Iroquois Ridge High School

The International Business Case Study Series

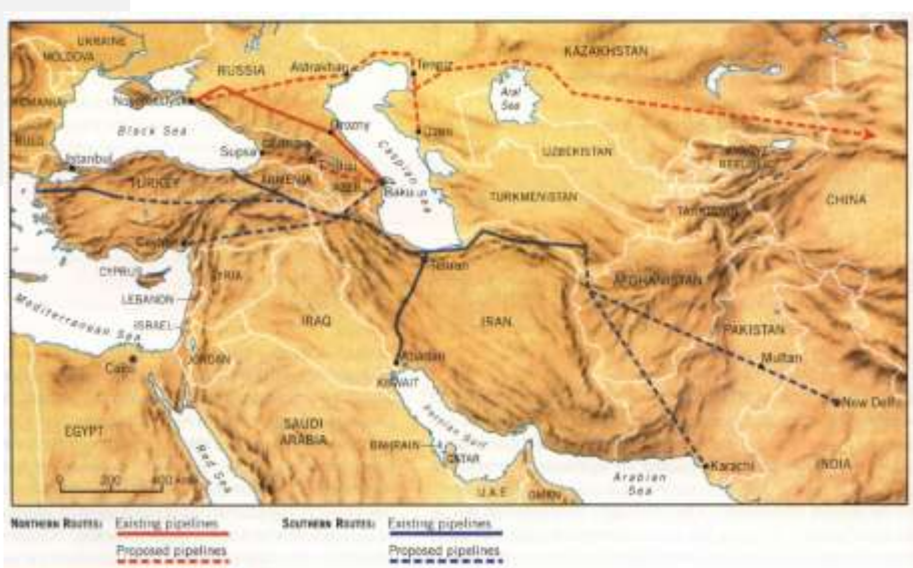
Assembled by Jeff Boulton

A Job For 007

The Dangerous Business of Oil in the Middle East

During the winter of 2000, millions of people around the world watched Pierce Brosnan play James Bond, 007, in *The World Is Not Enough*. The movie's plot centred on the destruction of an existing pipeline bringing oil from the Caspian Sea to Western markets. The pipeline's destruction would make the value of a new pipeline owned by the movie's villainess skyrocket. Although Hollywood producers are often accused of playing fast and loose with the truth, The World Is Not Enough focuses on a real world problem: There's a lot of oil in the Caspian region, but it has to be brought to market. Moreover, if you are looking for a perfect example of the importance of political risk analysis, you cannot find a better one than the conundrum facing oil companies trying to exploit the rich oil and gas reserves of the Caspian Sea and the Central Asian Republics.

Baku, the capital of Azerbaijan, is the center of the oil industry operating in the Caspian Sea region. Home to nearly 40 percent of Azerbaijan's 7.5 million citizens, Baku is also the Caspian's main port (see Map 3.3). The Caspian Sea sits on a sea of oil, which virtually every oil company in the world is eager to exploit. The companies know where the oil is; they know how to get it out of the ground. There's just one catch: They need to get the oil to market, and all the possible transportation routes traverse territory marked by political instability.



