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Political Risks and Opportunities for South Korea's Natural Resource Diplomacy

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With record global oil prices hovering in the US$100 range, much attention have focused on "event risk" disruptions — or a perceived threat of disruptions — in fuel supplies that could potentially keep oil prices at record highs for prolonged periods (see table). Although these events can cause periodic spikes in prices, barring a major catastrophe such as another war in the Middle East, these fears may be unwarranted as current market prices have already calculated in most known "event risk" uncertainties. In fact, on a fundamentals basis oil prices will likely decline with the slowing US economy over the next few months.

TWO KINDS OF GEOPOLITICS IN OIL MARKETS	
EVENT RISK	**RESOURCE NATIONALISM**
US/Iran military confrontation	US/Iran military confrontation
Iraq/PKK/Turkey conflict	Russia post-Yukos "Putinism"
Iraq splintering/collapse	Mexico PEMEX reform delay
Attack against Iraq/Basra export route	Project Kuwait delay
Niger Delta violence	Nazarbayev-Eni Kashagan clash
Nigerian oil worker strike	Brazil oil and gas law change
Terrorism in Saudi oil sector	Alberta royalty increase

A greater challenge for energy and commodity markets in 2008 will be heightening resource nationalism in the emerging markets. Newly enriched and newly confident developing states are forcing multinational corporations to give up greater shares of the revenue from natural resource extraction through contract renegotiations, the passage of tougher new laws and regulations, and the expropriation of foreign-owned assets. Further complicating matters is the fact that resource nationalism adds political risk to projects that are increasingly geologically complex and risky, such as the Kashagan project in Kazakhstan, or the Brazilian offshore deepwater oil project.

This trend is potentially troublesome for South Korea, as state-owned and private South Korean companies seek to do business in volatile frontier regions under President Lee's banner of "natural resource diplomacy." Korean firms will find themselves increasingly vulnerable to host country intervention and pressured to give up ever-larger shares of revenue for access to resources. On the positive side, Korean firms will benefit from a strong appetite for foreign investment and, in the smaller frontier markets, from an ability to offer a less politically complicated investment relative to either US or Chinese firms. It will be critical for both Korean businesses and the government to work together to prepare for the hazards ahead and mitigate these risks to ensure the future of South Korea's energy security. Here are a few recommendations.

Building "Political Risk" Early Warning Systems and Enhancing Leverage

As Korean firms move into unstable political environments, it will be increasingly important to develop early warning systems and rapid response teams to address developing crises. The government's recent decision to reopen embassies in developing countries where Korean firms are heavily invested (*eg*. Cameroon) is a positive step toward building a network to monitor conditions on the ground and provide valuable support systems for businesses abroad. Risk mitigation, however, will need far more than monitoring; it will need regional political and economic analytical capabilities to examine risks and provide solutions for potential trouble in distant markets.

In addition to early warning, South Korean government and businesses need to coordinate their efforts to protect Korean assets, businesses, and personnel. Although South Korea is a large energy importer, it is still a small player in the oil exploration and production market, with no cutting-edge niche technology. Consequently, Korean firms may be more vulnerable to state intervention and exploitation than their foreign counterparts. The South Korean hostage situation in Afghanistan demonstrated the government's limitations in confronting dangers faced by its citizens in the most volatile places of the world. With Korean companies moving into more hostile zones both government and businesses will need to think strategically and systematically about how to integrate diplomacy, economic statecraft (eg, foreign assistance, sanctions), global public relations, and grassroot outreach to mitigate threats and sustain business operations. For example in regards to grassroot outreach, Barrick Gold Corporation's partnership with local civic groups and investment in community HIV/AIDS prevention, education and care in Tanzania's Shinyanga region is a good example. The company's contribution helped control the spread of this epidemic in this area especially among the mining community, elevated the company's image, and helped reduce major operational disruption caused by sick employees. The Chinese are masters in providing infrastructure support, public health assistance, and other foreign aid to build goodwill, create leverage with African governments, and gain access to resources when other countries have failed. How the government and energy sector acts when faced with expropriation, blatant contract breaches, hostage situations, and regulatory discrimination will be critical.

Two areas to consider over the medium term are Kazakhstan and Congo. In the case of Kazakhstan, the current tax reforms under consideration will cut deeper into the revenue flows of foreign natural resource extraction companies in 2009 and will no doubt impact

South Korea's oil exploration and production contracts. In Congo, the government is currently renegotiating its long-term mining contracts with foreign firms. Given this low regard for contracts, both KNOC and Samsung, which recently entered the onshore oil sector, may be vulnerable to government exploitation.

In addition to detecting political risks, competitor analysis will also be increasingly critical. The Chinese government and state-owned firms have perhaps been more aggressive than any other global player in securing access to energy and other commodity resources across the developing world (*eg.,* Angola, Sudan). With new wealth and their economic dominance, China may be redefining how commodity deals are made with resource-rich developing countries and changing the expectations of host countries when negotiating deals. For example in the Democratic Republic of Congo, China has recently adopted a new strategy to secure long-term access to commodities by cutting multi-billion dollar infrastructure-for-minerals swap deals — an innovative agreement which is part barter and part joint venture. In a recent deal, China provided a $3bn infrastructure loan to establish a mining joint venture that will be paid by exporting copper and cobalt. After the loan is paid off, revenues from the mining joint venture will be split 68-32 between Chinese firms and local mining companies. The challenge for competitors is that developing countries may want investment in the country's infrastructure or development aid in order to gain access to its resources.

Korea Near-Abroad Strategy

South Korea will not only need intelligence to assess risk, but also to discover and assess opportunities. Not all overseas oil suppliers are evenly suited to meet South Korea's energy demand, and careful consideration will be required to find markets and projects that best address the country's needs. Korea will need to formulate a "near-abroad strategy" to prudently channel resources toward markets where energy resources are both geographically reachable and friendly to South Korean investment.

Two potential areas that fit these characteristics are the Russian Far East and Canada. In the Russian Far East, oil fields are still underdeveloped compared to other areas. Larger IOCs have avoided this area because of high Russian mineral taxes and the Russian government's insistence that foreign investors be junior partners in exploration and production projects. Most IOCs may not agree to these terms, but for South Korean firms, this may be an acceptable deal. And, for Russia, striking deals with South Korea is an attractive means to diversify its distribution channels away from the China market.

A second opportunity is Canada, where pipelines are being built from Alberta to the Pacific Ocean by Canada's Enbridge. hase one of this oil project will produce 300,000 bpd, while the second phase will be increased to 600,000 bpd. Chinese state-owned oil firm CNOOC has been negotiating for the purchase of this fuel once construction is finished, but these talks have broken down because of the Canadian government's displeasure with Beijing's human rights record. This opening may provide an opportunity for South Korean firms to pick up a deal to access new oil that is both amply available and easily transportable.

Other areas of interest should be exploratory and production opportunities in Vietnam, Thailand, and the deep waters of India. South Korea, however, must reevaluate whether areas like Central Asia present an ideal environment for investment. For example, Kazakhstan may provide promising new supplies, but the country's geographical location would make it a costly challenge to distribute Kazakh oil to the Korea market. ■

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