Obsolescing bargaining and transit pipelines economics essay

Economics

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Abstract

Transit pipelines are increasing in relevance because of international trade. As the pipelines now involved in international market now faces some setbacks. These setbacks are as a result of bargains that obsolesce with time between parties involved. What makes the bargain obsolete is aim of this paper. This paper explores economic, geopolitical and geostrategic issues facing transit pipelines. The paper does not intend to solve the issues but to give the reader an insight of bargaining issues. The paper further looks at the bargaining issues faced by the Caspian basin in its fourth section.

Table of Content

Abbreviation

1. 0 INTRODUCTION

Valuable oil and gas resources have been discovered in landlocked areas and this has enhanced international energy trade in recent years.[1]The answer to unlock the secret for transportation of these resources for full operating potential in the international energy market lies with " transit pipelines". The Transit requires agreement, negotiation and compensation of the countries which it transits through. The renegotiation of agreement terms forms a framework of conflict due to issues that are discussed in this paper. The agreement forms an unavoidable relationship between the parties involved which may be used as a diplomatic or punishment tool. However, in most cases the transit pipeline is inevitably designed to suit the geopolitics of the transit region which at times may not be beneficial to the other users. For example, the Russian-Ukrainian Crisis (2006) shows a " diplomatic coercion to energy" and a clear use of the " energy weapon" tactic.[2]The geopolitics of transit countries may evolve into political risks of transit pipelines. Since the situation favours the bargaining power of the transit countries to disrupt agreement terms in order to squeeze out better deals for themselves during the pipeline operation period. The bargaining power based on accessible studies on pipeline geopolitics and economics relate this attitude of the transit countries to a term known as an " obsolescing bargain".[3],[4]The temptation to demand a higher export price, lower import bills and to increase transit fees by the exporter country, consumer country and transit country respectively shows the independent greedy nature of the three parties involved. These temptations give rise to economic and political issues which lead to an obsolescing bargain.[5]Obsolescing bargain was first used by Ray Vernon to describe the risk of transit pipeline agreements. He defines it as a shift in the equilibrium of bargaining power between the transit and supplier country (exporter) which often causes disruptions to the supply of consumer country.[6]Taking into consideration the participants involved in the bargaining process, the construction companies should be included as another party. Furthermore, the construction companies are not exempted from the temptation concept as they will desire a larger share and economic rent from the operations of pipeline facilities.[7]This paper introduces the basic economic and political issues of bargaining that can lead to obsolescing bargain.

2. 0 BARGAINING AND TRANSIT PIPELINES.

The bargaining issues arise as a result of the theory of obsolescence bargain. In other to understand the issues facing bargaining one must first understand the bargain principle and the obsolescing bargain theory. This bargaining principle clearly states that " in all bargaining situations, all participants involved share an interest to trade and this interest is time and cost dependent".[8]The time taken for a change in relationship to occur between parties (governments and foreign corporations) is the time dependent interest.[9]The delay of the desired trade outcome that motivates a bargaining position is the cost dependent interest.[10]In oil and gas transit pipelines, there are three possible bargaining outcomes for the transit country regarding the transit fee; two of the outcomes include an acceptable fee or off take. The first with no renegotiation agreement during the pipeline operation, the second is if the transit country decides to use an obsolesce bargain as a benefit and the third is if the country receives an unprofitable fee.[11]The first and the third are outcomes before pipeline operations while the second is an after pipeline operation outcome (the second outcome is the interest of this paper). The outcome further leads to seven factors that affect the post or pre pipeline operations which are " common trade interest, off taking by the transit country, the economic contribution of the transit fee, the availability of pipelines, political relations, domestic market and active participation in cost sharing".[12]These factors of bargaining influence the obsolescing bargain theory and are the reasons for conflicts in transit pipelines.

