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Iran nuclear row to lift Latin American, African prospects

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As the International Atomic Energy Agency (IAEA) Board voted Feb. 4 to refer Iran to the United Nations Security Council for pursuing a nuclear weapons program, a real possibility emerged that Iran may be sanctioned by the world community.

This standoff between Iran and the West has substantial and often ignored implications for the business climate facing oil and gas companies operating in Africa and Latin America. The crisis provides both opportunities and risks that companies must carefully consider as they prepare for the fallout from what promises to be drawn out negotiations and a game of "chicken" between a belligerent Iran and the West.

The contours of the crisis are well known. Three members of the European Union -- the UK, France, and Germany -- tacitly backed by the US, have been negotiating with Iran for almost 2 years to convince it to abandon what most believe is a clandestine nuclear weapons program.

In the past month, Iran broke off negotiations and vowed to restart work on uranium enrichment, ending the likelihood that a negotiated settlement will be reached, at least under the current framework.

The Western negotiators threatened to refer Iran's case from the IAEA to the UN Security Council. They executed on this threat by convincing Russia and China-two countries with substantial energy interests in Iran-that the geopolitical challenge presented by a nuclear Iran required that the Security Council become involved, even if the economic interests of Russia and China may be jeopardized by this approach.

No matter what the outcome of the diplomatic crisis, it will have several important repercussions for oil and gas companies:

•China, India, and other developing countries will invest more aggressively in African and Latin American energy assets.

•Nuclear energy may become an ever more tempting option for Europe.

•Latin American governments will gain new leverage over oil and gas firms.

Africa investment

As Iran becomes a political hot potato, the world of available oil and gas deals and acquisitions is shrinking for developing world oil giants (DWOGs), particularly China and India.

Following the US rejection last year of CNOOC Ltd.'s bid for Unocal Corp.-on what the Chinese perceived as political grounds-China and India have concluded that the only "safe" place to seek energy assets is in Africa and Latin America, particularly now that Iran's oil and gas exports could face sanctions.

Given Africa's greater proximity and African countries' more flexible position in allowing foreign ownership of resource assets, Chinese, Indian, and other DWOGs likely will substantially increase investment in Africa.

While Iran was not the linchpin of either China's or India's oil and gas strategy, it did present important opportunities. Sinopec, a unit of China Petrochemical Corp. and a DWOG, signed an agreement with Iran in 2004 for the development and purchase of oil and gas worth $70 billion. Similarly, India has been negotiating an oil pipeline through Iran and Pakistan that would become an important new source of energy for India.

Iran is a logical source of energy for the two Asian giants, independent of those specific deals, because it sits atop the world's second largest gas reserves and also has substantial oil deposits.

Iran's location, its desire for long-term energy deals to stimulate domestic energy development, and the inability of American majors to purchase its oil and gas because of a trade embargo have made Iran an accommodating partner for Chinese and Indian firms.

As the long-term security of supplies from Iran comes into question, however, both China and India will become more focused on investing in countries where access to resources will not be interrupted by geopolitical events.

This is not to say that Iran actually will face sanctions from the UN Security Council. China can veto these, and India can make its displeasure known. However, the Chinese likely will be reluctant to veto sanctions unless Russia does-a precarious position for Beijing, which is unlikely to entrust China's energy security to the benevolence of the Russian government.

Policy-makers in Beijing understand that Russia is playing a complicated game in the current crisis, where it wins whether sanctions are implemented or not. While negotiations proceed, Russia plays the world power and honest broker, achieving a level of influence in global affairs not seen since the fall of communism. In the end, however, if sanctions are the ultimate outcome, Russia still benefits, as a decreased oil and gas supply will play into

its hands as a major producer of both.

Given these complicated incentives, diversifying supplies through investments in accommodating African countries is a logical strategy for China, India, and other DWOGs.

Such an action, however, could hurt Western companies currently doing business in Africa.

If India, China, and other developing world oil giants (DWOGs) increase investments in African countries, it could have several negative repercussions for Western companies doing business in Africa:

§ Prices on African assets likely would soar as Chinese and Indian bidders stepped up efforts to ensure access to prime resources. As African countries auction exploration licenses and engage foreign companies in lucrative partnerships with national oil companies, Chinese and Indian companies would pay top dollar and absorb large risks to gain access to these resources. This could be problematic for Western firms also focused on Africa as a major area of growth.

  Particularly pronounced would be the push into Angola, Nigeria, Gabon, and Equatorial Guinea, where corruption and complicated deal structures give a bidding advantage to Chinese and Indian firms not bound by the US government's Foreign Corrupt Practices Act or similar restrictions.

  Countries such as Sudan and Congo (Brazzaville), which have problematic security situations or human rights records, could also see a spike in Chinese and Indian investment.

§ Western firms having a history of mismanaging large, complicated projects could be ousted as African governments accommodate new entrants.

  Western oil and gas firms that retain their access to African reserves would be those that provide a comparative advantage in extracting oil and generating revenues for host government treasuries. Western firms most likely to be pushed out are those that have had trouble managing mega-projects or that have had conflicts or difficulties working with national oil companies.

