now would be it.

Regulators and other International Oil Companies (IOCs) have been trying to distance and differentiate themselves from BP in the wake of Deepwater Horizon. However, this is unfair – the Blind Spot is far from a BP-specific phenomenon. From Shell's travails in Alaska and Nigeria, to political risks facing IOCs in Iraq, to the political fallout faced by Toyota over safety concerns, to exposure governments face over a range of issues (e.g., the UK MP expenses scandal, questions facing the Canadian government over treatment of Afghan prisoners, how regulators are grappling with climate change or financial reform), it is clear that *all* organizations are vulnerable to Blind Spots. How and why do they occur?

## Blind Spots

There are a number of conditions that create risk management Blind Spots:

- 1) **Misaligned incentives can create wilful blindness to Blind Spots.** Often the internal incentives of managers and agents are contradictory to the need to look for Blind Spots and to test assumptions. In the private sector, this can occur when managers are incentivized to achieve short-term targets quickly at the expense of incentives to test for vulnerabilities to Blind Spots and to preserve and enhance longer-term value. In the public sector, *regulatory capture* – structures that incentivize a regulator to err on the side of a regulated party whether implicitly or explicitly – can similarly create vulnerability to Blind Spots.
- 2) **Blind Spots tend to lie outside the core expertise of the organization.** Blind spots tend to arise because of some exposure to a risk outside the core competencies of an organization. Most commonly, they tend to be political, environmental, social, reputational or other non-technical or above-ground risk areas. Many organizations may have a high level of exposure to risks in these areas but lack the expertise and tools to properly assess this exposure. A blind spot for an oil or mining company will almost likely *not* be a sudden collapse in oil prices (the exceptional 2008-09 collapse in commodity prices caused by the credit crunch was a true Black Swan not a Blind Spot) and will more likely be in the areas oil and

mining executives find more nebulous or fuzzy such as political or socio-environmental risk.

- 3) **Blind Spots are often based on erroneous, untested assumptions.** Many Blind Spots occur because organizations make implicit assumptions about their risk environment that they rarely test or challenge.
- 4) **Sacrificing value creation and sound risk management on the altar of compliance creates exposure to Blind Spots.** Often, organizations that move into a tick-box mode of compliance with regulations or standards can lose perspective on the risks that those regulations or standards are designed to mitigate. As a result, they can put too much faith in them as risk controls or value drivers. Deepwater's Environmental Assessment – complete with sections on nonexistent walrus and contact details of dead environmental managers – may have, unfortunately, been an example of this.

### What Organizations Can Do About Blind Spots

There are a number of things an organization can do in order to try to uncover and manage its Blind Spots. These are:

- 1) **Use outside subject matter expertise to support key decisions and strategies.** If most Blind Spots lie outside the core expertise of the organization, then bringing in subject matter experts to help with key decisions and strategy formulation should be a regular practice. These could range from country experts for decisions on new market entries, social experts on community issues or environmental specialists on environmental questions. But there's more to this than just bringing in experts. Information that subject matter experts have needs to be placed in light of the decision considered or objective being pursued with heavy emphasis on the *so what?* question. This may require translating subject matter expertise into the language of cost, capital, strategic objectives or other things that have high levels of currency and validity in an organization. This also means ensuring that subject matter expertise is understood by those making or influencing the

decision, not just technical experts in the organization.

- 2) **Test Assumptions.** Organizations should regularly seek to uncover and test their operating assumptions. "House prices always go up" or "invading Iraq will be the hardest part in all of this" are some examples of assumptions that were not sufficiently tested.
- 3) **Look for incentives that can create wilful blindness.** Once an organization has uncovered a few Blind Spots by using outside expertise and testing assumptions, it should examine its internal incentive structures to ensure incentives do not exist that could exacerbate exposure to Blind Spots. Incentives might then need to be re-designed to account for newly discovered Blind Spots.
- 4) **Think Performance, not just Compliance.** Whether it's regulations or voluntary standards, organizations should examine the underlying rationale for compliance with laws or standards and any residual risks. Simply complying with a law or standard may still leave significant risk exposure and create a false sense of security. Conversely, examining key risk management or performance objectives that would include meeting compliance requirements along the way can add significant value.

Black Swans are very real and can profoundly impact societies and organizations. However, not every seemingly rare event is a Black Swan. Many are the result of Blind Spots and all organizations are vulnerable to them. Successful organizations regularly test for and manage them. Those that do will significantly increase the chances of meeting their objectives. For those that don't, they can always blame the Black Swan.

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