2. 2 The Obsolescence Bargain Theory in Transit Pipelines

The theory of obsolescing bargain defines a positive relationship between bargaining power and gains. That is " the higher the bargaining power, the higher the gains and vice versa". In transit pipelines, the relationship above exists between a multinational company (MNC) and a host country or government. The relationship arises as a result of resources, goals and setbacks each party faces. The theory then indicates that the party with fewer setbacks, more resources and a higher intimidating ability wins the bargaining position and has more gains.[13]The question now is who has the higher bargaining power in the transit pipeline case? Defining the obsolescing bargain, the bargaining power at first favours the MNC since it has the advantage of other possible investment choices hence MNCs are moveable.[14]Another literature[15]has argued that the host government wields first advantage since it has important resources and therefore cannot be taken advantage of. But taken into consideration that the host country welcomes foreign investment, one can agree that the MNC has the first advantage. On the other hand, in a competitive market where different MNCs are attracted to the host country's resource, the host government has the first advantage. For either case, the advantage is only for a period of time. Assuming the MNC has the first advantage and agrees to undertake an investment their initial bargaining advantage will become obsolesce over time. The obsolescence is because the MNC can be made a captive of the host country who becomes advantageous. The more time the MNC operates under the governance of the host country, the more lucrative the investment will be and the more the prospect of the government's opinion of cost-benefit ratio agreement terms will worsen. In that case, the bargaining power shifts to the host country since economic advancement and technology in effect makes the host government less dependent on the MNC. This explains the " obsolescing bargain theory".[16]But the answer to who has the higher bargaining power makes this theory to be influence by bargaining issues that are economical and geopolitical in nature.

3. 0 THE ISSUES

3. 1The Economic Issue of Bargainingin Transit Pipelines

The economic bargaining issue gives rise to conflict between participants involved in any post transit pipeline activity. The issues vary from sharing of rent and profit issues regarding obsolescing bargain to failure to meet transit terms. For example, the Iraqi pipelines histories[17]. The economic issue is due to the pipeline characteristics as it has a high fixed cost from a large sunk capital investment and a low operating cost (compared to the fixed cost) because of the large economics of scale.[18]The economics of scale simply put is the larger the better. The implication of large numbers or calculations is a large loss in the event of any failure. This loss consequence brings about the ‘ bygone rule’. The bygone rule states that if an oil or gas pipeline project makes losses, the activities of the company continue as long as the operating cost of the pipeline is covered. This rule favours the bargaining power of the transit country. The Transit country is rewarded and favoured because of justifications for reasons like without the transit country the project will not run to compensation for loss of control. The reward may either be in form of a transit fee or off-take agreement.[19]From the theory and brief technical details, the economic issues become clear that" nobody really holds the bargaining power" hence the economic problem is the obsolescing bargain. The ability of any party to withhold resources or practical ability determines that party’s gain. For instance, the higher the profitability, the higher the potential power of the host government. But then the project is not always lucrative for the host government since it depends on a lot of factors like but not limited to level of development of the country, the oil price and the outcomes of the bargain.[20]For a developed country that has control over its resources with potential project profitability, the bargaining power of the host country is higher compared to that of the MNC this is because of a higher ratio of reserve per production. For instance, if a transit pipeline starts from Saudi Arabia or Iraqi to another country, the MNC has a low bargaining power against Saudi Arabia. This situation may affect profit sharing agreement which may lead to a higher fee because of the level of reserves of Saudi Arabia. The consumer country with the less bargaining power may tend not to pay their rent or choose an alternative supply route. However, the case scenario is different if the country has a low ratio reserve per production that is MNC has higher bargaining power over the host country.[21]This is clearly the economic problem of bargaining. Another economic problem that can affect the transit pipeline is the market price. For example, the crude oil price skyrocketed from US$50/barrel in January 2007 to a high price of US$147/barrel in July 2008.[22]This change in price can cause a change in market requirements and the result is a change in bargaining power which will thereby cause a change in disruption in transit agreements. Basically, a high oil price is less favourable for the MNC because of increased competition and less investment options. A high price can also make a transit country very demanding on negotiating an increase in transit fee.[23]