§ Smaller players could be squeezed out in the battle for access. As prime resources are divided among large Western firms and DWOGs, smaller players with less expertise advantage relative to Western supermajors and little operating and flexibility advantage relative to DWOGs would be the first companies ousted from their properties. These smaller players would need to develop coherent strategies for maintaining their properties and creating incentives for local authorities to retain their concessions.

Europe’s nuclear option

The Iranian crisis and the recent Russo-Ukrainian dispute over gas prices are likely to push Europe to reconsider nuclear energy as an important element of its energy security.

The conflict between Russia and Ukraine earlier this year highlighted for Europeans how much their gas supply is dependent on Russia-now perceived as a potentially unreliable partner.

As a result, Europeans have reopened a debate concerning the viability of nuclear energy as an alternative source of power for the continent.

The other alternative being considered is LNG, which could allow Europe to purchase its gas from a variety of global suppliers. But with the Iran crisis and a general instability in another of the world’s largest gas sources, Turkmenistan, Europeans have seen that even with LNG, supply security may never be achieved. Thus, under the assumption that energy independence is a worthy policy goal in the first place, nuclear power may be the most likely solution to this dilemma.

It is far from clear whether European voters will tolerate nuclear energy, however. The industry’s environmental and safety records are a major concern to many. Nevertheless, there are many plausible scenarios under which nuclear energy could become a politically viable alternative to the status quo.

One possibility, discussed often in European capitals over the past few weeks, is that the French will lead the push for nuclear energy, having made the investment in nuclear themselves over the past 2 decades. This approach would give France two advantages:

•The Chirac government could regain control over the European agenda and revive a lame duck presidency by making energy security a central issue that the EU must confront. In this, France may be supported by the Blair government in Britain and the Berlusconi government in Italy-should the latter survive spring elections. The Merkel government in Germany also would be open to considering the nuclear option.

•French firms, experienced in building and supporting nuclear reactors, would have a clear comparative advantage in providing others in the EU with similar installations, giving the country a small economic boost.

Profiting from nuclear

Currently the future of nuclear energy in Europe remains murky. However, oil and gas company management and executive boards can take several steps to protect themselves from possible changes in the European energy landscape that the advent of nuclear energy would initiate:

•Energy firms may consider investing in nuclear energy or at least preparing a set of

operational playbooks to guide them should nuclear energy become a viable European industry. By understanding what investments in nuclear power would entail, how that industry operates, and which acquisitions are most likely to create significant opportunities for growth, oil and gas firms can prepare themselves for what could be a relatively rapid shift toward nuclear energy. The experience of Australian mining giant BHP Billiton, which has invested in uranium, is a valuable case study in examining these issues profitably.

•Energy firms also must understand the likely impact a European focus on nuclear energy would have on the rest of the world. The industry must consider the possibility of an EU shift toward nuclear creating a wave of change across the globe, with a possible revival in the US as well as in the developing world. These scenarios would have wide-ranging implications for the entire oil and gas industry.

Latin American leverage

The crisis in Iran highlights yet again the unstable nature of the Middle East as a source for oil and gas. As multinational oil companies and governments consider alternatives, they will realize that Latin America may be a fairly attractive place to do business. Supply is not at risk from sanctions or war, and governments are nationalistic but not particularly strong.

Especially appealing will be those Latin American countries that provide predictable aboveground risk environments, even if these environments are not especially hospitable towards international oil and gas firms.

Leaders of these countries know that oil and gas markets likely will be tighter than ever and that concern about security of supply will dominates discussion. Under these new circumstances political leaders such as Bolivia’s Evo Morales understand that they will be able to extract far better terms than they would under more stable international conditions.

Even talk of nationalizing foreign assets-or at least revoking ownership of reserves, which Morales recently suggested Bolivia might do-may reduce oil and gas investment in Bolivia and nearby countries but will not eliminate it.

As long as companies believe that the new rules of the game adopted by Latin American governments are likely to remain in place for the next few years, the region will attract oil and gas investment in 2006 and beyond.

As assets in Africa become more expensive and governments more concerned about security of supply, Latin America, for all its flaws, will appear more attractive as a destination for investment.

The losers will be companies with substantial assets in countries such as Bolivia, Mexico, and Ecuador. Their push for property rights will be met with extreme resistance from governments in these regions.

The increase in oil and gas prices that could result from an escalation of tensions between

Iran and the West, along with the shrinking world of inexpensive oil and gas plays, is therefore likely to give governments in Latin American added leverage. How these governments use their new leverage will depend in large part on who comes to power in the many Latin American countries holding elections in 2006.

Market implications

That the crisis in Iran will directly affect oil and gas markets has been well understood from the beginning. What has received less attention is the impact of the crisis on the specific operating environments in the places where oil and gas companies do business.

The nuclear stand-off with Iran, whatever its ultimate outcome, will have important implications on the key oil markets of Africa and Latin America and may very well change the course of the debate about energy security in Europe. Companies seeking to invest or manage existing projects in these markets must understand the different possible outcomes of the Iran crisis and prepare themselves to take advantage of the opportunities the crisis provides.

This article is based on a Frontier Strategy Group client report on the Iran issue.

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