Leading Latin America's strong above-ground risk landscape

By Jimena Blanco
Head of Americas, Political Research, Verisk Maplecroft

More than 30 per cent of the world's remaining oil and gas reserves sit in areas posing a high level of ESG, climate and political risk. The good news for investors in Latin America is that it could offer a relative haven from the spectrum of physical and operational risks that can impact operators when compared to other regions, including sub-Saharan Africa, MENA and South East Asia.

Using our Corporate Exposure Tool (CET), which combines our 150+ risk indices with commercial data on all reserves, companies and assets from our sister company, Wood Mackenzie, we have analysed Latin America's risk landscape to focus on the region's prospects for investors.

Despite outliers, the region enjoys strong governance profile

Beyond the headlines of political crisis and economic devastation in Venezuela, our risk data shows that Latin America offers a comparatively benign operating environment from an above-ground risk (AGR) perspective (see map below). Overall, the CET's above-ground risk score for the Americas shows a region with a medium-risk profile. Crucially, this is still the case even when we remove Canada and the US.

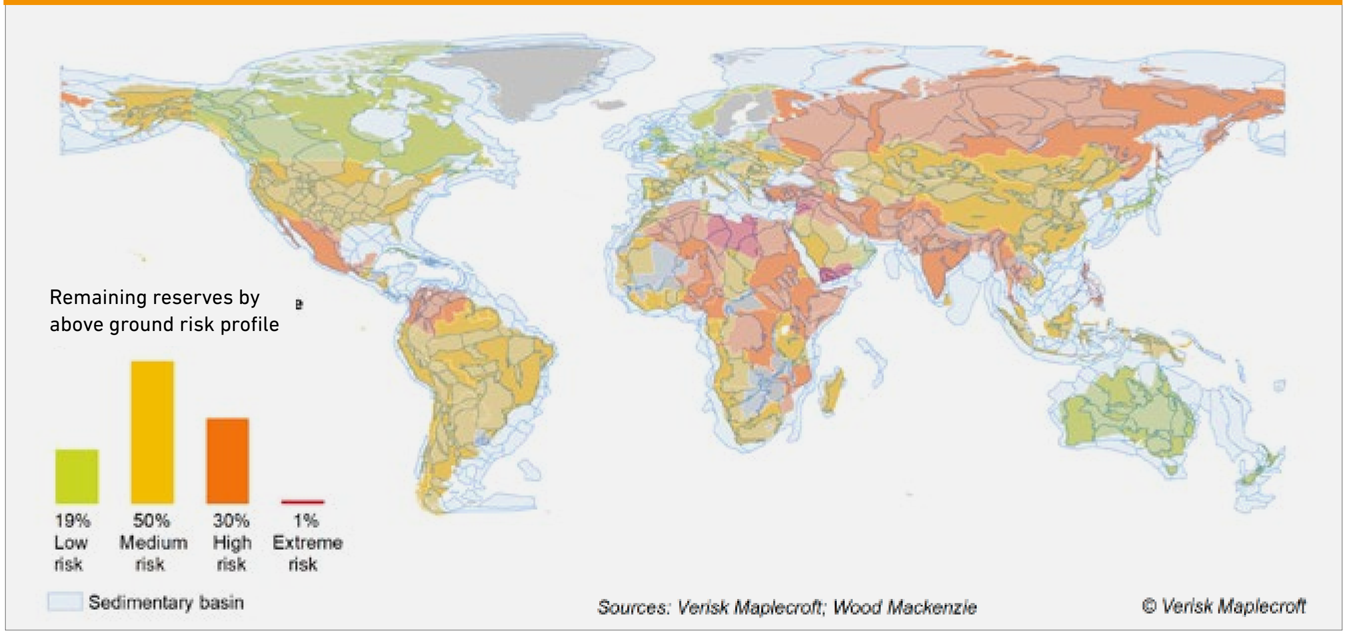
This is good news for investors in the region, home to roughly 20 per cent of proven oil reserves and close to 5 per cent of gas deposits, as it is set to attract long-term, capital intensive investment driven primarily by Brazil's pre-salt deep offshore deposits, and Argentina's Vaca Muerta shale formation.

Brazil and Argentina are the strongest performers among the major producers. Venezuela, Colombia and Mexico, on the other hand present a more elevated risk – albeit with major differences in the challenges they present to operators and institutional investors.

Indeed, Latin America provides a generally stable political environment for operators, which is second only to Europe in our *Government Stability Index*. Leaving Venezuela aside, major challenges to governments stemming from unconstitutional mechanisms, widespread demonstrations, or military interventions are now a rare occurrence across the board.

