

ABOVEGROUND RISK

In today's international-risk environment, it is often aboveground risk that causes energy deals to turn upside down. Here's how to get, and use, better information.

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In 15 years of providing strategic advisory and intelligence services to companies operating in the energy space, from Sakhalin to West Africa to U.S. shale gas, we have seen just about everything: investments done right, and the aftermath of deals that have gone very wrong. Along the way, we have learned quite a bit about the importance of successfully managing risk—and the consequences of not doing so.

In many cases, particularly outside the U.S., the deciding factor between a deal's success or eventual failure is the up-front identification and management of non-spreadsheet risk—the kinds of red flags that do not show up in a standard market-entry strategy or accounting-based due diligence.

Non-spreadsheet risk, which some in the energy space refer to as “aboveground risk,” includes a variety of factors that companies may not automatically consider—corruption, bribery, adversary attacks, hidden business conflicts and agendas, counterparty reputation and political risk. Put simply, it involves accurate and specific information related to the country in which you plan to operate; your local partner; and entities that might have a negative or competing interest in your particular project.

While due-diligence teams and risk executives most often focus on deal economics and “below-ground,” technical issues, in today's international-risk environment, it is often this aboveground risk that causes deals to turn upside down.

The Enron example

During its heyday in the late 1990s, Enron was considered a pioneer in risk management. The energy giant leveraged unique, locally sourced intelligence to manage aboveground risk associated with its global trading operations better than almost anyone—except in one notable case. Enron spent 10 years attempting to develop a 2,184-megawatt gas-fired power plant in Dabhol, India. Priced just shy of \$3 billion, the project was the largest foreign direct investment vehicle in India's history.

Enron's handling of negotiations underpin-

ning the deal at the federal level was textbook, convincing India to slash tariffs on natural-gas imports while also brokering a deal with Qatar to provide the plant with 2.5 million tons of liquefied natural gas per year. However, Enron's vision did not extend to the state and local level. Insufficient efforts were made to identify or forge relationships with politicians or community leaders in Maharashtra state, where the plant was located. Little consideration was given to the negative impact local issues might have on the project.

Within months of starting construction, a groundswell of local opposition to the plant appeared with accusations that Enron had bribed government officials, stolen land from local farmers, and ruined water supplies. The ferocity of local protests attracted the attention of Human Rights Watch and Amnesty International, adding to the opposition against Enron.

With limited local relationships and no way to defend itself against these charges, Enron was caught flat-footed and put on the defensive. Compounding the seriousness of its local problem, Enron's due diligence also had missed that licensing and permitting for the power plant was driven at the state level, not in New Delhi. Enron spent the next six years trying to make up ground before being forced to sell the project, still only 95% complete, during its bankruptcy.

Risk defined

“Intelligence deals with all the things which should be known in advance of initiating a course of action.”

—*The 1955 Clark Task Force,
Hoover Commission on Intelligence*

Aboveground risk can best be understood as the unique non-economic factors that impact a transaction's likely success or failure. Current and future international locations for energy extraction are only amplifying these risk exposures. One need only look at today's headlines for the damages in costs and reputation from a

For companies involved in international energy development, information is key. The availability of this information, and the difficulty obtaining it, vary widely from region to region.

Information Opacity

	Personal Information	Company Information	Civil Court Records	Criminal Records
U.S. & Canada	Widely Available	Widely Available	Local Court only	Local Court Only
Mexico & Central America	Generally Available	Generally Available	Local Court Only	Human Services Only
South America	Generally Available	Local Court Only	Varies Widely By Region	Human Sources Only
East/Southeast Asia	Human Sources Only	Local Court Only	Human Sources Only	Human Sources Only
Europe	Human Sources Only	Widely Available	Local Court Only	Very Limited Availability
Former Soviet Union	Human Sources Only	Generally Available	Human Sources Only	Human Sources Only
Middle East	Human Sources Only	Generally Available	Very Limited Availability	Very Limited Availability
Africa	Varies Widely By Region	Local Court Only	Very Limited Availability	Very Limited Availability

Source: TD International

Foreign Corrupt Practices Act (FCPA) investigation. Beyond the FCPA, there are significant additional risks that energy companies operating internationally must identify and mitigate. Doing so in a meaningful way will force companies to ask some difficult questions.

