



INSTITUTE FOR DEFENSE ANALYSES

**Commercial Perspectives on Political
Risk in Sub-Saharan Africa**

Andrea S. Pongo
Ashley N. Bybee
Stephanie M. Burchard

October 2012

Approved for public release;
distribution is unlimited.

IDA Document D-4841
H 13-000385

INSTITUTE FOR DEFENSE ANALYSES
4850 Mark Center Drive
Alexandria, Virginia 22311-1882



The Institute for Defense Analyses is a non-profit corporation that operates three federally funded research and development centers to provide objective analyses of national security issues, particularly those requiring scientific and technical expertise, and conduct related research on other national challenges.

About this Publication

This work was conducted by the Institute for Defense Analyses (IDA) under contract 2012-12062700-003, Global Coverage Analyses Program. The views, opinions, and findings should not be construed as representing the official position of the U.S. Government.

Approved for public release; distribution is unlimited.

Copyright Notice

© 2013 Institute for Defense Analyses, 4850 Mark Center Drive, Alexandria, Virginia 22311-1882 • (703) 845-2000.

INSTITUTE FOR DEFENSE ANALYSES

IDA Document D-4841

Commercial Perspectives on Political Risk in Sub-Saharan Africa

Andrea S. Pongo
Ashley N. Bybee
Stephanie M. Burchard

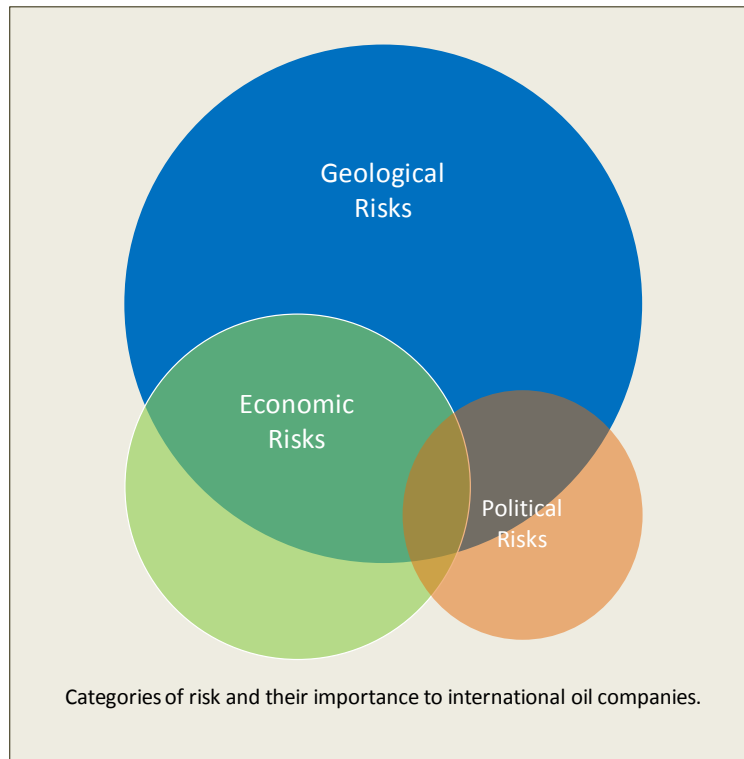
Executive Summary

During Phase I of the project on the impacts of new oil discoveries on political stability in Africa, IDA studied commercial approaches to political risk. Commercial approaches to risk assessment are based on different criteria from assessments performed in an academic or public-sector context. It is important to understand the risks inherent to oil and gas (O&G) operations and how international oil companies (IOCs) judge whether to enter a new market when new O&G discoveries are made in host countries.

U.S.-based IOCs perform political risk assessment as part of their larger, more comprehensive overall assessments for each country where they operate and for new markets they seek to enter. These assessments, which are overwhelmingly qualitative in nature, are usually conducted by subject-matter experts (SMEs) either directly employed by the IOC or under contract with the company to supply qualitative analyses. Key lessons learned during this phase of research are that quantitative methods are very rarely applied and that commercial entities seem skeptical about the value of quantitative modeling of political risk.

There is no widespread consensus about the meaning of “political risk,” although most SMEs seem to share a sense of the concept. Generally, political risk is understood to be the actions of a host government or society that could negatively affect some or most foreign businesses in that country.¹ Within a commercial context, political risk is evaluated almost solely in terms of its effect on investment success within the host country. The concept of regime failure or regime change that preoccupies other analysts is only one risk among many for IOCs and is important only insofar as it jeopardizes a project or seriously harms the investor.

The most important factors of an investment decision are the quality and accessibility of hydrocarbon assets, the favorability and sanctity of contract terms agreed with the host government, and the predictability of the O&G regulatory environment (see illustration below). When asked about risks specific to Africa, most SMEs agreed that operating in Africa presents special challenges, but they noted that they are different from those in other regions – more in terms of degree than type.



Another finding of Phase I of the project is the relative importance placed on political risk assessment by IOCs specializing in different areas of the O&G supply chain (exploration, development, or production). Whether an IOC plans to engage a host country for a short or long term will affect how relevant it regards political risk to its operational outcomes.



INSTITUTE FOR DEFENSE ANALYSES

GLOBAL COVERAGE ANALYSES PROGRAM – AFRICA
ECONOMIC AND DEMOGRAPHIC ISSUES



OIL AND POLITICAL STABILITY

**COMMERCIAL PERSPECTIVES ON POLITICAL RISK
IN SUB-SAHARAN AFRICA**

MS. ANDREA S. PONGO, PRINCIPAL RESEARCHER
DR. ASHLEY N. BYBEE
DR. STEPHANIE M. BURCHARD

OCTOBER 5, 2012

Contents

Commercial Perspectives on Political Risk in Sub-Saharan Africa	1
Introduction	1
Definitions of Political Risk	2
Methodology	2
Objectives	3
Commercial Perspectives among IOCs	3
Findings	4
Finding 1: IOCs base their investment decisions on several other types of risk before considering political risk.....	4
Finding 2: The size of an IOC and its role in the E&P chain determine its interest in political risk assessment	6
Finding 3: Commercial risk assessment tends to be unstructured and to rely heavily on the opinions of subject-matter experts.....	8
Finding 4: Despite their higher risk tolerance, IOCs identify certain considerations as deterrents to foreign investment.....	9
Finding 5: Africa presents similar operational challenges to other less stable regions of the world, but to a greater degree.....	10
Conclusions	12
Subsequent Research	13
Appendix A. Map of Africa	A-1
Appendix B. Literature Review: Commercial Perspectives on Political Risk.....	B-1

Commercial Perspectives on Political Risk in Sub-Saharan Africa

Introduction

Political risk analysis is one component of the assessment work done by investors in volatile regions of the world. Because of the size and duration of their investments, oil and gas companies in particular need to identify risks that could potentially affect their planned or ongoing operations in resource-rich host countries. That said, IDA research demonstrates that political risk is a less important factor influencing international oil company (IOC) investment decisions than many other aspects of country risk. Major exploration and production (E&P) projects undertaken by IOCs require 9- to 10-figure upfront investment commitments and decades of ongoing operations in a host country. Because of the specific constraints that guide the decision-making processes of IOCs (necessity of a timely and worthwhile return-on-investment (RoI), reasonable risk calculations, adherence to home country and host country legal requirements, accountability to shareholders), these companies often have exceptional knowledge about political, economic, and social power structures in a host country. Experience operating in difficult environments teaches them about security issues, corruption levels, banking structures, transportation challenges, bureaucratic hurdles, and workforce issues, among many factors.

As a result, commercial approaches to risk assessment provide a different perspective than assessments performed in an academic or public-sector context. It is important to understand the risks inherent to oil and gas (O&G) operations and also how IOCs judge whether to enter a new market when new O&G discoveries are made in host countries.

The thriving field of commercial consulting that provides political risk assessment tools to commercial clients began serving primarily IOCs in the early 1980s after waves of nationalizations and forced divestitures affected energy investments in developing economies during the late 1960s and 1970s. The forced divestiture of Exxon, Mobil, Texaco, and Standard Oil from Saudi Aramco in 1973 and 1976, along with regime change in Iran and the nationalization of foreign assets that followed in 1979 made business leaders acutely aware of the need for adequate political risk assessment.

At the same time, academics were eager to develop new paradigms for explaining the relationship between political events and how they affect the investment decisions of (primarily U.S.) corporations active in foreign countries around the world. Since then,

they have worked to develop a theoretical base for political risk analysis in order to identify recurring patterns and trends across countries.² Although there is no unified theory of political risk, scholars have written about various aspects of the concept and have developed conceptual tools for how to think of, evaluate, and mitigate risks particular to political systems. IDA performed a review of political risk assessment literature and identified key themes relevant to the topic. (See Appendix B.)

Definitions of Political Risk

There is no consensus in the academic literature over the meaning of “political risk.”³ Generally, political risk is understood to be the actions of a host government or society that could negatively affect some or most foreign businesses in that country.⁴ In an article examining political risk models for a corporate executive audience, University of Virginia professor Charles R. Kennedy, Jr. defined political risk in 1988 as:

[The] risk of a strategic, financial, or personnel loss for a firm because of such non-market factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labor, and developmental) or events related to political instability (terrorism, riots, coups, civil war, and insurrection).

Kennedy’s definition illustrates that, within a commercial context, political risk is evaluated almost solely in terms of investment success within the host country. The concept of regime failure or regime change that preoccupies other analysts is only one risk among many (i.e., one contributing factor) in a commercial setting and is important only insofar as it causes the failure of a project or seriously harms the investor.