Our *Regulatory Framework and Resource Nationalism* indices show that strong government stability has had a positive effect, with the Americas now rated as the second-best performing region on these issues after Europe. The adoption of open government and the promotion of digitalisation by the largest oil and gas producers in Latin America have markedly improved regulatory transparency by allowing investors to understand existing rules and assess potential gaps in enforcement. The region's main problem relates to the inadequate resourcing of

Figure 1: The global above-ground risk profile



enforcement agencies, which drives conflicting enforcement or implementation gaps in some jurisdictions.

In resource nationalism, the region registers sustained improvements following a political shift to the centre-right over the past four years. A reduction in the rate of economic interventionism, and structural reforms in the relationship between governments and the management of NOCs – such as Argentina's YPF and Brazil's Petrobras – have increased the reliability of key players as JV partners for IOCs.

However, stagnant or negative economic outlooks in Brazil and Argentina increase the risk of greater political pressure to cap energy prices. In the former, this includes presidential pressure on Petrobras to maintain diesel subsidies, while in the latter it requires the freezing of energy prices until the electoral cycle is resolved in Q4.

Furthermore, Petrobras's divestment plan is at increasing risk of requiring asset-by-asset legislative and/or judicial approval. Such scrutiny will delay the improvement of the company's debt position. It will also worsen the country's score in the *Resource Nationalism Index* indicator measuring the propensity for external, political intervention in the economy.

Key players – 'the good, the bad and the uncertain'

In Brazil, the oil and gas sector is poised to deliver the big investment inflows that the new government wants to see. O&G tenders include the so-called transfer of rights areas, considered one of the world's most promising offshore prospects; we expect major investment in the pre-salt 2019-Q4. This will help energise the country's still weak economic recovery, with signing bonuses for three offshore rounds due in October and November are projected to bring in USD47 billion. Meanwhile, NOC Petrobras is moving ahead with plans to privatise eight refineries. The sale of Petrobras's refineries could attract a further USD20 billion in funds.

Despite promising to pursue business friendly policies, the Bolsonaro administration has been distracted by internal disagreements and has moved slowly on delivering change. Disagreements within the cabinet are increasing the risk of sub-par macroeconomic management. Notwithstanding these tensions, the administration has made some tepid progress, such as the drafting of an *"Economic freedom decree"*, a new measure cutting red tape. It removes the requirement for operating licences when the activities concerned are deemed to be "low risk".

Mexico is an altogether different story. The halt of tenders by President Andrés Manuel López Obrador (AMLO), and his interventionist tendencies in the regulatory sphere continue to fuel investor uncertainty. In terms of resource nationalism, Mexico was the best performer among major Latin American producers in our 2018-Q3 index. AMLO's interventionism triggered the sharpest downgrade of any other country in the region and it is now the third worst performer among large players, closely behind Argentina in the high-risk category.

Political pressure on the Energy Regulatory Commission (CRE) has triggered internal changes and their independence and effectiveness as a regulator will continue to be challenged. How PEMEX navigates through all these changes will be closely watched by the IOCs.

Argentina, meanwhile, faces a highly volatile election cycle, which is to determine the country's openness to foreign investment as well as its future macroeconomic stability. Vaca Muerta, the world's second largest proven shale gas reservoir, needs both foreign players and a stable economic landscape to secure the long-term E&P and infrastructure investment it needs to realise its potential.

We expect the fragmentation of the political opposition and a high level of voter polarisation to give President Macri a fighting chance at securing re-election in Q4. However, the return of a left-wing populist alternative cannot be ruled out, threatening a future decline of the country's performance in our *Resource Nationalism Index* as a cash-strapped government could increase interventionism in YPF policy and energy pricing markets.

Regardless of the electoral outcome, regulatory stability will continue to underpin investor interest in Vaca Muerta and in the recently opened offshore basins. We expect the maintenance of the existing regulatory and investment frameworks regardless of the election outcome. With investors viewing recent changes to regulations to stimulate gas production as evidence of more regulatory unpredictability, a second Macri administration almost certainly would steer clear of abrupt change.

Social and Environmental risks

While government stability, clear regulatory frameworks, and receding resource nationalism risks ease of IOC entry, these issues are not the only game in town. At a regional level, our *Corporate Exposure Tool* and in-house qualitative research show that social opposition to the sector, driven by environmental concerns, is the leading emerging threat to operators in the region.

While navigating the political and regulatory environment remains crucial, obtaining and securing social license to operate will be one of the biggest challenges for the O&G sector in Latin America going forward.