Counterparty risk. Many international jurisdictions require foreign developers/investors to partner with in-country entities. Are these agents and potential partners who you thought they were? What is their record on corruption, criminal or civil litigation, or their overall business reputation? Will they embarrass or turn on you six months into the relationship? Choosing the wrong partner can have unforeseen ramifications through the life of the deal and beyond.

Capital sourcing. When partnering with another entity, are you familiar with the source of funding or existing capital already placed into an ongoing project? How confident are you that funds were not obtained illegally?

Political risk. Beyond general stability and the rule of law, companies must understand and manage additional risks, including various forms of “soft” expropriation, extortion, power struggles in the energy sector, and current and historical interests pertaining to your particular project/concession.

Adversary risk. In many international locations, the host government is often controlled or influenced by unseen power brokers, competitors or oligarchs who may harbor animosity towards your interests. These individuals may be able to apply unseen, but effective leverage to disrupt your project’s timing, funding, government approvals, etc. The impact of their interference can be to effectively de-value or expropriate your assets.

Security risk. Threats to assets, people and operations vary widely from country to country and can run the gamut from political instability/insurgency to labor issues to industrial espionage to retail and commercial theft.

In many locations, companies cannot rely on

their traditional business and social network connections or open-source information to understand the specific risks to their investments. Due to privacy laws or simply the lack of centralized or electronic recordkeeping, obtaining accurate and specific information overseas is difficult—but not impossible.

Country- or counterparty-based risk?

The U.S. energy market spends a great deal of time trying to understand risk based on a country-centric model: Norway is good, Nigeria is bad, and everyone else falls somewhere in between. This simplistic approach ignores the most important factor in managing above-ground risk—the human element. Particularly in the developing world, organizational behavior is driven by human decision making and motivation, usually involving a few key individuals.

You can get great insight into how a deal is likely to play out by identifying all of the counterparties to a particular deal; understanding how they have behaved in the past; and understanding their current objectives.

Because counterparties are usually local and by nature understand their environment better than a U.S. company ever will, knowing how these factors relate to your project is a key component of risk. Having a local partner whose goals align with yours and who is committed to project success will mitigate political and adversary risk.

For instance, in the previous example, if Enron had realized that a) two conservative nationalist parties had swept local elections as they negotiated the Dabhol plant, and b) the federal government had decentralized licensing authority to the local level, how might Enron have approached local public relations differently and how might this have impacted the outcome?

On the other hand, realizing at the outset that a local oligarch is competing for control of the

same asset as you and that he will use every means at his disposal to block your interest places a considerable risk premium that might otherwise not have been considered.

Managing risk

“All the business of life is to endeavor to find out what you don’t know by what you do.”

—Arthur Wellesley, *Duke of Wellington (1852)*

The objective is to learn to identify and mitigate risk, since it cannot be avoided entirely. Aboveground risk can be managed through a focused, eyes-open approach to market entry and penetration; progressive vetting of prospective partners and deals; and perhaps most importantly, the requirement that an acceptable standard of business transparency—even if it is not quite the U.S. standard—can and will be achieved.

Understanding how to achieve these goals is critical. Start with the theory that most companies grow and succeed by maximizing three classic inputs: people, capital and technology.

However, there is a fourth input that is just as essential, but often is misunderstood and underutilized—information.

You could fill textbooks with case studies of bad business decisions that were made based on inaccurate or simply not enough information. If your strategy is based on superficial information—open-source information, databases, trade publications, assumptions and rumors—are you really differentiating yourself from your competition or protecting yourself from local risks? What may have worked well in Louisiana and Texas does not apply to opaque and complex operating environments like West Africa or the former Soviet Union.

U.S. companies operating overseas often make the critical mistake of underestimating what is “knowable.” There is a small amount of information that is genuinely out of reach—trade secrets, insider information, government intelligence and facts known to only one or two people. But even in the developing world, most of the information required to make a business decision can be known in advance, leveling the difference between overseas-risk environments and the U.S.

Obtaining, analyzing and using accurate, targeted and differentiated information can not only help your company understand and manage these environments, but can also provide a distinct advantage over your competition.

How do you improve your ability to obtain and use better information in your business decision process? Begin by delineating between “data” and “intelligence.”

Most deal teams collect reams of data associated with a potential project. This is the “fire-hose” approach—a data dump without much focus on accuracy or differentiation of information. While some of the data collected is worth-

while, the sheer volume makes analysis difficult and impedes decision making.

