Managing Geopolitical Risks
The Global Oil and Gas Industry Plays a Winning Game
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Managing Geopolitical Risks: Lessons from the Global Oil and Gas Industry

Abstract: Rising geopolitical risks associated with the return of great power politics and growing nationalism have generated new challenges for foreign investors across industries. Oil and gas companies are well acquainted with such risks and have developed strategies to manage them. This article reviews five of these strategies: (1) Divorcing ownership control from operating control in designing collaborative ventures; (2) proactively managing stakeholder relationships; (3) ensuring transparency and communication; (4) diversifying risks while proactively positioning for emerging opportunities; and (5) deliberately planning for exit should such an eventuality arise. Firms outside of oil and gas can draw on these strategies as they navigate the emerging geopolitical context.

Keywords: Oil and gas, geopolitics, political risk
Introduction
The end of energy free trade: Welcome to a new era in oil and gas, prompted by Western sanctions against Russia, that gives geopolitics an edge over market forces.

Wall Street Journal, June 4, 2022

The Return of Geopolitical Risk
As globalization accelerated in the late-20th Century and Western MNCs moved into markets that they had previously avoided or been restricted from, the potential for disruptions from international and host-country politics grew. Decades of efforts to promote rules-based global economic integration through institutional mechanisms such as the World Trade Organization (WTO), international financial institutions like the World Bank Group, and a host of regional trade and investment agreements largely kept the risks at bay. A new global political landscape is now emerging. The landscape is driven by China’s arrival as a global economic power and its increasing influence across Africa and Asia, Russia’s influence in global energy markets and its aggression in Eastern Europe, and rising nationalism even in historically trade-friendly democratic countries. Amid this new world of complex international relations, economic linkages between Eastern autocracies and Western democracies have receded and new host country pressures have emerged. These developments have significant implications for global companies.

There is reason to believe that geopolitical risk has reached its most severe state since the Cold War era. The Eurasia Group highlighted Russian aggression and Xi Jinping’s consolidation of power in China as the two greatest risks for 2023 in its annual list. Maplecroft, a global risk consulting firm, declared global political risk in 2023 to be at its highest level in years. These concerns do not appear misplaced. China’s rise has been accompanied by a growing rivalry with the United States, leading to some degree of economic decoupling, which in turn reduces the opportunity costs of additional conflict between the two powers. Meanwhile, Russia’s invasion of Ukraine has led to retaliatory sanctions by Western countries and charges from the International Criminal Court. The war seems likely to drag on
for the foreseeable future and, perhaps, to expand as Western nations continue arming Ukraine and as Russia enlists allies such as Belarus. These international political conflicts emerged alongside rising nationalism and democratic backsliding. Rising nationalist sentiment in some of the abovementioned countries has contributed to these international conflicts.

While risk incidents associated with these geopolitical trends – the rivalry between the US and China, Russia’s aggression in Eastern Europe, rising nationalism – are predictable, even as the probability of each potential incident varies, other risk incidents may come out of nowhere, with devastating consequences. The COVID 19 pandemic is a reminder that black swan events can and do occur with some regularity. They defy prediction, even if the contributing factors are evident in hindsight. In the realm of geopolitics, events might take the form of an unprovoked invasion of one country by another, a large-scale terrorist attack, or the unexpected collapse of one or more governments. Russia’s attack on Ukraine, the 9/11 terrorist attacks, and the Arab Spring each showcase the sorts of black swan incidents that can unexpectedly upend global politics. While risk management often requires fostering resilience against undesired occurrences, building resilience against black swan events is especially difficult because it is not entirely clear what sort of incident an organization should expect to encounter.

Geopolitical risks, whether predictable or unpredictable, have significant implications for global companies, as their business operations may span feuding nations or put them in conflict with one party or the other. While some MNCs may respond to trends threatening their operations in foreign nations by reshoring or nearshoring, the long-term viability of such strategies will depend on the ownership, location, and internalization attributes of the industry. The economic value of a market, the ability to secure cost competitive inputs such as technology, and the global connectedness of value chains are a few of the obvious influences on strategic rethinking facing firms in the midst of tectonic geopolitical shifts. While the negative repercussions of geopolitical risks grab the headlines, these events also provide unique opportunities for firms in some industries to rewrite their own strategies in meaningful ways that have significant performance consequences. For example, the Western governments’ sanctions imposed on Russia has opened the door for Indian oil and gas companies to benefit from lower input prices for
Russian oil, and has allowed them to profit from the sale of refined products. Similarly, the testy relationships between the US and China have opened the door to firms in India to enter industries such as semiconductor manufacturing that would not have been feasible otherwise. Although some of these strategies might appear to be nothing more than knee-jerk reactions to profit from quickly appearing opportunities, it would be a mistake to conclude that these firms had not prepared for such scenarios as part of their own strategic planning process well before the opportunities appeared on their horizon. In the changing global landscape, the ability to manage geopolitical risks is increasingly becoming a core competence. Hardly any industry can be considered to be insulated against these emerging risks.

