Latin America: Competitive landscape mitigates policy volatility

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The 2018 'super cycle' will give way to a calmer electoral schedule in 2019, but turbulence is likely on the oil and gas policy front. The market-friendly reforms that began in Mexico in 2013, and then extended to Argentina in 2016 and Brazil in 2017, could be under threat by end-2019.

A short shelf-life for South America's reforms could quickly flip investor sentiment on the region's major offshore and unconventional plays.

A relapse – even a moderate one – towards resource nationalism in Argentina and Brazil could leave Colombia a pro-market regional outlier – and potentially a big investment winner. However, the more likely mixed outcome at the ballot box in the Southern Cone, and the considerable fiscal restraints on both countries, mean that a complete policy U-turn is improbable.

Furthermore, none of the big regional NOCs (from Pemex to YPF) have the financial capacity – or the technical skill – to go it alone. Therefore, competition to attract IOC partners and investors will oblige governments – including in Mexico – to stick with broadly pro-business frameworks.

Regional stand-off will fuel pragmatism

Verisk Maplecroft's Extractives Risk Index – an aggregate of 37 political, regulatory, economic, security, environmental and human rights indices – shows that the four countries have a broadly comparable risk profile. Drilling down to specific performance drivers shows two clear camps though. Colombia and Mexico have higher risks in the Threats pillar, while Brazil and Argentina are characterised by their weaker operating environments .

Criminality is a major issue in both Colombia and Mexico, while the risk of terrorism in Colombia drags its score down further. Security will not improve significantly in either. Therefore, a worsening of the operating environment would remove the offsetting role played by strong pro-business frameworks, solid economic performance, and stable political landscapes.

Without a structural shift in security policy, the presence of drug trafficking organisations (DTOs) will continue to grow under in Mexico. And with DTO expansion, pipeline taps, kidnap and extortion rates will also rise, pushing up security costs.

Extortion is common in areas with high rates of oil theft, and Pemex reported 10,363 incidents of pipeline tapping last year alone. Companies entering JVs with Pemex need to determine how the rise in tapping will decrease the NOC's profits and investment capability.

In Colombia, President Iván Duque will have to tread a fine line between his pledged tougher security policy and the risk of collapsing the peace deal with the FARC. Verisk Maplecroft expects the exploratory peace talks with the country's other guerrilla group, the ELN, to end without a positive outcome. This means that attacks against oil infrastructure, one of the ELN's main tactics, are set to continue.

If implementation of the peace deal with the FARC falters under Duque, the agreement could collapse. Recidivism by former FARC members could boost the ranks of the ELN, as a willing host for ex-guerrillas. As such, direct and incidental security risks could increase, including the likelihood of more aggressive turf wars between criminal groups for control of the cocaine business.

In Brazil and Argentina, a stronger performance in the Threats pillar does little to assuage investor concerns over economic and political volatility.

The key variable is the outcome of the highly unpredictable presidential races in October 2018 and 2019, respectively. Popular frustration with the political class in Brazil, and dissatisfaction with the economic performance of both countries could weaken the pro-market options at the ballot box. This leaves investors looking at a potentially boggling array of changes to economic and regulatory frameworks.

In Brazil, the proposals threatening E&P range from tighter environmental and social regulations to the expropriation of all the 'pre-salt' concessions tendered after Rousseff's impeachment.

The main risk in Argentina stems from efforts to prevent the removal of energy subsidies. Subsidies threaten macroeconomic stability, and limit the state's ability to invest in the infrastructure required to reduce business operating costs and shipping bottlenecks.

However, the potential return of the Peronist party to power in 2019 does not appear as threatening as it once was from a regulatory standpoint. With Mauricio Macri already managing to get legislation into place from a minority position, progress made thus far has a greater chance of survival in the medium-term.

Public consultations – the thorn in Duque's side

In addition to curbing security risks, Duque must clarify the severe legal uncertainty surrounding public consultations. With 27 oil projects facing this threat in 2018, the lack of a social license to operate could prove the main stumbling block to revitalising Colombia's production, which has been in decline since 2015.

Anti-extractives sentiment has intensified in recent years. Increasingly, activists have managed to delay and even stop projects by alleging violations of their social and environmental rights before the Constitutional Court.

