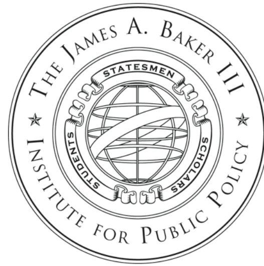

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Latin America's Changing Energy Landscape (Unabridged)

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The dramatic decline in oil prices from a high of $150 per barrel (bbl) in July 2008 to the $35-$45 range has 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 posed by the weak energy and capital markets were the focus of a recent conference at the James A. Baker III Institute for Public Policy, 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, with the exception of Brazil, the major oil and gas producers in the region will be unlikely to mitigate the impact of falling oil prices by raising crude oil production in the near term. Longer term, the prognosis is more mixed, with production gains expected in Brazil, Peru and Colombia, which are undertaking active programs in oil and natural gas exploration and development. But it is unclear whether more optimistic projections about the region's medium- to long-range oil export capacity will be met, with the future investment path for the energy industries of Venezuela and Mexico currently unclear, according to expert presentations. Latin America's failure to produce proportionately to its resource endowments may very well 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 revolve around the dominant role of national oil companies (NOCs) in the region. NOCs have important national goals and priorities that go beyond producing returns for shareholders, whether public or private. These social and political priorities — such as wealth distribution, industrialization, foreign policy and diplomatic goals — often negatively impact the country's ability to replace reserves and increase production, as well as hinder effective management of capital investment by NOCs. In the current context of weak capital markets, a number of 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. Russia and Venezuela have pledged money and their NOC expertise to help Bolivia, but it remains to be seen if, in this market, they

have the resources to follow through; certainly Venezuela's PDVSA is short of skilled personnel to keep things operating in its own country.

In the current context, many Latin American NOCs are also generally unlikely to prove attractive borrowers. The exceptions to this are Colombia's debt-free Ecopetrol, PetroPeru and Brazil's Petrobras, which has a monopoly position in a huge market and is consistently reporting new oil and gas discoveries. The share prices of Latin American NOCs have fallen more than those of the major private international oil companies (IOCs), indicating that markets have less confidence in NOCs' ability to perform in the new energy market conditions. Venezuela and Peru are seeking significant reductions in the fees charged by contractors working their wells and refineries. This effort to squeeze more profit out of operations, combined with the firms' own concerns about how the global downturn is going to affect them, mean the countries are less likely to generate the significant amounts of investment dollars needed in the sector. Consequently, Latin American state oil companies are likely to reduce oilfield investments because of falling crude prices as well as reduced access to, and higher prices for, borrowed money.

However, some complementary sources of capital for the region's energy sector exist. China, as an oil importer with NOCs of its own, has been providing long-term financing for development projects in exchange for a guaranteed supply of oil. The IOCs are currently cash rich, and may look to Latin American opportunities for investment — but Latin American oil and gas producers will have to compete for this cash with other non-Latin American hydrocarbon producers who also need capital and may be more welcoming to private investors. IOCs have to be concerned about their ability to invest in the medium term if they plunk a large share of their cash into politically vulnerable investments. There is always the possibility that Latin American governments could shift some of the burden of stimulating their domestic economy onto the IOCs, as Argentina did in the natural gas market after the economic collapse of 2001. The recent history of renationalization of assets also must be overcome in terms of perceptions of political risk.

Many of Latin America's important producers have recent histories that cause analysts to be skeptical of their ability to restore production to robust levels. Ecuador's ability to back Petroecuador has declined since the country's refusal to pay interest on foreign bonds in December 2008 and March 2009.

In Venezuela, constitutional change now permits President Hugo Chávez unlimited re-election, but he will still need to deliver on political promises in order to be re-elected. The economic inefficiencies of his "socialism of the 21st century" program have dramatically undermined PDVSA's ability to produce, while reducing incentives for IOCs to increase their investment. Although Venezuela finished 2008 with more than $80 billion in foreign currency reserves, a National Development Fund (Fonden) and a central bank stabilization fund, Chávez began the new year dipping into the foreign currency reserves for $12 billion. In February 2009, in the face of international recession, domestic economic contraction of 1 percent and low oil prices, Chávez reaffirmed his continued commitment to spending on social programs. The 2007 agreement with China created a $6 billion binational development fund through which China provides capital and Venezuela increases its oil exports to China, but, with oil production down, it is uncertain if Venezuela can meet its end of the bargain. Chávez owes money to private firms contracted to supplement PDVSA's declining ability to produce. In February 2009, the Venezuelan government seized control of a private oil rig whose operator had stopped producing in order to force payment. The Chávez government's threats to take over more private oil rigs and the seizure of a private rice mill for not producing sufficiently under price controls, suggest an increasingly coercive approach to stimulating production.

In Argentina, Christina Fernández de Kirchner and her husband Néstor Kirchner — the current and former presidents — have provided more incentives for exploration and production (E&P) 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.

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 Evo Morales administration had trouble meeting its contract to Argentina last year because production was negatively affected by foreign investors' pullback in operations following worries concerning the administration's energy policies. Now the problem is falling demand. Brazil has cut back on its imports from 30 billion cubic meters (bcm) per day to 22 bcm and perhaps will drop to 18 bcm, the level at which the "take-or-pay" clause kicks in.[1] Argentina is also reducing its demand. The situation is not helped by the fact that Bolivia's state-controlled energy company YPFB's president was recently sacked for corruption, nor that, since Morales assumed office three years ago, there have been four energy ministers and six presidents of YPFB.

Mexico has a cushion from falling oil prices because it used financial market hedging of energy prices. But the country will confront the need to fully adjust in September when a new budget is prepared. Pemex, Mexico's state-owned petroleum company, which lost $8.1 billion in 2008, has announced it will seek to borrow $10 billion in 2009 — but analysts expect it to only get 80 percent of that total. Pemex's rapidly declining production from the giant Cantarell field and the geological and technological difficulties of drilling in new areas onshore (Chicontepec) and in deep water (Gulf of Mexico) bode ill for near-term production levels. Pemex reform was largely based on the premise that Pemex could access the capital to move Mexican production into this next phase of costly and difficult exploration and production without disrupting its monopoly over oil production, refining and distribution. While it appears that some companies have been picking up service contracts in hopes of being favored in future reforms, the number of wells drilled in this geologically challenging basin continues to lag behind required levels.

Brazil has resisted the siren call of resource nationalism and maintained a fruitful partnership with the private sector. Although oil accounts for a small portion of government spending, the country is challenged by the changed energy and capital markets. Capital demands for E&P in Brazil's pre-salt layer are huge, and the risks are great. The current energy situation may make IOCs less willing to put their increasingly valuable cash reserves into such costly and risky ventures; Petrobras' ability to continue raising the required levels of capital to fund E&P will

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

also likely be constrained. Earlier auctions of exploration blocs should begin to reduce Petrobras' privileged position in production, but operators will worry that the most promising exploration blocks have been unofficially reserved for Petrobras as was suspected in the past. There will be a new auction round soon. 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 to try to meet the pressing future needs for additional resources and coping with the fact that oil and gas have become less attractive in the immediate term in a very weak energy market and tight capital market, according to conference participants. The big unknown right now, which extends well beyond the energy situation, is whether the current global economic crisis — widely perceived in Latin America as the result of U.S. exuberance with free markets — will discredit any move back towards permitting the market to have more influence over the economy.