For more than a century, international oil and gas firms have experienced many geopolitical events. Expulsions, asset expropriations, international embargoes, the formation of OPEC and OPEC Plus, and armed uprisings in producing countries are just some of the events the industry has faced. Given the inherently global nature of the industry, firms have learned to deal with dissimilar government priorities across home and host countries, changing tax regimes, varying land access rights in cross-border jurisdictions, shifting cross-border operating regulations, and ownership control issues spanning multiple governmental jurisdictions. These experiences have helped oil and gas firms develop strategies to manage the sorts of risks that are now rising due to geopolitics. We highlight five strategies that firms in oil and gas, and beyond, should consider to shore up their ongoing operations about against geopolitical risk in a rapidly changing world.

**Geopolitical Risks and Oil & Gas**

Geopolitical risks reflect the “threat, realization, and escalation of adverse events associated with wars, terrorism, and any tensions among states and political actors that affect the peaceful course of international relations” (Caldara and Iacoviello, 2022, p. 1197). Researchers have explored these risks and their impacts on international business, with attention to, among other things, military conflict (Li and Vashchilko, 2010) and terrorism (Dimitrova et al., 2022). While these cross-border risks interfere with international commerce, they can also exacerbate domestic-level risk factors. For example, terrorism has
been shown to generate political instability, (Park and Bali, 2017) and to contribute to democratic backsliding (Huq, 2018) and nationalistic sentiments (Getmansky and Zeitzoff, 2014), each of which are, in turn, associated with host-country risk (Jensen, 2008; Ko and Shin, 2021; Li, 2009).

Geopolitical risks are especially acute in oil-producing countries. According to Colgan (2013, p. 147), “between one-quarter and one-half of interstate wars since 1973 have been connected to one or more oil-related causal mechanisms.” Additionally, terrorism frequently targets oil producing nations (Tichý, 2019) as well as oil and gas companies themselves (Lambrechts and Blomquist, 2017). Not surprisingly, oil rich countries are often fraught environments for multinational companies to operate within.

Scholars have identified various strategies that global companies can take to manage risks (e.g. John and Lawton, 2018). Broadly speaking, MNCs may choose to avoid risky nations altogether, to transfer risks, or to manage risks strategically. Those taking the latter approach can, for example, seek joint ventures with local companies that are well acquainted with local laws and regulations and have experience navigating local challenges, they can work with international financial institutions that specialize in risk mitigation, or they can engage in corporate social responsibility (CSR) to gain a social license to operate. Each of these strategies seeks to prevent risk incidents from occurring in the first place.

There are also approaches that companies may use to mitigate the impacts that such incidents have when they do occur, including cutting one’s losses and walking away. While scholars of international business have published many studies on the identification and management of geopolitical risks, little attention has focused on the oil and gas industry, despite the abovementioned challenges that companies in this industry routinely face. In the remainder of this paper, we fill this void by considering several strategies carried out by oil and gas companies. In doing so, we identify a set of best practices for companies to utilize as they pursue foreign investments.

Managing Geopolitical Risks: Lessons From the Oil and Gas Industry
The oil and gas industry has several key features such as (a) location specific assets that are largely immove; (b) large capital requirements and high sunk costs; (c) a central role that its products play in human existence; (d) high political sensitivity, some of which they share with peers in other industry settings; and (e) an often major role in the national revenue of the producing country. Most of the world’s oil and gas reserves are located outside OECD countries. For example, ExxonMobil holds prospecting leases in 38 countries and production operations in 23 countries, while its European peer Shell, operates in 70 countries. Over the long arc of their history, large oil and gas companies have learned to navigate geopolitical risk. We highlight five strategies that pertain to firms either in risky geopolitical environments or contemplating entering such contexts: (1) Divorcing ownership control from operating control in designing collaborative ventures; (2) proactively managing stakeholder relationships; (3) ensuring transparency and communication; (4) diversifying risk while proactively positioning for opportunities, and (5) deliberately planning for exit should such an eventuality arise. These strategies are best practices that oil and gas companies and counterparts in other industries should lean into as geopolitical risks increase. These strategies are summarized in Table 1 and detailed in the text that follows.

