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ANALYSIS

Strategic implications of emerging market-oriented Latin American petroleum policies

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ABSTRACT

This paper examines key policy features of strategic importance to oil and gas companies with interest in Latin America. Recent energy policy developments in the region have shifted between alternate models about the roles that the state and the private sector play in petroleum exploration and production activities. Major shifts in the energy policies of the eight most important petroleum producing countries in the region over the last twenty years are discussed. Four prominent features are found to be present in regimes with the most attractive and stable conditions for private investors. The role of independent resource administration institutions and of national oil companies is highlighted as a stabilizing factor and a key vehicle for domestic policies on fuel pricing. Two other aspects of energy policy are examined: the relative energy wealth status of the eight countries as a driver for fuels subsides, and the types of petroleum exploration and production contracts used to delineate the roles of private investors.

1. Introduction

One of the foremost strategic decisions of oil companies is the choice of countries in which to operate. Latin America is a region of growing interest, with untapped reserves and geological potential, featuring various degrees of openness and attractiveness to private companies. The energy policies of the main petroleum producing countries in the region are driven by two highly politically sensitive factors: the domestic prices of petroleum products to the public and the government needs of revenue for social spending, energy subsidies and, in many cases, for political gain. These objectives represent a cost to investor returns when the private sector is involved in exploration and production. For these fundamental reasons, energy policies in the main Latin American petroleum producing countries have historically been at the centre of the political agenda, with important implications on the strategic choices of industry players. Other aspects of the public debate have more to do with emotions and historic memories.

The strategic landscape is further complicated by the high volatility of international fuel prices and the international nature of private capital in the sector, a feature that contributes to exacerbate nationalistic sentiments.

Political alternation in power is natural and desirable in functioning democracies, but at times of disruptive political upheavals, these political changes often bring with them strong shifts in energy policies, between market orientation and resource nationalism. However, those countries that have embraced market-oriented reforms with adequate institutions and licensing/contract vehicles for private investment have seen their energy industries flourish, their government revenues increase and their policy frameworks gain in stability and acceptance across the political spectrum.

Eight countries[1] account for 99% of oil and of gas production in Latin America [1]. With few exceptions,[2] their governments have swerved between opposing ideological stances since the first oil concessions were granted to North American companies and individuals in Mexico towards the end of the 19th century.

Of these eight countries, Brazil, Colombia and Peru have put in place investor-friendly policies, whereas Argentina, Bolivia, Ecuador and Venezuela have been reversing their earlier market orientation, adopting more nationalist policies. Mexico has decided to open its oil

[1] Argentina, Bolivia, Brazil, Colombia, Ecuador, Mexico, Peru and Venezuela [Trinidad and Tobago is not included as it is considered a Caribbean country, rather than Latin American.].

[2] Colombia is the main exception, having never nationalized the sector or taken extreme liberalization measures.

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and gas sector to private capital and has started a complex transition process, after 75 years of state monopoly.

Four distinctive elements emerge as the most visible and perhaps fundamental characteristics of the modern market-oriented systems of administration of their petroleum resources:

- institutional arrangements that ensure an independent, professional and transparent administration of the resource;
- the essential strategic role played by National Oil Companies for the capture of rent for the State and for other key energy-related policy objectives such as the stabilization of product prices;
- flexible licensing arrangements that offer effective incentives but also allow for a reasonable capture of rent for the state, leaving at the same time sufficient room for attracting risky investments by private operators, in alignment with the country's interests; and
- market-driven domestic pricing policies for petroleum products, combined with stabilization mechanisms, given the political sensitivity of this issue.[3]

The most recent and relevant policy shifts over the last two decades along these four dimensions in the eight main oil producers in the region are identified, tin order to ascertain common elements that may lay the foundations for a stable and long-term mutually beneficial relationship between State institutions and private capital.

The discussion is presented in three core sections and a concluding one. The first section describes the recent evolution of the key elements of energy policy in those countries that have created and currently maintain market-friendly environments. The second section examines the corresponding recent developments in the four more nationalistic-oriented countries. Mexico is presented as a transitional case. The third section identifies the trends that are currently inspiring the latest policy reforms in the group of market-oriented countries, in contrast with the remaining ones.