3. 2 The Transit Issue of Bargaining in Transit pipelines

This is a derivative of the economic issue. The economic issue creates a background for the transit issue. The transit issue has to do with the transit country and its transit fee and tariff. The transit fee is not a transit tariff.[24]Therefore, calculating the fee is based on bargaining power as explained in the economic issue. This transit fee can influence the transit tariff. The transit country may ask for an increased economic rent outside the terms of the agreement if the host country is making a supernormal profit. For example, the Belarus and Ukraine transit case, where both countries ask for a greater tariff from Europe because of their supply transit from Russia, because Russia makes a great amount of profit.[25]Basically, the opportunity cost or service cost determines the transit fee. This opportunity cost issue applies where there is no alternative route for transit. Therefore, the transit cost can increase to the point at which the sale of the commodity becomes unbeneficial for the seller. On the other hand, if an alternative route is available for transit, the transit country can only demand a service fee because its bargaining power is weak. In summary, the transit issue is that in real life, the transit country does not require a justification for the increase in transit fee; the country can simply just do so and this evolves into a continuous bargaining process.[26]

3. 3 The Geopolitical Issue of Bargaining in Transit Pipelines

The geopolitical issue of bargaining is simply that every country has its own politics and this can interrupt the operations of the pipeline. A domestic change in politics and culture within a host or transit country can affect the bargaining power between the host country and the MNC. Domestic politics can impact negotiations with external parties and this can cause an obsolesce bargain. A political change in the host country can shift the bargaining power from MNC to the host government since new politicians may want a higher reward or profit and thus intervene with subsidiaries. A political change in the transit country can affect the transport system of the consumer country. This political change may mean changes in environmental or operational standards which will definitely affect bargaining power and the operations of transit pipelines.[27]Committing the transit country to international established practice like an inter-governmental agreement[28]reduces the likelihood of further bargaining. This is seen in the case of Baku-Tbilisi-Ceyhan and Shah-Deniz pipelines where the US goal is to unravel the Caspain reserves, avoid passage through Iran or Russia and to minimize traffic through Bosphorus. Turkey in this case, plays an important political and diplomatic role but since its aim is to form an international trade relationship with the European Union, any disruptions through renegotiations will not promote the aim of international relation. [29]Basically, transit pipeline operations depend on the internal stability of the host or transit countriesinvolved. Political or social disorder, terrorism or civil war is the determinant of a countries internal instability. Pete Harrison (2009) echoed the instability issue in this statement " It would be like building a pipeline through Afghanistan – it would be bombed and attacked all the time".[30]

4. 0 ILLUSTRATION OF POTENTIAL OBSOLESCENCE BARGAIN

4. 1 The Caspian Sea: South Caucasus pipeline.

South Caucasus Pipeline is a gas transit pipeline from Azeri-Caspian Sea to countries like Turkey, Georgia and Azerbaijan[31]. This case is an issue because of the predicted increase in the demand of natural gas from 2010 to 2030.[32],[33]The EU currently faces economic and political geographical problems from its main gas supply route through Russia. Russia in the case is more than eager to gain upper bargaining power and has monopolized control over Asia's energy industries through political support. The country is still desperate to limit control to foreign countries like US and China who want shares from the Caucasus pipeline.[34]Russia while willing to use coercion to gain interest and control invaded Georgia in 2008 making western powers like Central Eurasia and Eastern Europe to withdraw power struggle of the project. The easiest and alternative energy supply routes that the EU can take is through former Soviet Union like Kazakhstan, Turkmenistan and Uzbekistan but the chess power play by the Russians have subjected EU to only one route which is through Azerbaijan via Turkey since other former soviet routes listed above must pass through Russia. This condition thereby increases the bargaining positions of Azerbaijan and turkey.

