Risk and renaissance in Latin America

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The last decade in Latin America has been hostile for the oil and gas industry. The sector has been marked by heavy state intervention, regulatory volatility and outright nationalisation in some cases. But 2016 marks an inflection point. Numerous elections and recent political developments suggest as much, with incumbent populist governments losing their footing or being rejected outright. The shift emerged following presidential elections in Argentina, won by Mauricio Macri in November 2015. Since then, opposition wins in Venezuela's legislative elections; the impeachment process against Brazil's President Dilma Rousseff; and the election of a technocrat and former World Bank economist in Peru have sent firm signals that populist, left-of-centre governments have lost their lustre across the region.

The timing of the political upheaval in Latin America was not entirely unexpected, due to the growing fiscal strain governments have been under. The bust in the commodity cycle – largely due to the economic slowdown in China – has stymied Latin America's growth story. Near the bottom of a commodity super-cycle, the prices for key commodities such as copper and oil have collapsed from their respective highs, thereby shrinking government budgets. Since June 2014, the Brent benchmark dropped 77 per cent to a low of US$25.76 per barrel in January 2016. And a strengthening US interest rate has stiffened economic headwinds against emerging economies. These conditions have placed enormous pressures on fiscal accounts, particularly among the major hydrocarbon producers. As a result, public spending has retrenched, turning off the tap on largely pro-cyclical economic models.

Renaissance on the horizon

This year will be defined by economic adjustment as Latin American countries attempt to regain their economic footing. New governments are focusing efforts on their most urgent needs: namely stabilising currencies and cutting government expenditures. Such programmes require time to fully execute and may create political costs in the short term. However, Verisk Maplecroft is forecasting an overall improvement in the risk environment for the oil and gas industry over the medium term out to 2020 across the region. In particular, our Asset Risk Index (ARI) – developed in conjunction with Wood Mackenzie – anticipates that from these economic changes will flow a more attractive investment environment for oil and gas. As a result, ease of entry is likely to improve, while fewer regulatory obstacles and a smaller state presence in the sector are anticipated, among other favourable developments. With this in mind, we take a look at some of the region's major oil and gas producers.

Argentina turns a corner

The Vaca Muerta shale formation in Argentina has generated significant industry interest in recent years, but regulatory volatility and economic uncertainty under the previous government stunted investment. However, the economic adjustment programme implemented by the Macri administration has generated early success and may offer a model for neighbouring countries. The administration is focused first on stabilising the economy. Once its economic footing is improved, the Macri administration can then shift its attention more fully to the oil and gas industry. In particular, it is expected to build on earlier incentives announced in the 2014 Hydrocarbon Law. Alignment between domestic prices and the global oil market is planned, but this will be gradual as the government is under pressure to mitigate the inflationary impact on local provinces.

Still, there are local risk conditions to monitor, including organised labour which requires special attention due to its historic influence. In addition, stubborn inflation has eroded purchasing power and exacerbated tensions in wage negotiations. However, more market-friendly policies and less political intervention will provide a stable foundation for Argentina to begin to optimise development of its hydrocarbon resources.

Brazil attempts to right its path

In Brazil, the government has been preoccupied with a severe economic recession and the on-going corruption scandal, which has delayed efforts to pass sector reform in congress. However, the new administration of President Michel Temer is expected to promulgate changes to the mandatory pre-salt operatorship on Petrobras on new pre-salt blocks this year, among other proposals.

Local content is another obstacle that will require government attention, but we anticipate growing flexibility over time, including less onerous requirements in subsequent licensing rounds. According to Wood Mackenzie, close to 40 per cent of all production by 2025 will require at least 59 per cent local content in the development phase. Without changes, complying with local content commitments will become the largest obstacle confronting the industry.

Brazil's oil services sector will also take time to recover, as local service firms have been implicated in the recent corruption probe or filed for bankruptcy as their major client, Petrobras, cuts spending. And political uncertainty may remain in the background through the 2018 elections as investigations over allegations of graft continue. Nevertheless, the trajectory is favourable for foreign companies as Petrobras pursues an aggressive divestment programme and the government is eager to modify measures that have slowed development and hampered investment.

Venezuela reaches a tipping point

Finally, Venezuela, with its estimated 240 billion barrels of remaining commercial and technical reserves, also appears to be at the cusp of change. Efforts by Caracas to meet its sovereign debt commitments have resulted in growing scarcity of food stuffs and medicine leading, to social unrest. Coupled with escalating triple-digit inflation, dismal popular support for the current government and substantial sovereign debt payments (principal and interest) coming due through mid-2017, the government's manoeuvring room is shrinking. Some economic stabilisation programme will be required.

Unlike Brazil and Argentina, reform to the oil and gas sector will likely occur in tandem with any economic adjustment, as the industry accounts for 96 per cent of exports revenues and 45 per cent of fiscal receipts. These will open up opportunities for foreign investment. However, momentum for new investment will likely be contingent on a new government taking office. Moreover, such an administration will also be tasked with repairing credibility and reducing political uncertainty in order to fully restore investor confidence.

Policy is changing in Brazil and elsewhere in Latin America

And the ideological pendulum?

Latin America has been marked by stark swings in the ideological pendulum in recent decades – with the 1990s privatisation wave under the Washington Consensus being followed by a sharp shift in the other direction and rising expropriation risk in the 2000s. While we are once again at the point of an inflection, the cycle may be different this time around. Greater transparency, stronger institutions and contracts, and a growing middle class may bode well for long- term contractual stability.

In particular, contracts have evolved to better respond to the volatility in oil markets, thus reducing the incongruities that lead to unilateral changes by governments in a price upturn. On the institutional front, corruption investigations underway into some of the region's national oil companies (Petrobras, Ecopetrol, Pemex) support a shift towards improved corporate governance and transparency in the sector. Over time, these developments strengthen potential domestic partners in the region and augur well for the wider petroleum industry.

While an active civil society may lead to additional scrutiny on environmental and community issues upfront – more meticulous attention by oil and gas companies at the initial stages of a project will reduce the risk of more costly disruptions later on. Particularly in an era of social media, securing social licence to operate increases in importance for operators. At the same time, the region's growing middle class will also ensure more political consensus around more moderate policies. These developments should give rise to more durable agreements between government, foreign partners and local communities and reduce the cyclical volatility which the region has been prone to.