Intelligence is targeted and analyzed information specific to the country, counterparty or project. It is information that is obtained from accurate, reliable and often proprietary sources—local records, subject-matter experts and even direct conversations with counterparties and officials. Gathered and used effectively, intelligence achieves the transparency needed to understand and manage aboveground risks. Distinct from the fire-hose approach, the goal is not to provide vast amounts of data. In analysis and decision making, the mind easily becomes overloaded: more information is not better. Better information is the goal.

Case study

An E&P company operating in West Africa was told by the local government that its contract was no longer valid due to “improper negotiations” during the signing. The government had warned it would seize and sell all assets if this contract could not be successfully reviewed and renegotiated. The company realized it could be facing hundreds of millions in losses associated with its purchase and development costs as well as potential lost future revenues from production. But it also believed “renegotiation” by the host government included certain provisions and demands that would violate FCPA and other international bribery statutes.

To confront this issue, we assisted the E&P in establishing an in-country intelligence gathering and monitoring capability, allowing the company to understand the government’s true intentions and the individuals behind the negotiations. Using this network and understanding of the real issues, the company developed a three-point approach:

- Garner the support and leverage of international government and non-government entities with influence inside the host country.
- Establish and implement a favorable public-affairs program based upon the insight developed from the monitoring program.
- Develop negotiation points that the company could live with but on which it could “give in” to the host country without violating bribery statutes, allowing the government to save face.

The intelligence-collection platform allowed the company to implement this strategy and successfully renegotiate the contract, thus avoiding significant losses to its bottom line and reputation.

A risk-management model

Applying this background to your current business practices, does your due-diligence process provide acceptable answers to these critical questions?

- What are the sources of your current due-diligence process? Is it solely from industry

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subscriptions, open source/database exploitation and business-colleague networks?

- Does the due diligence incorporate differentiated information tailored to the transaction, environment and risk?
- Is your due diligence conducted independently from the deal team (which may be incentivized to just get the deal done)?
- Does your due diligence provide transparency around the various aboveground risks that could affect your transaction, bottom line or company reputation?

Focusing on this last point, what is an acceptable degree of transparency and how do you achieve it? At a minimum, management should consider the following:

Do you have a detailed understanding of the risks prevalent in the host country? For example, while the prevalence of corruption in Nigeria is a given, knowing how corruption works, its impact on foreign investors and how to avoid it should inform any potential transaction.

Do you understand the commercial, political and regulatory landscape impacting your transaction?

Do you know who the true owners of your counterparty are and whose money they are using? Due to banking-sector instability and capital flight, the answer to this question often lies in offshore jurisdictions, such as Cyprus, Switzerland and the Caribbean. Any ambiguity on this point is a red flag that should be addressed and documented in frank discussions with the counterparty and through independent investigation.

What is your counterparty's professional reputation and how does it conduct its business? While open source searches will sometimes uncover major scandals and criminal

charges associated with a company or individual, the surest way to address this issue is through searches of local civil and criminal court filings and through confidential inquiries.

The model above can be implemented as follows:

- Establish a mandatory aboveground due-diligence process that is independent from the deal team and tailored to the transaction, environment and risk.
- Incorporate differentiated, accurate intelligence gathering. This is not solely an Internet/database collection exercise. Ask yourself if you are answering the “hard questions” and whether the process is providing the necessary transparency.
- Audit to ensure the due-diligence process is incorporated into the decision-making process, and that the appropriate risks are being identified, quantified and managed.

For example, a U.S. E&P was surprised by the 2004 Orange Revolution in Ukraine and, adding to its uncertainty, discovered that a local oligarch wanted to gain control of the company's local natural gas concession. The E&P initiated a political-risk intelligence and due-diligence effort to understand the changes resulting from the revolution and the threat posed by the oligarch.

Through this process, the company leveraged in-country and international relationships to broker introductions to both parties in the new democratic government and arranged to initiate a series of international conferences to foster energy independence in Ukraine. The Ukrainian government responded favorably to the company's overture, and the conferences resulted in favorable Western government engagement and positive media coverage for both the company and the new government. The E&P was able use its strong relationship with the new government as leverage to fend off the oligarch while pursuing a favorable asset sale.

Companies involved in international energy development are engaged in the risk-management business—not risk avoidance. To properly manage this risk in opaque environments, intelligence gathering and proper aboveground due diligence are critical components that must be incorporated into decision making. While this may require more up-front effort, the results will be seen in a company's bottom line and reputation, providing a distinct edge over the competition. □

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