

**Political Risk in the Oil and Gas Industry in Emerging Markets:
A comparative study of Nigeria and Mexico**

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DECLARATION

By submitting this thesis, I declare that the entirety of the work therein is my own, original work, that I am the sole author thereof (save to the extent explicitly otherwise stated), that reproduction and publication thereof by Stellenbosch University will not infringe any third party rights and that I have not previously in its entirety or in part submitted it for obtaining any qualification.

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ABSTRACT

The interplay between political risk and emerging markets is current and dynamic. As global interest shifts, investors cannot ignore emerging market behaviour and their influence. However, with great potential and opportunities, too comes great political risk. This research study begins with the point raised by the Eurasia Group that emerging market risk differs to that of developed market risk, and that risk in some instances can be ‘unbounded’. Subsequently, the Eurasia Group deems emerging markets a top risk for 2013. Focussing on the oil and gas industry in emerging markets, Nigeria and Mexico offer valuable case studies. This research study offers a comparative study of these two countries in order to determine a generic list of political risk factors that are facing the oil and gas industries in emerging markets. In an increasingly volatile world, with a growing global demand for energy sources, and greater uncertainty surrounding investments and potential returns, political risk analysis is an invaluable decision-making tool for Transnational Oil Corporations (TNOCs) in order for their assets and interests to be protected.

The central research question concerns the main political risk factors facing investors who want to participate in the oil and gas industry in emerging markets. The aim of the research study is to answer the central research question through the help of supplementary questions. The first of these ask what the main political risk factors for TNOCs operating in the Niger Delta are. The second question asks what the main political risk factors for TNOCs operating in the Gulf of Mexico are. So as to complete the political risk picture, the last question asks how political risk in the oil and gas industry can be mitigated. This research study will contribute to existing research, and will assist investors with risk identification, analysis and mitigation. By utilising the generic list of essential political risk factors, TNOCs are made aware of the most salient political risks in the oil and gas industry in emerging markets, and therefore are better placed to make rational and informed decisions when it comes to foreign investment.

OPSOMMING

Die wisselwerking tussen politieke risiko en opkomende markte is intyd en dinamies. Soos globale belange verskuif, kan beleggers nie die opkomende markte se gedrag en invloed ignoreer nie, alhoewel met groot potensiaal en geleenthede kom daar ook groot politieke risiko. Die navorsingstudie het begin met die Eurasia Groep wat uitgelig het dat opkomende markrisiko verskil van die van 'n ontwikkelde mark en dat die risiko in sekere gevalle “ongebonde” kan wees. Gevolglik is opkomende markte as 'n top risiko vir 2013 geklassifiseer. Met 'n fokus op die olie- en gasindustrie in opkomende markte, bied Nigerië en Mexiko waardevolle gevallestudies. Die navorsingstuk bied 'n vergelykende studie van dié twee lande met die doel om 'n generiese lys van politieke risikofaktore wat die olie- en gasindustrie in opkomende markte in die gesig staar, vas te stel. In 'n toenemende onstabiele wêreld met 'n toenemende globale aanvraag vir energiebronne en groter onsekerheid rakende beleggings en potensiële opbrengs, is politieke risiko-analise 'n waardevolle besluitnemingsmeganisme vir Trans-Nasionale Oliekorporasies (TNOKs) om hul bates en belange te beskerm.

Die sentrale navorsingsvraag fokus op die hoof politieke risikofaktore vir beleggers wat in die olie- en gasindustrie van opkomende markte wil belê. Die doel van die navorsingstudie is om die sentrale navorsingsvraag te beantwoord met behulp van aanvullende vrae. Die eerste vraag raak die hoof politieke risikofaktore vir TNOKs aan wat in die Niger-Delta opereer. Die tweede vraag handel oor die hoof politieke risikofaktore vir TNOKs wat in die Golf van Mexiko opereer. Die laaste vraag voltooi die politiese risiko profiel deur te vra hoe die politieke risiko in die olie- en gasindustrie verminder kan word. Die navorsingstudie sal bestaande navorsing aanvul en beleggers help om risiko's te identifiseer, analiseer en verminder. Deur 'n generiese lys van politieke risikofaktore te gebruik, word TNOKs bewus gemaak van die mees prominente politieke risiko's in die olie- en gasindustrie van opkomende markte, wat hulle in staat stel om rasonele en ingeligte besluite te neem wanneer dit by internasionale beleggings kom.

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LIST OF ABBREVIATIONS AND ACRONYMS

ASPRO	Assessment of Probabilities
BRIC	Brazil, Russia, India and China
CNH	Comision Nacional de Hidrocarburos
ECA	Excess Crude Account
EIA	Energy Information Administration
EITI	Extractive Industry Transparency Initiative
FDI	Foreign Direct Investment
GEM	Global Emerging Market
IMB	International Maritime Bureau
IMF	International Monetary Fund
JIBs	Japan, Israel, Britain
JVs	Joint Ventures
MEND	Movement for the Emancipation of the Niger Delta
Morena	Movimiento Regeneracion Nacional
NAFTA	North Foreign Trade Agreement
NCD	Nigerian Content Development Bill
NNPC	Nigerian Petroleum Company
PAN	National Action Party
PIB	Petroleum Industry Bill
PRI	Institutional Revolutionary Party
PRD	Party of the Democratic Revolution
OECD	Organisation for Economic Cooperation and Development

OPEC	Organisation of Petroleum Exporting Countries
OSAC	Overseas Security Advisory Council
PEMEX	Petróleos Mexicanos
SENER	Secretaria de Energia
SPAIR	Subjective Probabilities Assigned to Investment Risks
SPDC	Shell Petroleum Development Company of Nigeria
SNEPCo	Shell Nigeria Exploration and Production Company Limited
TNOC	Transnational Oil Corporation
UN	United Nations
US	United States

CHAPTER ONE – INTRODUCTION TO THE RESEARCH STUDY

1.1 Background to the study

Emerging markets have been deemed by the Eurasia Group¹ to be a top risk for 2013. “It is critical to understand that emerging market downside differs wildly from country to country, and in many of them, in stark contrast to developed markets, that risk is ‘unbounded’” (Eurasia Group, 2013b). The Eurasia Group identified ten risks for 2013 in their ‘Top Risks 2013’ report. They were: emerging markets, China versus information, Arab Summer, Washington politics, JIBs (Japan, Israel, Britain), Europe, East Asian Geopolitics, Iran, India and lastly, South Africa. The Eurasia Group sees political risk as having emerged once again with recent events spurring it on such as the global recession, the ensuing Eurozone crisis, the conflict in the Middle East, and East Asian geopolitics (Eurasia Group, 2013b). “Politics has come to dominate market outcomes around the world...Economic statecraft is a key component of global foreign policy. State capitalism is a principle challenge to the free market” (Eurasia Group, 2013b).

Political risk is a dynamic and complex phenomenon. Literature first emerged after the 1973 oil crisis, and interest increased after the Falklands crisis between Argentina and Britain, along with the war between Iran and Iraq (Fitzpatrick, 1983:249). Interest in political risk however waned near the end of the Cold War (Brink, 2004:3). It is cyclical in its prominence and has an ever-expanding nature. Political risk analysis is generally understood as “governmental or societal actions or 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” (Simon, 1982:68). When looking at political risk analysis through a foreign investment lens, Hough (2008:6) provides the following definition, “the analysis of the probability that factors caused or influenced by the (in)actions or reactions of stakeholders within a political system to events outside or within a country, will affect investment and business climates in such a way that investors will lose money or not make as much money as expected when the initial decision to invest was made”.

Globalisation has led to a changing and complex environment in which global affairs operate. “In no area is political risk more relevant than in analysis of globalisation and the rapid growth of emerging markets” (Bremmer & Keat, 2009:68). Radiating from globalisation has been the increased movement of money, goods, services, ideas and people. With economic

¹ The Eurasia Group is considered to be one of the world’s leading political risk consulting firms (Eurasia Group, 2013a)

growth and investment in foreign countries, came “increased uncertainty and the salience of non-traditional business and societal risks such as terrorism, corruption, climate change and global warming...and these have not only increased the awareness of risk in a complex environment, but have also increased the demand for risk analysis” (Hough, Du Plessis & Kruys, 2008:6). The way nations interact and the expanding global economy has led to an increasing need to consider risks (Brink, 2004:3; Alon, Gurumoorthy, Mitchell, & Steen, 2006:623). Emerging markets are “those countries where politics matters at least as much as economics to market outcomes” (Eurasia Group, 2013b). The rise in literature and focus on emerging markets has highlighted both the political and economic spheres of such countries, and as such, economics comes to take its role alongside the political and “geo-economics now sits alongside geopolitics in matters of war, peace, and prosperity” (Eurasia Group, 2013b).

Emerging markets have until recently been perceived as a positive occurrence, accounting for growth and increased trade and investment. Since the global recession², which occurred after the 2007 financial crisis³, emerging markets appeared stronger and more resilient to economic crisis, when compared with certain developed nations, like those in Europe. Economic momentum during the recession has meant that emerging markets have been applauded for their growth; however, one must remember that emerging market nations too can experience instability and volatility. As such, “we have to stop treating emerging markets as an asset class for outsized growth and instead consider which developing country governments have enough political capital to remain on track toward a more advanced stage of development” (Eurasia Group, 2013b). This presents scope when assessing the political risk that may arise in emerging markets across the world. The growth in foreign investment and commerce has meant that the risks involved in such undertakings have grown too. These risks are not only economic or social, but also political (Alon & Herbert, 2009:127).

Two examples of emerging markets are Nigeria and Mexico (O’Neill, 2011). Nigeria is situated in West Africa and is the most populated country in Africa, accounting for more than 20% of the continent’s population. Nigeria is an oil-rich country, and as such has an oil-dependent political economy. A vital part of Nigeria’s economic growth lies in its resource wealth, specifically in its oil and gas reserves (Omeje, 2006:1). However, Nigeria has long been considered unstable by investors, having to contend with corruption and conflict surrounding its oil industry (Frynas & Mellahi, 2003:548). Mexico is situated in North

² Global recession is a period of economic decline, notably economic slowdown for two or more consecutive quarters (IMF, 2009).

³ The 2007 financial crisis began in the United States due to causes such as the bursting of the property bubble, bank fragility, deregulation, and availability of finance (Gamble, 2009:6).

America and is the fifth largest country in the Americas. It has a free-market economy, and with regards to the oil and gas industry, it is the ninth largest oil producer in the world and is the third largest in the Western hemisphere. Oil is a crucial sector for the economy, forming 16% of export earnings and 34% of total government revenue (Energy Information Administration (EIA), 2012a:1). Nigeria and Mexico have been selected as cases for this study, and why they are deemed adequate will be explained later in this chapter.

Extractive industries are lucrative, especially the oil and gas industry, and as such are valuable to emerging market countries as they can be huge drivers for economic growth. However, these industries also face increased political risk. “Industries of strategic importance – such as natural resources, banking, finance, and utilities and insurance – are more likely to be regulated than are industries of minor strategic importance, and thus face greater political risk” (Alon & Herbert, 2009:129).

Oil and gas exploration had previously been done in politically safe areas and this left much of the developing world yet to fully be explored (Lax, 1983:46). There are opportunities for Transnational Oil Corporations (TNOCs) to explore new areas, some of these being in emerging markets. In these areas there may be higher political risk; however, investing here could lead to high rewards. The TNOC could have the opportunity of capturing early market share, but they will need to decide how much risk they are willing to accept. The oil and gas industry and the wealth gained from it can aid governments in development and economic growth, and consequently the extractive industry becomes a concern for national governments and is more sensitive to political events. With increased control by host countries, comes a decrease in the importance of TNOCs, and the political risk within the industry rises. “As a logical correlation to the amount and intensity of political activity that has been focused on oil, the attendant political risks confronted by oil companies have been particularly high” (Lax, 1983:6).

1.2 Preliminary Literature review

This research project will focus on four avenues of observation; political risk, emerging markets, Nigeria and Mexico and their oil and gas industries, and lastly mitigation of political risk. Political risk is a complex and wide-ranging subject and there is a great deal of literature which encompasses its many different sides. The main texts examined provide a clear understanding of political risk and taken together, form the theoretical and conceptual foundation of the research study. The main texts include, Brink’s (2004) *Measuring Political Risk: Risks to Foreign Investment*, Hough’s (2008) *An Introductory Context of the*

Methodological, Conceptual, and Theoretical Framework of Risk Analysis, which provides a good conceptualisation as well as a discussion on the different frameworks for political risk analysis. Further texts include, Bremmer and Keat's (2009) *The Fat Tail: The Power of Political Knowledge for Strategic Investing*, Kobrin's (1978) *When does Political Instability Result in increased Investment Risk?*, and Lambrechts, Weldon & Boshoff's (2011) *Political Insecurity and the Extraction Industry in the Democratic Republic of Congo: Moving towards an Industry Specific Political-security Risk Analysis Model*. Other authors include Simon (1984), Frei & Ruloff (1988), Bischoff & Lambrechts (2010), Howell & Chaddick (1994), Hough (2008), Lax (1983), Tarzi (1992), Venter (1998), and Robock (1971).

Political risk is increasing in importance, and as such, companies need to ensure they take the right steps towards being able to forecast risk as well as having plans in place should such risk arise. According to Diamonte, Liew and Stevens (1996:71), political risk represents "a more important determinant of stock returns in emerging than in developed markets". In their study however, they found political risk in emerging markets to be decreasing, while over a decade later with the launch of the latest Eurasia Group 'Top Risks 2013' report, emerging market risk is on the rise once again. Political risk is about understanding that, "governments and businesses have different expectations and goals. To operate a global business successfully, you need to understand what motivates government action, particularly in places where politics matter at least as much as economics to market outcomes" (Eurasia Group, 2013b).

Emerging markets have grown in stature, accounting for two-thirds of the world's growth. Bremmer and the Eurasia Group have conducted a great deal of research on emerging markets and their role in the global sphere. Further literature on emerging markets includes Khanna & Palepu's (2010) *Winning in Emerging Markets: A Road Map for Strategy and Execution*, Kvint's (1999) *The Global Emerging Market in Transition*, as well as other authors such as van Agtmael (2008) and O'Neill (2011).

This research study will look at industry-specific risk, focussing on the oil and gas industry. Some of the main texts relating to industry-specific risk include, Alon *et al's.* (2006) *Managing Micropolitical risk: A Cross-Sector Examination*, Berlin *et al's.* (2003) *Managing Political Risk in the Oil and Gas Industries*, Lax's (1983) *Political Risk in the International Oil and Gas industry*, and Frynas and Mellahi's (2003) *Political risks as Firm Specific (Dis)advantages: Evidence on Transnational Oil Firms in Nigeria*.

This research study aims to look at political risk in the oil and gas industry in emerging markets and the selected case studies are Nigeria and Mexico. The oil and gas industry in the

Niger Delta will be the focus regarding Nigeria, while the oil and gas industry in the Gulf of Mexico will be the focus regarding Mexico. There is a great amount of literature on Nigeria, specifically surrounding the oil and gas industry. Texts will include Obi and Rustad's (2010) *Oil and Insurgency in the Niger Delta – Managing the Complex Politics of Petro-Violence*, Watts' (2007) *Petro-Insurgency or Criminal Syndicate? Conflict & Violence in the Niger Delta*, El-Choueiry, Feather, Jeffrey & Shaw's (2013) *Federal Republic of Nigeria: Risk Assessment Report*, Bischoff & Lambrechts' (2010) *The Regional Impact of Political Risk: The Conflict in the Niger Delta and the Political Risk of the Gulf of Guinea*, Ebohon's (2010) *Nigeria: State, Oil and Malignant Underdevelopment*, and Peel's (2009), *A swamp full of dollars: Pipelines and paramilitaries at Nigeria's Oil Frontier*. The oil and gas industry forms an integral part of Mexico's economy and its growth. Literature on Mexico will include; Hamnett's (1999) *A Concise History of Mexico*, Trotta & Hughes' (2012) *Key Political Risks to watch in Mexico*, OSAC's (2013) *Mexico Crime and Safety Report*, The Energy Information Administration's (2012) *Report on Mexico's oil and gas industry*, BBC News' (2013) *Mexico Profile*, Kerner & Hernandez's (2013) *Mexico Moves Toward a Major Energy Reform*, and Harary Security Consulting International' (2013) *Mexico's annual Security Review for 2012*. Further authors include; Schtulmann (2013), Snow (2013), Thomson (2012), Harrup & Luhnnow (2011) and Khan (2013).

To conclude, the research study will also briefly look at risk management and mitigation as it is a vital step in a political risk analysis and "risk management is of paramount importance to the economic consequences of investments in the oil and gas industry" (Berlin *et al.*, 2003:1). The main texts here will consist of; Berlin *et al.*'s. (2003) *Managing Political Risk in the oil and gas Industries*, Riordan's (2007) *Mitigating Emerging-Markets Risks in mining operations*, Alon *et al.*'s. (2006) *Managing Micropolitical Risk: A Cross-Sector Examination*, Hough's (2008) *An Introductory Context of the Methodological, Conceptual, and Theoretical Framework of Risk Analysis*, and World Risk Review's (2013) *Identifying and Managing Political Risk in Pipeline Project*. Further authors include; Brink (2004), Wood (2009) and Lax (1983).

1.3 Research problem

The interplay between political risk and emerging markets is current and dynamic. Emerging markets are becoming increasingly important and as global interest shifts, investors cannot ignore emerging market behaviour and their influence, as in "a G-Zero world, with an absence of global leadership and geopolitics very much 'in play', everyone will face more volatility" (Eurasia Group, 2013b).

Firms can reduce uncertainty and be made aware of risks and as such, ways can be found in which to manage and mitigate it. It has become increasingly important to accurately measure political risk for emerging markets. Brink (2004:4) succinctly puts it:

“There is and always has been a relationship between politics and business that affects investment, and understanding that relationship better aids in understanding the political risk involved when investing. By undertaking this research study, the nature and extent of the political risk involved can be determined, and therefore risks can actually be exploited and even possibly profited from depending on the degree to which an investor is either risk averse or risk assertive”.

The focus of this study is accordingly to discover essential generic political risk factors, which will enable businesses to think about investment in the oil and gas industry in emerging markets, in a clearer manner. TNOC investors need to be made aware of the political risks in emerging markets, in order for the firms to be able to mitigate and manage such risks, and in doing so protect their assets and interests.

Accordingly, the main research question that will drive this research study is: *What are the main political risk factors facing investors who want to participate in the oil and gas industry in emerging markets?* The independent variables are the main political risk factors and the dependent variable is the oil and gas industry in emerging markets.

The following two sub-questions will aid in the answering of the main research question: *‘What are the main political risk factors for TNOCs operating in the Niger Delta’* and *‘what are the main political risk factors for TNOCs operating in the Gulf of Mexico?’* The third sub-question looks at the final aspect of risk analysis that investors need to look at, which is: *‘How can political risk in the oil and gas industry be mitigated?’*

1.4 Objectives and relevance of the research study

The aim of research is a “systematic inquiry designed to further our knowledge and understanding of a subject” (Smyth & Robinson, 2001:110). For this research study, the first aim is to discover the links between political risk and emerging markets, determining the main political risk factors facing investors who want to participate in the oil and gas industry in emerging markets. This enables the second aim to be looked at, enhancing a TNOCs capacity for risk management and mitigation in the oil and gas industry in emerging markets, as “knowing tomorrow is not sufficient; determining how tomorrow will affect operations, profits, and other corporate concerns is the key” (Lax, 1983:110). This research study will therefore assist with political risk identification, analysis and mitigation.

The relevance of this research study is found when looking at the Eurasia Group's 'Top Risks 2013' report. Number one on their list was 'emerging markets', which they state will witness more volatility and instability than the advanced industrialised democracies in 2013. The risk emerging markets present, according to the Eurasia Group, is 'unbounded'. Along with this, in 2005, Jim O'Neill, the Chairman of Goldman Sachs⁴ Asset Management identified "the Next 11 largest populations after BRIC"⁵, which, "combined with economic and political conditions—could greatly impact the global economy" (Goldman Sachs, 2013b). The N-11 countries are Vietnam, South Korea, Iran, Pakistan, Bangladesh, Egypt, Indonesia, Mexico, Philippines, Turkey and Nigeria (O'Neill, 2011).

Emerging economies, with their dynamism and size are attractive to investors. Added to this has been the global increase in Foreign Direct Investment (FDI) and the integration of markets globally (Alon *et al.*, 2006:623.) As such, it becomes pertinent to explore TNOC investment and the political risks involved in such an exercise.

The focus on the oil and gas industry is relevant due to the geo-political location of oil reserves (Berlin *et al.*, 2003:2) and the risks geo-politics bring. Furthermore, in the emerging markets, Nigeria and Mexico, the oil and gas industry plays a fundamental role in economic growth. The focus on industry-specific political risk is relevant, as rather than political risk being evaluated on a general scale, it "should be construed as being primarily a firm-specific or project-specific value assessment" (Frynas & Mellahi, 2003:546), in order to conduct a more comprehensive risk assessment. Political events will impact certain industries and firms differently, and each industry and firm has different resources and capabilities to deal with political risks. While macro risk is seen to be dramatic, micro risks are more prevalent as well as manageable. Micro political risk analysis within specific industries holds great relevance, as "the nature and scope of political risk changes with respect to the specific time, home and host countries and organisations involved" (Alon *et al.*, 2006:626), and thus micro political risk becomes more important for companies to gauge (Robock, 1971:10).

⁴ Goldman Sachs is a multinational investment banking firm based in America (Goldman Sachs, 2013a).

⁵ BRIC consist of Brazil, Russia, India and China, and are seen to be the world's emerging economies. The acronym was coined by Jim O'Neill in 2001. O'Neill of Goldman Sachs stated that the BRIC countries would play an increasingly larger global role (Goldman Sachs, 2013b). The use of the term 'BRIC' is done so intentionally and should not be mistaken with the term 'BRICS'. O'Neill, who coined the term 'BRIC', did not agree when South Africa was added to the grouping acronym (Spector, 2011). Accordingly, his point of reference remains 'BRIC'. O'Neill also came up with the N-11 and it was from this list of emerging markets that the case studies for this research study were chosen.

1.5 Research design and research methodology

As this research study focuses on political risk in the oil and gas industry in emerging markets, the underlying theory will be that of problem solving and decision making. Decision making theory is a theory “underlying rational decision-making under uncertainty” (Brink, 2004:30). The methodology used in this research study will predominantly be qualitative. Studies of a qualitative nature are flexible in their approach and have the ability to include new ideas while gathering data (Kumar, 2011:225). It will be inductive, in that it will begin by “observing the empirical world and then reflecting on what is taking place...moving towards theoretical concepts and propositions” (Neuman, 2006:60). Data will predominantly be of a secondary nature. Academic books and journals will be sourced from the University of Stellenbosch library, as well as reputable sources gathered from the internet. Some primary data will be obtained. Emails will be sent out to the major risk companies and experts in the field of political risk and emerging markets with the hope that they may provide insight into the main research question. If primary data is obtained, it will be used to supplement and support the secondary data.

The methodology will be comparative research, investigating the oil and gas industries within Nigeria and Mexico. The underlying principle of comparative research is that, “by comparing two or more cases, researchers can identify causal variables which could not be deduced from a single case” (Pierce, 2008:55). A comparative methodology uses an empirical approach and compares selected cases with the aim of discovering something, in this case, political risk variables that are found in emerging markets. The comparative method “makes claims about empirically observed relationships without rigorous controls for other variables” (Burnham, Lutz, Grant & Layton-Henry, 2008:71). This method will be used so that the main political risk factors become evident when analysing emerging markets, with specific reference to the oil and gas industry.

As mentioned, the research study will investigate the cases of Nigeria and Mexico. Nigeria and Mexico have been chosen as the cases for this research study, as both are seen to be emerging markets and have been deemed to be in the N-11 by Goldman Sachs. A comparison of these two cases is justified in that it offers a global study, offering a country from Africa and one from America. They are both oil producers on a large scale and their economies rely on oil production and export. Both Mexico and Nigeria possess BRIC-like potential and are seen to have positive momentum which can drive the global economy. Mexico’s oil and gas industry is at a threshold in terms of foreign investment. The Mexican oil sector has been state-owned and run since 1938. However, current government reforms are looking towards

liberalising the oil and gas industry and allowing greater foreign investment (Schtulmann, 2013).

