

How energy companies can improve global business performance by better managing political risk*

Political change has a greater impact on business performance than ever before.

Energy companies understand the business consequences of political change perhaps better than organizations in any other sector. Matching energy demand and supply is, at its very core, a high-stakes geopolitical business endeavor. This is truer today than at any time in the past.

The signs of this abound. National oil companies (NOCs) are expanding at an unprecedented rate. Geopolitical uncertainty, across both producer and consumer countries, is on the rise. At the same time, the industry is coping with a surge in published and unpublished incidents involving business setbacks such as contract renegotiations or cancellation by host countries, increases in taxation driven in part by political agendas, or impromptu exits from countries after significant investment.

What's different today is an increased level of complexity—and in some jurisdictions, a new urgency—in how global politics impact the energy value chain.

Consider the political complexities surrounding the seizure of Occidental's oilfields in Ecuador. Directly at stake are the interests of Ecuador, the United States, China, and Canada as well as Occidental, two Chinese national oil companies, a private Canadian energy firm and a host of public and private organizations impacted by the US's freeze of its free-trade agreement with Ecuador. For any of these parties, managing the business implications of political risks in this situation requires insight and analysis across a complex range of probabilities, trade-offs and dependencies involving issues such as Ecuador's emerging nationalist objectives, regional trends in politics and energy policy among neighboring countries such as Venezuela, and both local and global implications of China's vigorous drive to expand its access to global energy reserves.

What is political risk?

Any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.

In effect, the bar for political risk has been raised. Threats are on the rise worldwide. Conflict in the Middle East, terrorism, and pandemic threaten the safety of infrastructure, the security of energy supply, and the continuity of business operations. At the same time, energy companies are under growing pressure to increase exploration and investment in emerging and nascent markets. Tapping frontier areas to find new sources for reserve replacement ahead of competitors is an enormous driver. So is capitalizing on rising levels of energy demand in the world's fastest growing markets.

Also pressing energy companies to increase international exposure is the need to capture or monetize emission credits in order to compete effectively in a carbon-constrained global economy. In addition, global compliance with the U.S. Foreign Corrupt Practices Act (FCPA), multilateral trade agreements and a web of global and local regulations is now becoming more acutely challenging.

Every one of these trends has been looming on energy's horizon for a long time. What's new today is a crucial and growing gap between the willingness of energy company executives to accept rising levels of political risk in search of greater economic rewards and their ability to adequately protect business performance and economic value by managing this risk in a consistent, efficient, and systematic manner.

Our point of view

Political risk can be anticipated—and its impact on energy business performance managed.

At PricewaterhouseCoopers and Eurasia Group, we know from experience that, because political risk can be anticipated, it can also be measured and managed. When energy leaders understand political change—not just in a specific country or region but also across the enterprise—they can direct their risk analysts and country or segment managers to anticipate and prepare for the risks most likely to affect business operations, market performance, and ultimately, shareholder value. They can also position their companies to take advantage of new opportunities before competitors do.

We think energy companies need to increase their focus on managing political risk in two critical areas.

Sharpening strategic insight into potential risk-adjusted performance outcomes

Energy companies need to get better at evaluating potential business outcomes of various political scenarios over different time horizons—both qualitatively and quantitatively. The industry has traditionally assessed political risk by analyzing discrete issues such as the risks associated with security, expropriation, and changes in currency valuations or by integrating this data and analysis into larger strategic planning models.

Energy executives need better insight into and across key issues such as investment timing, the risks of nationalization or mid-stream changes to regulations, and the suitability of individual governments as commercial partners.

They also need better visibility across constantly changing geo-political dynamics. As the China National Offshore Oil Corporation encountered with its unsuccessful bid for Unocal, global dynamics influencing an investment decision can have a deleterious effect on a transaction even when price is not an obstacle.

Improving global operational performance

Energy companies also need to get better at systematically capturing political risk measures across operational management systems and consistently making this information available to key decision-makers across business units, functions and geographical centers of command.

In fact, quite often energy companies already possess the political risk information needed to make more informed decisions on strategy, operations, compliance, and risk management. Key decision-makers, however, are often not aware that this information is available internally—and make critical decisions on operational performance and crisis preparedness without it.