<table>
<thead>
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<th>Strategy</th>
<th>Actions</th>
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| Divorce ownership control from operating control | • Design collaborative ventures that allow the local partner to control operations  
• Ensure that the foreign partner retains control over ownership and strategic direction to reduce exposure to political interference and expropriation risks |
| Proactively manage stakeholder relationships  | • Identify and engage with key stakeholders in the host country, such as government officials, regulators, customers, suppliers, employees, local communities, and media  
• Build trust, legitimacy, and goodwill with stakeholders  
• Proactively address potential issues and conflicts |
| Ensure transparency and communication         | • Disclose relevant information and communicate clearly and consistently with stakeholders about the company’s goals, values, activities, and impacts  
• Focus on enhancing the company’s reputation and credibility and reducing the likelihood of misinformation and rumors |
Diversify risks while positioning for opportunities

- Spread the company’s investments and operations across different countries and regions
- Seek new markets and sources of growth to reduce dependence on any single country or market and increase the resilience and flexibility to cope with changing geopolitical conditions.
- Proactively plan for opportunities that could arise from the changing geopolitical landscape through techniques such as scenario planning.

Deliberately plan for exit

- Prepare contingency plans for exiting a country or market in case of a severe geopolitical crisis or deterioration
- Identify trigger events, assess exit costs and benefits, secure alternative options, and, if necessary, execute exit actions swiftly and smoothly

(1) Ownership Structure and Power Sharing

Most oil and gas projects are partnerships with resource owners, often national oil companies (NOCs) where reserves are located, or with peers who bring capital and expertise. While partnerships can reduce geopolitical risks (Luo et al., 2019), partnership management requires many competences, from the management of governments as investors to collaborating with partners that are competitors in other projects. Many of the typical pressure points in such ventures involve ownership and control.

Consider the experience of ExxonMobil as a partner in the consortium that established the Sakhalin I project in Sakhalin, Russia in 1996. The partners included a Japanese investor group SODECO (30% share), two Russian companies owned by majority state-owned oil giant, Rosneft (40%), and ExxonMobil (30%), the project operator. The venture involved complex technologies such as the horizontal drilling that had never been tried in the industry before, especially in Arctic conditions. ExxonMobil was the only partner with the required technical skills and Russia was in the midst of an economic shock following the breakup of the Soviet Union. ExxonMobil, in a strong position, could have negotiated a larger equity position in the venture. Instead, the company settled for a tangible, albeit minority position. During the project’s early years, the Russian government wanted to bring ONGC Videsh, an Indian NOC, into the venture to cement its ties to India, a major buyer of Russian arms and ammunition. ExxonMobil did not protest although it had the right of refusal. Instead, the company agreed
to allow ONGC Videsh to acquire 20% of the project from Rosneft in 2010, thus onboarding a new partner and, given the strong India-Russia relationship, reducing its geopolitical risk. The project was executed largely on schedule with minimal cost overruns.

In contrast, Shell experienced a markedly different set of negative outcomes in its venture in the same region. In contrast to ExxonMobil, Shell insisted on a majority equity share in the Sakhalin II project formed in 1992. Its partners were Japanese companies Mitsui and Mitsubishi. There was no Russian partner. By the time Sakhalin II was into the construction phase, the local governor in Sakhalin, a staunch supporter of the project, had changed. President Putin was in power, and Russia’s economic fortunes were improving. Putin vowed to re-nationalize energy assets that were privatized during the Yeltsin era. The Russian Environmental Ministry strong-armed Shell to rethink its equity structure under the threat of environmental sanctions and cancellation of its license to operate. Shell acquiesced and allowed Gazprom, the Russian gas giant to take a majority position in the venture in 2006. The project was considerably delayed and cost overruns were over 100%.

There are three important lessons from the contrasting experiences of ExxonMobil and Shell. First, as JV researchers have long advocated, equity stake does not translate to operating control. In complex ventures, retaining operating control is likely to pay richer dividends than equity control. Assuming a minority equity position, especially in an uncertain geopolitical environment, allows the foreign company to maintain a reasonable presence and test the local waters, while avoiding the klieg lights of excessive scrutiny. Trading off some equity to gain operating control à la ExxonMobil is a wiser choice because it builds trust at the local level and motivates local partners to actively lobby for governmental support. Second, shifting focus to the operational realm can be strategic because it allows the foreign investor greater influence over project execution, control over proprietary technologies and management systems, and opportunities to build trust across partners at the grassroots levels. Third, ExxonMobil’s willingness to add ONGC Videsh and dilute its own stake helped enhance the consortium’s geopolitical balance.
(2) Managing Stakeholder Relationships

