IRAN: ALTERNATIVE STRATEGIES OF ENTRY INTO THE INTERNATIONAL PETROLEUM MARKET

M. Tehrānian

Major petroleum exporting countries have all established their own national oil companies. The common objective of these companies is to enter the international petroleum market. Each company, however, is faced with a different set of circumstances and has consequently adopted its own particular policies towards the common goal. Each company and its parent country have also different resource endowments and different possibilities. Kuwait, Saudi Arabia and Libya have each abundant supplies of capital but a limited internal market. Indonesia, Irān and Venezuela each have a substantial reserve of technical manpower, a large and developing internal market but, relative to their population, scarce capital resources. Algeria and Iraq are roughly in an intermediate position.

Among the emerging national oil companies, the National Irānian Oil Company (NIOC) is by far the most advanced. It has already developed an extensive network of production, refining, transportation and marketing facilities in the domestic market with gross sales of about $1 million a day; it has been exporting crude oil on its own in cash sales and barter deals; it will be soon exporting gas to the Soviet Union; and, in partnership with foreign companies, it has diversified into the production of petrochemicals. NIOC has also ventured into the downstream operations by building a refinery in Madras in association with a US independent oil company, another one in South Africa, and by actively seeking similar opportunities elsewhere. A pipeline from Ahwāz to Eskandaroun as well as a joint venture with Pakistan for that country's domestic requirements are currently under negotiation.

NIOC's efforts towards market entry are being made in the face of formidable obstacles. The international petroleum market is dominated by a small group of vertically integrated international oil companies who

are, quite naturally, wary of new competitors. Access to sources of cheap crude could have been a powerful factor in the exporting countries' bid for market entry, but the world has been saddled for the past decade with a continuing problem of excess producing capacity in the crude oil industry. High prices and the search for security of supply have continued to support extensive exploration activities in the old and new oil bearing territories, and the rate of discovery of new reserves has been generally higher than the rate of production. Competition in the downstream operations is, moreover, extremely intense; the market in the advanced industrial countries is saturated and opportunities in the developing countries are limited.

Despite these obstacles, it should be apparent that the stakes are sufficiently high for the bidders to play the game with considerable gusto. The purpose of this report is (1) to examine the nature of the problem of entry, (2) to assess some of the possible strategies of entry, (3) to evaluate NIOC's oil policy in the light of these strategies, and (4) to draw some conclusions about the possible choice of a strategy that could maximise national development objectives.

Market Entry and Choice of a Strategy

Recent economic literature on giant corporations in industrial societies has shown that planning is nowdays an axiomatic rule of their behaviour.[1] Corporate decision making has been taken out of the hands of the legendary industrialists of bygone days and put into the hands of a managerial elite whose social and psychological attitudes demand fewer risks and adventures and more security and steady growth. Long-range planning and the adoption of a strategy of growth has become, therefore, the chief concern of coporate managers.

A private corporation is primarily, if not exclusively, motivated by the profit incentive. Its strategic planning is therefore focused on the

1. For a critical evaluation of this phenomenon from liberal and marxist points of views, respectively, see K.J. Galbraith, *The New Industrial State* (London, Penguin Books, 1969) and P.A. Baran and P.M. Sweezy, *Monopoly Capital* (New York Monthly Review Press, 1969). For a specific study of the oil industry: see E.D. Penrose, *The Large International Firm in Developing Countries: The International Petroleum Industry* (London:George Allen and Unwin Ltd., 1968).

long-run maximisation of its profits. By contrast, a public corporation such as NIOC and other national oil companies are faced with a multiple of objectives. Profit maximisation has to be reconciled with national development objectives such as manpower training, creation of linkage effects and employment opportunities, and a variety of political objectives which are determined exogenously. To reconcile these objectives, the public corporation is often torn between conflicting external and internal pressures and demands. In order to adopt a satisfactory strategy, therefore, it would have to establish its own priorities. Otherwise, the danger is that the public corporation will act neither as a profit-maximising firm nor as a national welfare agency. It will try to do both, but its aims will be confused, its direction will be uncertain, and its resources will be dissipated in conflicting pursuits.

Irān's exploding population, great development needs, and scarcity of capital, have already dictated for the government an oil policy of revenue maximisation. Acute short-run demand for a growing supply of capital has had to be reconciled with national ambitions for an oil industry that could become increasingly self-sustaining and independent of the foreign concessionaire oil companies. Investment in the downstream operations of the industry, both at home and abroad, must be therefore evaluated against alternative investment opportunities.An opportunity cost of capital of about 15 per cent must be therefore included in the appraisal of all investment projects.

