

Argentina: how not to assert energy independence

27 April 2012

Summary

- The announcement on April 17 by Argentine President Christina Fernandez that she would be sending a bill to Congress to mandate the nationalisation of oil company YPF has sent shockwaves through the energy industry. Although a degree of nationalisation was expected, the expropriation of a majority stake from Repsol was abrupt and sweeping. It was also hugely politically popular.
- Christina Fernandez's actions were arbitrary, but they were not erratic. In fact they are a part of a pattern stretching back to Argentina's 2002 default and its subsequent battle to maintain its dollar reserves and exploit its energy resources. To understand the YPF nationalisation, you have to understand why energy-rich Argentina produced more energy in 2000 than in 2011.
- In Latin and Southern-American terms, Argentina's fully privatised energy sector was in fact an anomaly. However clumsily, by asserting a public claim on reserves and revenues, the Fernandez government is aligning itself with the emerging regional norm.
- The YPF episode will probably cost Argentina less in terms of energy investment than some predict, especially if it can reform its subsidy regime. It will however reinforce perceptions of political risk in Argentina and is likely to further isolate Argentina in Europe and the US. It may well push it further towards closer ties with China.

Last Tuesday, the government of Christina Fernandez in Argentina announced that it would expropriate a 51% stake in Yacimientos Petroliferos Fiscales (YPF) from Spanish energy company Repsol. Two days later, it announced a similar seizure of YPF Gas, the primary provider of LPG cylinders to low income households in Argentina.

Reaction from the energy industry and third country governments was predictably sharp. Repsol has demanded compensation and has mobilised both the Spanish government and the wider EU in a orchestrated condemnation. The nationalisation was hugely popular in Argentina, passing the Senate this week with a substantial majority and likely to receive the same treatment in the Congress early in May.

The chain of causation leading up to the YPF nationalisation stretches back to the 2002 default and predates Christina Fernandez's presidency. It has its roots in the shrinking scale of the dollar reserves needed to service Argentina's debts and the complex question of why energy-rich Argentina produced less oil and gas in 2011 than 2000. Answer both these questions and you start to understand the YPF nationalisation. This Global Counsel Insight note explains why.

For a few dollars more

Since its 2002 default, Argentina has not been able to raise funds on international markets and it relies heavily on foreign exchange income from agricultural exports to maintain its balance of payments. Rising energy import costs since 2005

have eaten sharply into this flow of dollars (Chart 1). The Argentine government has taken a number of steps over the last few years to try and shore up these reserves, including requirements that energy companies realise their export revenue in Argentina, insurance companies repatriate their foreign investments and tough restrictions on individuals buying dollars. Reserves have nevertheless fallen since 2005 as Argentinians have bought dollars out of fear that the Central Bank of Argentina will devalue the peso, while the Central Bank of Argentina has spent dollar reserves to maintain the value of the currency.

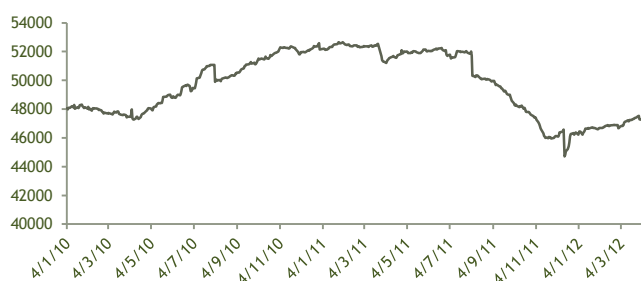


Chart 1: Argentine foreign reserves (US\$mn)

Source: Central Bank of Argentina.

For an energy-rich country, the burden of large energy imports seems unusual. In fact, Argentine energy production has fallen over the last decade, despite a one third increase in domestic energy consumption and a booming global economy. The Fernandez government argues that Repsol YPF and other oil and gas companies operating in Argentina have systematically failed to invest in Argentine prospecting and production. At least until the confirmation of the large shale gas reserves in the Vaca Meurte basin this charge has something to it (Charts 3 and 4). The question is: why?

Repsol and most industry analysts argue that Argentina's mature oil fields were dwindling anyway and that this, combined with domestic sales requirements and price caps imposed by the Argentine government because of its high domestic retail fuel subsidies, made investment in new production essentially uneconomic. Argentine domestic gas producers are paid \$2.8 per million BTUs, yet Argentina stumps up some \$11 per million BTUs for gas from Bolivia and \$17 for

liquefied natural gas. Oil producers are paid at a similar sharp discount to global prices. Repsol had diversified out of Argentina for this reason, and was planning to offload its stake to Sinopec when the government announced the nationalisation.



Chart 2: Argentine oil imports and current account balance 2005-2012 (US\$bn).

