Global competition for upstream investment: key test for Latin America's policymakers

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Latin America is back on the industry radar, but the world is a different place

In the last five years, Latin America has re-emerged on the world stage of global upstream opportunities. Brazil has proved up its massive pre-salt trend boasting tens of billions of barrels of potential. Argentina, seen as a mature producer well past its prime only a few years ago, has a new lease of life in its world-class Vaca Muerta shale province. In August, Mexico completed far-reaching energy reform; many in the industry had long hoped for this, but it had seemed politically unthinkable even after President Enrique Peña Nieto had submitted his proposal to the legislature a year earlier.

If Latin America's re-emergence had taken place in an environment of restricted resource access for major companies, the key questions for the region's policymakers would have centred on how to maximize the value for the benefit of their respective countries. The ability to attract any needed investment from outside companies would have been almost a given. This was, in fact, the status quo during much of the 2000s. But that has now changed.

'Today we clearly have more opportunities than we can develop ... we are not project constrained, we are more capital constrained'. Former Shell CEO Peter Voser's words from the 2013 Oil & Money conference still ring true not only for Shell but for major oil and gas companies more generally. Constraints to resource access were seen as the critical issue for the industry until just a handful of years ago. In the last decade, limited resource access gave resource-holding states leverage to tighten contract terms and strengthen the role of the state in hydrocarbon sector development. Well before the latest softening of oil prices, however, the proliferation of North American unconventionals opportunities, in combination with other global offshore, LNG, and extra-heavy oil projects, led to a general perception that the industry was no longer lacking opportunities. Instead, rising cost pressures, particularly in key megaprojects, have become the top obstacle. In response, players in the industry are shifting their focus towards value rather than growth – greater efficiency is now more important than increases in reserves and production for many firms.

Policymakers in Latin America are thus confronted with the difficult task of ensuring that their hydrocarbon sector regulatory and policy frameworks are sufficiently competitive to bring in the necessary capital and technology, even as key countries like Argentina and Brazil are seeking to adapt their regimes to an expanding and increasingly strategic resource base.

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Effective policy and regulation: one size does not fit all

Evolving, often ideologically driven, perspectives on the optimal role of the state have often led to policy shocks. But in Latin America, as with other countries, there is no detailed blueprint for effective and successful regulation and policy. In some cases, such as the USA, a limited state role, a dominant private sector, and strong market orientation yield successful results. However, countries with capable state companies and a more limited reliance on market forces, like China or Saudi Arabia, also perform well within their specific contexts.

Effective and sustainable hydrocarbon sectors share three characteristics. First, the investment regime is stable. At the highest level, this refers to the political and economic environment;

underpinned by durable and effective institutions, economic and political volatility is generally limited. Political transitions are orderly, while the economy is well-managed at both peaks and troughs of the business cycle. Changes in policy and regulation can still be common – and in cases such as the emergence of new resource potential, policy shifts are often the best course of action for investors and governments alike. The second component, however, is essential: that any changes in policy and regulation are generally predictable. This does not mean that investors are able to anticipate future changes down to the last detail but rather, for example, that if a new government comes into office investors have a general understanding of its policy orientation and of the degree of changes it is willing to make. Third, effective and sustainable oil and gas sectors have supportive operating conditions which include: well-developed infrastructure, adequate security, capable human resources, sound rule of law, and sufficiently attractive contract terms, among others.

Crucial for success – and more of an art than a science – is for policymakers to craft a regulatory and policy framework that fits with local conditions. The top objective for policymakers is to implement reforms that are politically and economically sustainable. Dramatically opening an oil and gas sector to private investment in a country where most citizens have historically opposed such a reform is bound to generate a destabilizing backlash – as witnessed following the 'Capitalization' programme in Bolivia in the 1990s, for instance. Similarly, the instability caused by price liberalization, if implemented poorly, could prove to be worse than keeping subsidies in place in the short term, especially for weak states. Probably the most memorable regional example of this is the fuel price liberalization that sparked the 1989 'Caracazo' in Venezuela. A sustainable reform agenda will take into consideration a state's appetite and capacity to implement new policies.

Effective energy reforms will also align with a state's core energy sector objectives, which can vary from one case to the next. For some countries, energy security and self-sufficiency are the main priorities, while for others the addressing of revenue needs is paramount. Alternatively, broader economic aims – such as supporting industrialization through local content goals or ensuring affordable energy for particular sectors – can be the most pressing. Brazil's hydrocarbon sector opening in 1997, for example, was important for boosting investment, raising production, and, ultimately, approaching Brasilia's central goal of oil self-sufficiency. At the same time, the local content requirements included in each licensing round guaranteed opportunities for Brazilian industry to increase its capacity, which aligned with the country's historical policy orientation in this regard.

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Successful reforms will also take into consideration the existing competitive landscape. Although fully privatized oil and gas sectors can be among the most successful, full privatization is probably not the best fit in a country with a highly capable national oil company. The appropriate role for the private sector will depend on the capabilities and needs of the state companies. A more effective approach could be to build upon a NOC's strengths through partnerships and competition that bring in the needed capital and technology. Indeed, it is the model that Brazil and Colombia have successfully adopted – and Mexico is now following in their footsteps.

Finally, under a sustainable regulatory and policy regime, host governments will provide sufficient incentives to attract the needed investment, given country-specific risks as well as the rewards on offer. In many cases, states rely on international oil companies for financial and technical support, either in partnership with the NOC or on their own. Offering the appropriate incentives – in the form of contract terms, rule of law, regulatory independence, and adequate operating conditions, among other things – is fundamental.

Latin America: emerging era of competitiveness

In the last two and a half decades, the regulatory and policy landscape in Latin America has swung in and out of favour with investors – in some cases quite dramatically. The time period between the early 1990s and the present day can be broken down into three eras based on government approaches to policy and regulation.