[*For assisting readers in following the structure of the analysis, a keyword indicating which policy element is being discussed within each country's description is highlighted in italic format.*]

2. Market-friendly policies

Since introducing fundamental policy reforms to attract private investments in exploration and production, Brazil, Colombia and Peru have been successful in increasing production, with regimes open to private operators that coexist in peaceful and even collaborative concurrence with state-controlled NOCs. NOCs there continue to play a pivotal role as vehicles for the deployment of national energy policies.

One fundamental characteristic of these open regimes is the prominent role played by an independent government entity in charge of the administration of the petroleum resources. These independent administrators also organise the licensing rounds and design or coordinate the contract terms for exploration and production. The selection of operators grants equal access to the resources to NOCs and to third parties, at least in theory.

This basic model was first adopted by Peru in 1993, followed by Argentina, Bolivia, Brazil and Colombia in this chronological order, and most recently by Mexico, where a recent sweeping constitutional reform was passed by Congress in December of 2013.

The recent evolution of the three countries with market-oriented and investor-friendly policies is discussed below, in chronological order of their respective fundamental reforms, followed by the special case of Mexico, which has just started a transition to allow the participation of private operators, after 75 years of state monopoly:

2.1. Peru

After a severe economic and political crisis in the late 1980s that led the country to near bankruptcy, Peru was the first country in Latin America to open its energy sector in 1993, adopting a modern petroleum administration, inspired by the Norwegian experience. A new *institution* called Perúpetro S.A. was created as a wholly owned national corporation, and vested with the exclusive authority to issue exploration and production licenses, as part of a general policy of economic reform and privatization of state companies.

Petroperú, the operating *NOC* founded in 1969 after the oil industry nationalization, had to transfer the administration of its exploration and production areas to Perúpetro, maintaining the ownership and operation of the national infrastructure for transport, refining and distribution, and having to abandon its role in exploration and production until 2013, when the company was charged again with this role [2].

Perúpetro adopted a concession type of *contract* with basic and additional royalty payments[4] as the main fiscal terms.

In 2004, after a steep rise in international oil *prices*, domestic prices were deregulated and a stabilization fund created for an initial period of 120 days. The fund remains in operation to these days, given the high increase and volatility of oil prices over this period. The central government had to transfer US$2.5 billion between 2004 and 2011. Prices are revised weekly within price bands that are adjusted every two months [3]. Any deviation of prices outside the band is either financed or absorbed by the stabilization fund. As Peru is a relatively large net importer of liquid petroleum products, producing less than a third of its consumption according to Perúpetro[5] [4], any transitional intervention in domestic prices needs to be funded by the national treasury.

Peru is an important gas producer and exporter. Camisea[6] gas prices for domestic consumption have been set after negotiations between the government and the producers of the giant field, under an extended promotional scheme, allowing a capped annual increase in prices, which can be no higher than 5% or the percent increase of liquid fuels prices, whichever is lower.[7] New concessions under exploration have a more flexible regime and allow producers to negotiate prices with their clients [5].

2.2. Brazil

Following the example of the Peruvian reforms of 1993, Brazil adopted an *institutional reform* in 1997 and created the National Petroleum *Agency* (ANP) as an independent government entity in charge of resource administration and licensing, as well as of regulating the petroleum product markets. The NOC Petrobras continued to operate along the whole value chain [6]. Exploration and production became open to private operators, in competition with Petrobras.

The ANP adopted a system of concessions, which are awarded in competitive bidding rounds. The system grants equal access to private participants that meet minimum conditions.

Petrobras, founded in 1953 as a wholly State owned *NOC*, first opened its capital to financial investors in 2000 through a dual system of voting and non-voting shares, with the government maintaining the

[3] Brazil is the notable exception to a market-driven policy on fuel prices, with Petrobras absorbing the difference between domestic and international prices, although Petrobras' management has begun to propose to the government a more transparent and predictable subsidy mechanism.

[4] Additional royalties are the main competitive parameter in bidding rounds.

[5] Excluding natural gas liquids.

[6] Camisea is a large producing field in the Peruvian Amazon.

[7] A textbook example of perverse effects of fuel subsidies, this measure, intended to promote the use of gas over liquid fuels, ended up affecting the economic viability of new hydroelectric projects.