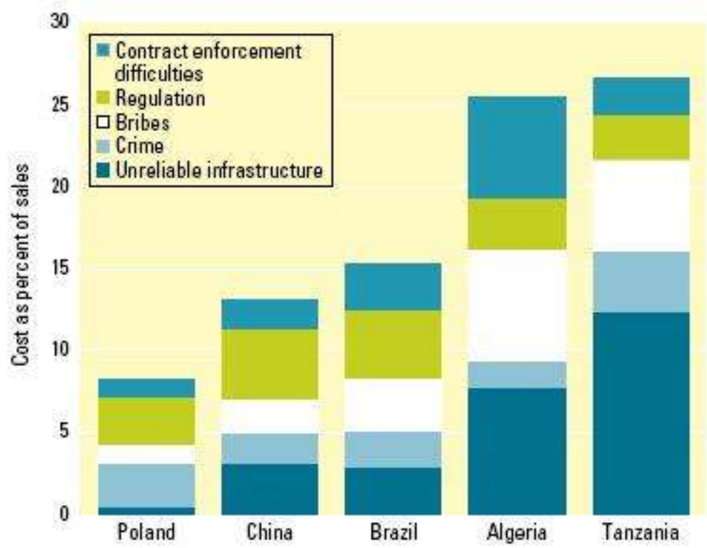
MAP 3.3 Possible Pipeline Routes

The problem is most acutely felt by the Azerbaijan International Operating Company (AbC), which is owned by a consortium of oil companies, including British Petroleum, Exxon, Unocal, Pennzoil, and Russia's Lukoil. AIOC expects to spend $8 to $10 billion over the next three decades to develop and produce 4 billion barrels of Caspian Sea oil. AIOC can ship the oil to Western markets through two pipelines from Baku to the Black Sea. The first route, which is 850 miles long, goes from Baku to Russia and thence to the Black Sea port of Novorossiysk. The second route goes from Baku through Georgia to the Black Sea port of Supsa, a mere 550-mile journey. Unfortunately, the first route goes through Grozny, the capital of the breakaway Russian province Chechnya. Chechnyian rebels fought the Russian army to a standstill during a bloody revolt from 1994 to 1996 and proclaimed their independence from Moscow's control. Russian troops re-seized most of the province in early 2000 in a bitter struggle that horrified foreign human rights observers. Armed conflict could break out again at any time. The second route, which bypasses Russia, goes through rough mountainous terrain where security is difficult. Local residents routinely tap into an existing pipeline in the area, siphoning off oil to heat their homes. Moreover, some Russian politicians have indicated their displeasure with the second route, claiming that it threatens the "energy security" of Russia. (A less charitable interpretation is that Russia does not wish to lose its monopoly over the transportation of Caspian Sea oil and the lucrative transit fees that it generates.) The Yeltsin and Putin administrations have not blocked the pipeline's development, but if Russian

R.W. Griffin et al, International Business: A Managerial Perspective, Prentice Hall, 2002

nationalists capture control of the government in the next election, they might adopt a more bellicose policy Turkish officials, concerned about traffic jams and possible collisions of oil tankers going through the narrow Straits of Bosporus (which separate the continents of Europe and Asia at Istanbul) on their way to Western markets, prefer a new pipeline from Baku to Ceyhan. Although this 1,236-mile route would be very expensive– an estimated $2.9 billion– Turkish officials fear that one collision between loaded tankers at the Bosporus would make the Exxon Valdez disaster seem like a minor slipup.

Figure 1 Costs vary widely in level and composition



Azerbaijan has problems of its own. Although business is thriving at bars like the Ragin' Cajun and Margaritaville that cater to slaking the thirst of free-spending American oilfield workers, the oil boom has not yet benefited the average citizen: Annual per capita income is only $420. The country is run, Soviet style, by a former KGB general, Geidar Aliev, who is not a poster boy for democracy. After taking office in a 1993 coup, Aliev suppressed political dissent, stifled freedom of the press, and imposed a blockade on neighbouring Armenia. Moreover, after Azerbaijan declared its independence from the Soviet Union, the ethnic Armenians of the Nagorno-Karabakh province declared their independence from Azerbaijan. A bloody, still unresolved civil war ensued, sending hundreds of thousands of refugees to Baku and other cities.

MAP 3.2 Countries' Relative Political Riskiness, 2000

Meanwhile, oil companies operating on the other side of the Caspian Sea in Turkmenistan and Kazakhstan face similar problems. California-based Unocal, which owns production rights in Turkmenistan, is proposing to build an oil pipeline and a gas pipeline from Turkmenistan to Pakistan. The only problem is that the proposed route goes through Afghanistan, which has been ripped apart by insurrections and civil wars since the mid-1970s. Even Sylvester Stallone (remember *Rambo III*?) has been unable to bring political stability and peace to the Afghanis. Another possible pipeline route for Turkmen oil is through Iran to the Persian Gulf or through Iran and Turkey to the Black Sea. However, the United States has exerted diplomatic pressure to discourage companies from doing business with Iran. The volatility in diplomatic relations between the United States and Iran should make company executives think twice about this project. Moreover, Russian companies like Gazprom are unhappy that such a route would limit their access to Turkmen reserves.

Kazakh oil has a similar set of options and a similar set of problems. One potential pipeline route is to go around the northern coast of the Caspian Sea to Novorossiysk. Although avoiding Chechnya, the Kazakhs would be at the mercy of a Russian government that has a reputation for imposing new tax burdens on foreign companies whenever it faces a revenue shortfall. Alternatively, Kazakh oil could tap into the Turkmen pipelines to Pakistan or Iran.

