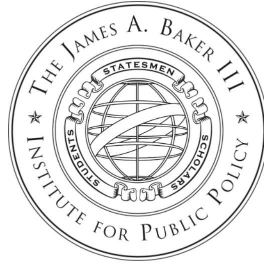

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What We're Thinking: Latin America's Changing Energy Landscape

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The dramatic decline in oil prices from a high of $150 per barrel (bbl) (July 2008) to the $35-$45 bbl range caught the world by surprise. The impact could be particularly important in Latin America, where a number of oil and gas producers structured economic and political strategies on the supposition that extremely high oil prices were here to stay.

The challenges raised by the weak energy and capital markets were the focus of a recent conference at the Baker Institute, co-sponsored by the institute's Energy Forum and Latin American Initiative as well as the Washington, D.C.-based Council of the Americas.

Conference participants projected that major oil and gas producers in the region, with the exception of Brazil, will be unlikely to mitigate the impact of falling oil prices by raising crude oil production in the near term. The longer-term prognosis is more mixed, with production gains expected in Brazil, Peru and Colombia, which are actively engaged in oil and gas exploration and development. It is unclear whether more optimistic projections about the region's medium- to long-range oil export capacity will be met, according to conference presenters. Latin America's failure to produce proportionately to its resource endowments may keep energy prices higher than necessary in the future, potentially dampening the global economic recovery when it begins, conference participants noted.

The factors driving these pessimistic views are related to the dominant role of national oil companies (NOCs), which have important national goals and priorities that go beyond producing returns for shareholders. The social and political priorities — such as wealth distribution, industrialization and diplomatic goals — often negatively impact the country's ability to replace reserves and increase production. As capital markets continue to weaken, governments will likely be looking harder at their NOCs and hydrocarbon resources to fund countercyclical macroeconomic policies, thus further starving the energy sector of capital, conference presenters warned.

In the current context, many Latin American NOCs are generally unattractive to lenders. The exceptions are Colombia's Ecopetrol, PetroPeru and Brazil's Petrobras.[1] The share prices of Latin American NOCs have fallen more than those of major private international oil companies (IOCs), indicating the markets have less confidence in the ability of NOCs to perform in current conditions. Falling crude prices and reduced access to borrowed money are likely to curtail oilfield investments by Latin American state oil companies.

However, some complementary sources of capital for the region's energy sector exist. China, an oil importer with NOCs of its own, has provided long-term financing for development projects in exchange for a guaranteed supply of oil. In addition, currently cash-rich IOCs may look to Latin America for investment opportunities, but Latin American producers will have to compete with non-Latin American producers who also need capital and may be more attractive to private investors.

Recent events in Latin America have raised questions about the ability of some countries to restore production to robust levels. Ecuador's ability to back Petroecuador declined after it twice refused to pay interest on foreign bonds in recent months. In Venezuela, a change in the constitution now permits the unlimited re-election of President Hugo Chávez, but he still must deliver on political promises to win at the polls. The economic inefficiencies of his "socialism of the 21st century" program have dramatically undermined the ability of Venezuela's NOC to produce, and reduced incentives for IOCs to increase investments there.

In Argentina, Christina Fernández de Kirchner and her husband Néstor Kirchner — the current and former presidents — have provided more incentives for exploration and production by adjusting domestic prices and delegating contract negotiations to state governments. But royalty, tax and export policies are still controlled by the national government, and the credibility of Kirchner policies for foreign investors is extremely low — particularly after the government nationalized its own citizens' pension savings last fall.

[1] As to why these NOCs are exceptions, for example, Ecopetrol is debt free, and Petrobras has a monopoly position in a huge market and is consistently reporting new oil and gas discoveries.

As a natural gas producer that negotiates prices directly with its clients, Bolivia is less affected by the global drop in oil prices. Nevertheless, the administration of President Evo Morales had trouble meeting its contract to Argentina last year because foreign investors, concerned about the administration's energy policies, pulled back operations, which curbed production. Now the problem is falling demand. Brazil has cut back on imports from 30 billion cubic meters (bcm) per day to 22 bcm and could possibly drop to 18 bcm, the level at which a "take-or-pay" clause kicks in.[2]

Mexico has a cushion from falling oil prices because it used financial market hedging of energy prices, but it will face adjustments in September when a new budget is prepared. Pemex's rapidly declining production from the Cantarell oil field and the geological and technological difficulties of drilling in new areas onshore and in deep water bode ill for near-term production levels.

Brazil has resisted the siren call of resource nationalism and maintained a fruitful partnership with the private sector. However, the current energy situation may make IOCs less willing to put their increasingly valuable cash reserves into Brazil's risky pre-salt layer. Petrobras' ability to raise development capital will also likely be constrained. Earlier auctions of exploration blocks should begin to reduce Petrobras' privileged production position, but operators worry that the most promising blocks may be unofficially reserved for Petrobras. Whether some highly attractive blocks are finally included in the international tender round will give some indication of the future direction of Brazilian energy policy.

The challenge for the region will be to find a balance between implementing new drilling programs that try to meet pressing future needs for resources and coping with the fact that Latin American oil and gas have become less attractive in the immediate term, according to conference participants. The big unknown — which extends well beyond the energy situation — is whether the current global economic crisis will discredit any move that permits the market to have more influence over the economy.

Read the unabridged piece at http://www.bakerinstitute.org/energy-forum/LAenergy-Mares.

[2] The provision requires the buyer to take at least the minimum amount contracted or pay for it anyway.