This research study will have an exploratory aspect, as it aims to discover the main risk factors that need to be measured when wanting to invest in the oil and gas industry in emerging markets. Furthermore it will also explore mitigation strategies. It will be descriptive in that it will create a picture of: political risk in emerging markets, the essential political risk factors, as well as the situation in the oil and gas industries in Nigeria and Mexico. It will also have an explanatory aspect as will explain the links between political risk and emerging markets, specifically by using the cases of Nigeria and Mexico as emerging markets. Exploratory research aims to ask 'what' and strives to develop new questions. Descriptive research offers a picture of a certain situation, and aims to ask questions relating to 'who', 'when', 'where' and 'how'. Explanatory research looks at 'why' something is the way it is, and as such attempts to explain why certain happenings take place (Neuman, 2006:33-35). The level of analysis for this research study is micro in scope as looks at the oil and gas industry, but also macro since two states, namely Nigeria and Mexico will be looked at.

1.6 Limitations and delimitations of study

The discipline of political risk can be seen as a limitation. It is broad in scope and there is a lack of consensus surrounding the term. By analysing a wide range of political risk definitions in chapter two, an informed conceptualisation of political risk will be arrived at. A further limitation is that there will be no use of field research due to time constraints and lack of funding. While this research study will have a reliance on predominantly secondary sources, the descriptive and relevant literature used will be sufficient in determining the essential political risk factors that need to be measured when looking at the oil and gas industry in emerging markets. The use of primary data, through correspondence with established risk companies and experts will further enhance this research study.

A further limitation relates to the oil and gas industry and the fact that many established risk companies do not make information public and keep the way they look at risk as part of intellectual property. However, the necessary information can still be gathered from academic and general sources. It is imperative for this research study that the data used be credible and reliable. A further limitation regarding the oil and gas industry in emerging markets is that some data is invalid and thus unreliable. This will be overcome by using country briefs and reports from credible sources. Furthermore the inclusion of primary data received from established risk companies, which will provide expert knowledge and should prove reliable

and valid. A further limitation relates to the use of Mexico as a case and the fact that Spanish is the predominant language there. However, the existence of English research and literature surrounding Mexico means that using Mexico as a case is not prohibitive.

The delimitations regarding this research study will be firstly, that only data up and to 31 October 2013 will be used. Secondly, in terms of investigating emerging markets, only two cases will be discussed, namely Nigeria and Mexico. Furthermore, due to time and space constraints, this research study will be delimited to discovering the main political risk factors in the oil and gas industry in emerging markets with the aim being to then look at mitigation and management strategies. As such, a full political risk analysis of the oil and gas industry in Nigeria and Mexico will not be conducted.

1.7 Chapter outline for the remainder of the research study

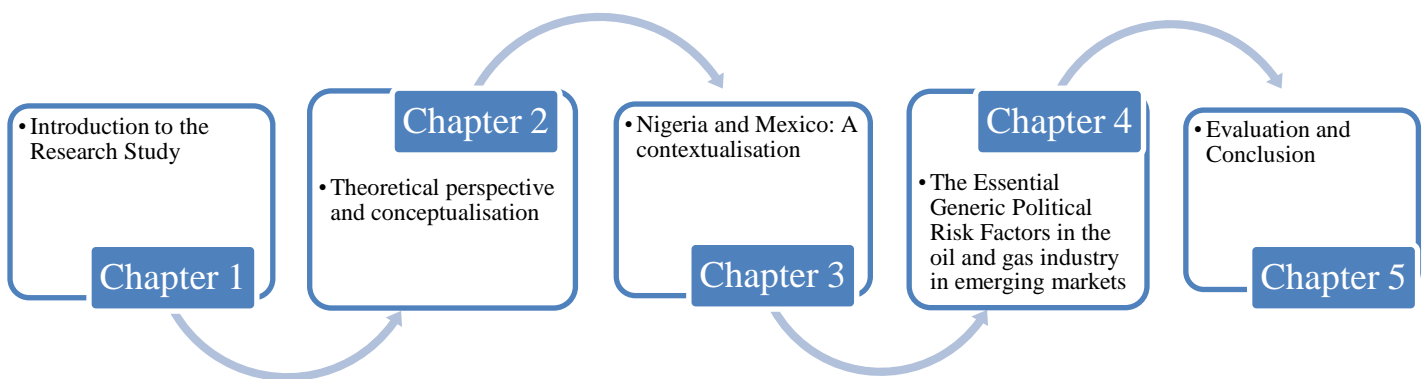


Figure 1: Outline of the remainder of the Research Study

Figure one shows the course this research study will take. Chapter two will conceptualise key terms relating to; political risk, emerging markets, the oil and gas industry, and risk mitigation. It will offer a theoretical foundation to the research study, based on problem solving theory and rational choice theory.

Chapter three will offer a comparative contextualisation between Nigeria and Mexico. By analysing the cases of Nigeria and Mexico, one will gain a better understanding of emerging market behaviour, specifically in the oil and gas industry. This chapter will provide the basis from which to move towards finding the main political risk factors discussed in chapter four.

Chapter four will highlight the main political risk factors that the oil and gas industries in Nigeria and Mexico face. Using these case studies as examples of emerging markets, chapter four will then highlight the essential generic political risk factors that face TNOCs in emerging markets; those that investors should be aware of when looking to invest. This chapter will also provide a brief discussion on risk mitigation of industry-specific political risk.

Chapter five will conclude the research study and give an overview of what each chapter discussed and how the research study progressed. An evaluation of the research study will be provided, along with possible recommendations regarding further research on the topic.

1.8 Conclusion

This chapter has presented a general introduction to the research study. It has provided the general aim of the research study, as well as a road map of how it will be directed. It has highlighted the research questions, the objectives and relevance of the study, the limitations and delimitations of the study, the methodology and research design, as well as a technical outline of the study and how it will progress. This research study will primarily be concerned with industry-specific political risk within emerging markets. It will use the cases of Nigeria and Mexico and the oil and gas industry in order to determine the most salient risk factors that should be measured when wanting to invest in the oil and gas industry in emerging markets. Thereafter, risk mitigation and management strategies will be discussed.

CHAPTER TWO – THEORETICAL PERSPECTIVE AND CONCEPTUALISATION

2.1 Introduction

The marketplace has become increasingly global; there is increased trade, economic integration and capital mobility, along with greater government intervention and political instability. A climate has been created in which “political risk is more relevant than ever for companies and governments” (Bremmer & Keat, 2009:3). Risk and risk analysis should receive ample attention when making an investment decision, as “risk is a constantly present factor in the business decision making process” (Berlin *et al.*, 2003:1). Investors need to be made aware of these risks, especially if looking to invest in emerging markets where this risk is considered ‘unbounded’. Many emerging markets rely on their natural resource wealth to be a driver of economic growth, and the oil and gas industry is highly lucrative. Oil and gas reserves are often situated in politically unstable areas, and “the uncertainties and vagaries of the political economy of petroleum create a high risk environment” (Lax, 1983:7). As exploration and production of oil and gas in emerging markets continues, and foreign investment in the industry rises, the need for political risk analysis increases.

This chapter will explore the theories associated with risk and risk analysis. Risk analysis is an ‘ancient craft’ that has been used by traders for centuries, as well as by political and military personnel (Hough *et al.*, 2008:6). It looks toward “historic, current, as well as future investigation and aims to interpret something in terms of its effects” (Brink, 2004:25). Political risk and political risk analysis became a relevant discipline and popular field of study in the 1970s after the 1973 oil crisis and political risk analysis was used during the Cold War as a decision making tool. After the Cold War ended, political risk’s status waned partly due to narrow conceptualisations of political risk as well as incorrect forecasts (Lambrechts *et al.*, 2011:108). Political risk has experienced a revival since the onset of globalisation, the shifting of global relations, and the 2008 global financial crisis (Brink, 2004:3). The global environment is constantly changing and the framework within which political risk operates is never static. Risk analysis holds great relevance and the justification behind political risk analysis lies with the fact that business climates and political situations are ever-changing. This dynamic nature means that investment opportunities are constantly being influenced and altered by the changing environment. Subsequently, this means that “political risks have to be checked constantly and assessments have to be upgraded continually in order to provide clients with literally the latest and most thorough political risk analyses” (Brink, 2004:10).

The purpose of this chapter is to explore the theoretical foundation of the research study by discussing the underlying theory of political risk analysis, which is found in decision-making and problem-solving theory. As has been noted in chapter one⁶, and discussed by Brink (2004:2) and Alon *et al.* (2006:624) there are differing opinions regarding political risk and there has been no agreement on a clear and concise definition. As such, this chapter will provide conceptualisations of the core terminology and aspects of political risk relevant to this study, in order to gain conceptual clarity and arrive at a concise definition of political risk. Furthermore, this chapter will provide conceptualisations of emerging markets and the oil and gas industry. Accordingly, this chapter will provide a political risk framework and a clearly defined point of departure from which to move to the next chapters, regarding political risk in the oil and gas industry in emerging markets.

2.2 Decision-making and problem-solving theory: A theoretical foundation

With regards to making an investment, the investor is faced with many uncertainties. Under such conditions, the investor must look towards making a rational decision that will aid in solving the problem. Decisions are considered rational if the choices made “best help them achieve their objectives, given all relevant factors that are beyond their control” (Green, 2002:4). Political risk and political risk analysis are grounded in decision-making and problem solving theory. Political risk analysis firstly creates awareness of a problem, and thereafter makes a rational attempt at problem solving. According to Bunge (in Brink, 2004:30), “in all decision making processes, rational agents behave as risk-averse persons intent on minimising uncertainty with the help of expert knowledge”. Problem solving theory complements decision making theory. The formulation of the specific problem along with the personal characteristics and values of the decision maker control the decision making (Tversky & Kahneman, 1981:453). The relationship between problem solving and decision making theory becomes apparent when looking at foreign investment. Here political risk analysis is the initial step taken in decision making and “political risk assessment focuses on problems that call for decisions concerning the implementation of actions (investment), and in a way, deals with decision problems” (Brink, 2004:31).

“The modern theory of decision making under risk emerged from a logical analysis of games of chance rather than from a psychological analysis of risk and value. The theory was conceived as a normative model of an idealized decision maker, not as a description of the behaviour of real people” (Tversky & Kahneman, 1986:S251). The operative principle in

⁶ Refer to 1.6. Limitations and delimitations of study

decision making is that a decision maker should anticipate what is likely to happen, decide what should be done, then make a choice based on the anticipated events that will produce a favoured result (Venter, 2009:2). Decision making can be perceived to be a cognitive problem. It relies on sufficient and trustworthy knowledge; however, there is often limited knowledge available. Furthermore, humans have a restricted capacity in terms of obtaining and understanding the knowledge, and lastly humans “are always at the intersection of the past, the present and the future. Human experience always leads back to the past” (Venter, 2009:2). This applies to political risk analysis.

Political risk analysis is the first step in the decision making process. Decision makers will consider the impact of political events on their investment and its profitability. This is vital as in a competitive environment, the quality of a decision will determine whether an investment is successful (Tversky & Kahneman, 1986:S251). It is a logical and rational attempt to overcome the vast uncertainty that prevails in this world. “By identifying the political risks that are contained in the implementation of a foreign investment decision through political risk analysis, structure is given to the complexities of the decision and, in doing so, one becomes familiar with the risks involved and uncertainty can thus be reduced” (Brink, 2004:172). Political risk can impact an investment and its profitability, and political risk analysis enables the decision maker to see this more clearly and act accordingly (Brink, 2004:30). Dealing with uncertainties, political risk analysis can be used as an instrument to guide investments and developments (Lambrechts *et al.*, 2011:108).

Political risk analysis allows the problem to be identified, and subsequently the risk can be managed or mitigated. Political risk is dynamic in nature, thus risks need to be consistently monitored. Changes will constantly occur and as such changes arise, new decisions will need to be made (Brink, 2004:31). In order to see potential problems, the risk analyst must collect data and information, and gain a thorough understanding of the host country, the needs of the investor, as well as the investment climate.

2.3 Conceptualisation of core terminology

2.3.1 Risk

There are many definitions of risk. Risk is “a manifestation of doubt regarding the frequency and consequences of undesirable events” (Chicken in Brink, 2004:17), while Bremmer & Keat (2009:4) see risk as probability times by impact. Similar to this definition, Hough (2008:11) states that risk is “a probabilistic assessment and not a precise prediction”. Hough *et al.* (2008) propose that risk is the “undesirable and potential harm or danger to anyone that

results from behaviour and action, or from a particular event, situation or issue". Hough (2008:11) also distinguishes between three types of risk; real, perceived and acceptable. Real is the actual risk, perceived risk is socially constructed, and acceptable risk is seen to be sustainable risk decided by decision makers. According to Lax (1983:8), risk is dynamic and deals with change, "current conditions are not risks; rather, risk stems from changes in those conditions." For example there are certain rules in place when a decision to invest is made, and risk highlights the notion that these rules may change in the future. The connotations linked to risk are usually negative, as often risk has an unfavourable impact on a company.

Risk is frequently wrongly equated with uncertainty and instability and therefore a clear distinction is necessary. The terms are not synonymous; rather uncertainty and instability can be seen to be properties of risk. "Political risk is a more objective measurement of the amount of doubt, in contrast to the more subjective nature of instability and uncertainty" (Brink, 2004:19). According to Miller (in Alon & Martin, 1998:11), uncertainty can arise from varying sources; political, social, natural, macroeconomic and government policy. Uncertainty "implies an inability to determine the probability or the impact (or both) of a certain future event" (Bremmer & Keat, 2009:16). Political risk on the other hand, aims to determine both of these, even if at times this cannot be done. Political risk is measurable, thus can be seen as quantifiable uncertainty. It looks to transforming uncertainty into something that is easier to deal with (Bremmer & Keat, 2009:17). "Political uncertainty results from inadequacy of information, whereas political risk is rather a more objective measurement of the amount of doubt, in contrast to the more subjective nature of instability and uncertainty" (Howell, 1986:5). Valid information can aid in taking uncertainty, measuring it and then converting it to risk (Kobrin, 1979:68).

Political instability is a political risk factor, and "political risk implies some ability to form a judgement (if only subjective) about the probability of different types of instability and to take all reasonable precautions against it (Frynas & Mellahi, 2003:546). Political instability and political risk are not mutually exclusive, they relate to each other in that instability can be seen as a factor of political risk. The biggest difference however, is that political instability is a property of the environment, while political risk is a property of a firm (Kobrin, 1979:70). For example, in Nigeria, the religious tensions resulting from political instability stem from and belong to the environment, that being Nigeria, while the level of political risk that is experienced because of these tensions belongs to the firm.

Political instability, stemming from changes in government, riots, policy changes or implementation of policy gets a great deal of attention in global affairs and is often the reason for corporations not investing in a country. “With such a high sensitivity to ‘political instability’, it is possible that inexperienced international enterprises have missed business opportunities because they have perceived more political risk than actually existed” (Robock 1971:15). Before political risk can be looked at in-depth and a concise definition arrived at, the concept of country risk must be addressed.

2.3.2 Country risk

Country risk and political risk used to be seen as one and the same and were used interchangeably. Nowadays however, it has been realised that different firms and industries face differing risks, risks which go beyond the explanation that a country risk report provides (Alon *et al.*, 2006:626). Country risk can be explained as “potential financial losses due to the problems arising from macroeconomic events...that are uncontrollable yet often inevitable. Political risk, on the other hand, recognised as factors caused by government policy (in)action or reaction, can to some extent be managed, if not avoided” (Brink, 2004:175). Country risk also relates to a sovereign state not being able to pay back money borrowed, whereas political risk implies that a country is unwilling to pay back money borrowed (Krayenbuehl, in Frei & Ruloff, 1988:3; Brink, 2004:23).

Political risk is a “specialised relation of country risk” (Brink, 2004:21). Country risk factors are relevant to political risk. Country risk is more economic, and focuses on transfer and sovereign risk. As such, country risk reports are used when determining credit ratings (Brink, 2004:19). Political risk deals with micro and macro risks, whereas country risk focuses on potential financial losses, those that arise from macro-economic events. Country risk’s focus is on business outcomes, whereas political risk aims at an assessment and management of risk, which can not only be beneficial towards business, but a variety of sectors (Hough, 2008:6). As country risk refers to macro-economic factors, this research study is not intimately concerned with country risk, and instead will focus on political risk as will be explained below.

2.3.3 Political risk

Political risk definitions range between the general and the specific (Fitzpatrick, 1983:249). The changing environment, especially the effect of globalisation has recently brought political risk to the fore. Whereas traditional approaches lacked systematic analysis, nowadays political risk has become more adaptable due to the awareness of a changing global

environment. This being said, consensus has not yet been reached regarding the term political risk and there are many definitions. Bremmer and Keat (2009:5) define political risk as, “the probability that a particular political action will produce changes in economic outcomes”, while Root (in Kobrin, 1979:68) defines it as the “possible occurrence of a political event of any kind (such as war, expropriation, exchange controls and import restrictions) at home or abroad that can cause a loss of profit potential and/or assets in an international business operation”.

Kobrin (1979:77) states that political risk is “the probability that changes in the political environment will reduce returns to the point where the project would be no longer acceptable on the basis of ex ante criteria.” Similar to this is Howell’s (1998:3) definition, that political risk is “the possibility that political decisions or events in a country will affect the business climate in such a way that investors will lose money or not make as much money as they expected when the investment was made”. Lax (1983:9) states that political risk “is the likelihood that political changes will prompt a change in the investment climate regulating a project”. A further definition is that of Robock (1971:7) who defines political risk as what emerges “when discontinuities occur in the business environment, when they are difficult to anticipate, and when they result from political change...These changes must have a potential for significantly affecting the profit or other goals of a particular enterprise”. Kobrin’s (1979), Howell’s (1998), Lax’s (1983) and Robock’s (1971) definitions focus on changes that occur within the political environment.

An industry-specific definition of political risk is found in the ASPRO/SPAIR model (Assessment of probabilities/subjective Probabilities Assigned to Investment Risks) designed by Shell Oil. This definition relates to the oil and gas industry and defines political risk as, “the probability of not maintaining the described contract during the 10-year time span in the face of changing economic and political circumstances” (Gebelein, Pearson & Silbergh 1978:726). This is very focused towards the oil and gas industry. Using a slightly expanded definition can provide more flexibility and scope, as found in Brink’s definition.

Brink (2004:25) defines political risk as, “the probability that interrelated factors caused or influenced by government political decisions, (in)actions, reactions, or other unforeseen external or internal events will affect business and investment climates in such a way, that investors will lose money or not make as much money as they expected when the initial decision to invest was made”. This definition, while providing more clarity to the term, does not mention the distinction between macro and micro risk. However, this distinction can be

found in Simon's (1982:68) definition which states that political risk is, "governmental or 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". Joining Brink (2004) and Simon's (1982) definitions form an appropriate definition that holds relevance for TNOCs wanting to operate or who are already operating in the oil and gas industry in emerging markets. For the purposes of this study, political risk is defined as: *the probability that interrelated factors caused or influenced by government political decisions, (in)actions, and reactions, originating either within or outside the host country, will negatively affect either a select group of, or the majority of, foreign business operations and investments.*

2.3.4 Political risk analysis

Political risk analysis should be one of the first steps in a foreign investment decision, as it allows investors to be better equipped. Hough (2008:6) theorises risk analysis to be "the systematic means of assessing and managing the political risks of foreign direct investment or international business". According to Lax (1983:17), political risk analysis serves three vital functions. It enables a company to; firstly, rationally question whether an investment project should be pursued; secondly, it keeps a firm aware of political conditions and their influence on corporate interests, which allows for smart management of political risk; and thirdly, it aids a firm in developing an external policy that is applicable to the particular national environment (Lax, 1983:17).

Political risk analysis is becoming more systematic, and a variety of methodologies, approaches and models can be used. According to Lax (1983:109), political risk analysis has two steps, forecasting relevant risks and then evaluating the impact, as "knowing tomorrow is not sufficient; determining how tomorrow will affect operations, profits, and other corporate concerns is the key" (Lax, 1983:110). When conducting a political risk analysis, one needs to determine political risk factors, depending on the circumstances and context. Failed states, border disputes, foreign policy, support for government and states in transition are examples of political risk factors (Brink, 2004:25). "It is irresponsible to present a client with a risk assessment that does not incorporate economic as well as political risk factors, let alone environmental, societal and socio-economic factors of political risk" (Brink, 2004:11). A further important attribute of risk analysis is mitigation, finding a way that losses can be avoided (Bischoff & Lambrechts, 2010:61).

For the purposes of this study, political risk analysis is conceptualised as: *an analytical process by which political risk is assessed within a specific framework, which aims to determine relevant political risk factors, measure them, forecast the probability of the political risk occurring, and look at ways of managing and mitigating such risk.*

With relevant definitions of political risk and political risk analysis now provided, it is essential to look at industry-specific risk as this research study looks at political risk in the oil and gas industry in emerging markets. According to Frei & Ruloff (1988:5), “political risks should always be assessed in the specific perspective of a specific business project”.

2.3.5 Industry-specific political risk

Industry-specific risk holds significance nowadays in political risk analysis. Country risk and political risk used to be categorised as one in the same. However now, “it is understood that specific projects, firms, and industries face markedly different risks within countries” (Alon *et al.*, 2006:626). The nature and scope of political risk changes and different industries face different risks. What one firm may deem a political risk, another firm may not. As such, political risk definitions should be adapted to fit with different circumstances (Alon *et al.*, 2006:626). Kobrin (1982:40) agrees with this aspect, stating that “the impact of most political events varies from firm to firm and from project to project”. Macro risk is often country-wide, affects most or all industries, and can be caused by governmental, societal or economic factors. Civil war or shifts in governmental power are examples of macro-risk. Macro risks are more visible and dramatic, while micro risks are more prevalent. The effect that micro risk has on a firm can be “substantial and unpredictable, as well as more frequent and widespread” (Alon & Herbert, 2009:129).

Micro risk affects a certain industry, firm, project, or select group. It is much more specific in nature when compared to macro risk, as the level of analysis includes the host country, along with factors such as project features, the firm’s nationality, the industry, as well as the relationship with host country (Alon & Herbert, 2009:127). Examples of micro risk are price controls, expatriate employment limits, labour unrest, and corruption. Alon & Herbert (2009:130) define micro political risk as:

“The uncertainty associated with outcomes or events from political processes, which have the potential and specific consequences for the firm that is either contemplating entry into, or has already entered, another country. These political processes can result in outcomes or events which can (1) emanate from environmental factors both within and outside the foreign host

country, and (2) either positively or negatively affects the firm's operations, assets, or financial condition".

Both macro and micro risk can originate from either internal or external sources. Internal sources are those which originate from inside the country, for instance government policies, local power struggles and economic conditions. External sources are those which originate outside of the host country, for instance international sanctions or conflicts between the host country and other countries (Alon & Herbert, 2009:129). Macro and micro risk are not mutually exclusive and rather, overlap in some instances. Micro risk will supplement and facilitate macro risk analysis and "a firm can use its micro risk understanding to adjust the macro political risk profile to its particularistic risk exposure" (Alon & Herbert, 2009:128). Kobrin (1982:40) agrees and states "the impact of most political events varies from firm to firm and from project to project". It is also important to look at political risk, not just within the business environment, but also from a resource based view, as different firms have differing resources which may impact the effect that certain political risks have, as well as differing capabilities through which to deal with risk (Frynas & Mellahi, 2003:562). Rather than industries and firms being helpless victims of political risk, it can work to their advantage depending on how it is managed. For example, in 2003 because of the disorder in Nigeria's petroleum policy, Shell was able to maintain their dominant position in the industry without there being too many other firms entering (Frynas & Mellahi, 2003:561). A specific firm or industry must be an active actor when it comes to the arena they operate in, as "successful business strategy is about actively shaping the game you play, not just playing the game you find" (Brandenburger & Nalebuff in Frynas & Mellahi, 2003:563).