Practitioners who spoke with IDA also indicated that in the commercial world, there is no concrete definition of political risk, *per se*. Experts told IDA that companies and industries all seem to have their own understanding of political risk and often find they are talking about different things.

For the purpose of this report, political risk refers to macro-level issues – for example, currency inconvertibility, nationalization or expropriation of capital, acts of violence – that could affect all foreign investors in a host country, as well as industry-specific risks that could influence IOC investment decisions, including 1) shifting host government regulation of the energy sector in particular, 2) environmental activism native to the host country or undertaken by groups operating there, or 3) the compromised security of company personnel operating in unstable geographic areas.⁵

Methodology

During Phase I of the current study, IDA performed a review of academic literature in the field of political risk analysis, followed by qualitative research derived from interviews with subject-matter experts (SMEs). IDA conducted more than ten in-person

and telephone interviews with oil industry executives, as well as commercial-sector political risk analysts. Phase II of the project will provide a qualitative case study of Angola as a prominent African oil-producing state, and Phase III will bring together the previous lessons learned to inform the development of a quantitative model to assess political stability. The ultimate goal of the sub-task will be a cross-national examination of the effects of O&G discoveries on political stability in Sub-Saharan Africa, the implications of which are especially relevant for new market entrants, such as Uganda, Kenya, and Liberia.

The risk analysts interviewed have considerable professional experience within the United States federal government and in the private sector, providing them with the background to address the relationship between U.S. government policy and commercial interests. Commercial risk analysts often hesitate to explain how they identify and weigh risk factors because the process is usually proprietary. Fortunately, analysts were willing to share enough basic details about their assessment processes that IDA was able to develop a good understanding about commercial approaches to political risk.

Objectives

The objective of this paper is to consider the stability of a nation-state – political stability in particular – from a different perspective than academic and public-sector country analysts usually take. Analysts in the intelligence, defense, development, and diplomatic communities generally see stability in terms of human security, strength of democratic institutions, potential for social upheaval, and regard for human rights. The focus of this sub-task is to study the effects of oil production on political stability, necessitating a solid understanding of commercial perspectives on political risk. To that end, the IDA team sought answers to questions such as: 1) what makes an attractive investment environment for private enterprise? 2) how is Africa unique compared to other developing and traditionally volatile regions? and 3) under what circumstances would private enterprise deem their investments to be in jeopardy?

Commercial Perspectives among IOCs

The result of interviews performed by IDA was a better understanding of the factors that commercial entities rank highly when performing risk assessment of a new market. IDA learned that instead of stability, IOCs evaluate the *predictability* of a host country investment environment. Whether a host government is democratic or autocratic, the predictability of regime change (or lack thereof) is more important than regime stability. The predictability of various commercially important risks and a company's capacity to develop mitigation strategies are key to investment success. While IOCs do assess political risk as part of their project planning due diligence, political factors are seen as minimally determinative to the final investment decision.

In addition, investment decisions by IOCs are not geographically determined. Companies are guided by the presence and quality of hydrocarbon resources and not the political circumstances in a country or region. Challenges that would likely deter investment in other economic sectors are regarded as routine operational costs for companies in extractive industries.

Findings

Findings
As a result of primary-source research performed during Phase I of the current study, IDA learned the following:

- 1 International oil companies (IOCs) base their investment decisions on several other types of risk before considering political risk
- 2 The size of an IOC and its role in the exploration and production (E&P) chain determine its interest in political risk assessment
- 3 Commercial risk assessment tends to be unstructured and to rely heavily on the opinions of subject-matter experts
- 4 Despite their higher risk tolerance, IOCs identify certain considerations as deterrents to foreign investment
- 5 Africa presents similar operational challenges to other less stable regions of the world, but to a greater degree

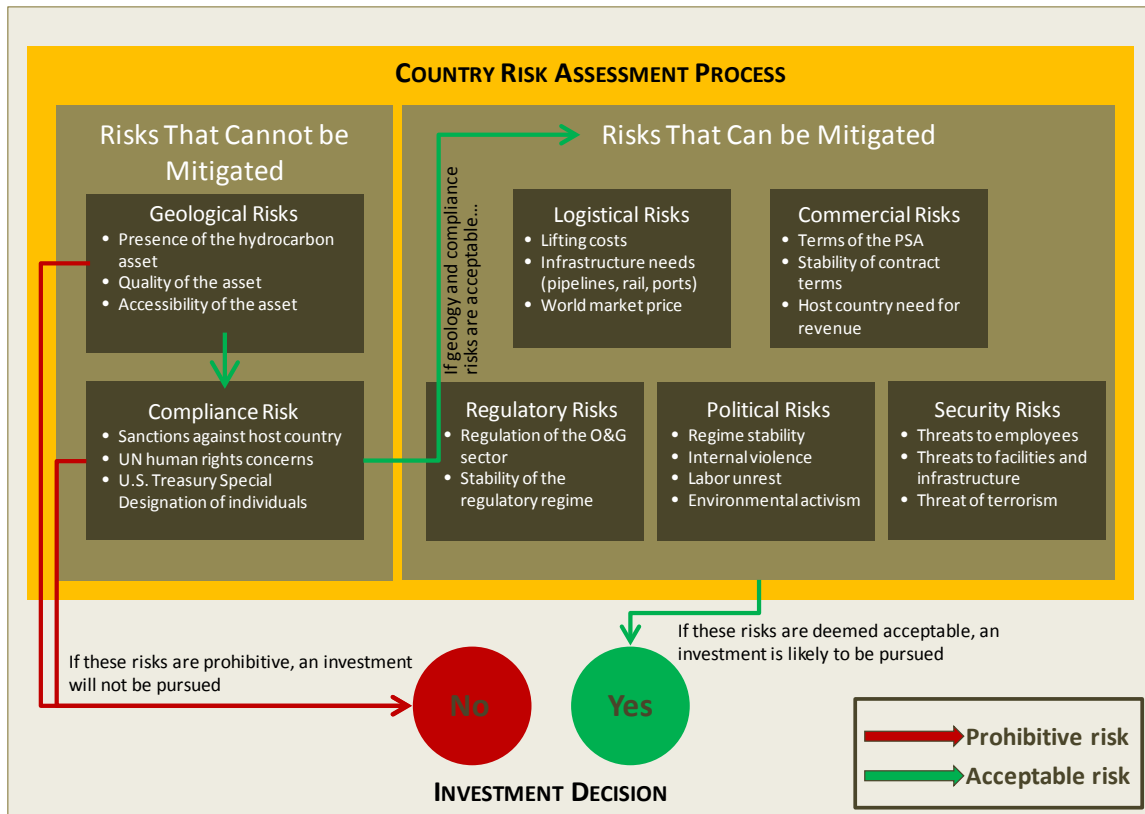
Finding 1: IOCs base their investment decisions on several other types of risk before considering political risk.

One of the most important findings was that IOCs prioritize other risks far above political risk and security risk when engaging with a host country. Perhaps more than in other industries, the value of the assets at stake and the overall investment is primary. The diagram on page 6 illustrates the different aspects of risk that IOCs consider when investing in a new market. The most important factors are the following:

- *Geological Risk:* So-called “below-ground risks” – i.e., the presence, quality, and accessibility of oil and gas resources in a given geological area. Questions about whether the resources are “deep” or “super deep,” the technology or time needed to extract the resources, and the size of the asset

are highly determinative for an investment decision. Representatives of big U.S.-based IOCs all made the point that the location and quality of hydrocarbon assets are the first consideration and that other factors rank lower in importance. Unlike other risks, geological risks are often very difficult to mitigate.

- *Compliance Risk:* Compliance risk includes the national and internal laws in place that apply to the host country, such as sanctions regimes, banking restrictions, U.S. Department of Treasury Specially Designated Nationals (SDNs), UN human rights concerns, and United States and United Kingdom programs on security and human rights.⁶ Similar to geological risk, compliance risks are very difficult for an IOC to mitigate.
- *Logistical Risk:* If an asset is determined to be geologically attractive, logistical risks will then be calculated. These risks could include The cost of extraction (so-called “lifting costs”), the availability of infrastructure or the need to create infrastructure to process the oil or gas, the availability of infrastructure to transport the product to market (e.g., pipelines, rail systems, port facilities), or the world market price of the asset. Part of this consideration is also whether an IOC can bring materials and equipment into the country easily, whether their equipment gets held up at the border by host or neighboring country customs officials, or whether they have to use local carriers for transport.⁷
- *Commercial Risk:* Once a project is deemed to be economically viable and advantageous to the investor’s global strategy, the IOC then determines whether it can arrange favorable contract terms. The specific terms of the production sharing agreement (PSA) with the host government are critical. Also critical is whether the terms of the contract will remain stable over the course of a decades-long investment. An IOC will ask whether a government can guarantee the terms of a contract, whether changes to the contract can be accommodated by the company, and how badly the host country depends on revenue from O&G production.⁸ Host country revenue needs indicate to the IOCs the likely commitment the government will have to the agreed contract terms.



- Regulatory Risk:* Whether a host government provides a stable regulatory environment is important to an investment decision, but only after the geological, logistical, and commercial prospects are judged to be favorable. Although the host government is responsible for shaping and managing the regulatory environment, this category of risk was often described as distinct from political risks such as regime stability, internal violence, or labor unrest. It is a category of risk over which IOCs have little control unless they hire foreign lobbyists or they bribe officials and thus run afoul of the Foreign Corrupt Practices Act (FCPA). If the regulatory regime in a host country is stable and transparent, IOCs can better predict project success.⁹

Finding 2: The size of an IOC and its role in the exploration and production (E&P) chain determine its interest in political risk assessment.