Figure 1: Pipelines Exploration of the Caspian Sea Reserves

C: UsersJosepheDesktopsouthern. PNG[35]The Russians have supported the idea behind State Oil Company of Azerbaijan supply to Europe in 2018, since in 2012; President of Azerbaijan Ilham Aliyev and Prime Minister of Turkey

Recep Tayyip Erodogan signed a binding geopolitical agreement for construction of Trans Anatolian Pipeline (TANAP) to replace Nabucco on Turkish territory.[36]The Russian quite happy with this TANAP project as it limits EU's supply to about one third of their initial capacity and EU must still be dependent on Russia as its pipeline will still connect to that of TANAP at Romania and Hungary. President Putin of Russia has set in place formation for checkmate on EU as he has clearly announced in December 2012 the new South Stream pipeline construction.[37]This case study shows the struggle for bargaining power related to issues beyond politics and economics. According to theory all countries in the case are in struggle for power to increase gains. In other words, any country (most especially Russia) willing to play on the Caspian Sea chess board wants to take advantage of Obsolescence bargaining.

4. 2 Russian-Ukrainian Transit Pipeline

The Russians in the South Caucasus pipeline case wants a position as the Ukrainians had in the Russian-Ukrainian pipeline (2005). The position of Ukraine as a transit country in the case had a higher bargaining power and initialized a higher transit fee not in the form of off take as agreed upon transit negotiation but as in actual cash. The aggressive step taken by Ukraine was as a result of increased gas price supply at market rate from Gazprom.[38]The Russian with force wanting to get their demanded gas sales at market price cut down supply to Ukraine and Ukraine in return cut down supply of Russian gas to their European consumers. The Europeans while dependent on Russia suffered during this period and with the help of international involvement to alleviate the Europeans, the Ukrainians eventually won higher bargaining power with an almost doubled transit fee in actual cash.[39]

Figure 2: Main Pipelines Route from Russia to Western Europe

C: UsersJosepheDesktop ussian ukraine. PNG[40]

5. 0 BARGAINING TOOLS (INSIDE AND OUTSIDE OPTIONS)

This section highlights some bargaining option drawn from the case studies. The option principle is that " the more attractive a party's outside option is the higher the power to bargain.[41]Example: If an alternative route exist. For the inside option, the more the inside option remains unattractive, the higher the power to bargain". For the transit country, one outside option is to deny full passage of transit pipeline on its sovereignty regions example is the Russia-Ukraine case. While debatably all parties involved, gains no benefit, it can increase its bargaining power for better fees. Another option provided all things been equal, is to undergo another project which is profitable and meets its basic requirement. The transit country can also create collaborations with alternative route owners that can be taken by the other player to subject the player to its own interest. While all these can work as bargaining tools, the transit country might be disadvantaged if it is an off taker and cannot find means to meet its internal energy supply. It may face unstable policies with the alternative project or collaboration measure and may loss bargaining power as a result of intervention by other stronger countries. The inside option here is an increase transit fee or off take quantity.[42]For the host country, the outside option is an alternative supply route. However, alternative routes are mainly costly from the projections of financial evaluation; this situation puts the host country in a position of obsolescing bargain. An alternative option is the use of martial law, invasion[43]or coercion (art of war) as seen in the Russia-Georgia case. This approach is unethical and against international law. Although, the use of this technique may not be approved of, the country with the higher military force has a bargaining power.[44]

6. 0 Conclusion

Transit pipeline is can be of great importance to the countries involved if the issues that affect resource supply security and revenue are dealt with. However, transit solutions are difficult because possible options (in the fifth section) have limitations and therefore do not indicate solutions that can secure and assure resource supply. Basically, the option of resource supply is obsolescing bargain. The obsolescing bargain leads to the economic and political issues the pipelines face which is quite similar to modern warfare. The issues of pipeline have to do with the control of bargaining power. However due to the complexity of bargaining as it relates to the game theory in economics this curtail paper cannot possibly cover all factors that may result to a higher bargaining power but it does give an introduction of how major political and economic factors may affect transit pipelines.

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