Macro risk is broad in nature and makes insights on national or regional level, whereas micro risk is more particular, and is thus seen to be more relevant and specific than macro risk (Alon & Herbert, 2009:128). Micro risk is also "much more manageable and thereby practically useful" (Alon *et al.*, 2006:627), and when risk is added to "conventional macro political risk evaluations, the firm can develop a full-continuum assessment of specific risks and potential political actions" (Alon & Herbert, 2009:136). Macro risk is important; however, each industry has unique micro political risks which they should take into consideration. Understanding political risk and conducting an industry-specific risk analysis in the oil and gas industry in emerging markets is vitally important, due to the uniqueness and nuanced nature of micro risk. Micro risk is also highly prevalent in the extractive industries, due to "growing nationalistic feelings and a conviction that natural resource endowments should be exploited for the welfare of all people in a nation rather than for private profit" (Robock,

1971:10). Political risk must be conducted from the standpoint of the specific firm involved in the oil and gas industry in emerging markets.

2.3.6 Risk management and mitigation

Identifying the political risks is just the start of conducting a full political risk analysis. Once this has been done, it should be looked at how to mitigate and manage such risks. This is a vital step for TNOCs to take when operating abroad and is “crucial to the ultimate success of any new investments or expansion of already existing business operations” (Berlin *et al.*, 2003:1). According to Brink (2004:149), political risk management is “the sum of the actions foreign investors or MNCs take to try and keep at an acceptable level the degree or measure of investment risk associated with their activities”. Hough (2008:5) defines risk management as, “protecting the organisation, its people, assets, and profits, against the physical and financial consequences (adverse) of event risk”. TNOCs need a knowledge and understanding of the various risks so that mitigating and management can look to reducing the risk or eliminating it altogether. The taking out of political risk insurance and conducting *de facto* insurance, which relates to behaviour such as maintaining good relations between local leaders and open and honest dialogue with the host country, are examples of risk management.

Brink (2004) discusses protective and integrative techniques when looking towards risk management. Protective techniques “reduce the severity of loss and aim to protect the key internal strengths of the MNC”, while integrative techniques, “are concerned with reducing the frequency of loss and their main aim is to influence relations with institutions and actors in the political environment” (Brink, 2004:156). Ideally, risk management should consist of both techniques. Protective measures will ensure the firm’s competitive strong points, while integrative measures will ensure the firm will respond to both “the demands of a host country’s political environment and the opportunities that the environment presents” (Brink, 2004:156).

Emerging markets exhibit high growth and profitable investment opportunities. Foreign companies find investment in these markets attractive; however, risk management in these emerging countries is of vital importance due to the large sum of capital investment made. For example, investments in the oil and gas industry can exceed US\$1 billion (Berlin *et al.*, 2003:1). Risk management strategies will depend on the nature of the investment and the industry (Lax, 1983:177). Emerging markets are rich in natural resources. However, they often “lack the capital and technical expertise to develop their mineral wealth efficiently and

safely” (Riordan, 2007:54), and this makes managing and mitigating political risk within the oil and gas industry in emerging markets that much more important.

Industry-specific risk analysis is unique depending on the firm involved. As such, mitigation and management strategies will differ depending on the risks involved and how the firm sees these and to what degree they think they will have an impact on the firm’s actions. Efficient political risk management requires differentiating between activities that pose a real threat to a firm’s performance from political actions that are merely dramatic (Berlin *et al.*, 2006:3). Most political risk is manageable but cannot be eradicated completely, hence effective management aids in a TNO’s exposure to risk being controlled. Management of political risks is needed in the oil and gas industry in emerging markets, as oil and gas reserves are often situated in unstable geological locations which can exhibit political tensions, and this leads to an unstable investment environment (Brink, 2004:149). Added to this, energy commodity prices are volatile and political risks may cause prices to rise or decrease at any time (Berlin *et al.*, 2003:2). Political risk is dynamic in nature, as such the risk may be mitigated in the short term but risk needs consistent managing (Brink, 2004:30). Volatile

2.3.7 Emerging markets

Emerging markets exhibit rapid growth and industrialisation and are seen to be in a transitional period. “For the past five years, emerging markets have accounted for two-thirds of the world’s growth. By 2020, that number is expected to grow to 75%” (Eurasia Group, 2013b). While political risks such as expropriation, political violence, and nationalisation are evident in emerging markets, “over the past several years, nothing has fuelled the optimism of pundits and the ambitions of investors more than the words ‘emerging markets’” (Bremmer & Keat, 2009:68).

The term ‘emerging markets’ was coined in 1981, by Antoine van Agtmael, a World Bank economist at the International Financial Corporation (Authers, 2006). Van Agtmael defines emerging markets as those economies with low-to-middle per capita income, which showed a sense of dynamism and progress. Jim O’Neill, Chairman of Goldman Sachs Asset Management defines emerging markets as the largest populations after BRIC, which, “combined with economic and political conditions, could greatly impact the global economy” (Goldman Sachs, 2013b). According to Bremmer and Keat (2009:68), an emerging market country is “one in which politics will matter at least as much as basic economic fundamentals for the performance of markets”. Bremmer and Keat (2009:68) also see emerging markets as those countries which have embraced globalisation because it is seen to be politically useful.

Khanna & Palepu (2010) see emerging markets as having institutional voids which lead to operational challenges and higher transaction costs. As such, “emerging markets reflect those transactional arenas where buyers and sellers are not easily or efficiently able to come together. Ideally, every economy would provide a range of institutions to facilitate the functioning of markets, but developing countries fall short in a number of ways”. A differing definition is offered by Kvint, who in 1999 conducted a study of emerging markets in order to find their main characteristics. He found these factors create a “comfortable and attractive environment for global business, foreign investment and international trade”. Kvint’s (1999) definition of an emerging market is:

“A society transitioning from a dictatorship to a free-market-oriented-economy, with increasing economic freedom, gradual integration with the Global Marketplace and with other members of the GEM (Global Emerging Market), an expanding middle class, improving standards of living, social stability and tolerance, as well as an increase in cooperation with multilateral institutions”.

A definition such as Kvint’s (1999) is very different to that of Khanna and Palepu (2010). Goldman Sachs has created an updated definition, referring to emerging markets as ‘growth economies’. A ‘growth economy’ is “one that is likely to experience rising productivity, which together with favourable demographics, points to economic growth that outpaces the global average” (O’Neill, 2011). Nowadays there are many definitions of emerging markets and this has led to the lists of emerging markets not being the same, due to different companies using differing criteria when choosing which countries to include. These differing lists blur the distinction between developed countries, developing countries, underdeveloped countries and emerging markets.

For the purpose of this research study the definition of emerging markets that will be used will be formed from the definitions of Jim O’Neill (2011) and that of Bremmer and Keat (2009). These definitions have been chosen due to the relevance they hold to the research study. Bremmer is the CEO of the Eurasia Group and the listing of emerging markets was the number one risk for 2013, as identified by the Eurasia Group in their ‘Top Risks 2013’ report. Jim O’Neill identified what has been termed the N-11 and this formed the basis of choosing of the case studies, Nigeria and Mexico. As such, emerging markets are: *those countries with the largest populations after BRIC where politics matters at least as much as basic economic fundamentals for the performance of markets, and have the ability to greatly impact the global economy.*

2.3.8 The oil and gas industry in emerging markets

Oil and gas are non-renewable and exhaustible natural resources that are readily marketable. Oil cannot be rivalled by other natural resources, as “in literal and figurative senses, petroleum fuels the world economy” (Lax, 1983:85). The oil and gas industry holds significance; politically, socially and economically. It is a vital input for emerging economies, holds importance for local welfare and is of importance to national governments and TNOCs.

The oil and gas industry is highly lucrative and oil companies are considered the giants in industry. In 2012, ExxonMobil, a multinational oil and gas corporation, held the number one spot on the Fortune 500 list, making a US\$44.8 billion profit. Success in the oil and gas industry is “quantifiable in terms of relative and absolute increases in petroleum prices” (Lax, 1983:7). While the potential profits are high, the industry is extremely capital intensive and costly. These costs extend to exploration, extraction, infrastructure, production and refining, and exploration makes up around 20% of the total cost (Lax, 1983:46). However, costs will vary depending on the geological location of reserves and as Berlin *et al.* (2003) suggest, “there is usually a direct correlation between the degree of political risk that a company is prepared to accept, and the degree of geological potential of the proposed area”. The set up costs are high; however, TNOCs are willing to accept this along with the risks, as once in place high profits can be made and the potential benefits outweigh the risks (Boschoff, 2010:1).

Governments at times are unwilling to assume initial costs and prefer to pass these on to TNOCs. This relates to exploration and initial production, where huge capital injections are needed. Once production starts, TNOCS’ agreements with host governments are regularly altered or renegotiated to work to the advantage of the host government. The government has greater control and more bargaining strength and as such, “an operating hydrocarbon-production project is a permanent hostage in the hands of the host government” (Lax, 1983:47). Once production begins, nearly all of the economic and geological risks are no longer; however, the political risk that a firm must deal with increases. The industry becomes vulnerable to political risks such as expropriation, nationalisation terrorism, wars, political instability, environmental activism, governmental regulations, energy vulnerability, and taxation, to name a few (Alon *et al.*, 2006:631; Lax, 1983:85).

Operation in the oil and gas industry is described as the “most sensitive of all international corporate activities because the resources involved are a country’s ‘national patrimony’, and such projects can impact a country more than other activities through the attendant wealth,

international prestige, and power” (Alon *et al.*, 2006:631). No matter the type of government system, whether they are democratic, authoritarian, or socialist, or from the North, South, East or West, host-countries exhibit very similar goals relating to political control and economic returns when it comes to the oil and gas industry. Oil’s contribution as a material input for economies is vast and as such, the industry is subject to great political concern. Host governments use the industry to further other goals such as welfare and political stability (Lax, 1983:7; Berlin *et al.*, 2003:1). This nationalist sentiment and the altering of agreements is a large political risk for the company involved. Some countries prohibit foreign participation and the oil and gas companies are state-owned. These companies become a source of national pride and government instrument to improve and strengthen policy (Lax, 1983:52). Nigeria conducted nationalisation and expropriation during the 1970s and anti-foreign laws were put in place in order for economic development to occur without foreign impediment (Banwo & Ighodalo, 2011). Nowadays however, the Nigerian oil and gas industry welcomes foreign investment and expertise. An example of a completely state-owned industry is Mexico’s oil and gas industry. State-owned *Petróleos Mexicanos* (Pemex) has sole control over the industry. However, there are signs that this may change soon, as the current President, Enrique Peña Nieto wants to allow foreign investment in the oil and gas industry. Oil production has been on the decline in Mexico and there is a need for foreign investment, technology and expertise (Daly, 2012).

2.4 Conclusion

The objective of this chapter has been to explore the underlying theory of political risk analysis, namely that of decision making and problem solving theory, which forms the theoretical grounding for this research study. This chapter also conceptualised the core concepts that will be used in this research study, that of risk, risk analysis, political instability, country risk, political risk, industry-specific risk, risk management and mitigation, emerging markets and the oil and gas industry. This chapter has provided a theoretical and contextual framework for the remainder of the research study.

Chapter three will offer a comparative contextualisation between Nigeria and Mexico. Here the cases will be contextualised. By analysing the cases of Nigeria and Mexico, one will gain a better understanding of emerging market behaviour, specifically in the oil and gas industry. This chapter will provide the basis from which to move towards finding the main political risk factors discussed in chapter four.

CHAPTER THREE – NIGERIA AND MEXICO: A CONTEXTUALISATION

3.1 Introduction

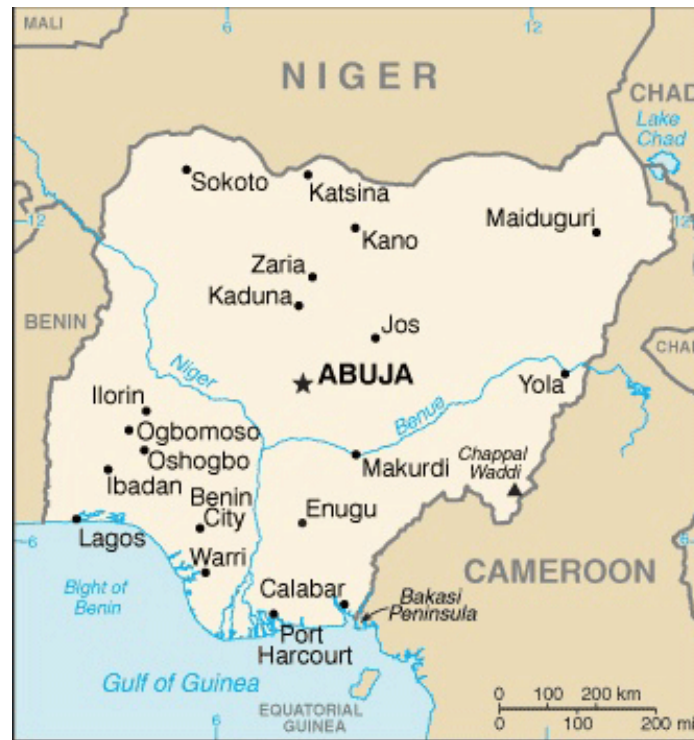
As explained in the previous chapters, Nigeria and Mexico are considered to be emerging markets. According to O'Neill (2011), Nigeria and Mexico's economies have "sufficient size and depth" which allows for ease of initial investment as well as freedom to exit when foreign firms so choose. Both Nigeria and Mexico are major oil producers, and the oil and gas industry contributes greatly to their economic growth. Chapter three will offer a comparative contextualisation between Nigeria and Mexico. The cases will be contextualised, which will enable a better understanding of emerging market behaviour, specifically in the oil and gas industry.

A historical contextualisation of Nigeria will first be provided, thereafter Nigeria as an emerging market will be discussed. This will provide an appropriate platform from which to move onto discussing the oil and gas industry in Nigeria, looking at the history of the industry as well as placing specific emphasis on the Niger Delta region. Mexico will then be contextualised in the same manner. A brief history of Mexico will be given before looking at Mexico as an emerging market. Thereafter the oil and gas industry will be discussed, with specific focus being placed on the Gulf of Mexico as an oil producing region.

3.2 Nigeria

3.2.1 Historical contextualisation of Nigeria

Nigeria is the largest and most populous country in Africa. Nigeria is a federal republic with a presidential system and is made up of 36 states and 774 local government areas. The capital Abuja is located in the centre of the country. Nigeria is Africa's largest oil producer and is bordered by Niger, Mali, Cameroon and Chad. Nigeria is "an archetypal deeply-divided society characterised by divergent languages, cultures, ethnic groups and geographic regions" (Bischoff & Lambrechts, 2010:75). With a population of over 160 million people, Nigeria makes up 47% of the West African population. There are more than 250 ethnic groups and over 500 indigenous languages. The south of Nigeria is predominantly Christian and urban, while the North is predominantly Islamic and rural (El-Choueiry *et al.*, 2013:1). The main ethnic groups are the Hausa-Fulani, Igbo, and Yoruba.



Map 1: Nigeria (EIA, 2012b:2)

Nigeria was colonised in 1901 by Britain. Independence was granted in 1960; however, Nigeria was left with many challenges. Britain had used Nigeria to serve its own interests, and when independence was granted, Nigeria was left to cope with severe economic, political and social under-development, along with colonial effects, such as personal rule, subordination, and weak centralisation. In comparison to other British colonies such as South Korea and India, Nigeria was left worse off when independence was granted (Kholi, 2004:291).

Nigeria had its first democratic elections in 1999. However, elections have been marred by tension and manipulation and the 2007 elections saw a great deal of election violence and vote rigging. Goodluck Jonathan took over as President in 2010 after the death of his predecessor, Mr Yar'Adua. In April 2011 new elections were held and Goodluck Jonathan was elected. He is Nigeria's current President. Nigeria has its challenges; one being political instability. This has been exacerbated by the ethnic and religious tensions apparent in the country and in recent years this has increased due to the presence of Boko Haram⁷, which presents a threat to national security (El-Choureyry *et al.*, 2013:1).

⁷ Boko Haram is an Islamic group dedicated to the spread of Sharia Law in Nigeria (Aribisala, 2013).

3.2.2 Nigeria as an emerging market

Economics and politics are still very interlinked in Nigeria, and this is one factor which makes Nigeria an emerging market. With its wealth of resources, Africa is attractive to foreign investors. In 2012 when asked about the potential of Nigeria joining the BRIC group, O'Neill stated that, "if Nigeria could impose the level of leadership, a whole new way of governance in which corruption is dramatically reduced, Nigeria is I think very interesting...It's 20% of Africa's population, which means it could be pretty powerful" (O'Neill in Cohn, 2010). As previously mentioned, O'Neill chose the N-11 countries due to their BRIC-like potential, large population size, and ability to experience positive momentum. According to a senior oil executive from ExxonMobil, Nigeria is an emerging market due to the fact that tremendous development needs growth potential, which Nigeria has (Personal interview two, 16 August 2013). Nigeria has a vast amount of both human and natural resources, placing it in a prosperous economic position.

The oil and gas industry forms the fiscal basis of economic development, and federal and state power in Nigeria. As such, oil plays a large role in this African emerging market, contributing greatly to economic growth and sustainability. In 2012, the oil and gas industry accounted for 70% of government revenue and 95% of export earnings (IMF, 2013). Nigeria abides by the Extractive Industry Transparency Initiative (EITI), which looks toward more effective governance within the oil sector. The strength of the oil industry is also evident when looking at the Excess Crude Account (ECA). After the financial crisis, Nigeria was able to maintain growth and finance the fiscal stimulus through accessing the ECA (World Bank, 2013b).

The oil and gas industry in Nigeria holds significant strategic importance, as oil has dominated the Nigerian economy and its international relations in terms of geo-political and economic power (Peel, 2009:xvi). The Nigerian economy however, relies heavily on the oil and gas industry and is said to be greatly dependent on TNOCs (Ebohon, 2012:204). Dependence on oil has led to a "transition to monoculture economy, which now sits side by side the politics of a petrol-state" (Ebohon, 2012:217). Nigeria holds wealth; however, there is a lack of development, showing one of the negative effects that the oil and gas industry has had on Nigeria.

An over-reliance on the oil industry has led to Nigeria developing what is known in economic terms as Dutch disease, which sees the natural resources continually exploited while the manufacturing sector continues to decline (Emerging Markets, 2013). This over-reliance on oil has left Nigeria vulnerable to fluctuating oil prices and oil crises (Kholi, 2004:351).

Furthermore, oil is of great significance to ethnic communities as oil producing areas are mainly situated in ethnic minority regions. Tensions arise relating to oil revenue access and distribution and oil plays a crucial role in community relations and national politics (Obi & Rustad, 2011:4). Nigeria needs to continue to look at energy reform and helping to grow the non-oil sector. An increase in economic growth through efficient use of all sectors will aid in the decrease of poverty and allow greater access to education and health, as well as greater infrastructural growth. Overall, corruption needs to be stemmed in all sectors of government (Emerging Markets, 2013).

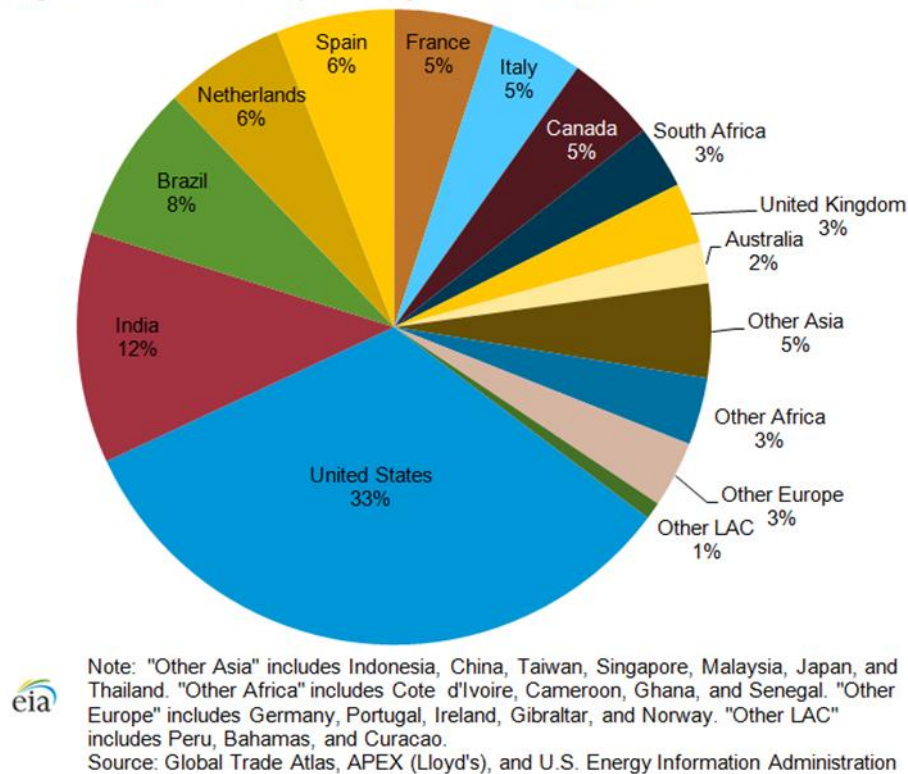
3.2.3 History of the oil and gas industry in Nigeria

Nigeria is the largest oil producer in Africa, and has the largest natural gas reserves on the continent. According to the EIA⁸ (2012c:3), Nigeria has the capacity to produce over three million barrels per day (bbl/d). Nigeria has miles of pipelines, four oil refineries, and ten export terminals. The pipelines range from 31 miles to 383 miles long and these are situated in swampy, rural areas predominantly. Oil is primarily found in the Niger Delta; however, oil is also present off-shore in the Gulf of Guinea, the Bight of Benin, and the Bight of Bonny. The first deep-water oil field began production in 2003, and today these deep-water fields contribute 800,000 bbl/d (EIA, 2012c:3).

In 1937 during colonial rule, British Petroleum and Shell were given the right by the government to explore Nigeria for oil (Ebohon, 2012:204). Oil was discovered in 1956 in Bayelsa state by Shell-BP, and oil was first exported in 1958 from the Oloibiri oil field. It was only in the mid-1960s however, that international interest in Nigerian oil escalated. After the 1967 Arab-Israeli War, alternative sources of crude oil needed to be found. Interest in Nigeria increased, exports rose and Nigerian oil began to gain political attention (Ebohon, 2012:201). In 1971, Nigeria became a member of the Organisation of Petroleum Exporting Countries (OPEC), which requires a production quota of 1.704 million bbl/d to be produced. In terms of total reserves, in 2011 it was reported that Nigeria had 37.2 billion barrels of proven oil reserves. The government wants to increase this to 40 billion barrels in the coming years. In terms of exports; Nigeria is the fourth largest foreign oil supplier to the United States (US). In 2011, 33% of Nigeria's crude exports were sent to the US (see Figure 2). The other major importers of Nigerian oil include; Europe (28%), India (12%), Brazil (8%), Canada (5%), and South Africa (3%) (EIA, 2012c:9).

⁸ The EIA provides "policy-neutral data, forecasts, and analyses to promote sound policy making, efficient markets, and public understanding regarding energy and its interaction with the economy and the environment" (EIA, 2012a).

Nigerian crude oil exports, by destination, 2011

**Figure 2: Nigerian crude oil exports (EIA, 2012c:10)**

As interest in Nigerian oil increased, the occurrence of TNOCs rose, leaving little room for indigenous participation in the oil and gas industry. Between 1958 and 1968, the oil industry in Nigeria was entirely controlled by foreign firms. In 1969 the Petroleum Act was passed, which gave ownership of the oil over to the state. In 1977, the Nigerian Petroleum Company (NNPC) was created. Later in 1988, the NNPC was divided into 12 subsidiary companies (EIA, 2012c:7). The NNPC's main function is the regulation of the oil and gas industry. The Nigerian oil companies lack the technology and expertise, and as such, joint ventures (JVs) with the NNPC make up the majority of oil and gas projects in Nigeria. TNOCs who operate in Nigeria under JVs include; Chevron, ExxonMobil, Eni, Total, Addax Petroleum, Petrobass, ConocoPhillips and StatoilHydro. The TNOCs enjoy large amounts of freedom within the industry, being able to decide budgets, staff conditions, and technology unhindered. The Nigerian government largely depends on the oil rents from the TNOCs, which makes the government "more of an oil gatekeeper and oil revenue collector" (Obi & Rustad, 2011:4).