It is important to note that companies engaged in different phases of O&G exploration, development, and production rank political risks differently when contemplating a major investment.

Exploration

Initial exploration work is often performed by smaller companies using a highly speculative business model. These companies are able to buy exploration rights to

onshore and offshore fields at a low price, perform the necessary geological and seismic surveys, prove the existence of reserves, and then often sell their rights to larger firms to perform development and production of the oil or gas asset. Total investment for these projects is in the range of \$200 million, depending on the type and location of the potential asset. Companies in this space include British company Tullow Oil plc, Hess Corporation/Triton Energy Corp., and Anadarko Petroleum Corp. Their business model allows for the likelihood that multiple exploration projects could fail – i.e., result in “dry holes” without oil or gas – but productive wells acquired for little capital ensure the continued profitability of the enterprise. IDA were told that these smaller, more speculative firms rarely perform political risk analysis because they are less involved with the host country, usually committing to a project for only a 4- to 6-year term, and can accept the risk of unexpected government actions. They often choose to forgo the time and expense of performing detailed political risk assessments.

Development

Companies engaged in the development of an asset require more thoughtful political risk assessment. Drilling the wells and beginning the process of extracting hydrocarbons require time and large amounts of capital investment. A key IDA finding was that the mid-size companies (Marathon Oil Corp., ConocoPhillips Co., Apache Corp.) that perform long-term development work are the most likely to carefully consider political risk when making a major investment decision. As it was explained, the capital requirements (approximately \$500 million to \$2 billion), the longer-term nature of the projects (approximately 10 to 15 years), and the relative size of the companies mean that the unexpected failure of a project could be catastrophic. If a mid-size development company “gets it wrong” in an overseas venture, it could lose its valuable senior management and also become vulnerable to takeover by a competitor.¹⁰ As a result, mid-sized IOCs will devote more time and resources to assessing the political variables that could potentially affect a project. For development projects, the stability of the contract terms is essential for investment success.¹¹

Production

Companies performing O&G production in foreign countries see limited utility for political risk assessment. Production work could involve drilling new wells in an existing reservoir or maximizing production from active wells. It is usually performed by the so-called “super major” O&G companies because of the ongoing capital requirements of a big project. Companies like ExxonMobil Corp., Chevron Corp., and BP pursue exploration work less often than niche explorers, but will buy the rights to proven assets from the small companies mentioned above. O&G production often requires a commitment to operate in the host country for a term of 20 to 50 years and often requires continuing capital investment to replace equipment or to drill new wells. Because of this,

large IOCs need to be aware of and realistic about potential political risks but are more likely to spend time and resources developing political risk mitigation strategies and are comfortable operating in potentially risky environments. IDA learned that political risks such as internal violence, regime instability, civil or labor unrest, and war are regarded as manageable contingencies that can be mitigated with extra expenditure by large IOCs. Only at the point where the value of the investment is critically undermined will large IOCs contemplate withdrawing from a host country. Several SMEs told IDA that even when confronting serious challenges, IOCs are very reluctant to withdraw from a long-term arrangement because of the size of the investment already made and the cost of trying to re-enter the market in the future.

Finding 3: Commercial risk assessment tends to be unstructured and to rely heavily on the opinions of subject-matter experts.

Selecting Key Variables

During this study, IDA sought to understand how commercial sector analysts identify and select the factors they believe contribute most strongly to country risk. IDA found that this process and the ensuing assessment are overwhelmingly driven by qualitative inputs by SMEs. Commercial risk analysts regard the value of the investment as the ultimate key variable being considered (i.e., the *observed result* of multiple factors). In a commercial context, political risk is important to the degree that it affects the value of a major investment and regime change is only one political risk factor among many.

IDA also asked how analysts choose the factors they believe have the strongest effect on the value of an investment and learned that the selection of risk factors is less systematic than initially assumed. While an organization might have a standard process to follow when performing a country-level or industry-specific risk assessment, there is no formal methodology used across the field of commercial political risk assessment.

Quantitative Modeling

Each of the experts interviewed by IDA indicated that there is widespread skepticism about the utility of quantitative models for predicting political and other human factor outcomes in a given host country. Several SMEs acknowledged that the data most often used for quantitative political risk models have limited explanatory value for political outcomes and that the historical results of quantitative models have a poor record of accuracy. Consultants who create quantitative models and develop the results for their clients are reluctant to share historical results because the quantitative model's record of predicting outcomes is weak.

That said, quantitative models of political risk can be useful for comparative studies across multiple countries. Unlike qualitative information, which not only is dependent on the quality of an analyst's sources and access to those sources, but also is unsystematic and often unstructured, quantitative data – by their nature more systematic – can be used as a basis of comparison. IDA learned that quantitative models of political risk are most often used when companies are at the initial stages of an investment decision process and need to compare risks across countries or regions. Companies will often purchase multiple quantitative analyses from different providers in order to compare the results.¹²

Finding 4: Despite their higher risk tolerance, IOCs identify certain considerations as deterrents to foreign investment.

As part of the study, IDA asked SMEs what might be unacceptable political risks that would deter even large, experienced IOCs from entering a new O&G endowed country. Responses demonstrated the limits of political risk tolerance for O&G companies and provide a set of risks that would be difficult or impossible to mitigate. The following are examples of circumstances that could have a strong impact on a company's investment decision:

- *Nationalization.* A host country with a history of foreign asset nationalization or the forced divestiture of foreign investors from joint projects. IOCs will carefully consider a host country's history of asset expropriation.
- *Punitive Actions.* A history of concession terms being radically renegotiated or punitive action being taken against foreign investors. For example, the government of Algeria assessed a \$450 million back tax liability against Anadarko Petroleum Corp. in 2006, wiping out three years of company profit. According to industry experts, many IOCs were deterred from future investments after the decision.¹³
- *Insecurity plus Lack of Governance.* When there is a high degree of insecurity in a host country, coupled with the absence of a functioning government to enforce regulatory or legal norms. If employees are killed, large IOCs will likely withdraw from a host country. This was the case in 1984 when three expatriate workers were killed at a Chevron facility in Sudan. By 1985, the company suspended operations in southern Sudan, and by 1992, it sold all its concession rights in the country.¹⁴
- *Arab Spring.* When a host country demonstrates potential for major social upheaval creating a climate of tremendous political, legal, and regulatory uncertainty as did several countries in North Africa during the “Arab Spring.”

Finding 5: Africa presents similar operational challenges to other less stable regions of the world, but to a greater degree.

IDA asked the SMEs whether Africa presented special challenges for O&G operations, different from challenges encountered in other regions such as South America, Central Asia, or the Middle East. Most SMEs agreed that Africa presents special difficulties, but they note that they are different from the challenges in other regions – more in terms of degree than type.

Security

SMEs explained that security considerations are more prevalent in sub-Saharan African host nations than in other regions of the world but that security risks are not a determining factor for an investment decision. Security risk was always described to IDA as a contingency that could be mitigated by higher levels of expenditure by the IOC and usually built into a company's projected operating costs. When asked whether acts of terrorism were a concern, SMEs pointed out that terrorism is more of a concern in the Maghreb and less of a concern in coastal areas of West Africa. In addition, security threats to personnel or infrastructure are more frequent for land-based O&G facilities – such as those in the Niger Delta of Nigeria – than for offshore facilities. The farther offshore a facility is, the easier it is to protect and the less frequent are approaches by potential aggressors – especially if the platform is over the horizon and invisible from the shores of the host country.

Ethnic Conflict

Ethnic conflict is more common in sub-Saharan Africa than other world regions, but ethnic conflict itself does not necessarily present higher security risks for O&G facilities and personnel. For example, in the Angolan exclave of Cabinda, there is an ongoing separatist insurgency being waged by the *Frente para a Libertação do Enclave de Cabinda* (FLEC) against the Angolan government. There are both ethnic and political components of the FLEC conflict. Acts of violence have occurred in the past and are expected in the future, but SMEs all seemed to agree that the U.S.-owned O&G facilities in Cabinda are not currently being targeted by the FLEC. Instead, groups target Angolan government officials and do not necessarily identify O&G facilities as government interests. To illustrate the level of trust practiced by the major U.S.-based IOC operating in Cabinda, the company mess is open to the public and members of FLEC have been known to take meals there during the day.¹⁵

Corruption

The widespread prevalence of corruption in all levels of government among several African O&G producing states means that IOCs operating there are exposed to more

acute reputational risks than in other regions of the world. While the SMEs with whom IDA spoke demonstrated that compliance with the FCPA is *de rigueur* among large U.S.-based energy companies, they also acknowledged that it puts U.S. firms at a competitive disadvantage operating in Africa compared to foreign firms such as Total S.A., Eni S.p.A, and state-owned entities from China or Russia. Nepotism was identified as a feature more common in Africa than in other O&G producing regions, made more difficult by the fact that in several African host countries, it is legal and customary for government officials involved with natural resource exploitation to have private-sector interests in the same area. High local content expectations, combined with nepotism and widespread corruption, make it relatively more difficult for IOCs to navigate the restrictions of the FCPA in Africa than elsewhere.

Lack of Infrastructure

The lack of infrastructure in Africa presents additional challenges to industrial operations on the continent. When a substantial new O&G discovery is made, it is often necessary for the investor to negotiate the construction of roads, pipelines, rail lines, and port facilities to transport hydrocarbons to world markets. Another critical consideration is the supply of electrical power and water to the industrial facility. In host countries where supplies of power and water are strained already, guaranteeing supplies to foreign-owned facilities can be difficult to arrange or politically unpopular.