Entry into the international petroleum market is also made difficult by some external constraints. The major integrated international oil companies control a high proportion of the downstream facilities.Independent marketers, refiners and tankers are few and vulnerable. Moreover, the majors have channelled most of their profit margins to the crude oil producing stage of the industry. Here, their 50 per cent income tax payments to the host governments are a credit against their tax liability to their own governments. Consequently, the profit margins of the downstream operations are, for accounting purposes, either extremely low or non-existent. Some refineries and marketers even claim losses. Integrated operations have obviously to be appraised on the basis of integrated profit margins, but the existing situation makes entry at the stage of downstream operations a costly affair. Competition at this stage is also

extremely intense and subject to the political and economic preferences of the consuming governments. A low-price energy policy as well as foreign exchange savings on the balance of international payments have increasingly become the major determinants of the oil policy of most importing countries.

Irān's chief bargaining leverage in its efforts to enter the international market consists of its access to relatively cheap sources of crude. The trade potential of Irān's growing domestic market is also a secondary bargaining leverage. While most crude exporting countries enjoy the first position, they lack the population and resources that Irān commands for extensive trade relations. Therefore, Irān's strategy of entry should take both of these factors into account.

Some Possible Alternative Strategies of Entry

Without going into exhaustive detail, we may now briefly survey some of the possible strategies of entry which present themselves to Irān and other major exporting countries.

Collective Nationalisation of the Crude Oil Industry. OPEC member countries (Irān, Iraq, Saudi Arabia, Venezuela, Algeria, Libya, Indonesia, Kuwait, Abu Dhabi and Qatar) collectively control about 72 per cent of world oil reserves, 45 per cent of production, and 86 per cent of oil exports. Their share of refinery capacity is about 8 per cent, which illustrates where the relative strengths and weaknesses lie in the international oil market. Assuming absolute solidarity, OPEC member countries or at least the Arab states among them could conceivably act as one side of a bilateral monopoly in selling crude oil at a price arrived at through bargaining with the majors. Given the present low level of realised prices and the alternative sources of crude which have opened outside of the OPEC area, the price of OPEC crude is likely to fall well below the present level of "tax-reference" prices. Since the establishment of OPEC in 1960, posted prices or, more accurately, tax reference prices, have been stabilised around $1.80 per barrel of crude while realised prices have steadily fallen to the low level of $1.20. Losses which the exporting countries may incur through lower levels of off-take from the OPEC area and lower prices per barrel of crude must be offset by higher per-barrel

receipts. Otherwise, collective nationalisation of the concessionaire companies would not be justified on economic grounds.

Forward Integration. Acquisition of the downstream facilities (tankers, pipelines, refineries and marketing facilities) is known in oil industry parlance as "forward integration". Investment in these facilities is generally capital intensive and returns are subject to severe market fluctuations. Nevertheless, control of the downstream facilities is crucial to the bargaining power of the exporting countries. The bargaining position of the exporting countries is, at present, essentially weak because they have no direct access to the consumer markets. This strategy of market entry must be weighed however against the other possibility of acquisition of downstream facilities through joint ventures with the importing countries.

Joint Ventures with Importing Countries. Partnership with the integrated private and public oil companies of the importing countries has been thus far the major channel through which Irān and other exporting countries have tried to enter the markets. This strategy has the advantage of tying consumer and producer interests together on a continuing basis in an enterprise that cuts across national boundaries. It depoliticises oil as an issue for political confrontations. Such a partnership, however, can take a variety of forms: Irān's joint ventures with ENI and Pan American are confined to the crude stage of production,while the partnership with India and the Union of South Africa are limited only to the downstream operations. An agreement with Pakistan, currently under negotiation, would provide joint operations from development to transport,refining and marketing for the entire Pakistani market. Pakistan will thus enjoy access to a cheap source of proved reserves of crude,avoiding costly exploration efforts, while Irān will have a guaranteed monopoly access to the Pakistani oil market. Profits from the joint venture will be split between the exporting and importing countries, avoiding the intermediacy of the foreign concessionaire companies.

In an era of crude oil surplus, however, many of the consuming countries may have neither the ability nor the short-run interest in entering into partnership with the producing countries. Since crude oil has been a buyer's market now for some time, major importing countries (Japan, Italy and France) have been strongly urged to shift away from a policy of search

for "cost oil". This was the policy which motivated these countries to compete against the majors for the exploration rights in the Middle East and North Africa. Political motives, commercial advantages and long-run economic interests may still draw the importing countries into such deals. These opportunities must be sought and taken advantage of by the exporting countries.

Participation with the Majors. OPEC's Declaratory Statement of 1969 has called for equity participation in the major concessionnaire companies. But the slogan of participation as a strategy of entry suffers from considerable ambiguity. If it means equity participation in the crude-producing concessionaries companies (such as the Iranain Oil Participants, IPC, KOC, ARAMCO, etc.), it would not necessarily improve the position of the exporting countries either in terms of per barrel revenues or of market control. The price of each barrel of crude would still have to be negotiated, and the exporting countries would still lack the means through which they could bargain effectively. Buyers of crude would still be the affiliates of the majors without whom access to the consumer market would be difficult if not impossible. The majors would have to shift their profits from their present location in the upstream to downstream operations, while unfavourable tax laws may undermine the present level of present level of posted prices.