Shell is the largest oil company operating in Nigeria at present, and has been there since 1936. The Shell Petroleum Development Company of Nigeria (SPDC) and the Shell Nigeria

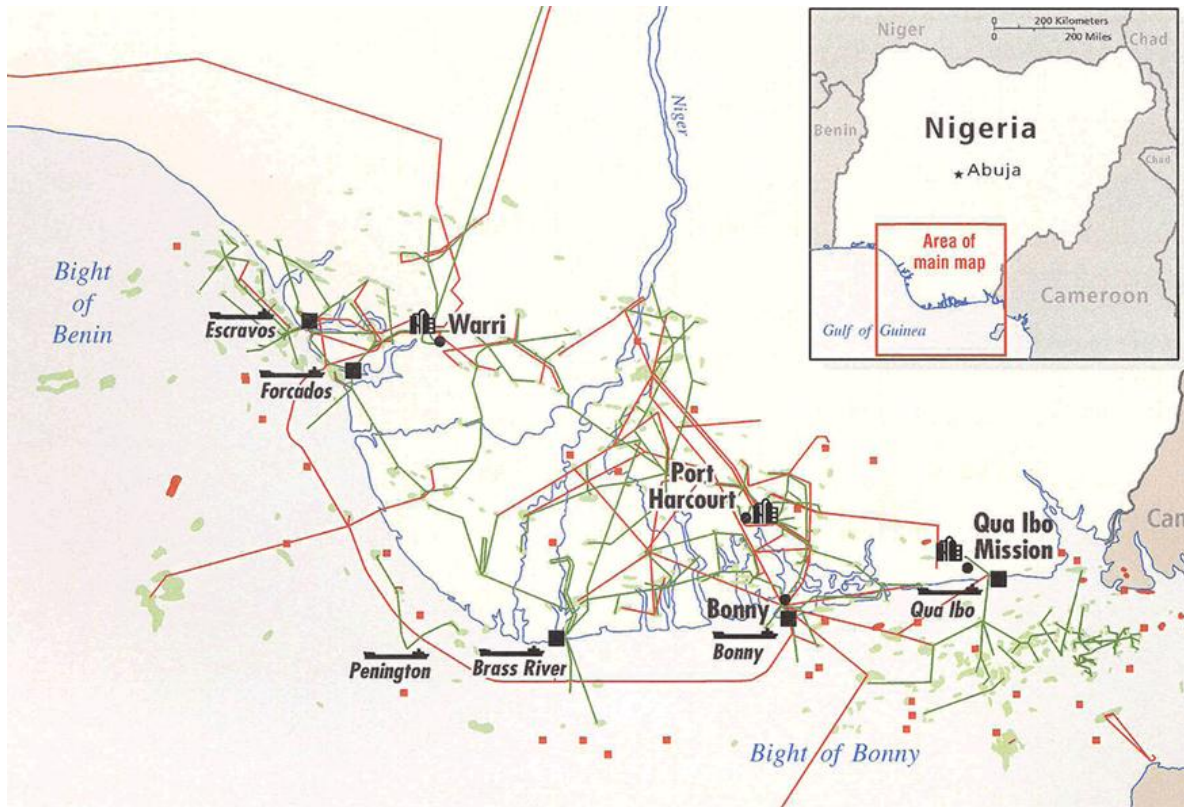
Exploration and Production Company Limited (SNEPCo) are the two branches of Shell operating in Nigeria (EIA, 2012c:8). SPDC is the largest in Nigeria. It is a JV comprising of NNPC (55%), Shell (30%), Elf Petroleum Nigeria Limited (10%), and Agip (5%). SNEPCo on the other hand is fully owned by Shell. SNEPCo focuses on deep water, off shore oil and gas production, and was formed in 1993. SDPC has two export terminals, nine gas plants, and a vast array of pipelines. They produce 1.2-1.3 million bbl/d (EIA, 2012c:8). The majority of their production takes place in the Niger Delta, in shallow waters and has often been the hardest hit by instability. ExxonMobil is the second largest TNOc operating in Nigeria, producing 800,000 bbl/d (EIA, 2012c:8).

A recent government objective has been taken to make the NNPC a more profit-driven company. In April 2010, the Nigerian Content Development Bill (NCD) was passed. This bill looks to increasing the role of Nigerian companies in the oil and gas industry. In 2008, the Petroleum Industry Bill (PIB) was drafted. The PIB looks toward major reformation of the oil and gas industry, and towards creating a clear regulatory framework for the industry. Its purpose is to “restructure the hydrocarbon sector, clarifying regulatory and operational roles of the Nigeria energy institutions, and increasing government take and local content requirements” (EIA, 2012c:1). If implemented the PIB will legislate that 10% of the oil revenues will be directly given to the oil communities, which it is hoped will decrease the tension apparent in the Niger Delta region (Ukiwo, 2011:27). At present, the 100-page document is being deliberated by the National Assembly, but progress has been slow due to debate within government as well as a lack of support from the TNOcs (EIA, 2012c:3). Subsequently, the PIB has delayed investment in the industry, particularly in the Niger Delta region.

3.2.4 The Niger Delta

Oil production is primarily found in the Niger Delta region of Nigeria, and the oil found here is considered to be high-quality light, sweet crude. The Niger Delta is located in the southern part of Nigeria, where the Niger River meets the Atlantic Ocean. The Niger Delta is Africa’s largest wetland and covers an area of 75,000 square kilometres, has a population of over 30 million people that come from 40 different ethnic groups, and is made up of nine out of Nigeria’s 36 states, with 185 local governing areas (Bischoff & Lambrechts, 2010:59). The nine states which make up the Niger Delta are: Abia, Akwa-Ibom, Cross River, Rivers, Bayelsa, Delta, Imo, Ondo and Edo. Delta, Rivers and Bayelsa States are considered the most important in terms of oil. Oil operations in the Niger delta are made up of 86 oil fields which

together cover 30,000 square kilometres and consist of 6000 kilometres of pipelines and 1000 oil wells (Kimer, 2012).



Map 2: The Niger Delta (EIA, 2012c:11)

Despite its oil wealth, the Niger Delta is one of the most fragile and under-developed areas of Nigeria. Instability in the Niger Delta has at times hindered development within the oil and gas industry. Since the 1990s, tensions in the Niger Delta have increased with oil being at the source of the conflict. Oil production has brought with it environmental degradation and pollution, and this along with the location of the TNOCs oil concessions has led to the loss of arable farming land (Obi & Rustad, 2011:2). Local communities have felt increasingly marginalised, which has been exacerbated by continued state corruption and repression. There is a lack of transparency regarding oil revenue and its distribution, and as such, relations have become strained between the local communities and the TNOCs, as well as between the local communities and the government elites who collect the oil rents (Bischoff & Lambrechts, 2010:59; Obi & Rustad, 2011:2). The growing instability in the region is not aided by the fact that there is growing distrust of the government. The conflict in the Niger Delta has been a symptom of the more fundamental socio-economic problems that Nigeria continues to face, such as inequality and poverty (Barclay, 2013:61). The situation in the Niger Delta has led

local groups to changing their method from one of peaceful protest to militant resistance, and as such, insurgencies and protests have increased (Obi & Rustad, 2011:3). “Since 2006, petro-violence has for strategic, economic and political reasons brought the Niger Delta to the forefront of international energy and security concerns” (Obi & Rustad, 2011:1).

The Movement for the Emancipation of the Niger Delta (MEND) has been a major force and aims to gain control over the resources in the Niger Delta and redistribute the oil wealth. MEND has damaged and destroyed oil pipelines, bunkered oil, destroyed oil tankers, kidnapped foreign oil workers for ransom, and damaged property. 300 foreign oil workers were held hostage during 2006 and 2007 (Watts, 2007:639), and over 895 pipelines were vandalised in 2004, this being a huge increase from the 497 pipelines that were damaged in 1999. MEND has used violence to bring attention to the plight of the local ethnic minorities (Obi & Rustad, 2011:3). 2006 saw the height of the violence, with the actions of MEND leading to more than 3650 pipelines being vandalised (see Figure 3), over US\$1 billion in oil reserves being lost and 29 military troops being killed in just three months (Watts, 2007:637).

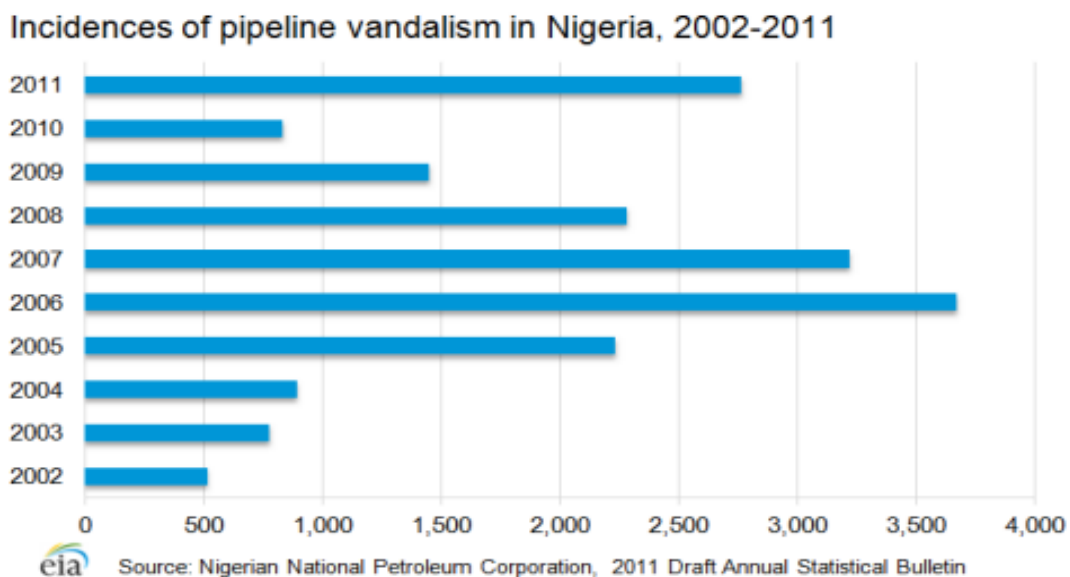


Figure 3: Pipeline vandalism (EIA, 2012c:6)

Oil production reached its peak in 2005 with 2.63 million bbl/d being produced. Production was then disrupted due to growing tensions in the Niger Delta region. By 2009, oil production had decreased by 25% and Presidential Amnesty⁹ was declared. Militants handed over their weapons in return for training and cash payments (Rice, 2009). This however has not been as

⁹ The 2009 amnesty was aimed at reducing unrest in the Niger Delta, and was a 60-day government offer to militants to hand over weapons in return for pardon and cash (Rice, 2009).

successful as hoped; there are a number of weapons outstanding and insecurity in the region persists (Obi & Rustad, 2011:6). Conflict continues to cost the Nigerian government millions of dollars as oil revenue is lost and militancy in the region has continued as the Joint Task Force failed to have an impact on regaining order.

Tensions and unrest remain apparent in the Niger Delta, and as such vandalism and oil bunkering still occur. In 2012, Shell reported that between 70 and 200 barrels were stolen each day (Kimer, 2012). This continued unrest slows progress and production. The PIB may aid the situation but what still remains is a drastic need for security reforms and development programmes (Obi & Rustad, 2011:6). As one can see, the Niger Delta and the conflict surrounding oil is extremely complex in nature. “The Niger Delta is the accelerator of this vicious merry-go-round, poisoning Nigeria’s entire political system” (Shaxson, 2008:208).

3.2.5 Conclusion: Nigeria

Nigeria, with its wealth of human and natural resources make the country attractive to foreign investment. Nigeria is the largest oil producer in Africa and oil holds vast strategic importance for the country. The oil and gas industry in Nigeria forms the fiscal basis of economic development, making the oil and gas industry and its impact on Nigeria’s emerging market status valuable for analysis. Economics and politics are still very interlinked in Nigeria. This, along with its economic dynamism, potential and size make it an emerging market. As will be noted, this is also evident in Mexico, which too is considered an emerging market. Both Nigeria and Mexico’s oil and gas industries are huge drivers of economic growth, aiding their status as emerging markets. Mexico will now be contextualised.

3.3 Mexico

3.3.1 Historical contextualisation of Mexico

Mexico, formally known as the United Mexican States is made up of 31 states and is a federal constitutional republic. The capital is Mexico City. Mexico is bordered by the United States, Guatemala, and Belize, along with the Gulf of Mexico, the Caribbean Sea, and the Pacific Ocean. Mexico is 1.96 million square kilometres, making it the fifth largest country in the Americas. The main religion is Christianity and the main language spoken is Spanish (*BBC news*, 2013a). The Aztec empire, now Mexico, was defeated by Spain in 1521. Independence from Spain was granted in 1821. In 1910 a revolution took place, which led to the current constitution being created in 1917.

Politically, Mexico is democratic and follows a federal representative system of government. Mexico has a presidential system, whereby the President is the head of state as well as the head of government. There are three levels of government; the Federal Union, the State governments, and the municipal governments (BBC News, 2013a). Politics in Mexico has witnessed the occurrence of a one-party state, being dominated by the Institutional Revolutionary Party (PRI). The PRI was formed in 1929 and was the party in power from 1929 until 2000, when the opposition Alliance for Change won the election. The other major opposition parties in Mexico are the Party of the Democratic Revolution (PRD) and the National Action Party (PAN). In 2012, the PRI regained power, promising not to return to its authoritarian ways. Enrique Peña Nieto is the leader of the PRI (Thomson, 2012). He won the election in July 2012 and was officially elected into Presidential office on 1 December 2012. President Peña Nieto wants to see greater reforms, looking towards making the government more efficient and Mexico more investor-friendly. The National Development Plan currently looks towards achieving five goals; 'Mexico is peace', 'inclusive Mexico', 'Mexico with Educational quality for all', 'Prosperous Mexico' and 'Mexico an actor with global responsibility' (World Bank, 2013a).



Map 3: Mexico (EIA, 2012b:2)

Mexico is not without its challenges. For example, it has one of the highest kidnapping rates in the world, 42.6% of the Mexican population live in poverty, and the murder rate continues to climb, this largely being attributed to the exponential growth in organised crime. In 2006,

the murder rate was 8 per 100 000 people, in 2013 this rate was 22 per 100 000 people (World Bank, 2013a). Mexico's biggest challenge is the escalating drug-related violence and crime. Drug cartels are said to be a US\$13 billion a year business. Former President Felipe Calderon launched an attack on the drug cartels in 2006. In reaction the cartels responded with violence, and since 2006 over 55,000 people have been killed in drug related violence (*BBC news*, 2013a). Still today, organised crime and the impact of drug cartels have a vast influence on Mexico and its stability. Violence is most prominent in the northern states of Chihuahua and Sinaloa, Guerrero and Michoacán in the south-west, and Veracruz in the south-east (OSAC, 2013b). It is an aim of President Peña Nieto to reduce the violence in Mexico by bringing in a stronger military presence and special police forces to deal with the problem (*Reuters*, 2012).

3.3.2 Mexico as an emerging market

Mexico has the second largest economy in Latin America. It is considered to be an emerging market and has drawn the attention of foreign investors. In the 1990s, Mexico embraced globalisation and economic reforms occurred making the economy more liberalised and open. Mexico's reputation has remained intact through upholding its international commitments and maintaining foreign investment in its economy (Bremmer & Keat, 2009:70). Today Mexico is considered to be a newly industrialised emerging power, with an upper-middle income status (World Bank, 2013a). The manufacturing sector, in specific the automotive industry is a huge driver of economic growth, being the eighth largest automotive industry in the world. Mexico's main trading partner is the US, and Mexico belongs to Organisation for Economic cooperation and Development (OECD), as well as the North American Foreign Trade Agreement (NAFTA) (World Bank, 2013a).

Mexico has shown resilience during times of economic crisis. When the financial crisis hit in 2009, Mexico had US\$150 million in place to aid against the recession (*BBC News*, 2013a). Since the global financial crisis, Mexico has increased bank loans to the private sector and consumer credit has risen. This has enabled Mexico to gain a greater market share, making it a true emerging market (Thomson, 2012). Furthermore, its stability and economic policy have made it attractive to investors.

“The mix of higher growth, nearly bullet-proofed macroeconomic fundamentals, expansion of credit, and stronger consumer spending has coincided with the relative dulling of Brazil's gloss as once-impressive growth rates have slowed. That has made international investors look all the more closely at Mexico as Latin America's brightest prospect in the coming years” (Thomson, 2013).

Foreign investment is set to increase if the necessary reforms in the energy sector occur. Such reforms will look towards boosting Mexico's competitiveness and growth (World Bank, 2013a). The World Bank (2013a) notes that Mexico's "strong fundamentals, sound policy frameworks, and management have resulted in favourable financial conditions that have supported national economic activity". Since the global recession, foreign investment in Mexico has grown (*BBC news*, 2013a). In the first half of 2010, investment rose nearly 30% from a year earlier. According to Alejandro Schtulmann, President of Emerging Market Political Risk Analysis¹⁰ (EMPRA), the fact that Mexico's political institutions are still transforming make it an emerging market (Personal interview 2, 7 August 2013).

Mexico has a stable macroeconomic policy, and the finance minister has stated that, "economic stability has become state policy. It is an asset, and it is one that nobody questions" (Meade in Thomson, 2012). Mexico is seen to have great economic potential and this potential for accelerating growth is evident when looking at Mexico's many factories and abundance of skilled and semi-skilled labour which keeps the working environment stable and the operating costs low. During 2012, growth was 3.9%. At present the interest rate is 4.5% and has been so since July 2009. In 2012, Mexico exported US\$349.7 billion worth of goods (Thomson, 2012).

Oil plays a vital role in the Mexican economy, influencing the fiscal stability of the country, along with the economic output. In 2011, oil contributed 34% of the total government revenue, and 16% of export earnings. However, the tax revenue still relies too heavily on oil, as oil contributes one-third of this revenue (*BBC News*, 2013a). The oil industry, while contributing to revenue, is slowing Mexico's potential growth. The oil industry in Mexico is becoming stagnant and "the lack of expertise at Pemex and the constitutional ban on private investment has resulted in a 25% drop in oil production since 2004" (Thomson, 2012). Pemex lacks the means to expand the oil sector and stimulate growth. The Head of the Central Bank in Mexico states that, "to achieve higher rates of growth, we need to make progress on structural reforms that increase the productivity and competitiveness of the economy" (Carstens in Thomson, 2012). These necessary reforms need to be seen in the oil and gas industry.

Furthermore, Mexico still witnesses a vast socio-economic gap and investment is not at its highest level due to the prevalence of drug-related violence. However, "on the heels of a contentious presidential election and soaring levels of criminal activity, the country's political

¹⁰ EMPRA is a "political risk advisory and consulting firm focusing primarily on Mexico" (EMPRA, 2013).

transition opens the possibility for a new era of reforms and policy changes that could drastically improve the country's outlook" (Schtulmann, 2012).

3.3.3 History of the oil and gas industry in Mexico

Mexico is the ninth largest oil producer in the world, and is the third largest in the western hemisphere. Oil production in Mexico began in 1901. Between 1910 and 1925 the oil industry increased in stature and Britain and the US carved out interests in the industry. However, the revenue was sent back to Britain and the US, with Mexico's resources continuing to be depleted and none of the profits staying in Mexico.

In 1938 the oil and gas industry in Mexico was nationalised. It is controlled by Pemex, which is the country's largest company by sales in Mexico. It controls all aspects of the oil sector; ownership, exploration, production, transportation and marketing. The Mexican oil industry consists of 500 pipelines which cover an area of 3000 miles in the southern part of the country. There are six refineries and three export terminals (Oil and Gas in Mexico – Industry Profile, 2012). This infrastructure too is controlled solely by Pemex, which has four branches; Pemex Exploration and Production, Pemex refining, Pemex gas and basic petrochemicals, and Pemex Petrochemicals (Oil and Gas in Mexico – Industry Profile, 2012). It is regulated by the Secretaria de Energia (SENER), and additional oversight is provided by the Comision Nacional de Hidrocarburos (CNH) (EIA, 2012b:4). The Mexican constitution enforces the state-ownership of the oil and gas industry, thus relieving the threat of new entrants. However, changes are in motion which will reform the oil and gas industry in Mexico, liberalising it and allowing foreign investment (Thomson, 2012).

The location of the oil reserves is predominantly situated offshore in the Gulf of Mexico in the Campeche Basin which is in the southern part of the country. Further oil reserves in the south of the country are found in the states; Veracruz, Tabasco and Campeche. There are some onshore oil reserves in the northern part of the country. The predominant onshore field in the north is Chicontepec, which is situated to the north east of Mexico City. There are said to be 442 million barrels of oil reserves situated here (EIA, 2012b:4).

Mexico and the US have a close trading relationship. This trading relationship extends to many sectors but is greatly prevalent in the oil and gas sector where the US imports Mexico's crude oil, and Mexico imports refined oil products from the US. In 2011, Mexico exported 1.34 million bbl/d, with 85% of this going to the US. At present Mexico imports most of its refined products from the US, but there are hopes to decrease this. In Tula, a new oil refinery is being built and it hopes to be operational by 2016. It will have the capacity to refine 300

000 bbl/d. In terms of oil production, in 2011, 2.55 million bbl/d were produced, and Mexico had 10.2 billion barrels of proven reserves. In 2012 the total revenue for the oil and gas sector in Mexico was US\$84 billion (Oil and Gas in Mexico – Industry Profile, 2012).

3.3.4 The Gulf of Mexico

The majority of Mexico's oil is situated in the Gulf of Mexico. The two largest oil fields in the country are Cantarell in the south and Ku-Maloob-Zaap (KMZ) in the north-eastern region of the Gulf of Mexico (see Figure 4). These fields produce what is known as the Maya blend of crude oil which is heavier, while the oil found off-shore of the Tabasco state are lighter blends known as Isthmus and Omega (EIA, 2012b:12). Production in the Cantarell field began in 1979 and this field is one of the largest in the world. Oil production in the Cantarell field peaked in 2004 at 2.1 million bbl/d and at the time the Cantarell field was producing 63% of Mexico's oil. In 2011 it produced only 500,000 bbl/d, while KMZ produced 860,000 bbl/d (EIA, 2012b: 2).

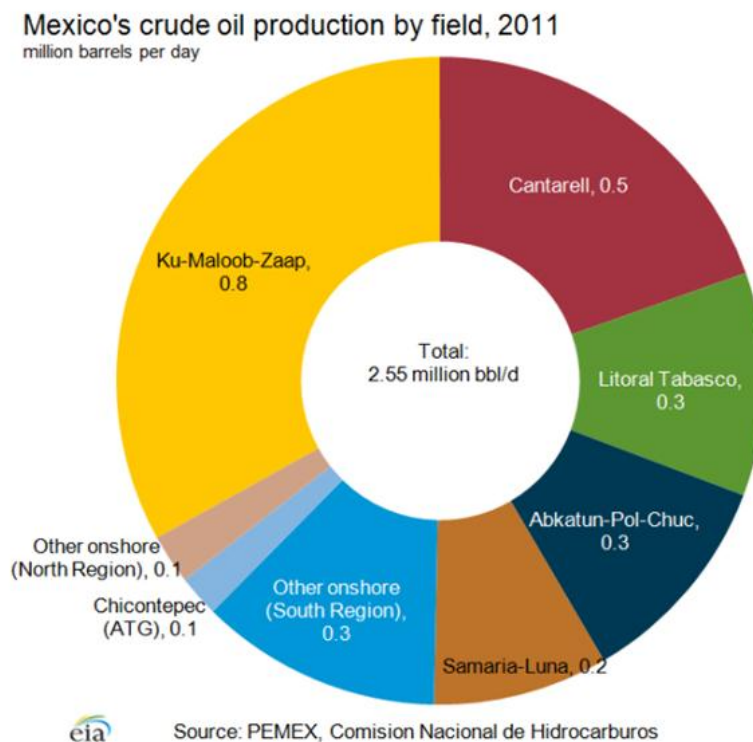


Figure 4: Mexican oil production by field (EIA, 2012b:6)

While the majority of instability and insecurity in Mexico is found in the northern states, insecurity is apparent in Veracruz, which is located in the southern oil region of Mexico. There have been incidences of oil being stolen from pipelines and fuel trucks, and this theft costs Pemex millions of dollars per year (Oil and Gas in Mexico – Industry Profile, 2012).