Among states with newly discovered O&G resources, the lack of infrastructure can also include the lack of institutional infrastructure to facilitate the development of the country's hydrocarbon reserves. Government ministries and regulatory agencies are generally weak. Experts indicated that IOCs sometimes find themselves in a position to advise the host government on how best to create institutional infrastructure, including ministries, regulations, the terms of PSAs with foreign IOCs, and the structure of newly established state-owned or -controlled O&G companies. Of course, an IOC that advises a host government to this degree will seek to craft highly favorable terms for cooperating with the host government and operating in the host country. That said, experts told IDA that it is important for IOCs to negotiate terms perceived as beneficial by the host government to ensure the long-term stability of the PSA and the regulatory environment. Contract terms must be perceived as fair or else an effort to renegotiate terms will happen sooner rather than later.

Human Resource Needs

IDA were told that the need for human resource development is more acute in Africa than in some other regions of the world known for O&G production. A lack of educational infrastructure makes it difficult in several African host countries to find managers and technical experts with the skills to perform at higher levels of O&G

operations. As a result, IOCs have developed extensive training and education programs to cultivate local capacity. One large U.S.-based IOC provides technical training for employees in Nigeria and another has formal programs to bring African company employees to Houston, Texas to provide managerial training and experience. IOCs may also provide vocational training to local communities to train electricians or plumbers.¹⁶ In Angola, a consortium of IOCs, the national oil company (NOC) SONANGOL, and the non-profit Citizens Development Corps (CDC) have created the Business Support Center (*Centro de apoio empresarial*, or CAE) to help train Angolans in business. A new CAE program enables Angolan businesses to receive certification used by IOCs as a standard prequalifying criterion for local business partners seeking contracts.¹⁷

Local Content Requirements

Although it is a generalization, there are relatively higher expectations for local content in Africa than in other O&G producing regions. Local and national-level officials seek to alleviate high rates of unemployment and to be seen to provide other economic benefits to local communities. IOCs have encountered challenges meeting the requirements for local content, especially when it comes to parts and equipment for the highly technical aspects of their facilities' operations. For example, local content requirements in Nigeria dictated that IOCs would need to procure sections of pipe with precision-measured threading within Nigeria and could not import materials from abroad. Consequences for material failure of the pipe sections could be major oil pipeline accidents. In response, one large IOC helped to establish a local pipe foundry and to train personnel at the foundry to produce the material needed at the required standards. Bringing the foundry up to standards required a seven-year process, but now the entity is an internationally certified precision pipe manufacturer.¹⁸ Excessive local content requirements can slow down a development project when it becomes difficult or impossible to procure the needed equipment or materials within the host country.¹⁹

Conclusions

According to the SMEs with whom IDA spoke, IOCs will pursue the hydrocarbon assets wherever they are found, as long as they are extractable at a rational cost and exportable to world markets for a profit. The regulatory and legal environment in a host country must be predictable enough that favorable contract terms can be arranged and the sanctity of the contract is – if not guaranteed – then at least assured for a reasonable number of years.

Different types of IOCs value political risk assessment differently. Smaller, more speculative enterprises often forgo detailed political risk assessments because of their limited engagement with a host country. Mid-sized companies are likely to value political risk assessment more because the consequences of facing an unexpected contingency that

jeopardizes their investment are serious. Large IOCs, so-called “super-majors” might not perform rigorous political risk assessment because most contingencies can be mitigated over the long duration of their engagement with a host country and they have the resources at their disposal for mitigation strategies.

Some risks were particular to O&G operations in sub-Saharan Africa, although circumstances will always differ, depending on the host country in question. In general, there is more widespread corruption and nepotism in Africa that exposes investors to reputation risk when they engage a host government. There is less available infrastructure, leading to important cost considerations when development and production projects are being proposed. Higher expectations for foreign investors to provision their projects locally in the face of limited local capacity have the potential to slow projects down. The human capital deficits encountered by foreign investors in African host nations are mitigated with extensive vocational and professional training programs and investment in local education.

Security risks faced by IOCs are seen as operational contingencies that can be mitigated with higher company expenditure on security improvements. For example, IOCs that entered the market for oil E&P in Iraq in 2003 were much less concerned with security considerations than they were with the Iraqi regulatory environment or the sanctity of contracts concluded with the interim government. Nonetheless, the security of company personnel is a vital consideration. If IOC personnel are harmed, it becomes a reputational risk for the company. When three expatriate employees of Chevron were killed by Sudanese rebels in 1984, the company curtailed its operations in southern Sudan. SMEs explained to IDA that one of the clear red lines for IOCs operating in Africa is if company personnel are killed.

Subsequent Research

During the process of conducting interviews with industry experts, IDA noted several factors that could potentially affect political stability. During the second phase of research, they will be examined using Angola as a case study. The following variables derived from this initial phase of research will be further examined to see whether testable hypotheses about their relationship to political stability can be determined. Findings will be presented in the final analysis presented after the third phase of the study. Noted variables include the following:

- *Local Content Requirements.* The level of local content required by a host country and the provision of technical training by IOCs: This may correlate with higher levels of political stability.
- *Public Officials as Economic Actors.* The existence of an economic elite in the host country who serve as public officials and also simultaneously own stakes in

private enterprises under their influence: Higher frequency of intermingling could create more regulatory stability.

- *Powerful National Oil Companies (NOCs)*. NOCs can potentially have more financial liquidity than the central government of a host country, and thus can become a major locus of power. Countries that depend on IOCs as a source of their oil revenue often centralize power in a strong executive branch of government.
- *NOCs as a Source of National Pride*. NOCs provide some benefits for the local population.
- *Presence of Foreign Enclaves*. The existence of foreign corporate enclaves (such as exist in the Angolan exclave of Cabinda) could potentially undermine political stability by engendering local resentment.
- *Level of Genuine Competition*. A truly competitive economic environment attracts small business partners or service providers to a host country O&G sector. Small businesses could be deterred from investing in a country in the presence of monopolies such as Angola's SONANGOL.
- *Civil Society Involvement*. If influential or mature civil society organizations (CSOs) provide oversight of O&G sector, they could demand better transparency and accountability of government activity, translating into greater political stability.
- *Type of Regime*. Democratic or autocratic regimes present different challenges to foreign investors when seeking to capitalize on petroleum resources and may affect political stability in different ways.

Endnotes

- ¹ Illan Alon, et al. "Managing Micropolitical Risk: A Cross-Sector Examination," *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 625.
- ² Jeffrey D. Simon, "A Theoretical Perspective on Political Risk," *Journal of International Business Studies*, Winter 1984, p. 123.
- ³ Illan Alon, et al. "Managing Micropolitical Risk: A Cross-Sector Examination," *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 625.
- ⁴ Illan Alon, et al. "Managing Micropolitical Risk: A Cross-Sector Examination," *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 625.
- ⁵ Illan Alon, et al. "Managing Micropolitical Risk: A Cross-Sector Examination," *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 631, 632.
- ⁶ Discussion with industry expert, Tuesday, Aug 28, 2012.
- ⁷ Discussion with industry expert, Wednesday Sept 19, 2012.
- ⁸ Discussion with industry expert, Thursday, Aug 30, 2012.
- ⁹ Discussion with industry expert, Tuesday Sept 4, 2012.
- ¹⁰ Discussion with industry expert, Wednesday Sept 19, 2012.
- ¹¹ Discussion with industry expert, Wednesday Sept 19, 2012.
- ¹² Discussion with industry expert, Tuesday Sept 4, 2012.
- ¹³ Discussion with industry expert, Tuesday Sept 4, 2012.
- ¹⁴ Human Rights Watch, *Sudan, Oil, and Human Rights: The Chevron Period 1974-1992*, (Brussels, London, New York, Washington DC: Human Rights Watch, 2003), p. 125.
- ¹⁵ Discussion with industry expert, Wednesday Sept 19, 2012.
- ¹⁶ Discussion with industry expert, Wednesday Sept 19, 2012.
- ¹⁷ Discussion with industry expert, Wednesday Sept 12, 2012.
- ¹⁸ Discussion with industry expert, Tuesday Sept 18, 2012.
- ¹⁹ Discussion with industry expert, Wednesday Sept 19, 2012.

Appendix A. Map of Africa



Appendix B. Literature Review: Commercial Perspectives on Political Risk

A. Introduction

Political risk analysis is a critical component of the assessment work done by investors in volatile regions of the world. Oil and gas companies in particular have a critical need to identify sources of instability that could potentially affect their planned or ongoing operations in resource-rich regions or countries. Trans-national corporations (TNCs) devote money and resources to developing political risk assessments that inform their decision-making processes about whether to invest in certain host countries or how to protect the value of existing investments.¹ TNCs, however, are primarily concerned with the applied side of political risk analysis. A thriving industry of commercial consulting has developed since the 1980s to serve the needs of large TNCs needing political risk assessment tools. In the meantime, academics have worked to develop a theoretical base for political risk analysis in order to identify recurring patterns and trends across countries.²

This appendix examines a small sample of journal articles in order to describe the most basic elements of political risk theory as it relates to commercial decision making processes. For the purpose of the current study, IDA has not attempted to examine or describe the wide universe of academic research into political risk analysis, but instead, has focused on research dating from the 1980s forward that provides representative examples of theoretical approaches to the concept of political risk assessment.