While most foreign investors are keenly aware of the importance of managing local relationships, oil and gas companies have deliberately honed their skills in this regard. Consider the approach that Shell undertook to navigate the complex bureaucratic maze of governmental approvals required to develop Sakhalin II project. Shell established an affiliate office in Moscow, eight time zones away from the Sakhalin project. The company assembled a team of relationship managers to identify the sources of influence across 20 different federal and local ministries encompassing multiple regulatory agencies that had to provide 50 different major project approvals. Shell mapped out each specific organizational unit involved, the relevant civil servants and their concerns, the ministers they reported to and their leanings, along with an extended mapping of other officials, ministers, and opinion leaders who had an impact on decision makers. Each individual was categorized into one of three buckets based on whether they were favorably disposed to the project, negative, or neutral. This formed the basis for Shell’s grassroots efforts to convert the neutrals to more actively support the project and the negatives to more neutral. It was this methodical approach complemented by grassroots community level engagement in Sakhalin and coordination with local oblast government officials that helped bring the project to fruition. Although Shell’s obsession with a majority equity position led to a negative outcome, its approach to navigating the federal and local bureaucracies provides an object lesson in managing risks at the grassroots level.

Firms in extractive industries are adept at managing stakeholders that impact project success. Firms in other industries often pay less attention to purposefully building external relationships or limit their efforts to the upper echelons of government. Enduring connections require careful nurturing before they pay off. When established, stakeholder relationships can offer a nuanced window into the operational cultures within governmental agencies and other institutions that shape the community’s normative expectations. It was this type of fine-grained understanding that allowed ExxonMobil to realize the value of allowing ONGC Videsh to enter the Sakhalin I venture. ExxonMobil realized that allowing ONGC Videsh to acquire a portion of Rosneft’s equity was an important outcome for the Russian government for its relationship building effort with India. Getting an Indian national oil company
on board provided some security against negative action by the Russian government since India and Russia were historically good partners. ExxonMobil saw the opportunity as a means of reducing geopolitical risk while enhancing its own position with the Russian government.

Extending beyond the practice of thoughtful stakeholder mapping, firms must also lay out a careful “insiderization” approach to engagement in local communities, which can take various forms that span a broad spectrum from building local infrastructure to skill building, education, health and social welfare. This approach generates moral capital between investors and host communities that makes it harder for the host government to paint the investor as a bad actor (Godfrey, 2005). Although standard practice among most large MNCs, the critical need for insiderization cannot be overemphasized. In today’s world where non-market forces transcend the corridors of governmental agencies to encompass citizens groups that arise unpredictably, thoughtful local entrenchment is an integral part of stakeholder management. Companies should go beyond typical forms of engagement by deploying tools (e.g., social media) that read the pulse of local communities. These approaches can offer firms the chance to proactively shape local thinking on issues that are critical to organizational success.

Nurturing stable relationships with home country governments and stakeholders can be equally crucial as the oil and gas companies have demonstrated over the long arc of their history. Whether it is opening the doors to beneficial opportunities (e.g., ExxonMobil in Iraq) or helping assuage local concerns and political frictions (e.g., Canadian government purchase of the Kinder Morgan pipeline in Canada to allow the project to continue despite opposition from local environmental groups), developing and maintaining proactive relationships with governments can serve as a barometer that can indicate changing conditions well before their impact can be felt.

(3) Transparency and Communication

In navigating the choppy seas of geopolitical risk, it is best to err on the side of transparency over secrecy. Oil and gas companies learned hard lessons in the early days when prospecting leases went to those who were able to strike one-off deals, especially in Central Asia and Africa, by offering “signing bonuses.”
The bonuses were non-public payments to governments that could influence lease awards. When regimes collapsed, as they often do in unstable countries, the signing bonuses were resurrected as critical fodder against foreign investors. The Extractive Industries Transparency Initiative was created to provide a common forum where countries with natural resources could disclose a wide range of information, including the process for awarding extraction rights, information on how governments receive and process revenues, and what benefits revenues bring to the public. The initiatives were developed after years of debate between NGOs, companies, and governments. Although transparency results in more scrutiny that not all stakeholders want, many countries now understand that transparency is good business.

These disclosure norms have percolated to the individual company level and many countries such as the United States and Canada require firms to disclose any payments made to foreign entities for the purpose of oil and gas development or mineral extraction (see for example Section 13(q) of the 2010 Dodd-Frank Act). Some companies have extended these disclosures further to encompass environmental and social impact assessments that they share voluntarily with the general public. These corporate approaches to transparency are extremely helpful in creating a verifiable record of benchmark norms that allow a company to build a reputation for openness and fair play, attributes that are invaluable in cross-border business operations.