The government argues that local consultations, which are organised and funded at municipal level, are not binding. However, in April the Council of State – the supreme tribunal with jurisdiction over administrative issues – ruled that local authorities do have the right to decide whether extractive operations should be permitted in their regions.

Legally, this ruling opens the door for local authorities to overturn national decisions on O&G projects. Duque, therefore, must find a legislative solution to assuage both community and investor concerns.

AMLO – executive intervention on the rise

An upsurge in policy uncertainty in Mexico is the only certainty for the O&G sector in 2019. AMLO's energy policy foreshadows greater politicisation of the 2013 energy reform and threatens fiscal instability, both at federal government level and for Pemex.

Senior energy appointments to date have been political and ideological in tone. There appears to be less of a focus on improving Pemex's performance and competitiveness (as was the case under Peña Nieto). Within the current 2013 legal framework – and without recourse to the constitution— this politicisation of institutions and regulatory agencies could put a brake on implementation of the reform.

For example, the executive ultimately decides which E&P blocks to put out to tender. It can also impose new limits on private sector downstream involvement; amend local content requirements; delay permitting processes; and dictate Pemex's policy on private partnerships and JVs.

High price tag will moderate resource nationalism

While the 'Pink tide' of the early/mid-2000s was able to deliver electoral dividends, it failed to bring economic ones. In the post-commodity supercycle context, governments need to boost production to contain fiscal pressures. Ultimately, the need for fiscal consolidation may prove a stronger check on resource nationalism in the region than political ideology.

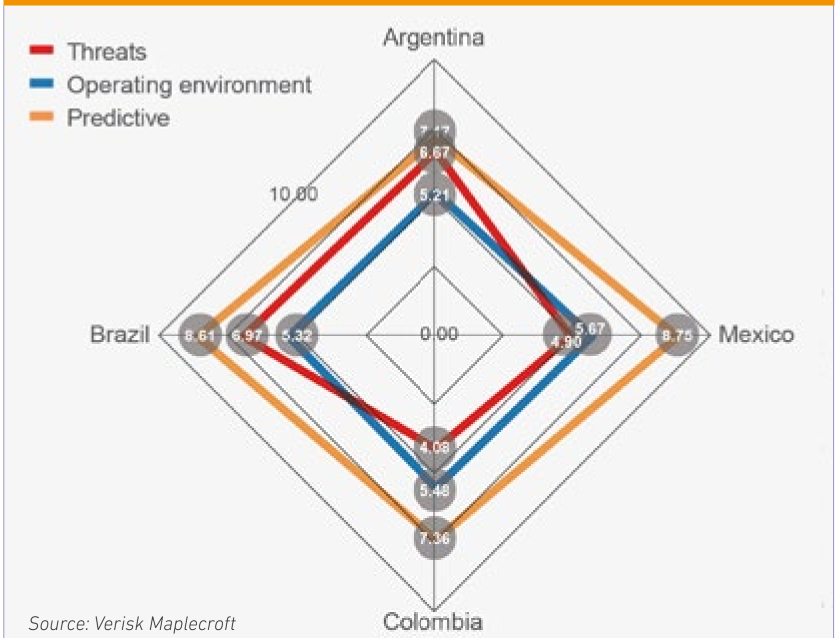
Mexico, Colombia and Argentina are all at various stages of trying to reverse production declines. In Brazil, the fallout from the Lava Jato scandal and a ballooning fiscal deficit will limit the ability of any future president to unwind the recent reforms.

The electorate wants more transparency, better public service delivery and cheaper fuel – greater state intervention in Petrobras would accomplish the opposite on every item.

In Mexico, AMLO's vision is too expensive to deliver without IOC involvement and the government will be forced to maintain a moderate degree of pragmatism. Economists put the minimum cost of his ambitious energy plan at MXN284 billion (US$15.2 billion) in the first three years, increasing Pemex's 2018 E&P budget by 44 per cent. To cover this, Pemex would need to turn to capital markets, swelling its already substantial debt.

Neither the federal government nor Pemex can meet this investment target without major additional borrowing. To deliver, AMLO ultimately may have no option but to remain open to further private investment in the energy sector – both upstream and downstream – even as he looks to retain certain privileges (but also obligations) for Pemex.

Extractions risk in Colombia, Mexico, Brazil and Argentina



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