When companies systematically and proactively monitor political risk, they help protect and enhance performance. For example, construction of the Trans Thai-Malaysia gas pipeline was hotly contested by local religious and environmental groups. Energy companies involved in the project needed to be perceived as neither harming local interests nor supporting government efforts to crush dissent. One energy company with a competitively-advantaged approach to political risk focused early on monitoring key factors, trends and indicators it believed would signal an intensification of the situation. They then used this information to gauge the need for changes to their communications and government relations strategies to help shape a better business outcome.

Systematizing political risk assessment across the global enterprise makes it far more likely that energy executives will gain earlier insight—and therefore a wider range of decision alternatives—to address a host of operational political risk issues, such as ensuring energy security, protecting infrastructure, and mitigating potential impacts from country-specific risks upon the global supply chain.

Energy companies need to embed political risk management more deeply within critical business processes

We believe the absence of a comprehensive political risk management capability will become increasingly expensive. Regulations and regulatory approaches are constantly changing. So are energy stakeholder expectations of appropriate business conduct and acceptable thresholds for key business practices.

Unless addressed, manageable dimensions of political risk uncertainty and surprise will continue to increase the overall—and sometimes avoidable—costs of doing business.

The best way for energy companies to manage political risk systematically is to embed political risk management into the company's business planning processes as a discrete risk category in accordance with the same principles or components that apply to effective enterprise risk management.

How energy companies can improve political risk management

A systematic approach to managing political risk starts with a comprehensive assessment. Here's how to make such an assessment effective.

Make better, more timely decisions about international investments and operations.

Map the politics

Create an external political risk profile—one that provides you with a cross-country portfolio view of your risk and allows you to begin managing your global investments from a portfolio perspective.

- Since many internal and external sources of political risk information have a natural bias, rely on a broad spectrum of trusted sources including in-country networks, on-site management, and neutral third parties.
- Identify your organization's global market presence at an entity, country, and regional level—whether this presence is direct (i.e., ownership interest or control) or indirect (i.e., dependence on a global supply chain or energy pricing influenced by global trends).
- Evaluate your potential exposure in each jurisdiction, particularly with respect to macro-level risks such as energy price volatility, terrorism, political instability, weapons proliferation, Northeast Asian security considerations, and the role of China and other large consuming countries in the global energy marketplace.

Evaluate the risks

Next, use this information to identify specific, prioritized, business-relevant risks to your operational performance.

- Examine the relationship between political stability and major macro-level indicators of energy performance, including economic drivers of energy supply and demand such as changes in GDP and disposable income.
- Develop a structured and iterative approach to assessing the impact of political stability factors on business performance and capital values.
- Analyze the impact of these political and business risks on your strategy and regulatory compliance as well as your critical operations and processes.

Assess controls and plans

Now focus on the adequacy of your assessment controls and procedures –particularly with respect to whether these controls are exercised through corporate oversight or local capabilities.

- Determine your level of preparedness. Examine the quality of your existing controls and the adequacy of your risk mitigation plans relative to the business risks you've identified.
- Estimate the impact of volatility within the political environment on your sales growth and gross margins.
- Then assess the degree to which you're integrating political risk management into your strategic decision-making and operational practices.

Determine the acceptability of residual risk

Finally, integrate political risk management into your strategic decision-making and ongoing monitoring activities.

- Look at the risks that remain after mitigation steps have been taken and evaluate the process your organization uses to determine whether or not these risks are acceptable.
- Communicate political risk information on a proactive, timely basis throughout the organization, especially to decision-makers at the corporate and operating unit levels responsible for areas such as strategic planning, operational processes, and crisis preparedness.
- Consider formalizing political risk assessments by having internal audit conduct overall assessments on a regular basis; focus on political risks in a specific country or region, such as a study of potential regulatory changes in Brazil; or audit an issue that continues to arise across the company's international operations, such as allegations of FCPA violations.

A systematic approach to political risk management impacts returns, alters risk profiles, and reveals opportunities.

We believe that energy companies that adopt formal, systematic, and business-aligned processes for managing political risks—from exploration and development to operations and customer delivery—improve sustainable business performance.

More accurate and reliable information supporting political risk visibility across a global portfolio of investments sharpens management insight. It expands executive options. And by embedding iterative political risk management practices into critical business processes, it helps avoid politically-influenced surprises to business results.

At stake, however, aren't just the hard-to-measure benefits of avoiding negative impacts to performance. Energy companies that understand how to anticipate, measure and manage political risk also pursue new opportunities with greater confidence.

For more information please visit:
www.pwc.com/politicalrisk

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