In the **neoliberal era** of the 1990s, several countries focused on privatization of state companies and opened hydrocarbon sectors to foreign investment. Argentina under Carlos Menem and Peru under Alberto Fujimori arguably went the furthest in this regard, by fully privatizing NOC YPF in the case of the former, and selling off all of NOC PetroPeru's upstream assets in the latter. Bolivia's 'Capitalization' of YPFB in 1996 split the NOC into two upstream units and sold operating stakes to separate consortia of private companies. Brazil also underwent a major oil opening, during Fernando Henrique Cardoso's presidency in 1997. This reform – which introduced private sector competition, created an independent regulator and licensing agency, and partially privatized Petrobras – served as an important model for Colombia and Mexico.

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The neoliberal paradigm proved unsustainable in the 2000s, however, as shifting political winds in many countries, together with rising commodity prices, led to a re-evaluation of the state's role in the economy and the hydrocarbon sector. The **statist era** – which coincided with sweeping political changes in several countries – resulted in hydrocarbon sector policies in Bolivia, Ecuador, and Venezuela that emphasized tighter contract terms for investors, a stronger role for NOCs, and in some cases the expropriation of assets. Brazil, motivated more by the discovery of the strategic pre-salt resources than by political changes or oil price dynamics, established a new investment regime in 2010 for unlicensed pre-salt acreage that guaranteed Petrobras operatorship. Finally, Argentina – facing declining oil and gas balances and arguably a hydrocarbon sector framework that was out of line with the policy priorities of President Cristina Fernández de Kirchner – took over YPF from Repsol in 2012.

Colombia took what may be best described as a contrarian approach during the statist era with its 2003 reform. Under Alvaro Uribe, Colombia introduced private sector competition into the hydrocarbon sector (removing the NOC's monopoly), created an independent regulator and licensing agency, and partially privatized Ecopetrol. The improved security environment in the country was also a critical factor. The policies paid dividends, attracting significant investment at a time of growing pessimism for investors in neighbouring countries.

Now, however, a new era has dawned. With the proliferation of opportunities and an easing of access constraints as outlined above, resource-holding states have lost leverage and are increasingly concerned about the competitiveness of their investment regimes. The recent softening of oil prices places even greater pressure on these governments to improve entry terms and operating conditions in order to attract investment. The approaches that are emerging in this **era of competitiveness** also appear to be more pragmatic and less ideologically driven than in eras past.

Mexico's energy reform is the most prominent example in the region. Mexican policymakers clearly took into consideration the global context in the formulation of the country's policy and regulatory framework. The reform has, at the same time, addressed critical factors that threatened the long-term sustainability of the hydrocarbon sector. It grants PEMEX greater financial autonomy and flexibility to strike partnerships in order to meet its technical and financial needs, while also forcing the NOC to compete against private firms across the value chain, with the aim of growing overall investment in the sector.

The Mexican oil opening is, in turn, yet another factor spurring others in the region to improve the competitiveness of their investment regimes. Colombia, for instance, is considering how it can reinvigorate interest in its sector, following a licensing round in July that did not meet expectations. The bid round has sparked fears that investors are turning their attention away from opportunities in Colombia as Mexico looks more promising, while many of the onshore conventional opportunities in Colombia face growing operational difficulties which include more cumbersome environmental licensing, community activism, and security challenges.

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In Brazil, the president will likely consider altering entry terms, particularly in the pre-salt, to boost investment following the 2010 reform that increased the role of the state and tightened terms in unlicensed pre-salt areas. Argentina has made incremental improvements to investment terms for investors, post-YPF nationalization (although economic and political uncertainties still prevail). These policy steps have paved the way for major partnership deals in the Vaca Muerta between YPF and foreign players, namely its joint venture with Chevron to explore and develop Loma Campana and PETRONAS's most recent tie-up with YPF. Even Ecuador is more actively seeking investment in its sector, including its undeveloped crown jewel, the Ishpingo-Tambococha-Tiputini (ITT) complex.

As this diverse set of countries pursues regulatory and policy adjustments, Venezuela looks increasingly like an outlier in the region. Characterized by economic malaise and stagnation in oil and gas sector operations, the Maduro administration faces an array of policy challenges with no clear path ahead. This is compounded by a lack of political will and capacity to carry out the structural economic reforms likely to be needed for appreciable growth in investment and production in the hydrocarbon sector.

Outlook: zero-sum game?

As various countries seek improvements in their investment regimes in the coming years, it remains to be seen whether the competition for global investment dollars will be a zero-sum game for the region. Large companies focused on efficiency, and seeking to balance their portfolios geographically, are likely to be more selective in their investment decisions. They could very well shift focus within Latin America rather than increasing overall investment in the region. Some independent E&P companies are facing shareholder pressure to exit international operations and focus on North America – this was exemplified by Apache's Argentina exit earlier this year. Smaller regional E&Ps with more limited financial resources will also carefully weigh the allocation of scarce investment dollars.

Nevertheless, Latin America's emerging world-class resource potential in Mexico, Brazil, and Argentina might attract players to increase their exposure to the region. In the past several years, Asian NOCs have shown a particular interest in expanding their Latin America positions in an effort to diversify away from other regions, such as the Middle East and Africa. The Chinese NOCs have been at the forefront of this trend but others, such as India's ONGC and Malaysia's PETRONAS, are also making important moves.

The Mexican oil opening is also likely to bring unique investors to the region, given its diversity of opportunities and its proximity to important US shale plays, such as the Eagle Ford and the Permian. Majors and independent E&Ps with a presence in the US Gulf of Mexico will likely be attracted to new deepwater opportunities. It will also lead to the growth of a new group of players: Mexican E&P independents.