Consistently communicating the benefits that firms bring to the country and local communities is another industry best practice. Instead of painting grand visions of benefits, a consistent and granular approach is most effective. For example, many oil and gas companies produce a report in countries where they operate, and outline specific community benefits encompassing initiatives such as infrastructure development, health, education, and welfare projects, local skill building, and local supplier development.

(4) Diversifying Risks While Positioning for Opportunities

All the oil majors have diversified their upstream operations across multiple nations to avoid “betting the company” on any single country. A large majority of global firms are familiar with sizing and managing
geopolitical risks. However, only the truly adept ones are able to shelter their operations from the downside risk of geopolitical changes while at the same time positioning themselves to take advantage of opportunities that emerge quickly in rapidly changing conditions. Oil and gas companies are among the more capable companies in this regard. Given the longer time horizons in the industry, firms often engage in fairly detailed “what-if?” scenario planning. Shell is an exemplar in this regard and has honed its scenario planning expertise into a source of competitive advantage. Given the expertise built in developing scenarios, Shell can anticipate shifts ahead of its competitors to build beachhead positions in resource areas as soon as opportunities emerge. Shell’s entry into Russia and Qatar ahead of its rivals demonstrates the efficacy of not only diversifying geopolitical risk, in Shell’s case to build a strong resource base in gas, but also to position itself for opportunities such as deploying new expertise in gas liquefaction. Thus, thinking ahead to opportunities that might arise due to changes in the geopolitical landscape is as important as thinking about diversifying away political risk, a major focus of most companies operating across borders.

(5) Be Prepared for Country Exit

MNCs should be prepared to leave a country when geopolitical shocks cannot be addressed through risk mitigation. Even when foreign investors follow all of the above-mentioned strategies, shocks such as coups, wars, sanctions on the host state, or excess tax increases can create overwhelming pressure to exit and divest. For example, the 2022 Ukraine war led over one thousand companies to curtail some or all of their operations in Russia.

Oil and gas firms have learned over many years that there is always the potential need for country exit. As a result, they ensure that terms of dissolution are carefully thought out and included in partnership agreements. Although in some cases, especially with forced exit, contracts may offer little protection, oil and gas companies do not give up easily. After many years of litigation, in 2020 ExxonMobil was able to win a sizeable award for its 2007 Venezuela expropriation. Time will tell if the
company can recover damages for the recent Sakhalin asset seizure although the litigation process is already underway.

Oil and gas firms have channeled their experience to deliberately plan for exit when they enter a country. The planning includes contractual clauses dealing with residual asset valuation models and technology control and transfer mechanisms. The firms adopt a long-term focus and, consequently, build relationships at the grassroot levels with NOC staff and lower-level bureaucrats. The relationships often prove useful when the firms re-enter markets they were forced to exit. Oil and gas firms know that geopolitical winds blow in multiple directions. Most of the oil majors have witnessed multiple expropriation events and exits across their geographic portfolio. Countries such as Iraq, Iran, Venezuela, Libya, and Mexico have hosted the majors at various points in time only to follow with expropriations and exits. In many cases, the exits have been followed by re-entry. As we were told by a former CEO of one of the supermajors, “we have been kicked out of Venezuela twice [1976 and 2007] and I am sure we will be back in at some point.” All the majors have diversified their upstream operations across multiple nations to avoid “betting the company” on any single country.

Beyond Oil and Gas

Drawing on the experiences of oil and gas companies, we have identified several strategies that companies can use to shield themselves from the risks that are currently emanating from geopolitics: (1) Divorcing ownership control from operating control in designing collaborative ventures; (2) proactively managing stakeholder relationships; (3) ensuring transparency and communication; and (4) diversifying risks while positioning for opportunities, and (5) deliberately planning for exit should such an eventuality arise. While these best practices originate in the experiences of oil and gas firms, the ability to deftly manage geopolitical risks is becoming an important prerequisite for all firms. For example, semiconductor companies today are caught in the confluence of geopolitical jockeying between China, the EU, and USA. Similarly, the last few years of the COVID 19 pandemic have amply illustrated the critical impact that geopolitical realities exert on pharmaceutical firm strategic choices ranging from
pricing vaccines, to managing regulatory approvals across multiple national jurisdictions, and ensuring fair and balanced supplies to global customers with varying national priorities. These are but two illustrative examples of industries that have been forced to contend with geopolitical risks that were less evident in the past. Lessons from their experienced peers in oil and gas will surely yield important insights that will help them shape their responses. With the right mix of mitigation strategies, global companies can thrive, even in a new era of geopolitical risk.

References