1. Definitions of Political Risk

Looking at even a small sample of theoretical work in the field of political risk analysis, one becomes aware of the nuances between different definitions. Illan Alon states directly that there is no consensus in the literature over the meaning of “political

¹ The current term “Trans-National Corporation” or “TNC” will be used in this report for the sake of continuity to denote the same thing as Multi-National Corporation (MNC) and Multi-National Enterprise (MNE) and other various terms used by the respective authors studied.

² Jeffrey D. Simon, “A Theoretical Perspective on Political Risk,” *Journal of International Business Studies*, Winter 1984, p. 123.

risk”.³ (See more below.) He agrees with the definition provided by Jeffrey Simon (also discussed below) who defines political risk as:

The governmental and societal actions and policies, originating either within or outside the host country, and negatively affecting either a select group of, or the majority of foreign business operations and investments.⁴

Alon favors the definition because it takes into account key considerations, such as the distinction between macro-level and micro-level risks and the difference between internal and external causes of political risk.

Alternately, in his piece examining political risk models for a corporate executive audience, Charles Kennedy defines political risk as:

...[The] risk of a strategic, financial, or personnel loss for a firm because of such non-market factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labor, and developmental) or events related to political instability (terrorism, riots, coups, civil war, and insurrection).

Both definitions illustrate the point that within a commercial context, political risk is evaluated almost solely in terms of its effect on investment success within the host country. The concept of regime failure or regime change that preoccupies other analysts is only one risk among many (i.e., an independent variable) in a commercial setting and is important insofar as it causes the failure of a project or seriously harms the investor.

2. Dependent vs. Independent Variables

It is important to identify the key dependent variable (i.e., the *observed result* of multiple factors) and the contributing independent variables one will consider when describing political risk analysis. How to identify the best independent variables (“best,” meaning those variables with the strongest explanatory value for the dependent variable being studied) is a matter of continuing academic debate. It will be important to understand how political risk analysts choose the independent variables that they hypothesize to have the strongest effect on the observed result. Commercial risk analysts are often reluctant to share how they identify and weigh the causative variables because the process is usually considered, “proprietary.” Conversely, scholars must explain which causative variables they select and analyze in order to further the ongoing academic investigation of political risk analysis.

³ Illan Alon, et al. “Managing Micropolitical Risk: A Cross-Sector Examination,” *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 625.

⁴ Jeffrey D. Simon, “Political Risk Assessment: Past Trends and Future Prospects,” *Columbia Journal of World Business*, Fall 1982, p. 68.

Other (government) analysts generally do not undertake a formal process of identifying variables or defining the ultimate dependent variable of an analytic study. The observed result usually studied by government analysts is regime change, i.e., whether the system of government of a given country is in danger of major change or collapse or whether key actors or institutions within the country's regime are likely to change. This represents a critical difference from how commercial analysts approach political risk. In a commercial context, political risk is important to the degree that it affects the value of a major investment (most often, the dependent variable being considered). For commercial analysts, change to the regime of a country is only one political risk factor among many that could affect the value of the investment – an independent variable, in the commercial context. Government analysts almost always study political risk as it affects regime stability. For the government analyst, regime stability *is* the dependent variable being investigated.

3. Macro- vs. Micro-level Risks

Political risk analysis traditionally addresses macro-level variables – for example, currency inconvertibility, nationalization or expropriation of capital, open armed conflict – that could affect all foreign investors operating in an identified host country. Analysts and scholars studying the concept of political risk are now calling for additional variables to be taken into account as well, especially micro-level variables that affect only one economic sector or industry. Investment in the energy sector is vulnerable to specific micro-level risks, clearly identified by a team of authors led by Ilan Alon in “Managing Micropolitical Risk; A Cross-Sector Examination,” published by the *Thunderbird International Business Review* in 2006. Examples of micro-level variables that could influence energy company decisions include shifting host government regulation of the energy sector in particular, environmental activism native to the host country or undertaken by groups operating there, or the physical security of company personnel operating in unstable geographic areas.⁵

4. Internals vs. External Factors

Macro-level variables can be both internal or external to the host country. For example, whether a host country head of government remains politically popular if economic (GDP) growth slows in 2012 is an internal risk factor. If he or she implements a program of import restrictions to support domestic producers, the retaliatory measures taken by the country's trade partners would be an external risk factor.⁶ In the context of

⁵ Ilan Alon, et al. “Managing Micropolitical Risk: A Cross-Sector Examination,” *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 631, 632.

⁶ Oxford Analytica, *Pivotal Powers: Politics and Prosperity in a Volatile World*, (London: Oxford Analytica, March 2012), p. 8.

the oil industry, whether the host government would unilaterally change the terms of exploration and production (E&P) contracts for foreign producers is a risk factor internal to that country, but whether future world market prices for oil justify a multi-billion dollar investment is an external risk factor, unlikely to be influenced by the host country.

5. Quantitative Models

Developing quantitative models of political risk is an ongoing effort most often undertaken by academic scholars and private-sector consultants. The purpose is to create a reliable tool to assess complex scenarios that could lead to major loss or gain for a strategic investor. The record of quantitative political risk models is problematic. The most acute impediment to quantitative modeling is the nature and quality of the data inputs. So-called “observable” data, usually taken from secondary sources, is used to build quantitative models. Examples of observable data include gross domestic product (GDP), population, rates of literacy, number of coups, revolutions, or regime changes in a given country. There is only a very limited number of quantifiable data available to use in the context of political risk assessment and all of them can be argued to have limited *causative* influence on political risks faced by a firm.

B. Articles

Stephen J. Kobrin, “Political Assessment by International Firms: Models or Methodologies?” *Journal of Policy Modeling*, 3 (2), 1981.

Stephen Kobrin performed extensive research in the field of political risk theory during the early 1980s, benefitting from both business and academic community interest following several large-scale expropriations of corporate assets by various governments during the late 1960s and the 1970s. By the end of the decade, regime change in Iran and the nationalization of foreign assets that followed (1979) made business leaders acutely aware of the consequences for failing to perform adequate political risk assessment. Academics, on the other hand, were eager to develop new paradigms for explaining the relationship between political events and how they affect the investment decisions of (primarily U.S.) corporations active in foreign countries around the world.

Kobrin is clear about his distinction between macro- and micro-level risks facing firms operating in a foreign host country. Macrorisks, as he calls them, are “environmental events [that] affect all foreign firms in a country without regard to organizational characteristics.” According to Kobrin, these include mass expropriations, changes in taxation, price controls, or environmental regulations. Microrisks are industry, firm, or project-specific and include events such as limitations on the repatriation of

capital, restrictions on expatriate employment in the host country, or local content regulations.⁷

Kobrin also differentiates between political risks that affect a TNC's ownership of assets within the host country and events that affect the TNC's operations only, possibly constraining cash flow or return on investment. According to Kobrin, TNCs operating in foreign markets are much more likely to face microrisks and more likely to experience events that affect their operations, rather than their ownership of assets. Additionally, one of Kobrin's main points is that the firm's industry, level of technology, and ownership structure are important factors determining how vulnerable the firm is to political risk.

Recent studies of historical data – from which Stephen Kobrin could not benefit in 1981 – have demonstrated that the number of mass expropriations of foreign assets undertaken by foreign governments during the 1960s and 1970s seriously dropped off during the 1980s and 1990s. Instead, as Kobrin correctly predicted, firms faced more frequent and more tangible so-called “transfer risks” that include restrictions on repatriation of profits and other capital transactions.⁸

It is an open question whether political risk assessment is fundamentally different from other types of risk assessment. It may be impossible to accurately map a relationship between the host country political environment in which a firm operates and a firm mostly because of a lack of sufficient historical data on one hand and quantifiable data on the other. The kind of data available – measures of GDP, population, literacy rates, or income disparity – can describe the macro-level risk environment, but not micro-level effects on specific industries or firms.⁹ There are two stages of a political risk assessment, according to Kobrin. First, a general analysis of the macro environment of the host country in which a firm operates, which requires expert knowledge of the political system and the country. Second, an assessment of contingencies that could affect the firm and in what way they would affect the firm requires detailed knowledge of the business. The experts in each of these areas often encounter difficulties communicating their knowledge and experience, requiring a translator that can enable the merging of the two disciplines.¹⁰

Kobrin examines several models developed by academics, as well as companies and organizations to assess political risk. He provides a matrix that categorizes the various

⁷ Stephen J. Kobrin, “Political Assessment by International Firms,” *Journal of Policy Modeling*, Vol. 3 No. 2, 1981, p. 253.

⁸ Nathan Jensen, *Measuring Risk: Political Risk Insurance Premiums and Domestic Political Institutions*, (Washington University, 2005), p. 3.

⁹ Kobrin, 1981, p. 258.

¹⁰ Kobrin, 1981, p. 255.

models according to whether their main inputs are observable data or expert opinion and whether the model is explicit about process or methodology. After explaining the model and his terms, Kobrin evaluates the nine models under consideration and develops his observations about their utility for describing reality.

Based on his evaluation, Kobrin asserts that models based on observable data have only limited utility. The main bodies of historical data (relating to political risk) that are both explicit and quantifiable are macro-level data that indicate political stability or political/economic development.¹¹ Models that depend on these inputs cannot assess the specific impacts on foreign firms, given a set of possible political contingencies judged to be likely in a host country.¹²

As a result, the more effective models use data inputs based on expert opinions but also built using structured and systematic methodologies. Because expert opinions are inherently subjective and based on associations the expert makes on an unconscious level, Kobrin advises that a model using these inputs must integrate an explicit process statement. By that, he means the modeler must lay out clearly the cause and effect relationship between political events and business decisions.