A route through China is another possibility. In 1997 the Chinese National Petroleum Company purchased a 60 percent stake in Aktobemunaigazs, a leading Kazakh oil company, which controls reserves containing 1 billion barrels of high-quality crude oil and 220 billion cubic meters of natural gas. In conjunction with Korean and Japanese firms China also agreed to finance and construct a new 1,800-mile pipeline to Karamay in the western Chinese province of Xinjiang, which would then tap into China's existing pipeline grid and allow Kazakh oil access to the Chinese, Japanese, and Korean markets and generate huge transit fees for China's government. Unfortunately, Xinjiang, a vast desert province, is the subject of a small but tense rebellion by native Uighur separatists. The Uighurs, who are ethnic cousins to the Turkic populations of the Central Asian republics, resent the growing influx of the Han Chinese to the province. Today the Han Chinese comprise 38 percent of Xinjiang's population, whereas in 1949 they comprised only 5 percent. The Uighurs claim that the Han (the main ethnic group in China) have flooded the province and reserved the best jobs for themselves. So far the attacks of the poorly trained and poorly armed separatists have had little impact on Chinese control of the province, although local residents fear the situation could worsen. During 1997 riots in the border city of Gulja, the army had to escort 1,200 Han settlers out of town to safety.

Needless to say, each of these choices poses problems for the oil companies operating in the region. Nonetheless, they are ready for the challenge, mostly because the potential rewards are so large. Proven oil reserves in the region are estimated to reach 15 to 20 billion barrels; based on the area's geology, some experts believe as much as 160 billion barrels lie underground waiting to be discovered.

Case Questions

1. *Characterize the types of investments that are most vulnerable to political risk. Characterize those that are least vulnerable. Oil and natural gas pipelines are immobile and long lived. They are also very expensive.*

    a. *On a scale of 1 to 10, with 10 being highest, how vulnerable are they to political risks?*

    b. *What, if any, do the experiences of the United States in their occupation of Iraq add to your understanding of the risks associated with this matter?*

2. *Which of the pipeline routes discussed in the case offers the least political risk? Which offers the greatest political risk? Why?*

3. *In his novel Kim, Rudyard Kipling introduced the phrase "The Great Game" to describe the struggle between the Russian Czars and the British Empire to control the wealth of Central Asia and the Caspian Sea. Clearly, the great game is being replayed as countries fight to control access to the area's oil and natural gas reserves.*

    a. *What can international businesses do to protect themselves from the geopolitical struggles of Russia, China, Iran, the United States, and other nations that are taking place in this region*

Rule Number One: Know the Territory

Political Risk – An Example

When Victor Cardenas, a Cuban expatriate employed by a British joint venture, opened his pizza parlor in Minsk, the capital of Belarus, he knew he faced many challenges. What he didn't anticipate, however, was having his restaurant closed by the local authorities for selling lasagna. It seems that lasagna was not included in the official Belarusian cookbook, a holdover from the Soviet era which prescribed to the letter the recipes to be followed in all of the country's restaurants. Fortunately, the Belarusian Department of Public Nutrition allowed Cardenas to reopen 10 days later, after he secured special licenses that let him sell exotic house specialties like ravioli and lasagna.

Rich farm land has made Ukraine one of the world's premier granaries. In the early 1990s Monsanto targeted this market, selling $38 million worth of fertilizers and herbicides to the agricultural ministry. However, it took Monsanto a year to receive payment, and then only after the U.S. State Department interceded on its behalf with the newly elected president, Leonid Kuchma. Burned by this experience, Monsanto decided to bypass the agricultural ministry and sell directly to private distributors and collective farms. This did not prove to be a wise move because it enraged apparatchiks (a Soviet era term for bureaucrats), who disliked any attempt to reduce their power. Ukrainian prosecutors, acting on behalf of the agricultural ministry, began harassing Monsanto's customers, asking why they were buying foreign products. Ukrainian courts declared Monsanto's chemicals unsafe, even though they had passed strict U.S. regulatory requirements. In addition, farmers using Monsanto products were denied licenses needed to export their crops.

TYPES OF POLITICAL RISKS	IMPACT
Expropriation	Loss of future profits
Confiscation	Loss of assets
	Loss of future profits
Campaigns against foreign goods	Loss of sales
	Increased costs of public relations efforts to improve public image
Mandatory labour benefits legislation Kidnappings,	Increased operating costs
terrorist threats, and other forms of violence	Disrupted production
	Increased security costs
	Increased managerial costs
Civil wars	Lower productivity
	Destruction of property
	Lost sales
	Disruption of production
	Increased security costs
Inflation	Lower productivity
Repatriation	Higher operating costs
Currency devaluations	Inability to transfer funds freely
Increased taxation	Reduced value of repatriated earnings
	Lower after-tax profits