

The Risks in Remote Locations

By Wim Plaizier, Michael McCool, and Guillaume Cretenot



Wim Plaizier is a partner with A.T. Kearney, based in Amsterdam and Johannesburg. Michael McCool is a partner with A.T. Kearney and Guillaume Cretenot is a principal with the firm based in Hong Kong and Brussels respectively. The authors can be reached through willem.plaizier@atkearney.com.

The reasons for relocating industries to remote locations are twofold: (1) natural resources are becoming scarcer and (2) their extraction takes place in increasingly distant locations. Resource-processing industries follow this trend because it is more efficient to organize supply chains for processed products than for raw materials—this is because products are usually of a lower quantity and higher value.

The rapid rise of emerging countries such as Brazil, Russia, India, and China (the BRIC countries) and Central Asia means that the demand for basic materials is often in areas with a dearth of infrastructure. For example, 80 percent of the rise in steel production between 2006 and 2010 was from the BRIC countries. Similarly, China and India alone represent 48 percent of the additional refining capacity between 2000 and 2008.

Supply chains in remote locations present major costs, challenges, and risks and have a significant impact on project strategy, specifications, profitability—and, ultimately, investment decisions.

Supply Chain Costs and Complications

Supply chain costs in remote locations can be high and significantly differ between potential markets. As a result, product pricing and net costs (“netback prices” in the oil and gas business) can vary greatly.

This has board-level implications; for example, the supply chain issues might result in the initially chosen market becoming less than ideal. And while slavish insistence on delivery to that market can destroy value, moving to a different market could have political or counterpart-relationship ramifications that cannot be dealt with effectively at lower levels. The move to a different market may also mean changing product specifications, which in turn may require the use of a radically different overall supply chain and investment strategy. The ripple effects from these issues may alter the investment’s financial attractiveness.

There can be other complications. Supply chain assets are often in the hands of joint-venture partners, affiliated companies or even competitors. For example, in one recent project a coal company was a joint venture partner and was also responsible for running the rail system and building the roads. Ownership issues like these can influence a project’s success, and therefore must be factored into the equation at the evaluation stage.

Also key to the decision are the lopsided risks—those that occur between the project owner and its customers. A project that is considered high-risk for a supplier (for example, one that has no influence with the state railway company) may be low risk for the customer (who may have substantial influence with the state railway—particularly if the customer is state-owned or a monopoly). In this situation, many companies would transfer supply chain risk to the party best able to mitigate it. This is sensible, but it can also introduce challenges to the

project's fundamental parameters—such as customer and market strategies. Again, this can lead to market changes, with all of the associated challenges. We are familiar with one situation in which a company's policy was to sell products ex-gate. However, working in a remote area with long supply chains involving asset ownership (rail cars and port terminal) meant that its marketing strategy had to be adapted to export sales.

These issues reinforce the logical premise that all factors must be weighed at the outset of any project.

Identify Supply Chain Risks

Balancing the risks associated with remote locations is crucial in determining the overall viability of locations. In fact, because supply chain risks can represent the biggest threats in remote locations, these assessments are essential to the decision-making process. There are several areas that deserve particular attention:

Make sure government-run institutions can deliver.

Before investing in a remote country, make certain that the government-run institution can deliver on any promise that it makes. For example, one company evaluated a location only to find that the chosen railway infrastructure was simply unable to cope with the needs of its project. Although the state railway promised to add capacity and build new lines, there was a definite risk that it would not happen. Recognizing the potential risk ahead of time allowed the foreign investor to negotiate safeguards into project agreements in order to cover itself in the event the railway failed to deliver.

Evaluate the various transport routes. Determining transport routes requires some complex decision making, as each route will have its own risks. In one case, a company had to choose a route for the transport of final product from a central-Asian republic. The low-cost route was through Iran; the high-cost route was via Russia. Neighboring countries all represented medium-cost routes. Each choice had its own commercial and sovereign issues, and risk assessment proved exceptionally difficult. Following the transport-route assessment, however, the differences between the routes became clear—as was the final choice.

Weigh the choices between self-owned and leased supply chain services. Determining who will serve the various elements of your supply chain—and the associated risks—is a key decision in remote locations. This is especially true when it comes to major supply chain assets such as railways, pipelines, and port terminals, all of which

can be susceptible to government intervention in terms of ownership, taxation, and operations.

Size up sovereign risks. Many risks, such as war, border closures, and tariff and duty increases, are sovereign and are unavoidable. However, identifying these risks early and assessing their potential impact on the supply chain can help mitigate them—at least in some cases. For example, a typical risk mitigation strategy is to identify a main preferred port terminal and a back-up in the event of transit restrictions. The transition from one terminal to the other should be smooth.

Other Key Considerations

When it comes to supply chains, significant assets sometimes lie outside project boundaries, costing millions or even billions of dollars. These can include pipelines, private railways, traction and rolling stock, terminals, and bulk storage at ports. Estimating this type of supply chain infrastructure requires rigorous, and thus early, assess-

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ment. Beware, however, for while determining exactly what causes supply chain costs might seem obvious in the beginning, there can be hidden ramifications.

Note, too, that in many cases supply chain factors relevant to an investment decision emerge as a costly surprise to project owners. By definition, such factors are not obvious. This reinforces the fact that, for major projects, supply chain factors are of great strategic importance. These factors must be identified and fully assessed alongside the usual factors—such as market opportunity and capital-expenditures estimates—during the project evaluation and feasibility stages. An appropriate supply chain study should include an understanding of the supply chain environment in the transit countries, the inbound supply chain, onsite operations (such as train and truck loading facilities), the outbound supply chain and enabling factors.

Because supply chain issues for major projects in remote locations are of enormous strategic importance, they should be germane to a project's justification. Early identification of supply chain risks, costs, and their inclusion in the overall viability assessment are critical and will go a long way toward supporting smooth execution of the project and return on investment.