As an example, Kobrin describes a major U.S. corporation that employs a staff of retired Foreign Service officers as political risk analysts. When asked to provide a country report, the analyst reviewed secondary resources and interviewed numerous U.S. government officials, company representatives, local resident professionals, etc. The resulting report was detailed and did consider implications for the firm including labor relations, price controls, and economic nationalism but was nonetheless unstructured and unsystematic. According to Kobrin, the weakness of an unstructured and unsystematic methodology is that this report and future reports cannot be analytically compared.

Of all the models studied, Kobrin chooses the ASPRO/SPAIR (Assessment of Probabilities/ Subjective Probabilities Assigned to Investment Risk) model developed by Shell Oil as having the best methodology. He prefers the model because it is generally project specific and it solicits expert opinion in a framework that reduces bias and variability. The original ASPRO/SPAIR model defines political risk in the context of an oil E&P contract and includes causal factors made up of independent variables that could have an impact on the contract.¹³ Expert opinions are used to evaluate each of the

¹¹ Kobrin, 1981, p. 258.

¹² Kobrin, 1981, p. 258.

¹³ The ASPRO/SPAIR model defines political risk as the probability of not maintaining a contract for oil E&P that is considered equitable by both the company and the host government over a 10-year period in the face of changing political and economic conditions. Kobrin, 1981, p. 264.

independent variables and then a statistical algorithm is used to weigh and combine the individual expert assessments.¹⁴

At the time, in 1981, Kobrin emphasized that more work needed to be done to explore the relationship between the political risk environment of the host country and the firm operating there. He advised companies themselves to review their past decisions and explore the causative factors that contributed to the decisions in order to build knowledge about the relationship. He explained that once the causal relationship was better understood, companies would be able to develop strategies to reduce their vulnerabilities to political risk in the host country, to reduce the cost of hedging strategies they might have to adopt, or even to spot opportunities that could be inherent in a politically risky operating environment.¹⁵

Jeffrey D. Simon, “A Theoretical Perspective on Political Risk,” *Journal of International Business Studies*, Winter 1984.

Simon identifies impediments to the development of political risk theory during the early 1980s. In the years immediately following the 1979 revolutions in Iran and Nicaragua, corporations were only interested in political risk applications that could inform their “go/ no-go” decisions about foreign markets.¹⁶ It was assumed that only so-called “hard” data such as economic and financial indicators could be quantified and assessed, whereas “soft” data like public attitudes, elite behavior, and international conflict were impossible to study systematically.¹⁷ Another impediment to the development of political risk theory was the preference among TNCs for single-country risk analyses performed without any conceptual framework that would identify patterns across many nations. Simon makes the point that political risk analysis within TNCs is usually performed by former Foreign Service officers or country analysts who follow traditional country and area studies approaches without knowledge of political risk theory.¹⁸ His view is that this limited view of political risk assessment can be enhanced by taking into consideration concepts developed in academic literature.

To that end, Simon presents concepts derived from scholarship done in the early 1980s that broaden the framework of political risk. For example, Thomas Gladwin and Ingo Walter Ingo proposed in 1980 that a TNC operating overseas must consider more than the host government as a source of risk. Risk can ensue from other actors including

¹⁴ Kobrin, 1981, p. 264.

¹⁵ Kobrin, 1981, p. 267.

¹⁶ Jeffrey D. Simon, “A Theoretical Perspective on Political Risk,” *Journal of International Business Studies*, Winter 1984, p. 124.

¹⁷ Simon, 1984, p. 124.

¹⁸ Simon, 1984, p. 124.

local host-country business interests or opposition groups operating there.¹⁹ Additionally, Gladwin and Walter point out that the source of political risk is less important than the implications of change or instability on the TNC – things such as changes in relative power among actors, the alignment of interests, and the quality of the TNC’s relationships with various host-country actors.²⁰ Simon also cites the 1982 work of Ashok Chatterjee, who developed a model of host country social performance (measured by secondary and higher education levels and annual per capita income) compared to levels of foreign investment. Chatterjee found an indirect relationship between the two, leading him to conclude:

Rapidly increasing the level of education [in less developed countries (LDCs)] is of questionable value, if the level of material achievement persistently falls behind the rising aspirations generated. Such a development is essentially unbalanced and likely to be destabilizing.²¹

As Simon explains, Chatterjee’s notion of the social performance gap adds to an understanding of the various origins of political risk. He uses it to build a framework that can help to identify key actors and developments that affect political risk assessment.²² Simon draws from previous research to construct an “environment” in which a TNC operates when it invests in foreign markets. (See Figure 1.)

In the remainder of his study, Simon adds to the framework of the TNC’s environments the concepts of industrialized versus developing host country status and also the relative openness or closed nature of the host country environment. He provides theoretical examples of risks faced in each type of host country environment, as well as global risks that could affect TNC decision making. Simon differentiates between direct and indirect risks that a TNC could confront, the former being policies or actions that directly target the TNC itself (examples include expropriations, demonstrations against TNC operations, unfavorable legal actions, or negative publicity) and the latter being policies, actions, or events that could pose challenges to the TNC but are not the result of direct action (such as leadership struggles within the host country or local business groups’ lobbying efforts).²³

¹⁹ Thomas N. Gladwin and Ingo Walter, *Multinationals under Fire: Lessons in the Management of Conflict*, (New York: John Wiley & Sons, 1980).

²⁰ Simon, 1984, p. 125.

²¹ Ashok K. Chatterjee, *Foreign Direct Investment and Political Risk: A Weak Signal Perspective*, (New York: NY University, PhD dissertation, 1982), pp. 170-171 Cited in Simon, p. 126.

²² Simon, 1984, p. 126.

²³ Simon, 1984, p. 127.

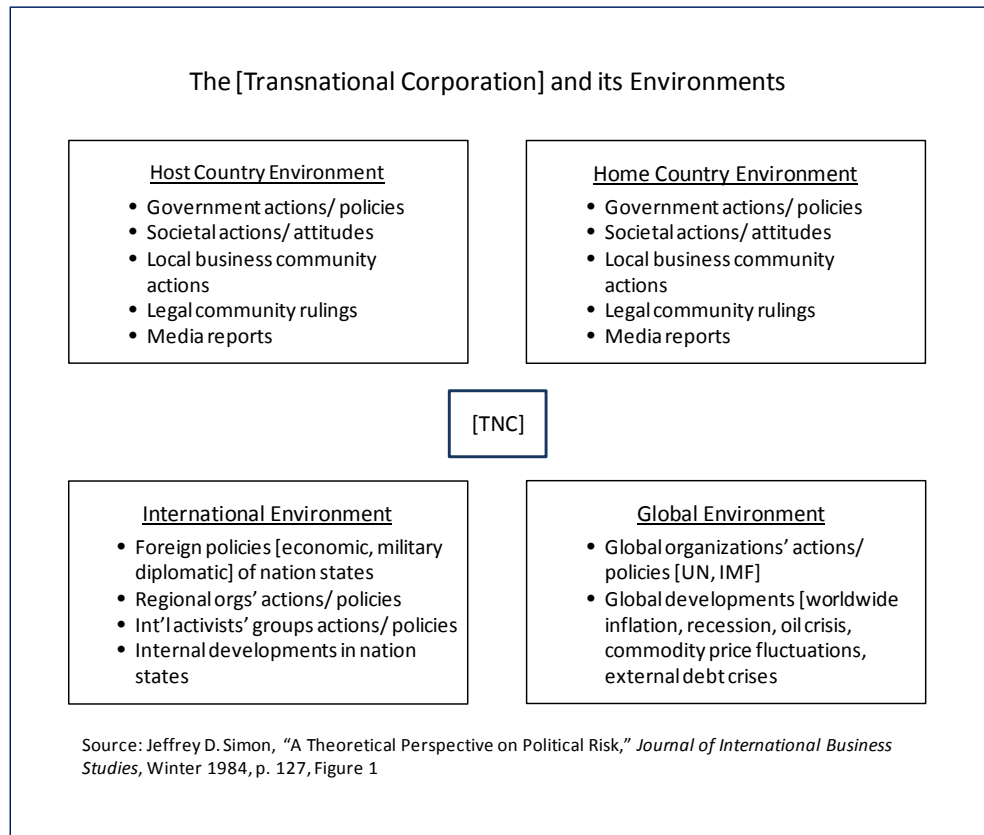


Figure 1. Jeffrey D. Simon Illustration of Political Risk Environments

Simon concludes his study with an application of his framework to the case of South Africa in the context of the mid-1980s. His detailed examination leads to the conclusion that South Africa represented a case where TNCs faced minimal risks from the government itself but did face direct risks from oppositions groups (the ANC, primarily) and organized labor groups, as well as the indirect risk at that time that South Africa would experience revolutionary change.²⁴ Simon goes one layer deeper by considering the relative capabilities and intentions of each actor to affect a foreign investor. Although it is a basic concept, it is nonetheless important for an analyst to consider not only the intentions of an actor toward an investor, but also that actor's capability to take action. (See Figure 2.)

²⁴ Simon, 1984, p. 138.