Oil production in Mexico has been decreasing since 2004 (see Figure 5) and it is said that oil production could become stagnant, with output remaining at 2.8 million bbl/d until at least 2030 if changes are not made and foreign investment does not occur within the oil and gas industry (Key political risks to watch in Mexico, 2012). This decline will continue, unless reforms can occur which will change policy and enable technological expertise. This, along with funding will most likely come about through the entry of foreign firms. The slump in oil production could see Mexico becoming a net oil importer by the end of the decade. At present Mexico already imports 40% of its gasoline (*Petroleum Economist*, 2013). Furthermore, the government relies too heavily on the oil revenues. The government takes the majority of the revenue leaving Pemex with not enough funding to expand and grow its technology. This flow of revenue is also affected by the fluctuating price of oil (Trotta & Hughes, 2012). The energy sector is ailing; however, Mexico still holds vast potential and reforms are vital so that this oil potential can be realised.

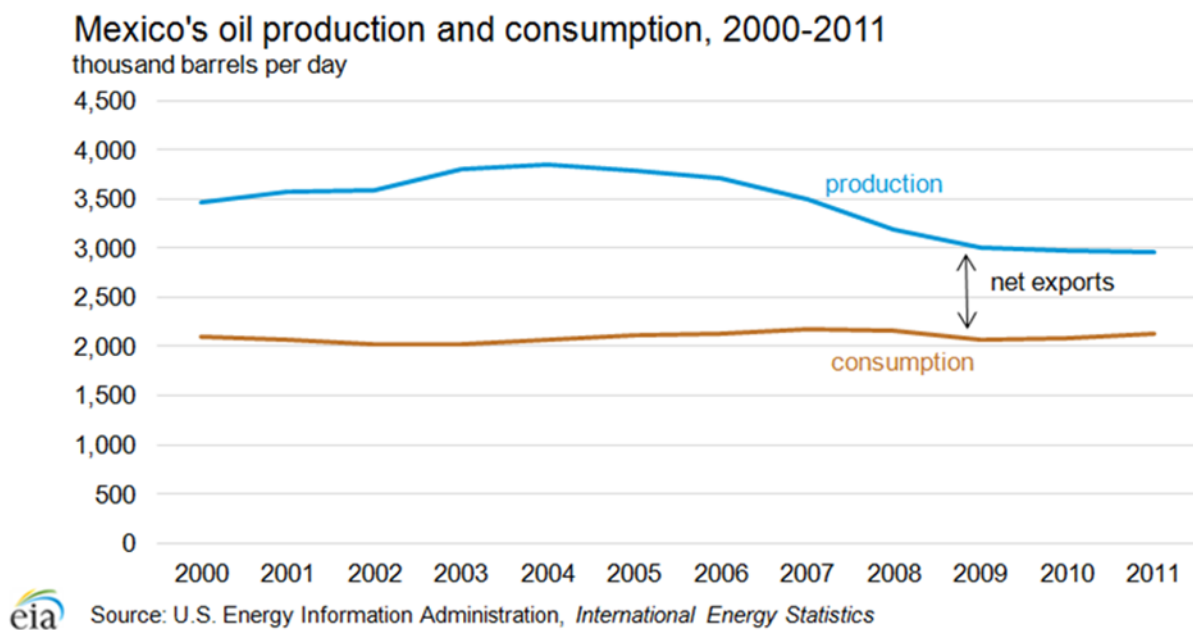


Figure 5: Mexico's oil production and consumption (EIA, 2012b:3)

3.3.5 Conclusion: Mexico

Mexico's economy is the second largest in Latin America and holds vast potential. Its resilience to the economic crisis and strong macroeconomic foundation has brought Mexico to the attention of foreign investors. However, organised crime, the incessant violence caused by drug cartels, and the widening socio-economic gap continue to hinder Mexico's ability and outlook.

Mexico is the ninth largest oil producer in the world and oil profits contribute one-third of government revenue. Until recently the oil and gas industry has been state-owned and controlled by Pemex. However, current government reforms are looking towards liberalising the oil and gas sector, with the aim of increasing foreign investment and bringing in needed expertise and funding to assist Mexico's ailing energy sector.

3.4 Conclusion

Nigeria and Mexico are emerging markets. They have BRIC-like potential, large population sizes, and the ability to experience positive momentum. This, along with their vast amount of human and natural resources, place Nigeria and Mexico in a prosperous economic position. A historical contextualisation was provided for both countries, along with looking at the oil and gas industries and their specific features in Nigeria and Mexico. The oil and gas industry is a lucrative sector and forms an essential part of the economy and its growth in both Nigeria and Mexico. The oil profits contribute to government revenue and export earnings. The majority of oil in Nigeria is found in the Niger Delta, while in Mexico oil is found in the Gulf of Mexico. In both Nigeria and Mexico, changes could be made which would improve the efficiency of the oil and gas sector. In Nigeria, instability caused by tensions between the government, the TNOCs and local communities needs to be curbed, while in Mexico the oil and gas sector is in need of reform, so to allow the entry of foreign oil companies and their technological expertise.

The importance and relevance of political risk has grown, with globalisation and the rapid growth of emerging markets bringing with it not only prosperity, but also volatility. There is an increasing need to consider emerging market behaviour and the political risks faced by foreign investors wanting to invest in the oil and gas industry. This chapter has provided the foundation from which to move towards chapter four, which will look at finding and presenting the main political risk factors faced by Nigeria and Mexico in their oil and gas industries. Thereafter the essential generic political risk factors that face the oil and gas industry in emerging markets, those that investors should be aware of when looking to invest in the oil and gas industry in emerging markets, will be presented.

CHAPTER FOUR – ESSENTIAL GENERIC POLITICAL RISK FACTORS FOR THE OIL AND GAS INDUSTRY IN EMERGING MARKETS

4.1 Introduction

In a tense geo-political world and the current global-economic context, emerging markets are playing an increasingly larger role. Furthermore, as energy demands grow throughout the world, the oil and gas rich nations have been placed in the spotlight. Many of these oil rich nations are politically highly volatile and their hydrocarbon supply is considered unstable; this brings increased political risk. When looking at the oil and gas industry in emerging markets, it is important to note that identification, analysis and mitigation of political risk is an essential requirement for TNOCs, in order for their assets to be protected and for investment to be successful (Bischoff & Lambrechts, 2011:61).

This chapter examines the political risk factor selection process before moving on to discuss the case studies. The case of Nigeria will then be looked at and the essential political risk factors which need to be considered by investors, wanting to invest in the oil and gas industry in Nigeria will be discussed. Mexico will then be looked at in the same manner, with the key political risk factors being analysed. After having addressed the essential political risk factors in Nigeria and Mexico, a generic list of political risk factors for emerging markets will be determined. These political risk factors will be the most salient elements which investors need to consider before choosing to invest in the oil and gas industry in emerging markets. Finally, political risk mitigation will be briefly discussed, providing an overview of how political risk in the oil and gas industry in emerging markets can be reduced.

4.2 Selection process of essential political risk factors

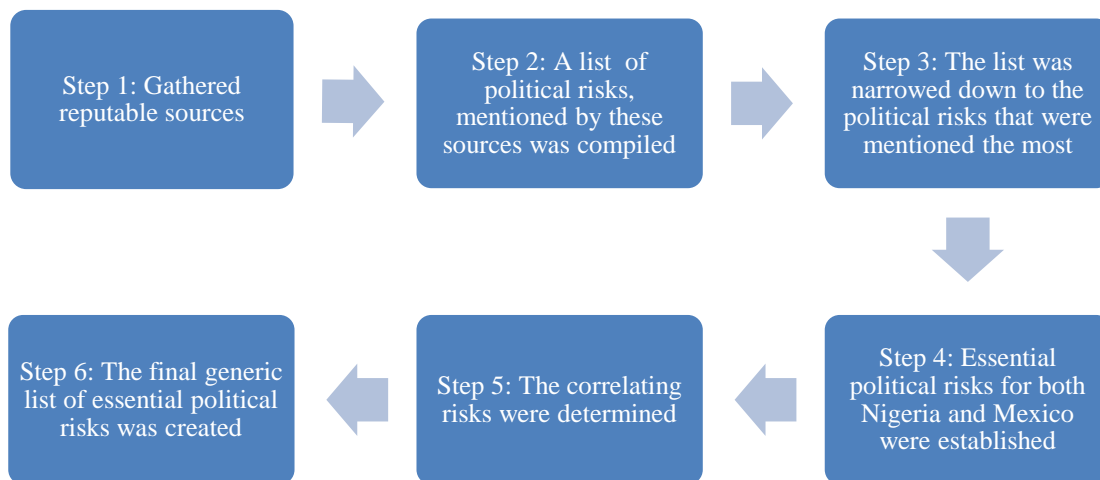


Figure 6 –Process of political risk factor selection

As explained in chapter one, the aim of this research study is to compile a generic list of risk factors. Emerging markets serve as the principal concept which drives this generic list. As a sub-category the case studies are utilised to complete this list of generic risk factors, within the context of the oil and gas industry. The political risk factors discussed in this chapter were compiled through a process which will now be explained (see Figure 6). The first step in identifying the political risk factors was finding reputable sources from which to gather a series of relevant political risk factors. The sources from which the political risks were gathered were the following: Control Risks¹¹ Risk Map Report 2013, Red24's¹² Threat Forecast 2013, Stratfor¹³, the Overseas Security Advisory Council's¹⁴ (OSAC) Crime and Safety reports, Frynas & Mellahi, the Centre for Strategic and International Studies¹⁵ (CSIS), World Risk Review, Harary Security Consulting International¹⁶, *BBC News Country Profiles* and articles by Thomson from Emerging Markets.org. As can be noted, the sources were

¹¹ Control Risks is “an independent, global risk consultancy specialising in helping organisations manage political, integrity and security risks in complex and hostile environments” (Control Risks, 2013:S2).

¹² Red24 is a “crisis management assistance company delivering a range of products and services to businesses, organisations and individuals around the world” (Red24, 2013a).

¹³ Stratfor is “a geopolitical intelligence firm that provides strategic analysis and forecasting to individuals and organizations around the world” (Stratfor, 2013a).

¹⁴ OSAC “provides security cooperation between America private sector interests and worldwide and the U.S. Department of State” (OSAC, 2013a).

¹⁵ CSIS is an organisation which provides “strategic insights and bipartisan policy solutions” (CSIS, 2013).

¹⁶ Harary Security Consulting International is a leading security firm in Mexico (Harary Systems, 2013).

company reports from notable risk companies and articles from prominent news agencies. These sources were chosen because they all discuss and analyse political risk for the years 2012 and 2013. This makes them both current and relevant. The one exception was the use of Frynas & Mellahi. Their journal article titled, *Political Risks as Firm-Specific (Dis)advantages: Evidence on Transnational Oil Firms in Nigeria* was published in 2003. While not current, the information contained in this article is still relevant, since the article presents a coherent analysis of political risks facing the oil and gas industry in Nigeria, which correlates to a part of this research study's focus.

These sources and the information obtained from them was complemented by primary data gained through Skype interviews with Alejandro Schtulmann, the President of EMPRA who was able to provide information on Mexico (Personal interview 1, 7 August 2013), as well as a senior oil executive from ExxonMobil¹⁷, a top TNOC operating in Nigeria (Personal interview 2, 16 August 2013). These two respondents were able to provide current and relevant information and expert knowledge regarding political risk for both Nigeria and Mexico.

Step two involved compiling a list of all the political risks the sources stated and then taking into consideration how these impacted on three levels; the emerging market level, the national level and more specifically the oil and gas industry. This list showed all applicable political risks for Nigeria and Mexico and which sources found them to be important. It is essential to note that the political risks were case-specific. There were risks found that only Nigeria had, while there were also risks that only related to Mexico. The aim was to find where the lists of political risks overlapped in order to establish a generic list that can be applied to all emerging markets. The political risks identified for Nigeria were: civil war, changes in government policy, corruption, kidnapping, extortion, disputes with neighbouring countries, social tensions, Islamic militancy, government reforms, political unrest and political instability. The political risks identified for Mexico were: drug-related violence, kidnapping, extortion, organised crime, civil unrest, energy reform, currency changes and political instability. Step three involved placing aside those political risks that had been mentioned by the most number of sources and thus had received the most attention. In doing this, some similarly worded political risks were able to be linked to come up with more comprehensively worded political risk factors.

¹⁷ ExxonMobil is the "world's largest publicly traded international oil and gas company" (ExxonMobil, 2013).

The final lists of essential political risks in the oil and gas industries in Nigeria and Mexico were then collated in step four using those risks that had been set aside in the previous step. The six political risks for Nigeria are: government reforms, civil war, political instability, social tensions, corruption and kidnapping. The five political risks for Mexico are: drug related violence, kidnapping and extortion, energy reform, civil unrest and political instability.

Nigeria and Mexico provided suitable case studies of emerging markets as well as providing cases which exhibited industry-specific political risks affecting the oil and gas industry. With the lists produced for both Nigeria and Mexico, step five involved finding the political risks that Nigeria and Mexico had in common. This was done by considering where the lists of political risks overlapped. With the correlating variables found, the final generic list could then be compiled. The six political risks that are essential for investors to consider are: government reform affecting the energy sector, political instability, kidnapping, internal violence, civil unrest and corruption.

Corruption was an exception as it was a political risk factor that did not correlate between the lists of Nigeria and Mexico. It was not a stated political risk for Mexico; however, corruption in Mexico still rates relatively high on Transparency International's Corruption Perceptions Index¹⁸, 105 out of 174 countries. Upon a general reading on emerging market political risk, corruption comes up regularly and is considered too important to be excluded from the generic list of essential political risks for the oil and gas industry in emerging markets.

4.3 Nigeria

4.3.1 Introduction

Nigeria has witnessed great turmoil, conflict and instability over the years, and issues such as corruption, poor infrastructure, ethnic tensions, and economic inequality have restrained growth in Nigeria (Barclay, 2013:57). As Africa's largest country by population, its actions and behaviour exhibit increasing power in the geo-political environment in which emerging markets are gaining influence. Nigeria, being an emerging market, along with having an active oil and gas industry, makes it attractive to foreign investment. When looking at Nigeria on a macro level and micro level in terms of the oil and gas industry, as well as taking into consideration its status as an emerging market, six essential political risk factors which TNOCs should be made aware of become apparent. These six political risk factors will now be analysed below.

¹⁸ Refer to Appendix A for Transparency International's 2012 Corruption Perceptions Index report.

4.3.2 Political Risk factors in the oil and gas industry in Nigeria

4.3.2.1 Government reforms

The investment landscape and business climate in Nigeria will be dramatically influenced by government reforms and their implementation (Barclay, 2013:58). Government reforms in Nigeria have so far been steady, yet slow and President Goodluck Jonathan needs to prove himself against a growing tide of dissatisfaction from civilians in the northern region of Nigeria, along with growing internal pressure as the threat of Boko Haram grows and the government fails to successfully manage the insurgency (Red24, 2013b:26). Reforms have looked towards increasing investment with a focus on diversification and the growth of non-oil and gas sectors (Aribisala, 2013).

Historically Nigeria has not always been as liberalised as it is today. The 1970s saw nationalisation and expropriation occur in Nigeria. These were seen as tools for achieving political-economic objectives without foreign nationals impeding economic development (Banwo & Ighodalo, 2011). Anti-foreign laws were put in place which restricted foreign investment and in turn aimed at increasing state control over the oil resources (Frynas & Mellahi, 2003:550). The government acquired equity stakes in the TNOCs and by 1979 the government had a 60% ownership share of the major TNOCs in the Nigerian oil industry. Today the TNOCs and the government have JVs; however, the TNOCs have still been able to experience effective control over their production due to technological expertise and funding which the government cannot provide.

The current reforms which relate to the oil and gas industry are the sovereign wealth fund, the fuel subsidy and the PIB. The sovereign wealth fund aims to provide long term stability; however, critics state that instead of money going into this fund, it should be injected back into the country to aid with building much-needed infrastructure (Rundell, 2011). A fuel subsidy has existed for many years in Nigeria, allowing fuel to cost US\$0.40 a litre in the country. This subsidy is seen by the public to be a benefit of living in an oil-rich country; however, Nigeria still has to import most of its fuel due to the lack of refinery infrastructure. On 1 January 2012, the government withdrew the subsidy as it was costing the government US\$7.6 billion a year. This led to a vast public outcry and an eight-day national strike. Two weeks after the subsidy was withdrawn, a partial subsidy was reinstated making fuel US\$0.60 per litre (EIA, 2012c:5). In August 2012, tensions over the fuel subsidy arose once more when Nigerian oil marketing associations began strikes to protest over unpaid subsidies (EIA, 2012c:5).

Perhaps the greatest reform at present to affect the oil and gas industry is the PIB which is likely to be passed soon. In terms of revenue, oil rents currently go to the NNPC. The PIB will aim to break up the NNPC's monopoly so that more oil revenue gets put into the Nigerian central bank which will, in turn, boost the economy and development of Nigeria's citizens. The PIB will also encourage greater foreign investment in the oil and gas sector, with the aim of boosting the Nigerian economy further and demonstrating its global status as an emerging market. The PIB will bring about necessary clarity; however, it will not aid in dealing efficiently with continued corruption and dysfunction in the oil and gas sector. The PIB will be met with slow and uneven implementation (Control Risks, 2013:88). Generally government reforms will bring some changes to the oil and gas industry; however, the structural flaws will not be addressed, and the inflow of foreign investment that the PIB strives to bring about will be more subdued than expected (Barclay, 2013:61).

4.3.2.2 Civil war

Foreign investors have dealt with a considerable number of political risks in Nigeria over the years including civil war and the ensuing effects it has. The civil war broke out in 1967 after a military coup overthrew the First Republic in 1966. This occurred due to tensions between the Biafran regime in the south-eastern region of Nigeria and the federal regime based in Lagos. The war ended in 1970, leaving over a million people dead (Lewis, 2011:2). It was deemed one of the "most threatening political events of Nigeria's history" (Frynas & Mellahi, 2003:548). The war disrupted onshore oil operations, with oil production declining during that time, from 420,000 bbl/d to 145,000 bbl/d (Frynas & Mellahi, 2003:548). However, offshore oil production was insulated during the civil war from onshore political disorder and having offshore resources was one way in which the political risk relating to the civil war was mitigated.

Civil war has not erupted again in Nigeria; however, it is necessary to consider the political, economic and social atmosphere before investing in the oil and gas region of the Niger Delta. Not only are the constant ethnic tensions and the growing north-south divide a point of concern, but so too is the fact that Nigeria has a growing number of unemployed youths who could turn militant. Currently the youth unemployment rate is 38% (*The Nigerian Voice*, 2013). Considering Nigeria's tumultuous history relating to coups and militancy, the possibility of civil war remains and therefore needs to be considered as a political risk in Nigeria.

4.3.2.3 Political instability

Political instability for the purpose of this research study can be conceptualised as volatility within the political system, focussing on the government and its officials. Political instability has been evident in Nigeria and affects the country on a macro scale. An example is the fact that since independence was granted in 1960, Nigeria has witnessed five successful military coups¹⁹. Federalism in Nigeria has led to a lack of government cohesion and has emphasised the differences between regions (Lewis, 2011:5). The lack of a strong central government has led to poor governance, weak and delayed decision making, a lack of legitimacy and accountability, weak institutions and idleness in the government bureaucracies.

Political instability has increased as credibility in the government has declined. Government credibility has been tainted by fraud and corruption, as there is continued misconduct by government elites (Lewis, 2011:7). In Nigeria, patronage and identity politics are evident, and the President Jonathan administration is said to have an agenda that, “is not an economic one but a political one that is informed by the logic of rent and patronage” (Kaplan, 2011). President Jonathan has received a great deal of criticism and has struggled to gain consensus from the population in the Northern regions of Nigeria. He has attempted to produce support in the North through the use of money by issuing lucrative government contracts (Kaplan, 2011). While patronage distribution has suppressed some civilian unrest, it does not get to the root cause of societal problems. On a national level patronage could further increase as the 2015 elections approach, and President Jonathan looks for re-election and the PDP endeavours to maintain its political power (Lewis, 2011:7).

Political competition is a powerful catalyst for instability. Instability increases during election time due to the weakness of electoral rules. The onset of intimidation, propaganda, violence and fraud occur in order to secure votes and win the election (Lewis, 2011:12). This was evident in the last national elections. General Muhammadu Buhari who comes from the north was Goodluck Jonathan’s main opponent in the 2011 elections. Voting showed a clear divide; the North voting for Buhari and the South voting for Jonathan. The announcement of Goodluck Jonathan as President was met with violence and protests in some northern regions (*BBC News*, 2013b). According to Human Rights Watch (2011), 800 people were left dead and 65,000 displaced after communal violence in 12 of the northern states. There is an unwritten pact in Nigeria that leadership rotates between northern and southern leaders (Agoi

¹⁹ January 1966, July 1966, July 1975, December 1983, and August 1985 (*BBC News*, 1999).

& Smith, 2013). The 2015 elections will see increased political tension if there is no rotation to a Muslim leader.

The PDP is seen to aid elite interests from certain ethnic southerly regions, while areas of the north remain overwhelmed by poverty (Barclay, 2013:59). According to the Control Risks' 'Risk Map report 2013' (2013:60), "the PDP will experience increased internal friction and disunity in 2013 as interest groups begin repositioning themselves with one eye on the 2015 elections". Political instability can be a catalyst for other political risks such as political discontent. A political risk such as this will lead to greater social tensions in Nigeria.

4.3.2.4 Social tensions

In Nigeria social tensions are deep-rooted and entrenched. These in part are due to the strong ethnic and cultural ties of a very diverse and heterogeneous population. Tensions have led to various forms of ethnic rebellion and clashes, as friction between the groups persists (El-Choueiry *et al.*, 2013:2). The Nigerian people long for better circumstances; however, the enigma remains...Despite the vast oil wealth and economic growth, poverty is increasing each year (Kale in Brock, 2012). Civil unrest and strikes regarding poor service delivery will remain so long as a great deal of the population is poverty stricken. Political discontent is a predominant factor which leads to social tension and arises from the elite as well as the grassroots level (Barclay, 2013:59). This is clear when looking at the north-south divide and the underlying socio-economic problems which have led to it. The gulf between the North and South is growing, due in part to the wealth disparity evident (see Figure 7) (*BBC News Africa*, 2012). This gulf is not aided by the fact that "the President leans more towards appeasing his southern support base than extending the olive branch to the north" (Barclay, 2013:60). The North feels marginalised and has not accepted the presidency of Goodluck Jonathan as he might have hoped.