But if participation means equity partnership in all stages of the industry, including the managerial prerogative of a true partner to defend his interests, it is extremely unlikely that the majors would concede such a privilege. The interests of the crude oil exporting countries and those of the international oil companies are perhaps irreconcilably in conflict on this issue. As Mrs. Penrose has pointed out:

"The companies draw their oil supplies from all over the world to supply refineries all over the world, and they would not accept a situation in which any of their refining and marketing operations would be politically tied to any particular source, except when this is enforced on them by the governments of the countries in whose territory operations are actually located, as it has been to some extent in France, Japan, and the United States. The reorganisation required of their entire supply lines and "logistic" policies would be unacceptably drastic, and the danger of political interference with their managerial decisions from countries attempting to force greater use of their own oil would seem to them very great. It is highly probable that the major companies would prefer to give up their major concessions entirely rather than accept such a

fundamental change in their whole "way of life".[2]

Partnership in the ownership and management of the integrated facilities of the oil companies is something quite different from equity participation. While the companies may consent to equity participation or to partnership in future ventures, they would probably refuse to enter into partnership in their present enterprises. But it is the latter form of partnership which would truly give the exporting countries important managerial and market power. Control over the uses of profits, participation in the profits of the downstream operations, of the level of output and prices by the government are among the means that must be made available to the producing countries to protect their own economic interests in such a partnership. But prospects for mutual agreement on the accommodation of these demands by the oil companies are dim indeed.

Purchase of Integrated Facilities of Oil Companies. Purchase of refineries and marketing outlets is perhaps the most expensive but also the most speedy road to entry in the major consumer markets. Getty Oil Company is reportedly in the process of selling its refineries. Similar opportunities arise from time to time, but purchase of even a small refinery in the United States or Western Europe will cost at least $100-200 million. Unless returns from this investment are fair, it is probably too high a tuition cost for education in downstream operations. Indications are however that NIOC has been considering such a purchase in the US, particularly because it would give the company a foothold in the world's greatest consumer market.

NIOC's Oil Policy

Although NIOC has already entered into a variety of agreements and joint ventures to reach the market, it does not yet seem to have an explicit strategy of entry for this purpose. It may be that a multiple strategy of entry, combining the best features of the above, is the best course. If so, this alternative should be chosen consciously by the policy makers rather than by default.

NIOC's current oil policy seems to aim at five different major

2. E.D. Penrose, "The International Oil Industry in the Middle East," Supplement to *Middle East Economic Survey*, 2 August 1968, p. 19.

objectives, which are, in their probable order of priority as follows:maximisation of current per-barrel and total revenues, expansion of the domestic market by NIOC itself, diversification into petrochemicals,maximisation of NIOC's managerial control in the newer agreements through partnership and contractual deals, and finally entry in the international markets. These objectives are not necessarily harmonious. Maximisation of current revenues is not necessarily harmonious with maximising long - run revenues. Price-cutting, for instance, could increase current income but it would also undermine prices and long-run revenues. It should be therefore subordinated to other objectives. Irān's insistance on a high rate of production and take-off is, to give a further example, at odds with the competing demands of other major exporting countries. Maintenance of high and stable prices demands co-operation among the major exporting countries for the control of output and, if possible, profit rationing.

Conclusion

Although the present period of change and adjustment in the market structure is characterised by many problems for the international oil industry, prospects for oil as a source of energy are encouraging. World demand for oil is expected to grow at the rate of 7.5 per cent for the next decade or so before it gives way to competitive sources of energy. Supplies of oil available or which can be easily developed in the major exporting countries are now of such magnitude, and the competitive threat from other sources of supply are so small, that the producing countries can proceed on the assumption that the petroleum industry will still be of vital importance to the world, certainly over the medium run, and possibly after the expiration of the present concession towards the turn of the century.

Irān, and by the same token other exporting countries, must therefore adopt a strategy that would put them in a position of power in the expanding oil market. The present concessions will run out in another 20 years. NIOC must be prepared by then not only to take over the present facilities in Irān but also to refine and market their products abroad. This would require a bold and single-minded strategy of entry. Among the various possibilities that we have examined here, the one which seems of

greatest promise is the strategy of partnership with the importing countries. Markets such as those of China, India, Pakistan, Brazil and Argentina have great potentials, but to tap them we would need an oil policy of considerable political courage and economic foresight. Irān's capital resources are admittedly scarce, but her experience and comparative advantage in the oil industry justifies her ambitions to become a major factor in the international oil market.