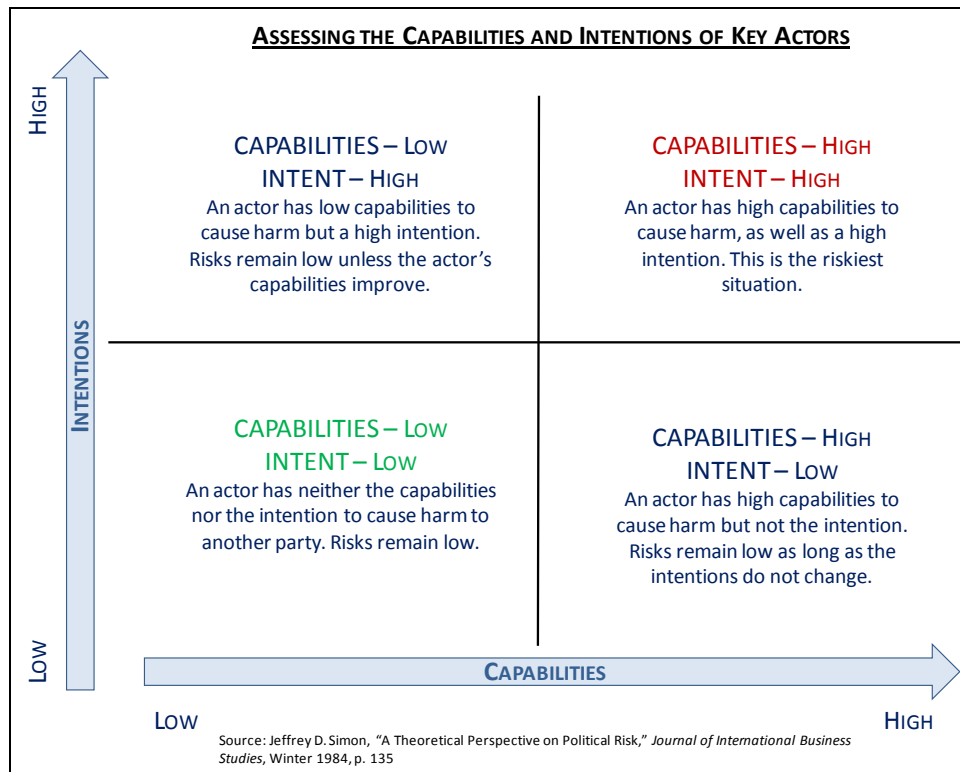


Figure 2. Capabilities versus Intentions

According to Simon’s theoretical framework, South Africa demonstrated the risks inherent in a closed-industrial society, with the caveat that the country’s economic dependence on gold exports presented the same type of global risks (i.e., the world commodity price for gold) that one would expect to see in an LDC economy.

The theoretical framework that Simon proposes uses three dichotomies for examining political risk: open versus closed societies, industrialized versus developing economies, and direct versus indirect risks to TNCs operating in a given country. The framework, as applied to South Africa, seems to have very useful explanatory value for studies of different political environments.

Charles R. Kennedy, Jr. “Political Risk Management: A Portfolio Planning Model,” *Business Horizons*, Nov-Dec 1988

When Charles Kennedy composed his study of portfolio management in 1988, his goal was to demonstrate that traditional portfolio management took place in a relatively stable domestic environment of the investor but that the growing internationalization of business operations made political risk considerations necessary. His position was that as investors move into more volatile markets around the world, the political risks inherent in less stable host country environments must be taken into account.

As stated above, Charles Kennedy defines political risk as:

...[The] risk of a strategic, financial, or personnel loss for a firm because of such non-market factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labor, and developmental) or events related to political instability (terrorism, riots, coups, civil war, and insurrection).

He separates the two concepts within his definition into 1) legal-governmental risks produced by the legitimate authority structures of the states, and 2) extra-legal risks caused by events or actors considered illegitimate under the existing political system.²⁵ Examples of legal-governmental risk include foreign exchange controls or trade regulations. Examples of extra-legal risks include revolutionary expropriations or terrorism.

Kennedy is able to make definitive statements about political risk factors based on his own empirical study of more than 50 large TNCs during five years of research.²⁶ Like other authors in the field, Kennedy differentiates between risks that confront all firms operating in a host country (macro risks) versus risks that affect only specific industries or investors (micro risks). Unlike other authors examined, Kennedy does not explicitly make reference to “macro” or “micro” risks, but makes the conceptual distinction nonetheless. He cites mass expropriations as a typical risk affecting nearly all firms in a country – one that could be legal-governmental or extra-legal, depending on circumstances – versus trade regulation, a risk likely to affect one industry more than others.²⁷

As he lays out the need to include industry-specific risk in a useful political risk assessment, Kennedy proposes three industry classification tiers that should be used when company or project characteristics are folded into the process: 1) Final goods (consumer goods, food/beverages, automobiles, etc.), 2) Intermediate goods (chemicals, tires, industrial equipment), and 3) Primary goods (oil, gas, mining). Based on his empirical study, Kennedy explains that military coups or revolutions threaten highly visible and strategic industries the most and consumer goods industries much less. Kennedy states that the larger and more politically sensitive a project is within the host country, the more vulnerable it is to government intervention.²⁸

²⁵ Charles P. Kennedy, “Political Risk Management: A Portfolio Planning Model,” *Business Horizons*, Nov-Dec 1988, p. 27.

²⁶ Kennedy’s study of over 50 TNCs is detailed in Charles R. Kennedy, Jr., *Political Risk Management: International Lending and Investing under Environmental Uncertainty*, (Westport, CT: Greenwood Press, 1987)

²⁷ Kennedy, 1988, p. 27.

²⁸ Kennedy, 1988, p. 28.

The main part of Kennedy's article is an illustration of his Strategic Business Unit (SBU)/ Political Risk Matrix. The intended audience for the article is business executives and the stated purpose is to "provide a decision matrix integrating political risk concepts with portfolio planning tools."²⁹ More than other authors considered, Kennedy proposes defined courses of action based on the existing success or failure of a TNC SBU (or subsidiary) operating in a host country and the low, moderate, or high degree of political risk the SBU faces. Very helpfully, Kennedy illustrates each proposed course of action with real-world examples of major TNCs and their investment decisions when facing risks including:

- Slow economic growth in socially unstable South Africa of the 1980s (G.E.)
- Competition from a planned government-controlled computer industry in France, following the election of Francois Mitterrand in 1981 (IBM-France)
- Declining influence and competitive advantage in the highly lucrative Brazilian petrochemical market (Dow-Brazil)
- The risk of forced divestment from the Saudi Arabian oil production industry in the 1970s (ARAMCO)

After presenting case studies of TNC responses to various political risk scenarios, Kennedy concludes his article by providing guidance and additional examples for executive decision-making. He cautions executives against considering more than two or three scenarios when undertaking intensive risk analysis and also against viewing any decision matrix as an automatic prescription for action.³⁰ He strongly advises against complacency when considering the host country operating environment and suggests that political risk analysis must be proactive and based on a scenario-building approach. To illustrate the point, Kennedy compares the experience of GTE and Du Pont in 1977 Iran. GTE, a telecommunications company, undertook a large contract with the government of Iran in 1977 after assuming a stable political environment – what the company had experienced since the 1950s. Chemical giant Du Pont on the other hand, halted a planned petrochemical project after it assessed that the Iranian political environment was worsening.³¹

Kennedy makes other important points in his conclusion concerning legal-governmental risks and extra-legal risks. He points out that the vast majority of political risk faced is legal-governmental, involving changes to laws or regulations that affect specific industries. Extra-legal risks, such as revolutionary change, are exceptional and

²⁹ Kennedy, 1988, p. 26.

³⁰ Kennedy, 1988, p. 32.

³¹ Kennedy, 1988, p. 32.

likely to affect all investors, making tactical responses less effective because one firm is unlikely to gain an advantage over the others.³²

Unlike other authors considered in this report, Kennedy believes that organizational decisions about who performs political risk analysis within the TNC and at what level is less important than how much political risk analysis is stressed and valued by the investor. Overall, his recommendation is that proactive political risk assessment and ongoing reevaluations are key to effective investment decisions.

Illan Alon, et al. “Managing Micropolitical Risk: A Cross-Sector Examination,”
Thunderbird International Business Review, Vol. 48 (5), Sep. – Oct. 2006

The team of contributors led by Illan Alon begins their assessment by referencing previous contributions to the conception of political risk. Echoing Jeffrey Simon, Alon mentions the 1981 work of Stephen J. Kobrin, who pointed out that smaller, more pervasive political risks affecting specific industries or companies had more of a cumulative effect on TNCs than dramatic disruptions, such as forced mass divestitures or expropriations.³³ Alon mainly addresses the concept of sub-dividing the broad category political risk into macro and micro dimensions. He cites previous work done by Jeffrey Simon and Charles R. Kennedy (described above) as examples of scholarship that define the components of political risk according to each author’s risk assessment system.³⁴

Alon is primarily concerned with delineating micro-level political risks that affect individual industries or companies within a host country. His own review of the literature led him to Stephen J. Kobrin’s definition of macro- versus micro-level risks articulated in 1981:

Macrorisks [are] environmental events, which affect all foreign firms in a country without regard to organizational characteristics, and microrisks... are industry, firm, and even project-specific.³⁵

Alon states explicitly that his study is intended for business-sector consumers and provides guidance about how firms should identify and assess micro-level political risks to their company or project. Case studies examining three different sectors (financial, energy, automobiles) are included to illustrate the different sector-level risks that could confront firms operating in the same host country environment, resulting in different

³² Kennedy, 1988, p. 32.

³³ Stephen J. Kobrin, “Political Assessment by International Firms – Models or Methodologies,” *Journal of Policy Modeling*, Vol 3 (2), 1981, pp. 251-270 cited in Illan Alon, et al. “Managing Micropolitical Risk: A Cross-Sector Examination,” *Thunderbird International Business Review*, Vol. 48 (5), Sep. – Oct. 2006, p. 624.