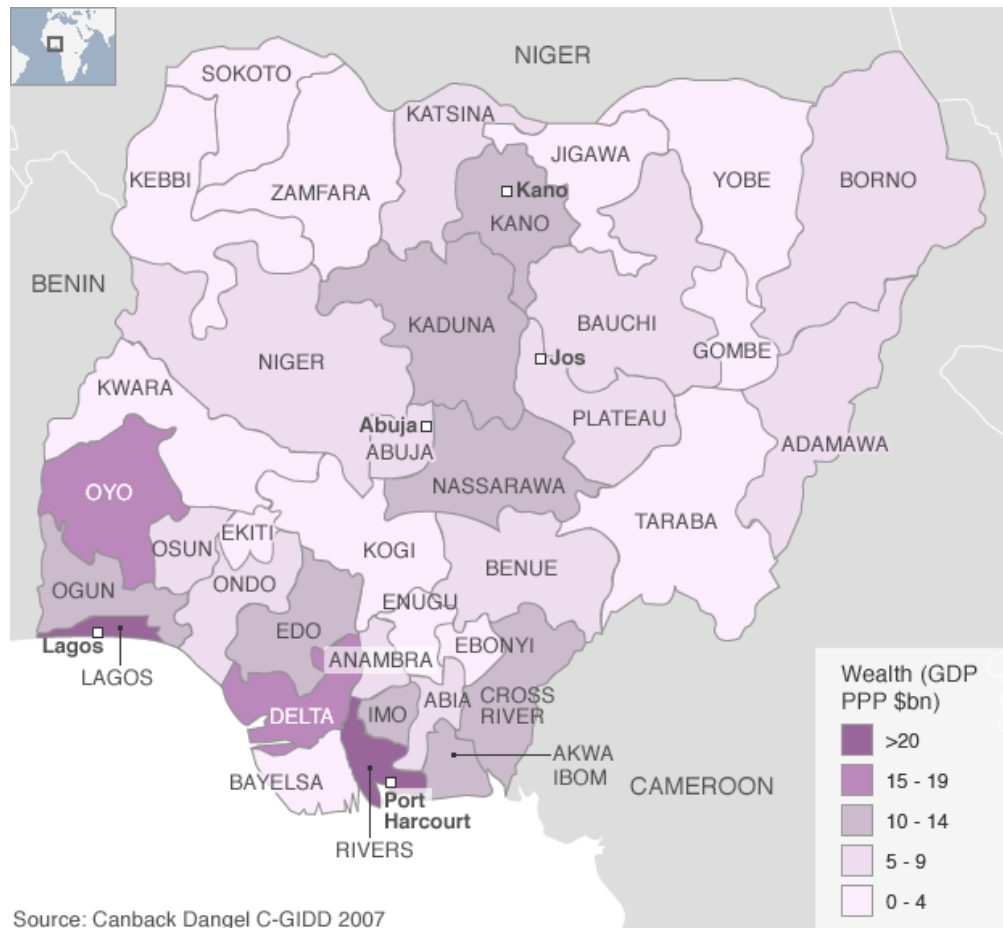


Figure 7: Wealth Disparity in Nigeria (BBC News Africa, 2012)

The North-South divide further widened when Islamic law was imposed on many of the northern states. The growing Islamic sentiment and the actions of Boko Haram have led to mounting militancy in the north of the country (Barclay, 2013:58). Boko Haram is an Islamic group, seen to be an al-Qaeda ally that is dedicated to the spread of Sharia law (El-Choueiry *et al.*, 2013:1). The group, who began their activities in 2002, are seen to be the main threat to political stability in Nigeria (Global Security, 2013). Their activities are part of the Northern effort to lay the foundations of an Islamic, theocratic state (Global Security, 2013). One of their aims is to destabilise the country and they have conducted a number of attacks in the north of the country. After attacks by Boko Haram in 2004, it was reported that at least 57,000 people fled their homes in central and northern Nigeria (Global Security, 2013). Boko Haram attack Christian minorities, which has led to a cycle of violence and retribution between Muslims and Christians (Barclay, 2013:60). In January 2012, 100 people were killed in Kano after Boko Haram told Christians to leave the north. In December 2012, a further 20

Christians were killed during the Christmas period (*BBC News*, 2013b). Boko Haram²⁰ and the growing number of their militant attacks is just, “one symptom of a wider social, economic and political problem that is finding its outlet in religious radicalism” (Barclay, 2013:59).

Security risks for foreign operators in Nigeria, due to the Islamist militancy present, are set to evolve and grow (Barclay, 2013:57). Boko Haram is seen as a growing threat to human safety. In 2012, more than 600 people were killed through Boko Haram attacks; this was more than any previous year (Red24, 2013b:25). In 2012, 19 of Nigeria’s 36 states were subject to Boko Haram attacks (see Figure 8) (Stratfor, 2012), and there has been evidence of the group expanding its operations, moving further and further away from their traditional geographic location (Red24, 2013b:25). In May 2013, the President deployed military troops into the northern states of Yobe, Borno and Adamawa and declared a state of emergency (*BBC News*, 2013b). The activities of Boko Haram remain hard to detect and their attacks are becoming more sophisticated.

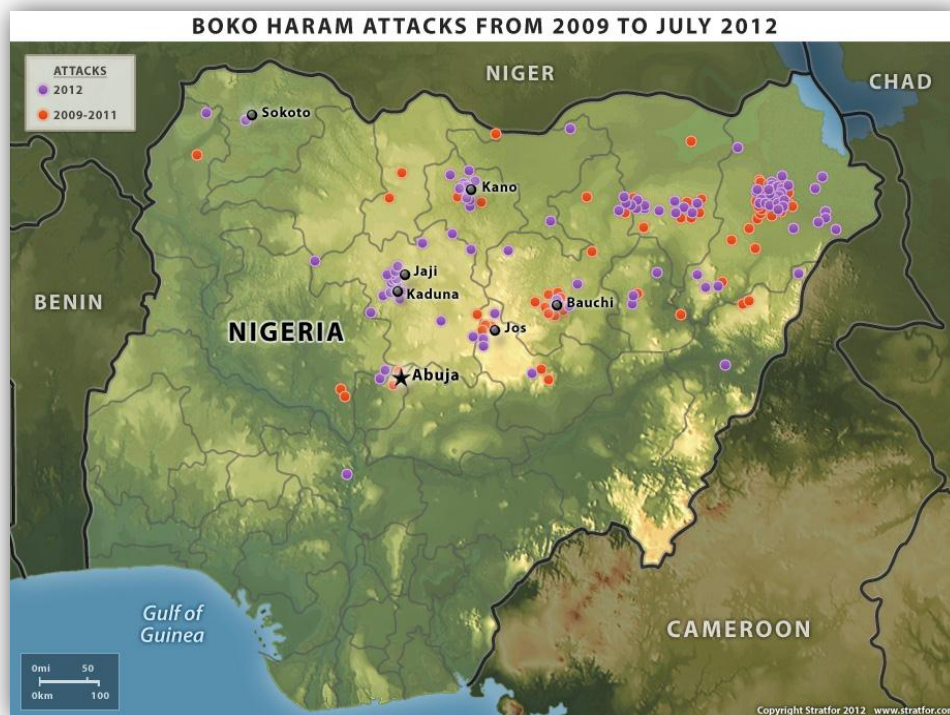


Figure 8: Boko Haram Attacks from 2009 to July 2012 (Stratfor, 2012)

²⁰ The increase in Boko Haram activities correlates with a growing increase in Islamic militancy throughout Africa. This is clear from the 21 September 2013 attack on the Westgate shopping mall in Nairobi, Kenya. The siege lasted 80 hours and left more than 200 people wounded and at least 67 people dead (Howden, 2013). Although this attack was committed by the Somalia-based al-Shabaab group and not Boko Haram, it is a clear indication of increasing Islamic militancy and growing regional instability in Central, Western and Eastern Africa.

Resources are a further instigator of social tension. Poverty and the lack of economic opportunity lead to greater competition over resources, in particular those of oil and gas (Lewis, 2011:10). Social tensions have led to violence and anti-oil protests, with local communities using oil as the issue and outlet to make their voices heard. This is especially apparent in the oil-rich southern region of Nigeria (Lewis, 2011:2). The Niger Delta region has been the location of considerable conflict over the years. The Ogoni minority were the first to start localised protests with activism then increasing to the Urhobo, Itsekiri and Ijaw groups during the 1990s.

The activities of MEND in the Niger Delta and their attacks on foreign firms have been devastating to oil industry profits. Violent attacks on oil production sites have decreased since the amnesty in 2009 with the government having, “effectively bought off a generation of militants” (Barclay, 2013:61). Theft however has increased as former MEND individuals continue to engage in violence and abductions and armed gangs continue to steal oil (Lewis, 2011:10; OSAC, 2013c). ExxonMobil considers the actions of both Boko Haram and MEND to be of major concern for oil and gas operations in Nigeria (Personal interview 2, 16 August 2013). As with most issues in Nigeria, the underlying causes remain unaddressed and profitable incentives for criminal activities continue. Until the fundamental problems are solved, the Niger Delta will continue to be a complex and hostile environment in which to operate (Barclay, 2013:61).

4.3.2.5 Corruption

Corruption is a complex phenomenon and receives considerable attention as a political risk factor. It takes place on various levels and can occur in many ways. As such, the lines can become blurred, making it challenging to differentiate between actual corruption and favouritism for example. Corrupt activities are carried out for personal gain, for instance, the demanding of a bribe, whereas favouritism does not result in a direct personal benefit, such as government officials promoting the interests of their tribe (UN, 2004:23). The notion of corruption is further complicated, “where a society has long-standing traditions of gift-giving unconnected to expectations of special or improper treatment” (UN, 2004:28). There are different types of corruption and therefore corruption can be conceptualised in several ways. Transparency International (2013) defines corruption as, “the misuse of entrusted power for private gain”, and the United Nations (UN) defines corruption as, “commission or omission of an act in the performance of or in connection with one’s duties, in response to gifts, promises or incentives demanded or accepted, or the wrongful receipt of these once the act has been committed or omitted” (UN, 2004:23). Jessen (2012:40) offers an industry-specific definition

and defines corruption in the oil and gas industry as, “the use of public office for private gains accrued from the oil and gas investor”. This illustrates an abuse of power by government officials and relates to activities such as the soliciting of bribes, receiving of special payments and embezzlement (UN, 2004:23).

Corruption is hard to detect but in Nigeria it is believed to be widespread. According to Red24, there are high levels of corruption in both the government and the military (2013b:25). Corruption occurs due to a lack of ‘a sense of national community’, enforcement mechanisms, changing moral codes, wealth inequality and the idea that political office will lead one to vast wealth (Fagbadebo, 2007:30). Corruption is evident on a macro scale in Nigeria but affects the oil and gas industry on the micro level too. According to OSAC (2012c), in 2012 corruption remained widespread in Nigeria. The corruption perception index, conducted by Transparency International, looks at how corrupt a country’s public sector is perceived to be. Scores range from zero (highly corrupt) to 100 (very ‘clean’). In 2012, Nigeria ranked 139 out of 176 countries, receiving a score of 27 out of 100 (Transparency International, 2013)²¹.

Corruption occurs on many levels. One form of corruption is patronage. Patron-client relationships present a risk as they take prevalence over the more formal aspects of politics, such as rule of law, a reliable electoral system, and respectable political parties (Fagbadebo, 2007:28). Godfathers are those notable local elites who are known to appoint election candidates through providing the necessary resources to ensure election victory for their chosen candidates (Lewis, 2011:8). “Political competition is organised around personalities and parochial appeals, which are typically pursued through the use of money, intimidation and the compromise of election authorities” (Lewis, 2011:8). Corruption has also aided conflict, with the military and government being implicated in corruption scandals in Nigeria (Red24, 2013b). There is wasteful public spending, and while President Jonathan has vowed to tackle corruption and governance issues, curbing it will be a vast challenge in a federal system of governance. In 2011 he fired the anti-corruption agency head stating that she was not conducting her duties and tackling the problem (*BBC News*, 2013b).

Corruption is a common occurrence that has become entrenched. Corruption by government officials erodes the rule of law, affects investor confidence and impacts economic stability (UN, 2004:23). Nuhu Ribadu, former head of the Economic and Financial Crimes Commission, believes that corruption has cost Nigeria US\$450 billion over the past decade (*The Economist*, 2013a). Many laws are in place to try and curb corruption, however, these

²¹ Refer to Appendix A for Transparency International’s 2012 Corruption Perceptions Index report

are not adequately enforced (Global Integrity, 2013). Government funds are viewed as open access goods and public office holders, “prefer to risk jail for embezzlement of public funds entrusted to their care rather than risk opprobrium in their home areas for failing to enrich themselves and their communities during their time at the public trough” (Global Security, 2013).

Natural resources are susceptible to corruption and plundering, as local officials seek economic opportunism. Investors are exposed to interference by the government as elite interests outweigh licensing and public procurement. Officials take bribes when giving out contracts and thus many contracts are signed by corrupt leaders. Corruption affects foreign firms when they have to pay the government for preferential access in order to gain contracts and other political favours (*The Economist*, 2013b:55). There is not only corruption on the part of government officials, but on the part of the TNOCs too, and the way they conduct their business. Ethics play an important role in a TNOC and a company needs to resist participating in corrupt activities and rather ensure that their reputation and ethical integrity remains intact. The TNOC should try and raise standards in the country they are invested in (*The Economist*, 2008). However, companies increasingly face ethical dilemmas with regards to the acceptable level of risk, dealing with impropriety and the way they conduct themselves in unstable places.

Corruption presents a political risk for TNOCs wanting to invest in the oil and gas industry. It is an issue that affects the country on a macro scale and reveals a huge abuse of power. Nigeria requires a “psychological reorientation away from corruption and towards meaningful development” (Fagbadebo, 2007:35). Dealing in the energy industry is complex and during an interview with *the Economist*, Cory Harvey of *Control Risks* remarked that, “energy transactions in difficult places can be spectacularly complex, making it hard to gauge the acceptable level of risk. Nigeria is arguably the most complex environment of all” (*The Economist*, 2013b:55).

4.3.2.6 Kidnapping

For the purpose of this research study, kidnapping will be conceptualised as the kidnapping of foreign nationals from oil and gas operations. This is done with a specific aim in mind; to acquire a ransom which will supplement the criminal group’s income, for a criminal group to gain attention due to the highly publicised nature of foreign national kidnapping, or as a form of protest against the TNOC for which the foreign national works. Within Africa kidnapping is most prevalent in Nigeria and Somalia. The official number of kidnapping incidents is

under-reported (OSAC, 2013c), but the African Insurance Organisation has claimed that a quarter of global kidnappings for ransom take place in Nigeria (Red24, 2013b:27).

Kidnapping is more prolific in the Niger Delta; however, during 2012 it spread to other parts of Nigeria, specifically the northern regions where Boko Haram have claimed responsibility. Along with Boko Haram, other Islamic terrorist groups, namely 'Ansaru' and 'Al-Qaida in the lands beyond the Sahel' have arisen in Nigeria and claimed responsibility for a number of attacks (see Figure 9) (Risk Advisory, 2013). A highly publicised incident in the North was the kidnapping and killing of a British construction worker and his Italian colleague. Chris McManus and Franco Lamolinara were kidnapped in May 2011 and held until they were killed in March 2012 (Hills, 2013). 'Al-Qaida in the lands beyond the Sahel' claimed responsibility for the attack. In April 2013 two Russian and two Ukrainian oil workers were kidnapped off the coast of Bayelsa State. They were rescued by Nigerian police a month later. MEND claimed responsibility for the kidnappings (Oil and Gas Industry's Top 5 Kidnapping Hotspots, 2013).

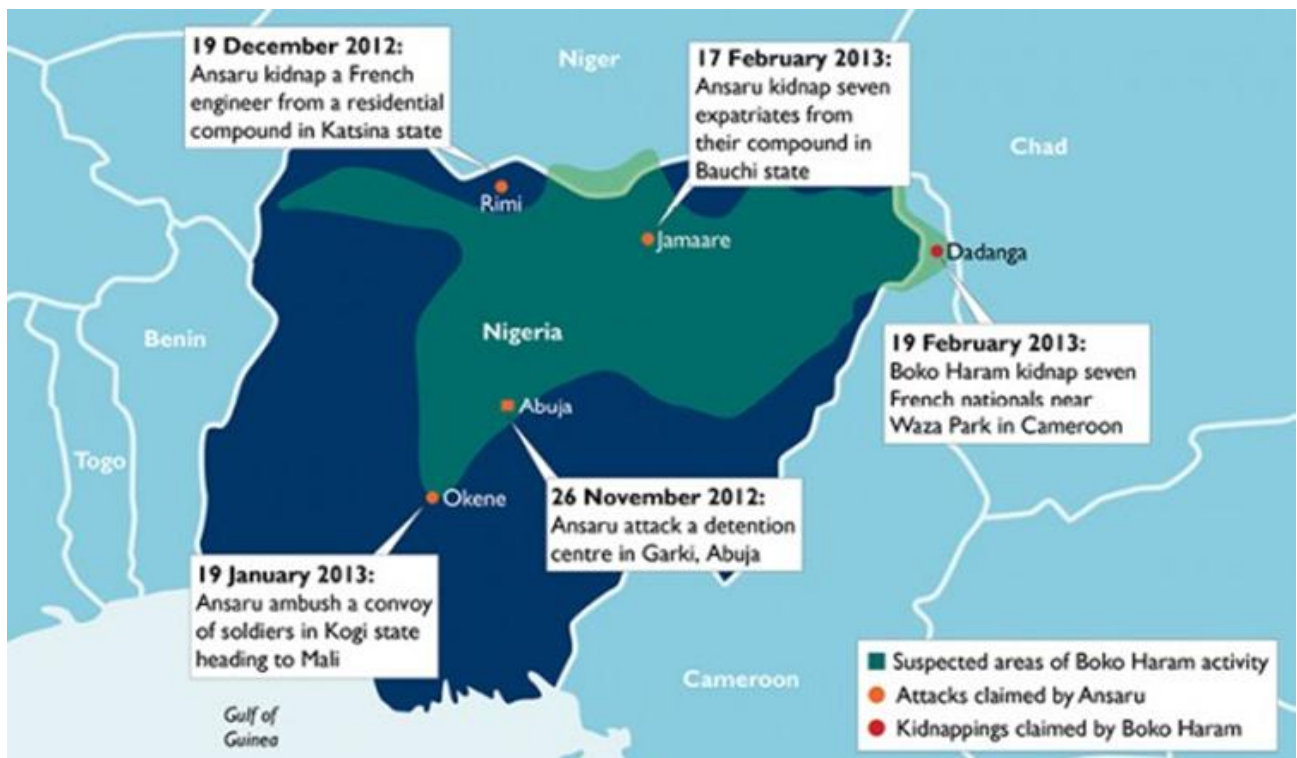


Figure 9: Islamic terrorist activity (Risk Advisory, 2013)

Foreign nationals from both onshore and offshore oil facilities have been kidnapped for ransom; however, there are growing incidents of kidnappings and piracy off-shore. Piracy in the Gulf of Guinea is primarily attributed to the violence and instability apparent in the Niger Delta region. The pirates are said to be those who did not benefit from the Presidential

amnesty in 2009. These individuals have thus resorted to kidnapping and piracy for income (Red24, 2013b:32). Between January and the end of November in 2012 there were 45 piracy incidents reported in the Gulf of Guinea²² (Red24, 2013b:32). The Niger Delta pirates target ships and kidnap the foreign nationals on board for ransom. There have been incidents where entire oil installations have been taken hostage on the condition that a ransom is paid by the authorities (Red24, 2013b:32). In December 2012 personnel consisting of four foreigners and two Nigerians from the South Korean company Hyundai were kidnapped off the coast of Bayelsa State (*BBC News Africa*, 2013). In the most recent incident at the time of writing, two American citizens were kidnapped by pirates from an oil supply vessel off the coast of Nigeria on 23 October 2013. The vessel belongs to US-based oil servicing company Edison Chouest Offshore. The victims were the ship's captain and chief engineer (Gladstone, 2013).

4.3.3 Conclusion

When looking at political risk from both a macro and micro level and keeping it in the context of emerging markets, there are six political risk factors which are essential for TNOCs to consider before choosing to invest in the oil and gas industry in Nigeria. These are: government reforms, civil war, political instability, social tensions, corruption and kidnapping.

Government reforms are not only applicable when looking at emerging markets, but are also of concern to the oil and gas industry. They will bring about structural changes, some of which will relate to foreign investment. Civil war has occurred before in Nigeria and may occur again as economic potential will not disguise the severe political and socio-economic challenges for long. Political instability in Nigeria is present due to poor governance, a lack of accountability and fierce political competition. Social tensions are increasing and relate to the growing north-south divide and ethnic and religious clashes. The social tensions are a symptom of the larger problems that exist in the political, economic and societal realms of Nigeria. Corruption in Nigeria is a widespread political risk that affects the country on a macro scale and undermines progress in Nigeria (Barclay, 2013:57). Kidnapping is prolific in Nigeria when looking at Africa and this presents a risk to the safety of personnel. Having looked at Nigeria as an emerging market and the political risks it presents TNOCs, Mexico will now be looked at, with discussion centering on its political risk factors.

²² Piracy off the coast of Nigeria declined after the Nigerian Presidential amnesty in 2009, but it is on the rise again. At the time of writing, the latest report released by the International Maritime Bureau (IMB) on 17 October 2013 shows a general rise in West Africa piracy, especially off the Gulf of Guinea which includes the waters off Nigeria, Benin, Togo and parts of Ghana. In the first three quarters of 2013, there were 40 pirate attacks, 34 crew kidnappings and 132 crew members taken hostage in the Gulf of Guinea. Off the coast of Nigeria, there were 29 piracy incidents and 32 crew kidnappings (IMB, 2013).

4.4 Mexico

4.4.1 Introduction

Mexico receives global attention due to the continual unrest and violence caused by drug-related activities. However, Mexico also receives attention due to its strong economy and sound macro-economic principles. In the global setting, Mexico exhibits power as an emerging market. The latest government reforms surrounding the energy sector, along with the fact that Mexico is the ninth largest oil producer in the world, make it attractive to foreign investment. Considering the oil and gas industry in an emerging market such as Mexico, five essential political risk factors are apparent: drug related violence and organised crime, kidnapping and extortion, energy reform, civil unrest and political instability. These five political risk factors will now be analysed.

4.4.2 Political Risk factors in the oil and gas industry in Mexico

4.4.2.1 Drug related violence

Drug-related violence is seen by Red24 to be Mexico's biggest political risk for 2013. It is a US\$13bn per year business and it will take a great deal to disrupt the cartels activities in Mexico. The situation presents a grave challenge for the Mexican government. Drug-related crime and violence affect Mexico on a macro scale and this has repercussions for the oil and gas industry as well as the TNOCs that operate in the country.

In Mexico the greatest drug related violence occurs not only between the cartels themselves but also due to infighting between the cartels and law enforcement (Red24, 2013b:7). The biggest battle is the conflict between the two largest cartels, the Sinaloa and the Los Zetas Cartels. They are continuously on the offensive and fighting for greater influence and power. Their attacks on one another are bold and violent. Los Zetas lost their leader, Heriberto Lazcano in October 2012 when he was killed by the Mexican Navy but they have remained a force in Mexico. Drug cartels also launch attacks on government officials. These attacks include ambushes, assaults, kidnappings, home invasions, and assassinations (Harary Security Consulting International, 2013:2). The cartels intimidate law enforcement officers in an attempt to stop them from conducting their jobs. Furthermore, if an official joins a cartel, this official is then at risk of being assaulted by a rival cartel (Harary Security Consulting International, 2013:2). Many law enforcement officials have been corrupted by the cartels and drawn into their criminal undertakings (Stratfor, 2013c). For example, local police in Tamaulipas were found to have ties with local cartels, leading to the already over-extended military having to step in (Harary Security Consulting International, 2013:1). These cartel

activities decrease the overall effectiveness of law enforcement and make the actions of law enforcement officials unreliable.

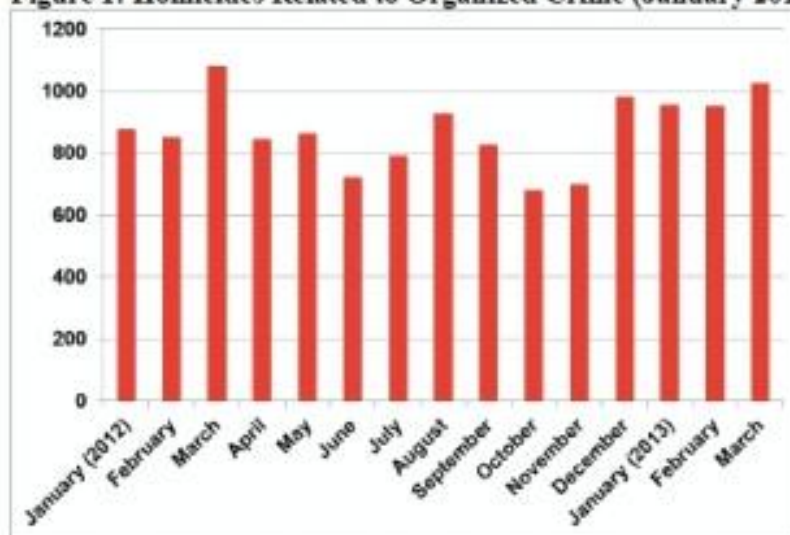
Violence has so far been contained to certain areas within Mexico. The violence may, however, disperse to more localised areas with smaller groups committing the same violence that is evident within the larger cartels. Smaller groups in more areas are far harder to police which creates further instability (Schtulmann, 2013:3). Cartels vie for influence and control (see Figure 10) over the most valuable trafficking routes in the inland parts of the country which could affect states which have, up until now been exempt from violence such as Michoacán, Colima, Guanajuato, and Morelos (Red24, 2013b:7). The main cartels growing in stature and operating inland are Cartel de Jalisco and Knights Templar. According to Schtulmann (Personal interview 1, 7 August 2013), “dynamics among Mexico’s largest criminal organisations are at a crucial juncture that could generate more violence and criminal activity”. With the presidency not as focused on eradicating drug trafficking, this could lead to big cartels like Los Zetas regaining influence in areas where previously it had lost its power.



Figure 10: Drug cartel areas of influence in Mexico (Stratfor, 2013b)

A full-frontal assault on drug and drug-related violence was launched by former President, Felipe Calderon; however, the dramatic offensive by the government had an unwanted result and crime and violence levels soared. In response, cartels went on the offensive and fought back against the government. An aggressive approach towards curbing drug-related violence works to a degree as it succeeds in disrupting the cartel's activities and dynamics (Red24, 2013b:7). However, it too comes with complications. Cartels respond by engaging in violent clashes with the security forces, and as cartels attempt to protect their revenue sources, they branch out their criminal activities. Between 2006 and 2012, more than 60,000 people died in drug-related violence (Norwegian Risk Consulting International, 2013). In March 2013 over 1000 homicides were related to drug-related violence (see Figure 11) (Conroy, 2013). Since coming into power in 2012, President Peña Nieto has attempted a different approach, one that aims at finding the root causes of crime and curbing these, rather than following previous attempts of using pure force to deter crime. Solving the root causes though is set to be a serious challenge and one that will not remedy the situation quickly. President Peña Nieto also wants to shift the focus of the international community towards Mexico's economic growth potential and its reforms and away from the violence. This, along with President Peña Nieto's aim of reducing overall violence in Mexico by 50% in 2013 will be a vast challenge (Norwegian Risk Consulting International, 2013).

Figure 1: Homicides Related to Organized Crime (January 2012-March 2013).



Note: President Peña Nieto took office on December 1, 2012.

Figure 11: Homicides Related to Organised Crime (Conroy, 2013)

The suppression of drug related activities has led cartels to diversifying and using other criminal activities to bring in revenue. These activities extend to kidnapping, prostitution, retail drug sales and human trafficking. Similar to Nigeria, Mexican drug cartels have also resorted to oil theft to gain revenue (Harrup & Luhnow, 2011). This expansion of the drug-cartels into other sectors presents a threat to public safety and security and as such, presents a political security risk to those TNOCs operating in the oil and gas industry in Mexico. The political risk comes with the lack of authority over organised crime (Personal interview 1, 7 August 2013).

4.4.2.2 Kidnapping and extortion

With resources focused on combatting the drug cartels and related violence, attention is taken away from other crimes. As such, there is a lack of effective security in many Mexican cities and kidnappings and murders have increased (Stratfor, 2013c). Smaller criminal groups have taken the opportunity to conduct lucrative kidnapping and extortion operations while the focus has been on drug trafficking (Control Risks, 2013:91).

Mexico was listed by Control Risks (2013:84) as the country with the second highest kidnapping rate in the world in 2012. Mexico had a reported 3000 kidnappings occur between January and September 2012 (Red24, 2013b:30). Mexico City, Nuevo Leon, Tamaulipas, Chiapas and Durango are the worst affected states. Businesses operating in these areas are often prone to extortion from the cartels. If businesses fail to comply with the cartels' wishes, small-scale bombs are used in order to intimidate them. In Mexico, there is no specific type of victim and a variety of types of kidnapping occur; kidnapping for ransom, express kidnappings which involve abducting the victim and then driving to ATMs to withdraw money from their accounts, as well as virtual kidnappings which involve the perpetrators falsely claiming to have kidnapped the victim to receive a ransom (Stratfor, 2013c). Kidnapping presents a risk to TNOCs operating in the oil and gas industry in Mexico as personnel may be kidnapped for ransom. In May 2010 five workers from Pemex were kidnapped and a further 30 disappeared from the Burgos Basin in Tamaulipas (Wilkinson, 2010). Drug cartel, Los Zetas, was implicated as the perpetrator. Their motive was unknown; however, events such as these force oil production to stop for a period of time, resulting in millions of dollars being lost in the process (Wilkinson, 2010). This risk will increase due the liberalisation of the energy sector and the influx of TNOCs into Mexican oil and gas regions. Drug-related activities are likely to be at the core, or smaller gangs identifying an opportunity to access money.

4.4.2.3 Energy reform

President Peña Nieto has deemed essential reforms a priority for Mexico. These reforms relate to various spheres such as education and tax. Energy reform was one of the main points used by Peña Nieto in his 2012 Presidential campaign. Energy reforms look to liberalising the electricity sector, as well as restructuring the oil and gas industry and opening it up to foreign investment. Such foreign involvement is a key alliance to progress in an emerging market (Personal interview 1, 7 August 2013). Mexico has many unexplored oil regions and many areas in the Gulf of Mexico have not yet been developed. This provides great opportunities to TNOCs wanting to invest. The energy reforms will increase competition and aim to improve market conditions in Mexico (Schtulmann, 2013). Reforms such as these would never have been thought possible ten years ago, but political transition after the past elections has paved the way for new and much needed reforms.

Mexico's energy sector is ailing. 40% of Mexico's gasoline is now imported and reforms in the oil and gas industry are necessary if Mexico does not want to become a net oil importer by as soon as 2018 (Norwegian Risk Consulting International, 2013). The Mexican oil sector was nationalised in 1938 and has been under the control and direction of Pemex for 75 years. Pemex has been the international face of energy self-sufficiency; however, it suffers from inefficiency and mismanagement. There is increasing oil instability and if reforms are not made, Pemex will lose its export power. Mexico potentially has vast amounts of oil reserves, but Pemex is in need of the expertise, funding and resources to discover these, which it does not have. As the Wilson Centre's Mexico Institute (in Thomson, 2013) points out, "the current system has shown itself to be unable to respond to changing circumstances, and has left us on the brink of a disastrous decline in oil production and reserves".

In October 2008 some oil sector reforms took place. This was the first step in trying to open the state-run oil and gas industry (*BBC News*, 2013a). These reforms allowed for foreign experts to sit on the Pemex administrative board, and looked towards bettering technology and long term strategies in order to help the oil sector become more efficient. The reforms also looked to the CNH with the goal of making it more independent and effective so more efficient regulation of the industry could occur. Along with this a few incentive-based contracts were awarded. For example, 20 blocks in the Tabasco State were tendered to international bidders in March 2011 (EIA, 2012b:3). These tenders did not give ownership of the land to the foreign companies; however, Mexico gained some needed technological enhancement. The major TNOCs now want more lucrative contracts opened to them in the Gulf of Mexico (EIA, 2012b:3). Serious reforms and changes have, up until recently been

continuously blocked by parliament, but some are vital to the growth and strength of the industry.

President Peña Nieto has described the current reforms as being transformational and aim to maximise oil revenue and make the energy sector more efficient (Oprita, 2013). Reforming the oil and gas sector will improve the long-term growth potential of the industry as well as improve business competition (Thomson, 2013). The reforms will also bring about a fiscal change as they will diminish the government's dependence on Pemex. Reforms will also look to widen the tax base by moving tax reliance away from the oil and gas sector which presently contributes one-third of the federal budget (Norwegian Risk Consulting International, 2013). While the reforms will allow foreign private investment, Pemex will not be privatised and there will be no private oil concessions. Energy reforms will allow Pemex to retain more of its revenues and while the state will maintain ownership of the oil reserves, the TNOCs will be able to share in the profits (Norwegian Risk Consulting International, 2013). Perhaps the biggest change and most drastic step for Mexico in terms of reforms will be the altering of certain sections of its constitution. Presently the constitution states that exploration and extraction of oil in Mexico can only be conducted by Pemex (Thomson, 2013). Sections 25, 27 and 28 of the Mexican constitution which relate to the structure of the oil and gas sector, will be rewritten to allow private investment. This constitutional change will provide TNOCs with legal certainty and clarity (Kerner & Hernandez, 2013).

The conservative party PAN is likely to support the leading PRI, and the necessary two-thirds majority to secure the reforms approval will be gained. However, significant opposition will come from the left, as it is highly likely that the PRD will oppose these reforms, especially those relating to the changes in the constitution. According to Sctulmann (Personal interview 1, 7 August 2013), this opposition from the PRD is a significant current political risk. Thus far the PRD have not shown support and will likely try to mobilise popular resistance against the reforms (Kerner & Hernandez, 2013). Along with this, it has been suggested that reforms are worthy if they can be transformative; however, establishment interests in Mexico may be too strong. After 75 years of state monopoly, it may take longer to hand over power to TNOCs. The PRI is known to have strong ties with certain sectors and is said to be "entangled with the country's largest vested interests" (Sctulmann, 2012). If the PRI is not willing to back away from these interests and their views, then reforms are likely to be weak. An example of such vested interests and their power is that of the labour unions. A proposed labour reform looked to increase transparency and accountability in the unions; however, this proposed measure has since been disregarded by the PRI (Sctulmann, 2012). Weak energy

reforms will only delay progress and economic growth, in a country that still has many systemic problems.

4.4.2.4 Civil unrest

Civil unrest is apparent in Mexico. The socio-economic gap in Mexico continues to widen and 40% of the population live below poverty line (Rubio, 2011). According to Schtulmann (Personal interview 1, 7 August 2013), one of the biggest political risks in Mexico at present is the growing disassociation between the average political citizen and the government. Protests will increase as the government is not able to offer the lower and middle income groups what they want. Social movements are one avenue where this dissatisfaction has found a voice (Personal interview 1, 7 August 2013), and there are growing dissident movements in Mexico. One such example is #YoSoy132, which is a radical youth movement. It aims to democratise Mexico focussing on the media. YoSoy132 have protested against electoral fraud and claim the media was favourably biased in its reporting of Peña Nieto during the 2012 election campaign. They also look towards generally challenging the traditional elite class system (Khan, 2013). The government will have to find a delicate balance between tolerating the various groups' sentiments as well as not employing too much force, as this could further empower the groups and their violent behaviour.

There is growing dissent against the government along with mistrust of the PRI. At the inauguration of President Peña Nieto there were protests and riots. Protests occur regularly and these are held by groups seeking changes in government policy (US Embassy Mexico, 2013). An example of such civil unrest was a protest held by teachers in August 2013. Parliament at the time was discussing a controversial education bill. The bill, which was approved by Mexican lawmakers, seeks reform by making teachers take tests annually to ensure their performance is up to standard. If the test is failed, that teacher would lose their job (*BBC News*, 2013a). The education reform looks to improve the quality and standard of education in Mexico. Teachers protested outside parliament in Mexico City, throwing rocks and fire bombs in the hope of disrupting the parliamentary session. Protestors shouted, 'Out with Peña Nieto' and police were called in and used tear gas to disperse the crowds. Some protestors were arrested for attacking police officers (Khan, 2013).

The Presidency vowed not to turn back on its decisions; however, this did not please the people, and teachers remained in protest outside the National Palace. The protestors also blocked access to the airport. The aggressive nature of the protest led to the postponement of President Peña Nieto's State of the Nation address (*BBC News*, 2013a). The address was

given on the 2nd of September 2013 and the President provided a positive assessment of his administration so far. However, “the new president is dealing with chaotic protests in the capital, intractable levels of violence and a less favourable economic outlook than predicted” (Khan, 2013). A preschool teacher Anna Allida Vazquez stated, “first Peña Nieto goes after the teachers, next will be the country's oil and other valuable resources...The truth is he is going to sell our territory to foreigners and someone has to take a stand” (Khan, 2013). Such sentiment could have effects when foreign investment in the oil and gas industry does begin. TNOCs will have to guard their production sites as civil unrest could have a drastic effect.

Furthermore, the population's frustration is growing with the continued drug-related violence as innocent civilians are put in danger. Drug-related violence is also leading to civil unrest. In some states police are incapable or reluctant to protect residents from the drug cartels and gangs. This has led to a growing movement of citizens taking up arms to protect themselves (Khan, 2013). This presents an aspect to consider for new TNOCs entering Mexico when reforms are signed in. Similar to the Niger Delta in Nigeria, local communities may disapprove of foreign entry and protests could occur. These stem from fundamental problems that find an outlet in protests against oil companies.

4.4.2.5 Political instability

Mexico is witnessing political instability. Being a federal country, Mexico lacks a strong central government (Rubio, 2011), and instability within the government is set to increase as protests grow against the proposed reforms. Political instability in Mexico has led to delayed decision making and weak cohesion within government. Furthermore, the government and President Peña Nieto have to deal with anti-PRI sentiment and fierce political opposition. While the PRI won 39% of the vote, 6.5% ahead of the closest rival, Obrador from the PRD, the PRI did not gain majority in congress. After the 2012 election, Obrador challenged the outcome and called for protests. This has led to tensions within government. Obrador is now forming a new political party, Movimiento Regeneracion Nacional (Morena). Morena as a party will be radically leftist and the introduction of a new political party will alter the political dynamic and lead to Mexico's political system being further fragmented (Schulmann, 2012:2). PRD members have already joined Obrador, which gives the new party further sway. Such leftist values may have great success with the young voters and the party's dynamism will appeal to the youth movements. The PRD, which until now has been seen as the face of the political left is going to have to review its values. It may move towards the centre; however, this could cost the party valuable votes (Schulmann, 2012:2).

Political instability is also impacted by the drug cartels. The government is waging a war with the cartels and is struggling to contain drug-related violence (Control Risks, 2013:5). As such, the government's credibility has become a casualty of the drug war and the struggle against the cartels has left the judiciary and the law enforcement agencies severely strained. Regarding the oil and gas industry, the drug cartels activities towards the industry are paralysing oil production, and as Pemex is the government's largest income earner, this has an effect of government and its revenue. The government's reliance on oil revenue is also vulnerable to changes in the oil price. Changes in the price of oil along with continued oil theft and pipeline damage will decrease the government's revenue, which will further delay development and progress in Mexico. The country is still dealing with severe poverty and a widening socio-economic gap. With the remaining proposed reforms set to be signed in at the end of 2013, an economist in Mexico City, Luis de la Calle succinctly puts it, "this government has the best chance in years to make progress, now they are going to have to start governing" (in Thomson, 2013).

4.4.3 Conclusion

It is a potentially exciting and prosperous time for TNOCs, as Mexico is undergoing structural changes which herald the dawn of allowing foreign investment in its oil and gas industry. There are political risks however that TNOCs should be aware of. The essential political risks which have been presented are: drug-related violence and organised crime, kidnapping and extortion, civil unrest, energy reform, and political instability. Drug related violence presents a vast challenge to Mexico and its government. Many criminal activities stem from this risk, one being kidnapping and extortion which remains extremely high. Civil unrest will increase as dissatisfaction with the government and its reforms continues. However, energy reform has been a necessary step for Mexico to take and presently it is an interesting time for foreign investors looking towards investing in the Mexican oil and gas industry. Political instability is due mostly to political competition and is affected by drug-related activities. These political risks affect Mexico on a macro scale but also affect the oil and gas industry on the micro level.

4.5 Essential Political Risk Factors for the oil and gas industry in emerging markets

4.5.1 Introduction

When considering emerging markets and their behaviour, certain political risks need to be considered. These risks differ to those of developed markets. The oil and gas industry holds differing political risks to other industries. It therefore becomes important to consider those political risks before investing in an oil and gas industry in an emerging market. By looking at Nigeria's and Mexico's oil and gas industries and using these two countries as case examples of emerging markets, one is able to determine those political risk factors which cannot be ignored by TNOCs wanting to invest in the oil and gas industries in emerging markets. The political risk factor selection process was stated earlier in this chapter²³. As can be noted from table one, six generic risk factors were selected. This study does not propose that these six factors are the only elements to be analysed when looking at investment in the oil and gas industry in emerging markets; however, they have emerged as essential generic risk factors.

According to Schtulmann (Personal interview 1, 7 August 2013), everything stems from politics, including economic policies. Thus, for investors wanting to make financial investments, considering political risk is vitally important, especially in an emerging market where politics matters just as much as economics does. To see the potential of an investment and its economic viability, it is vital to look at the political situation.

Table 1: Generic Political Risk Factors for the oil and gas industry in emerging markets
<i>1. Government Reform affecting the energy sector</i>
<i>2. Political instability</i>
<i>3. Kidnapping</i>
<i>4. Internal violence</i>
<i>5. Civil unrest</i>
<i>6. Corruption</i>

²³ Refer to 4.2 Selection process of essential political risk factors

4.5.2.1 Government Reform affecting the energy sector

Government reform affecting the energy sector is an essential political risk to consider when looking at investing in emerging markets. According to Schtulmann (Personal interview 1, 7 August 2013), while reforms in developed markets occur on a micro level, reforms in emerging markets occur on a macro scale and their impact is greater as they deal with more fundamental issues, and the political and economic spheres are interlinked. A feature of emerging markets is the fact that their political institutions are still transforming (Personal interview 1, 7 August 2013).

Government reforms can take many forms, for example host governments could enforce stricter labour regulations or apply punitive taxation. Further government reforms could relate to the changing of the legal framework of a country, such as statutory legal changes which impact the security of tenure for a TNOC. Reforms present a challenge as they may bring about changes in investor confidence and therefore a delicate balance needs to be struck. Government reform should aim at gaining popular approval as any changes in government policy or mention of reforms, especially regarding a country's resources tend to ignite a nationalist sentiment, which increases political risk and can affect the legitimacy of the regime (Brink, 2009: 84). Mining and petroleum operations "tend to be the most sensitive of all international corporate activities because the resources involved are a country's national patrimony" (Alon *et al.*, 2006:631).

4.5.2.2 Political Instability

Political instability has to do with government and their practices. Government stability is a measure of both the governments "ability to carry out its declared policies, as well as its ability to retain office" (Brink, 2004:84). Issues such as changes in government, an authoritative administration and a lack of legitimacy, transparency and accountability all lead to political instability which makes the government ineffective and the state weak. Instability breeds a lack of law and order, poor governance, delayed decision making and growing discontent (Bremmer & Keat, 2009:283n.17). In the build-up to elections, instability can increase due to opposition tensions, fragmentation within the parties and election intimidation and violence as governments use undemocratic measures to retain power. Instability presents a political risk, as rather than an environment and situation where the country is resilient to shocks and responsive to challenges which investors want; investors are met with the opposite.

4.5.2.3 Kidnapping

Kidnapping is a lucrative and established criminal enterprise which presents a threat to business operations (*BBC News Africa*, 2012). Emerging markets are prone to this criminal activity, with the most susceptible to kidnapping being “those countries destabilised by conflict or where increases in foreign investment have not been supported by an enhanced security infrastructure” (Control Risks, 2013:83). While kidnapping takes on various forms such as express and virtual kidnapping, kidnapping for ransom is a political risk for TNOCs operating in the oil and gas industry in emerging markets. This offers an additional form of income for criminal groups, or can be seen as a form of protest against foreign firms operating in the oil and gas industry. Kidnapping for ransom is prolific in emerging markets, as seen in the cases of Nigeria and Mexico. Foreign companies are targets as companies are willing and able to pay the high ransom demand in order to ensure the safe return of their personnel. Kidnapping affects a TNOC negatively, as the effects of kidnappings include; business interruption, adverse publicity and financial losses (Stratfor, 2013c).

4.5.2.4 Internal Violence

Internal violence occurs due to varying reasons. Tensions caused by religious, social or ethnic divisions are some such causes. These tensions find an outlet in protest, vandalism, conflict and armed insurrection, and often have a political objective as people grow dissatisfied and their societal tensions grow due to the ineffectiveness of the government. Internal violence can be sporadic or sustained and in some cases can lead to a civil war, revolution or a coup d'état occurring.

Internal violence can be resource driven. Well-organised movements materialise in the form of rebel groups or terrorist organisations as seen by the rise of Islamist militancy in the north of Nigeria or the activities of MEND in the south of Nigeria. Such terrorist activities and violence present a threat to TNOCs operating in the oil and gas industry in emerging markets. Internal violence has the ability to disrupt production, damage property and in some instances, even lead to the operations being stopped.

4.5.2.5 Civil Unrest

Civil unrest occurs when the population becomes dissatisfied with their current situation and seeks change. This unrest is most often a symptom of socio-political problems and a growing discontent with the government as it fails to be responsive (Brink, 2004:85). This may be due to economic or social inequality, government suppression, injustice, slow economic growth, unemployment, or a lack of provision of basic public services such as healthcare (Brink,

2004:113). This dissatisfaction finds an outlet in civil unrest which can take the form of protests, occupations, sabotage and riots which lead to general disturbance. Civil unrest often begins with little or no warning and can present a political risk to TNOCs and their operations if the violence or popular protests extend to the TNOC's location. Access to public areas may be halted, there may be destruction of infrastructure, and travel may become disrupted along with public services (US Embassy Mexico, 2013).

4.5.2.6 Corruption

Corruption occurs on various levels and affects various sectors and parties. Corruption as a political risk factor includes extortion, high and low level corruption and excessive patronage (Lambrechts *et al.*, 2010:119). Corruption has a cumulative effect, for instance, petty corruption can grow to such an extreme that the government becomes ineffective in dealing with other problems and fails to provide basic services to the population (Bremmer & Keat, 2009:20). An unstable environment caused by corruption leaves officials vulnerable to threats, a weak judiciary and greater intimidation, On a macro scale, corruption leads to a misuse of public resources and effects government as people gain power and prestige through patronage rather than ability (Brink, 2004:86). On a micro scale when looking at TNOC investment in the oil and gas industry, corruption can increase the cost of doing business in a country. With regards to TNOCs, corruption appears in the form of bribes, special payments, police protection, loans, and exchange controls (Brink, 2004:86). If a TNOC decides to partake in corrupt activities, possible corruption scandals could severely damage their reputation. The way companies go about conducting their business operations is increasingly being scrutinised and regulated. Companies need to guard their reputation and maintain a high ethical standard (Control Risks, 2013:9).

4.6 Risk Mitigation in the oil and gas industry

Political risk mitigation is the final step in political risk analysis and completes the political risk picture. As discussed in chapter two²⁴, risk management according to Brink (2004:149) refers to, “the sum of the actions foreign investors or MNCs take to try and keep at an acceptable level the degree or measure of investment risk associated with their activities”. As such, risk mitigation can be seen as a part of risk management. Mitigation is a vital step in political risk analysis. If risk is high it does not necessarily mean that foreign companies should not invest. Political risk can in some instances be sufficiently managed and can subsequently lead to increased opportunities (Alon *et al.*, 2006:624; Brink, 2004:156).

²⁴ Refer to 2.3.6. Risk management and mitigation

According to Control risks (2013:10), “companies that align risk management with business development will remain at the forefront of integrity risk management”.

Investments made in the oil and gas industry reach billions of dollars, and such a large sum of capital means that risk mitigation is of paramount importance in order for a TNO’s assets, property, personnel and profit to be protected (Hough, 2008:5). As specific industries and firms face differing political risks, mitigation will also differ depending on the industry and the specific firm. The political risk mitigation strategy should therefore be tailored to suit the individual TNO and a combination of risk mitigation techniques should be pursued (Lax, 1983:177).

Protective and integrative mitigation techniques were introduced in chapter two. Protective techniques aim at decreasing the severity of losses, while integrative techniques aim at bettering relations in the host country, and by doing so aim at reducing the occurrence of losses (Brink, 2004:156). Protective techniques such as, retaining full ownership and subcontracting aim at stopping host country interference or making sure steps are in place should such interference occur. Integrative techniques will look towards forming a stronger relationship between the TNO and the host country. This can be done through local employment, creating close ties with the government and ensuring expatriate TNO managers are made culturally aware. Both techniques have downfalls; if too protective the government may see the TNO as hostile and want to interfere, and if too integrative, it can harm a TNO’s ability to compete efficiently (Brink, 2004:156). A combination of both techniques is superlative as a TNO can maintain their competitive strong points while also grasping new opportunities and maintaining an effective relationship with the host government.