³⁴ Alon, et al., p. 624.

³⁵ Kobrin, 1981, p. 253.

outcomes for firms in different sectors. Alon many times makes the point that micro-level approaches to political risk have more practical applications for business consumers than macro-level theoretical approaches.

Regarding the energy sector, Alon notes energy sector firms are able to accept a high degree of political risk if risks can be managed and a project is forecast to be profitable. Energy companies are vulnerable to the usual macro-level risks that could potentially affect all foreign investors in a host country, including war, terrorism, labor unrest, political instability, corruption, taxation systems, government regulation, and repatriation restrictions. As they monitor and manage these risks, oil and gas companies also have to consider factors such as oil or gas embargoes, environmental activism, restrictions on oil or gas exports, and government local ownership requirements.

Beginning in the late 1970s, oil and gas companies began to formalize their risk calculations by using scenarios to model the effects of political and economic events on oil prices.³⁶ Shell Oil developed a structured risk model known as ASPRO-SPAIR (Assessment of Probabilities/ Subjective Probabilities Assigned to Investment Risk) that was adopted and modified by subsequent users. According to Stephen J. Kobrin (1981) who has written about ASPRO-SPAIR, the model explicitly defines political risk in the context of an oil exploration and production (E&P) project and constructs a causal model based on independent variables that could produce risks to the project.³⁷

Within the discussion of energy sector risk assessment, Alon et al. categorize security risk among the possible political risks faced by oil and gas projects.³⁸ Because oil and gas companies frequently operate in rural, minimally policed or administered regions of host countries, the physical security of property and personnel is more exposed to risk than, for example, the physical assets of financial companies operating in the capital city or automobile companies operating at the port or in an active marketplace. Additionally, extractive industries raise sensitivities in a host country as national resources are tapped and processed. The article describes how BP, plc (then British Petroleum) has its own internal security system to address these risks including personnel with law enforcement and military expertise.

The authors also describe the political risk index developed by IHS Energy Group, used by Société Générale equity research team to assess political risk confronting Shell (Netherlands, UK), Total S.A. (France), Eni S.p.A. (Italy), and Repsol S.A. (Spain). The index divides risk into three categories including political, economic, and commercial

³⁶ Molano, 2001, p. 26 cited by Alon et al., p. 633.

³⁷ Stephen J. Kobrin, *Managing Political Risk Assessment: Strategic Response to Environmental Change*, (Berkeley, Los Angeles, London: University of California Press, 1982) p. 207.

³⁸ Alon et al., p. 633.

risk and then sub-divides each category, resulting in 11 weighted variables. Countries are ranked from zero (risk-free) to 5 (maximum risk potential). The 11 variables included in the IHS Energy Group index are shown in Table 1.³⁹

Table 1. IHS Energy Group Index Variables

Components of Political	Weighted Value	Type of Risk
internal violence	21 percent	Political
regime instability	18 percent	Political
civil and labor unrest	15 percent	Political
threat of changes to contracts/ fiscal terms	8 percent	Commercial
investment constraints	7 percent	Commercial
war and external threats	6 percent	Political
environmental activism	6 percent	Economic
economic instability	5 percent	Economic
ethnic-linguistic factionalism	5 percent	Economic
repatriation restrictions	5 percent	Commercial
energy vulnerability	4 percent	Economic

Source: Ilan Alon et al., "Managing Micropolitical Risk: A Cross-Sector Examination," *Thunderbird International Business Review*, Sep-Oct 2006, p. 635.
See also: "Trading Political Risk," *Petroleum Economist*, September 2002.

Based on the results of the index, countries rank differently whether overall risk is considered or whether political risk is considered alone. For example, in terms of overall risk, Nigerian ranks with Norway, but in terms of political risk alone, Nigeria was the riskiest country analyzed.⁴⁰

The piece by Alon et al. concludes with recommendations for companies seeking to develop their own methods of political risk assessment. Alon advises a simplified assessment model that identifies macro-level risks (such as exchange-rate movements, threats of war, terrorism, civil and labor unrest) that could affect all investors in a country, followed by the identification of micro-level risks specific to an industry, company, or project. The authors advise that weights should be assigned based on the investor's industry, location, and risk tolerance. When scores are developed for each country under consideration, relative country risk can be discerned more easily. The

³⁹ Alon et al., p. 634.

⁴⁰ "Trading Political Risk," *Petroleum Economist*, September 2002.

authors further advise that an investor should make its team at corporate headquarters responsible for identifying and assessing the appropriate macro-level risks to all international operations, while the company teams at the international locations are responsible for identifying and assessing the micro-level political risks on the ground.

C. Conclusion: Summary of Basic Concepts

This review of available literature exploring the area of political risk and political risk assessment approaches provides some useful illustrations of key concepts.

Notable among these are that *different models of political risk assessment define dependent and independent variables differently*, depending on the level of analysis, the availability of data, or the methodological approach followed. For example, because the Political Stability Prospects model described by Stephen Kobrin in 1981 depends on observational data (GDP, literacy rates, etc.) that describe measures of political economy, it is limited to describing political stability across a range of countries, but cannot be used to delineate the possible contingencies that companies operating in those countries could face or possible responses the companies might have.⁴¹ On the other hand, the original ASPRO/SPAIR model developed by Shell Oil defines its dependent variable explicitly as the prospects for a 10-year oil E&P contract and its independent variables as those factors that could affect the prospects negatively or positively. ASPRO/SPAIR depends on subjective, expert-generated informational inputs (not quantifiable data) but makes provisions for this by using a statistical algorithm to weigh and combine the political-economic inputs.⁴²

Another concept explored by the authors studied here is *the differentiation between macro-level risks that affect all firms operating in a host country, versus micro-level risks that affect different industries, firms, or projects differently*. An analysis of macro-level risks is a sound starting-point for a political risk assessment, but risks inherent to an industry, firm, or project must be fully understood in order for the management of the investing firm to evaluate its range of options when and if it chooses to respond to the risks. The article by Charles Kennedy, which primarily delivers a systematic way to think about the range of responses available to firms operating in various risk environments, makes clear that risks differ according to the industry in question.

Finally, although quantitative risk modeling has the advantage of structured and systematic data inputs, as well as an explicit methodology, the data used are generally derived from secondary sources and have a limited predictive value for contingencies relevant to foreign investors. Many academics have created models extrapolating past

⁴¹ Kobrin, 1981, p. 257.

⁴² Kobrin, 1981, p. 264.

events into future scenarios. To do so, the past events must be explicit and quantifiable. As a result, *quantitative models are best able to describe conditions of political stability, but they are not useful for describing specific effects the potential instability could have on the operations of a TNC in a foreign host country.*

The identification of political risk became more important to firms during the past three decades as countries grew more interconnected and commercial enterprises expanded their operations to overseas markets. The operating environment in a single host country can no longer be considered in a vacuum. The challenges for TNCs operating abroad today include not only the identification of political and other commercial risks, but also the development of mitigation strategies that enable them to overcome challenges in a host country and ultimately, to maintain the value of their investments.

REPORT DOCUMENTATION PAGE

Form Approved
OMB No. 0704-0188

Public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing this collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden to Department of Defense, Washington Headquarters Services, Directorate for Information Operations and Reports (0704-0188), 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to any penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number. **PLEASE DO NOT RETURN YOUR FORM TO THE ABOVE ADDRESS.**

1. REPORT DATE (DD-MM-YYYY) October 2012		2. REPORT TYPE IAD Draft Final		3. DATES COVERED (From - To) 07-2012 – 03-2013	
4. TITLE AND SUBTITLE Commercial Perspectives on Political Risk in Sub-Saharan Africa				5a. CONTRACT NUMBER 2012-12062700-003	
				5b. GRANT NUMBER — — — —	
				5c. PROGRAM ELEMENT NUMBER — — — —	
6. AUTHOR(S) Andrea S. Pongo, Ashley N. Bybee, Stephanie M. Burchard				5d. PROJECT NUMBER — — — —	
				5e. TASK NUMBER EE-55-3604	
				5f. WORK UNIT NUMBER — — — —	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Institute for Defense Analyses 4850 Mark Center Drive Alexandria, Virginia 22311-1882				8. PERFORMING ORGANIZATION REPORT NUMBER IDA Document D-4841 Log: H 13-000385	
9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES) Institute for Defense Analyses 4850 Mark Center Drive Alexandria, Virginia 22311-1882				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S) — — — —	
12. DISTRIBUTION / AVAILABILITY STATEMENT Approved for public release; distribution is unlimited (18 July 2013).					
13. SUPPLEMENTARY NOTES — — — —					
14. ABSTRACT During Phase I of the project on the impacts of new oil discoveries on political stability in Africa, IDA studied commercial approaches to political risk. Commercial approaches to risk assessment are based on different criteria from assessments performed in an academic or public-sector context. It is important to understand the risks inherent to oil and gas (O&G) operations and how international oil companies (IOCs) judge whether to enter a new market when new O&G discoveries are made in host countries.					
15. SUBJECT TERMS Oil, Political Stability					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT Unlimited	18. NUMBER OF PAGES 41	19a. NAME OF RESPONSIBLE PERSON Richard Porterfield
a. REPORT Unclassified	b. ABSTRACT Unclassified	c. THIS PAGE Unclassified			19b. TELEPHONE NUMBER (include area code) 703-578-2812