Berlin *et al.* (2003) state the importance of political risk insurance. *De facto* insurance looks to the prevention of and protection from political risk. This may include entering into a JV with the host government or a local company, or hiring personnel from the local workforce. This correlates with the integrative techniques discussed by Brink (2004). Actual risk insurance assures that compensation will be received in the event of loss occurring. This insurance offers coverage for, to name a few; expropriation, war, trade disruption, and breach of contract. This insurance can be taken out with either a private company or through multilateral government programs such as the Multilateral Investment Guarantee Agency (MIGA) which is part of the World Bank, or the United States Overseas Private Investment Corporation (OPIC) (Berlin *et al.*, 2003:4). It is best if these two types of insurance are used

together as they complement one another. A final note to consider regarding actual political risk insurance is that it will become void if a TNOC engages in unethical activities such as environmental contamination, corruption or bribery (Berlin *et al.*, 2003:8).

Further mitigation strategies according to the World Risk review (2013) include; firstly, going into JVs and maintaining equitable sharing of rewards as governmental participation and trust will help avoid expropriation threats. Here the importance of legal clarity is important. A senior oil executive from ExxonMobil remarked on the importance of ensuring that the contract that the host government originally signed with the TNOC is maintained, as well as making sure that the contract holds a stability clause (Personal interview 2, 16 August 2013). Secondly, there should be increased engagement with non-governmental stakeholders. These stakeholders have a better knowledge of the local surroundings, the community and their customs which will aid the TNOC in being accepted and hence will increase stability. Thirdly, a TNOC should look to building relationships with multilaterals such as the World Bank. They will be of help and service regarding legal clarity along with dispute resolution and arbitration provisions, should such a need arise. Fourthly, lobbyists can be employed who can aid TNOCs and ensure important decisions work in their favour, as well as show the host government the benefits they will receive if they deal with the TNOC (Wood, 2009:2). Further actions include; improving on-site security, maintaining a sound reputation, and using local suppliers.

Mitigating micro political risk that is specific to the oil and gas industry in an emerging market is of paramount importance; however, a TNOC must not fail to consider and keep track of general political risks (Alon *et al.*, 2006:639). Country-wide political risks are macro in scale such as the outbreak of a civil war. A TNOC has little control over country-wide political risks and hence these are harder to mitigate (Berlin *et al.*, 2003:3). A senior oil executive from ExxonMobil remarked that the most suitable action is to track current events carefully and to keep in contact with the army and government officials. A further successful mitigation strategy for ExxonMobil has been avoidance. Such avoidance is reached by keeping production off-shore (Personal interview 2, 16 August 2013). With regards to both industry-specific political risk as well as macro political risk, it is imperative to understand that risk is continuously changing and never remains static in a country. Political risk mitigation therefore will have to be adjusted, reformed and improved as the political risks that a TNOC faces change (Brink, 2004:30).

4.7 Conclusion

Emerging markets provide an interesting outlook for growth and opportunity (Personal interview 1, 7 August 2013). However, many oil-rich states have volatile environments and this makes political risk analysis an invaluable tool when investing. This chapter offered a reflection on the essential political risks which need to be considered by TNOCs when looking at investment in the oil and gas industry in emerging markets. A comprehensive factor selection process was carried out. Thereafter Nigeria and Mexico were discussed and the political risk factors found in these case studies form the foundation for a generic risk index, which can serve as a basis for examining similar situations faced by TNOCs operating in the oil and gas industry in emerging markets in other parts of the world. A TNOCs' exposure to such political risks in emerging markets will depend on the TNOCs resources and capabilities (Frynas & Mellahi, 2003:548). Lastly this chapter provided a brief discussion on risk mitigation, which is the vital final step in a political risk analysis.

Chapter five will conclude the study with an overview of the research study, looking at the progression of the study, followed by an evaluation of the research study in the context of the research question along with the aims and objectives of the study. The chapter will also look at recommendations for future research in the field of political risk.

CHAPTER FIVE – EVALUATION AND CONCLUSION

5.1 Introduction

This research study began with the point raised by the Eurasia Group that emerging market risk differs to that of developed market risk, and that risk in some instances can be unbounded. Subsequently emerging markets were deemed a top risk for 2013. In emerging markets, “politics matters at least as much as economics to market outcomes” (Eurasia Group, 2013b). As such when looking at a country’s economy, the potential for success and the possibility of investment, it becomes vitally important and necessary to look at the political situation. Globalisation has led to a changing global environment, one where emerging markets hold more influence in international affairs. Foreign investment in these emerging markets has been increasing, due in part to the fact that “investments in emerging markets and developing markets generally provide higher rates of return than investments in developed states” (Bremmer & Keat, 2009:131). However, as the world is experiencing an increasingly unstable global environment, one which has brought with it new and uncharted challenges (Control Risks, 2013:9), the need for industry-specific political risk analysis in emerging markets is ever present.

The objective of the research study was to discover the essential generic political risk factors that are present in the oil and gas industry in emerging markets, and therefore assist investors with risk identification, analysis and mitigation. Such objectives enable TNOCs to think about investment in the oil and gas industry in emerging markets in a clearer manner and by doing so, TNOCs will protect their assets and interests. Nigeria and Mexico proved to be relevant case studies of emerging markets that have notable oil and gas industries. This last chapter brings the research study to its conclusion by firstly giving a brief summation of the research study by looking at a progression of the study and what each chapter involved. Next an evaluation will be offered in light of the research questions, the objectives and the relevance of the research study. Thereafter recommendations for future research will be provided and lastly, a general conclusion to the research study will be given.

5.2 Progression of the Research Study

Chapter one offered a background to the research study. A brief literature review was provided which introduced the areas which the research study touched on; political risk, emerging markets, the oil and gas industry, and the case studies of Nigeria and Mexico. A discussion then followed in which the research problem was formulated and defined. The research design and methodology were then outlined, the limitations and delimitations

delineated and lastly, a chapter outline was provided, showing how the remainder of the research study would be structured.

Chapter two had a dual aim as it provided not only the theoretical underpinning but also the necessary conceptualisations of the core terminology. The theoretical foundation to the research study was based on problem solving theory and rational choice theory. This provided this research study with a solid framework, which enabled a clearly defined point of departure for the remainder of the research study. Furthermore chapter two provided clarity as the core terminology and aspects of political risk relevant to the study were conceptualised. This enabled a concise definition of political risk to be arrived at. Furthermore, the chapter provided conceptualisations of emerging markets and the oil and gas industry.

Chapter three offered a comparative contextualisation between Nigeria and Mexico. The case studies proved valuable, and suitable for analysis. Both countries are part of the N-11²⁵ and are considered by O'Neill (2011) to have young and expanding populations, strong market growth, positive economic performance, and immense financial opportunities. Both emerging markets also have globally recognised and notable oil and gas industries. Oil forms the fiscal basis on their economies and provides the majority of government revenue. For Nigeria, oil accounts for 70%, while in Mexico oil accounts for 34% of government revenue (IMF, 2013). The comparative contextualisation between Nigeria and Mexico enabled one to gain a deeper understanding of not only the countries overall, but also their oil and gas industries, as well as emerging market behaviour overall. Chapter three provided an apt foundation from which to move towards discovering the main political risk factors that were discussed in chapter four.

Chapter four highlighted, through a careful factor selection process, the essential generic political risk factors that are present in the oil and gas industry in emerging markets. This chapter provided an outlet through which reflection on political risk could occur. Firstly the political risks apparent in the oil and gas industries in Nigeria and Mexico were highlighted. For Nigeria these political risk factors were: government reforms, civil war, political instability, social tensions, corruption and kidnapping. For Mexico these political risk factors were: drug related violence, kidnapping and extortion, energy reform, civil unrest and political instability. By using Nigeria and Mexico as case studies of emerging markets and discussing the salient political risks they display, a generic list of the essential political risks that affect the oil and gas industry in emerging markets was determined. These six political

²⁵ Refer to 1.4. Objectives and relevance of the research study

risks are those that investors should be aware of when looking to invest in the oil and gas industry in emerging markets and they are: government reform affecting the energy sector, political instability, kidnapping, internal violence, civil unrest and corruption. Lastly political risk mitigation was briefly looked at and discussed. This is the vital final step in political risk analysis and discussing mitigation allowed for a more comprehensive research study.

5.3 Evaluation of the Research Study

The purpose of this research study was to look at political risk in emerging markets and to compile a generic list of risk factors. Emerging markets served as the principal concept which drove the generic list. As a sub-category the case studies of Nigeria and Mexico were utilised to complete the list of generic risk factors, within the context of the oil and gas industry. Being aware of these essential generic political risk factors will better enable TNOCs to think about investment in the oil and gas industry in emerging markets, in a clearer manner. Furthermore this study will aid investors with risk identification, analysis and mitigation. Nigeria and Mexico as emerging markets worked well as the chosen case studies and proved to be successful for this research study. Nigeria has a prominent oil and gas industry and has demonstrated its emerging market power. Mexico is of current relevance owing to the energy reforms that are due to be passed by the end of 2013. Mexico's oil and gas industry has been state-run since 1938 and the current reform looks toward liberalising the sector and allowing greater foreign involvement and as such, provides great scope for investment.

The central research question was; *'What are the main political risks facing investors who want to participate in the oil and gas industry in emerging markets?'* This was achieved through the aid of the sub-questions; *'What are the main political risk factors for TNOCs operating in the Niger Delta'* and *'what are the main political risk factors for TNOCs operating in the Gulf of Mexico?'* These sub-questions were answered by gaining information regarding political risks in Nigeria and Mexico and seeing how they applied on three levels: the emerging market level, the national level and more specifically, the oil and gas industry. Once the main political risk factors for both Nigeria and Mexico had been determined and discussed, a generic list for emerging markets could be established by seeing which political risk factors correlated between the two case studies and their lists of political risk factors. Determining the main political risk factors came from a careful factor selection process²⁶ through the use of reputable sources and risk reports. A variety of steps were taken to ensure

²⁶ Refer to 4.2 Selection process of essential political risk factors

that the essential factors were found and highlighted²⁷. The generic list provides investors with the most salient political risks facing an oil and gas industry in an emerging market. The third research question, *'How can political risk in the oil and gas industry be mitigated?'* provided a more complete picture of political risk as it dealt with the last aspect of political risk analysis and the final step investors need to look at. This was answered through consulting highly-regarded literature on risk mitigation.

The use of secondary data proved sufficient for answering the research questions. However, the addition of some primary data gained from Skype interviews with the President of Empira regarding Mexico, as well as a senior oil executive from ExxonMobil regarding Nigeria was extremely beneficial to the study. The information gained provided deeper insight into the case studies and industry-specific political risk in the oil and gas industry. The use of primary data improved the quality of the research as it supplemented and supported the secondary data. The empirical and inductive nature of the research study proved effective as it allowed ideas to be formed and changed as the study progressed and evolved. This allowed for a process of continued learning.

The research study succeeded in being exploratory as it determined the main political risk factors that need to be measured when wanting to invest in the oil and gas industry in emerging markets. It was descriptive in the way that the research study created a picture of political risk in emerging markets, the essential political risk factors, as well as the situation in the oil and gas industries in Nigeria and Mexico. It was also explanatory as looked at the links between political risk and emerging markets, specifically by using the cases of Nigeria and Mexico as emerging markets and focussing on industry-specific risk in the oil and gas industry. The research study has contributed to existing literature and will assist investors in the way they go about investment in the oil and gas industry in emerging markets.

This evaluation will now turn to look at the limitations and delimitations of the research study, and aspects that could have been improved. Firstly, political risk is a complex and wide-ranging discipline with various definitions. This was overcome by arriving at an informed conceptualisation of political risk after analysing a wide range of definitions. This created a strong framework from which to work from. Political risk can be highly subjective. Deeming the generic political risk factors from a range of data was a subjective exercise; however, the study did not suggest that the six factors were the only elements that need to be investigated when looking at investment in the oil and gas industry in emerging markets.

²⁷ Refer to figure 5 – Process of political risk factor selection

However, they are important generic risk factors. Furthermore, there was no use of field research. However, the use of reliable data and the input from expert primary sources aided this exercise and enhanced the research. Further use of primary data would have led to an even greater understanding of the intricacies of political risk in the oil and gas industry in emerging markets. Such a limitation reveals the need to combine reliable secondary sources with more expert analyses. Combining such information creates a more objective political risk assessment and provides one with a sufficiently deeper understanding of the challenges faced by TNOCs operating in the oil and gas industry in emerging markets.

Initially it appeared that the challenge would be finding enough suitable and relevant data regarding Mexico. Not only has the energy sector been state-run and owned since 1938, and thus finding public information would be hard, but the main language in Mexico is Spanish, hence much of the necessary literature would be in Spanish. This did not prove to be problematic as there was enough reliable and credible data available and the texts were predominantly English. The interview with the President of EMPRA too aided the gaining of resources as he emailed through additional data.

In summary, oil and gas are of strategic importance for a country. They supply the government with revenue and inspire nationalist sentiment. Furthermore, oil is a driver of the global economy, as “in literal and figurative senses, petroleum fuels the world economy” (Lax, 1983:85). Along with this is the current focus on emerging markets, their behaviour and their ‘unbounded’ risk. In emerging markets, politics and economics are extremely interlinked, making the interplay between emerging markets and political risk dynamic, especially in volatile industries such as the oil and gas industry. The above mentioned facts make this research study extremely current and relevant and show the need for industry-specific political risk analysis of emerging markets. Furthermore, the research study has provided TNOCs with realistic political risks and practical advice.

5.4 Recommendations for further research

This research study looked at industry-specific political risk in emerging markets and contributed to the wider discussion relating to political risk analysis. Focussing on the petroleum sector is of great relevance to the subject, especially as the demand for energy sources grows and the search for new hydro-carbon areas intensifies. Along with this, political risk analysis is an invaluable tool for an investor considering entering the oil and gas industry in an emerging market. Political risk is a dynamic and interdisciplinary field and new developments are continually appearing and informing the theory of political risk analysis.

“Political risk seamlessly bridges the boundaries between the academic and the practical, bringing political theories out of the realm of observation and examination, and into the real world. It is a field that has the ability to focus years of training in political theory, in a precise way, in a growing industry of political risk practitioners and analysts” (Boschoff, 2010:96). Political risk has a wide scope and combining various methods will aid the political risk discipline.

There are many avenues open for further research, as quality industry-specific research is lacking in areas of the political risk field, such as that concerning emerging markets and their behaviour. Research focusing on industry-specific political risk in emerging markets can be expanded on. The first recommendation relates to the type of research. The use of field research would enhance this research topic as more quality primary data could be gained. Furthermore, field research would form an integral part for research conducted on a PHD level. The opportunity to speak to and gather information from local communities, foreign personnel operating on the ground, politicians, the media, the police, NGOs in the area, along with TNO executives and political risk analysts would be of great significance and enhance the research study. Interviewing a diverse range of subjects would be insightful and show more clearly the inner workings of industry-specific political risk in emerging markets.

Furthermore, this research study only looked at the oil and gas industry in the context of emerging markets. The second recommendation is that additional case studies could be used, expanding the research to other continents. The nine other countries from the N-11 could provide further case studies of emerging markets. These are: Vietnam, South Korea, Iran, Pakistan, Bangladesh, Egypt, Indonesia, Philippines and Turkey. From this list, Iran, Vietnam, Indonesia and Pakistan have oil and gas industries. Related to this point is a third recommendation, that other industries in emerging markets could be looked at, thus forming more quality research on industry-specific political risk in emerging markets. Examples of further studies are: the electronics industry in South Korea, the agricultural industry in Vietnam, the apparel manufacturing industry in Pakistan, or the tourism industry in Indonesia. Micro risk analysis is under-researched and with political risk analysis being such a diverse and wide-ranging discipline, there is a need for more industry-specific quality research. By looking at other emerging markets as well as other industries in the same manner, a valuable contribution to the field would be made.

5.5 Conclusion

This research study has contributed to the greater discussion regarding political risk analysis, and has highlighted the need for further industry-specific studies, especially those in emerging markets. Due to globalisation, emerging markets have become more dominant and influential due to their dynamism and size. They too, have become more attractive to foreign investors. However, the political environment is continually changing and subsequently is changing the conditions under which TNOCs operate. This is especially apparent in the oil and gas industries in resource rich emerging markets. As the demand for energy sources continues to climb, government reforms continue to evolve, and there is increased competition worldwide, therein rests great potential and interesting business outlooks for foreign investors. However, while emerging market power continues to intensify and the opportunities they offer continue to grow, investment in emerging markets does come with its share of risk and this risk can be unbounded. In an increasingly volatile world, with greater uncertainty surrounding investments and potential returns, the need for political risk analysis is immense. Understanding industry-specific political risk in emerging markets allows TNOCs to enter uncertain and at times volatile environments and remain there; taking full advantage of the opportunities they offer.

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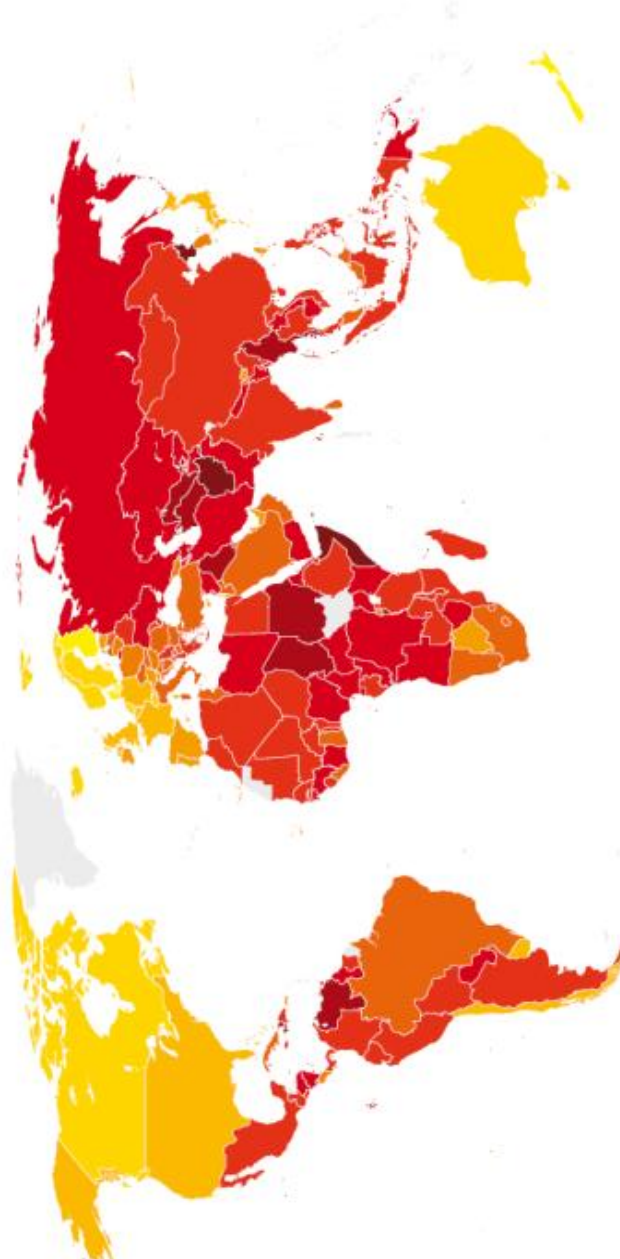
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APPENDIX A



176 COUNTRIES. 176 SCORES. HOW DOES YOUR COUNTRY MEASURE UP?

The perceived levels of public sector corruption in 176 countries/territories around the world.



RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE	RANK	COUNTRY/TERRITORY	SCORE
1	Denmark	90	22	Saint Lucia	71	113	Guatemala	53	167	Tajikistan	22
2	Finland	89	23	Austria	69	114	Niger	53	168	Democratic Republic of the Congo	21
3	New Zealand	89	24	Ireland	69	115	Timor-Leste	53	169	Laos	21
4	Sweden	88	25	Costa Rica	55	116	Dominican Republic	52	170	Libya	21
5	Singapore	87	26	Lithuania	54	117	Ecuador	52	171	Nepal	21
6	Sri Lanka	87	27	Rwanda	53	118	Egypt	52	172	Equatorial Guinea	20
7	Australia	85	28	Georgia	52	119	Indonesia	52	173	Zimbabwe	20
8	Norway	85	29	Cyprus	52	120	Madagascar	52	174	Chad	19
9	Canada	84	30	Belgium	51	121	Bolivia	51	175	Haiti	19
10	Netherlands	84	31	Czech Republic	49	122	Mauritania	51	176	Venezuela	19
11	Iceland	82	32	Malaysia	49	123	Mozambique	51	177	Burundi	19
12	Latvia	80	33	Turkey	49	124	Sierra Leone	51	178	Uzbekistan	17
13	Germany	80	34	China	49	125	Ukraine	51	179	Turkmenistan	17
14	Hong Kong	79	35	Cuba	48	126	Senegal	50	180	Iran	18
15	Barbados	76	36	Jordan	48	127	Guinea-Bissau	50	181	Myanmar	15
16	Belgium	75	37	Namibia	48	128	Guinea	50	182	Sudan	13
17	Japan	74	38	Oman	47	129	Uganda	50	183	Algeria	8
18	United Kingdom	74	39	Croatia	46	130	Kenya	50	184	Korea (North)	8
19	United States	73	40	Slovenia	46	131	Paraguay	50	185	Soviet Union	8
20	Chile	72	41	Cape Verde	46	132	Yemen	50	186	Angola	22
21	Uganda	72	42	Slovakia	46	133	Philippines	50	187	Cambodia	22
22	Bahamas	71	43	Ghana	45	134	Honduras	50	188		
			44	Kenya	44	135	Iran	50	189		
			43	Romania	44	136	Kazakhstan	50	190		
			42	Saudi Arabia	44	137	Ethiopia	50	191		
			41	Brazil	43	138	Kenya	50	192		
			40			139	Thailand	37	193	Russia	26
			39			140	Zambia	37	194	Azerbaijan	27
			38			141	Berm	36	195	Kyrgyzstan	24
			37			142	Colombia	36	196	Guinea	24
			36			143	Djibouti	36	197	Paraguay	24
			35			144	Ghana	36	198	Guinea	24
			34			145	India	36	199	Guinea	24
			33			146	Moldova	36	200	Guinea	24
			32			147	Mongolia	36	201	Guinea	24
			31			148	Senegal	36	202	Guinea	24
			30			149	Argentina	35	203	Guinea	24
			29			150	Gabon	35	204	Guinea	24
			28			151	Tanzania	35	205	Guinea	24
			27			152	Algeria	35	206	Guinea	24
			26			153	Kenya	35	207	Guinea	24
			25			154	Kenya	35	208	Guinea	24
			24			155	Kenya	35	209	Guinea	24
			23			156	Kenya	35	210	Guinea	24
			22			157	Kenya	35	211	Guinea	24
			21			158	Kenya	35	212	Guinea	24
			20			159	Kenya	35	213	Guinea	24
			19			160	Kenya	35	214	Guinea	24
			18			161	Kenya	35	215	Guinea	24
			17			162	Kenya	35	216	Guinea	24
			16			163	Kenya	35	217	Guinea	24
			15			164	Kenya	35	218	Guinea	24
			14			165	Kenya	35	219	Guinea	24
			13			166	Kenya	35	220	Guinea	24
			12			167	Kenya	35	221	Guinea	24
			11			168	Kenya	35	222	Guinea	24
			10			169	Kenya	35	223	Guinea	24
			9			170	Kenya	35	224	Guinea	24
			8			171	Kenya	35	225	Guinea	24
			7			172	Kenya	35	226	Guinea	24
			6			173	Kenya	35	227	Guinea	24
			5			174	Kenya	35	228	Guinea	24
			4			175	Kenya	35	229	Guinea	24
			3			176	Kenya	35	230	Guinea	24
			2			177	Kenya	35	231	Guinea	24
			1			178	Kenya	35	232	Guinea	24