Source: IMF.

Repsol YPF also paid high dividends in 2010 and 2011, providing ammunition for the government's case that it was rewarding shareholders rather than investing in new production. The widespread speculation that Repsol YPF's dividend policy was tied to the informal conditions under which the Eskenazi family agreed with previous President Nestor Kirchner to take their 25% stake in YPF in 2007 is just that. But they are a reminder that these are muddy waters.

It was this appetite for dollars, or for dollar-free energy in this case, that ultimately made YPF a target. As with the Argentine government's renationalisation of Aerolineas Argentinas in 2010, the nationalisation of a number of large pension funds and the rights to the Argentinian football league, the underlying motivation is not nationalism *per se*, but attempted relief of an underlying sense of economic vulnerability.

Will the nationalisation help? In the short term YPF's reserves and \$1.2bn annual profits will provide a source of income and energy, and any compensation bill for Repsol is likely to take some time to grind its way through mediation, especially if negotiations fail. Repsol will face a long and potentially fruitless legal battle in Argentina before it can seek international arbitration. For the future, much depends on whether the Argentine government is able to find private sector partners to help foot the \$25bn

annual bill for realising huge reserves in Vaca Meurte and elsewhere.

The assumption that political risk and the risk premium on Argentina will scare off likely partners is almost certainly wrong. Argentina's huge reserves of shale gas in particular are a formidable temptation. The resolution of some small local disputes with Brazilian state energy giant Petrobras would leave the door open for collaboration. Sinopec and CNOOC are also both potential partners, provided they can secure energy for export to the Chinese home market. Sinopec will no doubt be irritated that the nationalisation has deprived them of a stake in YPF, but the alternative of partnership will still be attractive.

Whether the perception of arbitrary government intervention will harm inward investment prospects in Argentina more widely is a bigger question. With the exception of Spain, inward investment in Argentina is already relatively low - less than Peru - in large part because the perception of political risk was already relatively high. Argentina has done its prospects of attracting non-energy investment from Europe and the US considerable damage, but this is only the latest act of self-harm. In its place, Argentina will likely continue to court Chinese inward investment, which takes a more sanguine view of its ability to avoid arbitrary government action. Chinese companies have invested around \$15bn in Argentina over the last three years.

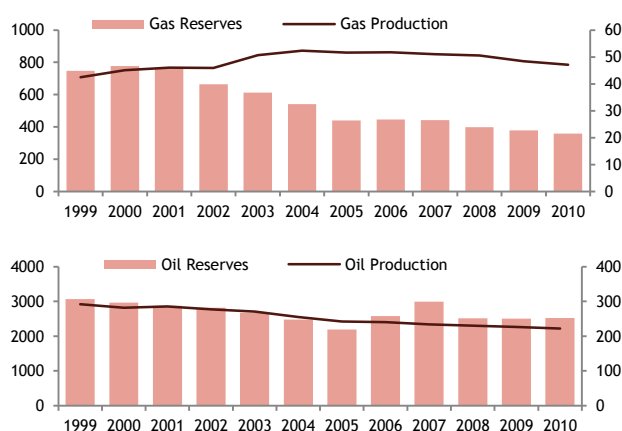


Chart 3 and 4: Argentina oil and gas production (RHS) and reserves (LHS) 1999-2011 (million barrels and million m3)

Source: Argentine Oil and Gas Institute 2012

Spain will push hard for coordinated external action to punish the decision and may get it to some extent. Standard and Poor's as already put Argentina's credit rating on negative watch. The US is currently pressuring the World Bank and the Inter-American Development Bank to stop them resuming loans to Argentina over outstanding compensation payments to two private US funds.

President Obama has also suspended Argentina from the Generalised System of Preferences scheme which gives favourable trading terms to developing countries, and there is talk of the EU doing the same. However this would take a long time to make its way through the EU's machinery and Argentina is due to graduate from the GSP preferences system in 2013 in any event. Argentina will no doubt be subjected to a dressing down at the G20 meeting in Mexico in June.

Arbitrary, but not erratic

It is a mistake to write off what is happening in Argentina simply as erratic behaviour from a desperate government. A possible renationalisation of YPF had been on the cards for some time, in part because of the underlying revenue problem. Moreover, the YPF nationalisation is the latest in a pattern of events that stretch back to the particular circumstances created by Argentina's 2002 default and its subsequent economic and energy policy choices. Fernandez is responding to a set of identifiable economic and energy supply constraints and her approach has a certain logic, albeit a short-termist and misguided one.

The Fernandez government is also not wrong when it points out that Argentina is the only state in Latin America that has not maintained a level of public-private, or entirely public ownership of energy assets - including the Central American states vocally condemning Argentina's decision. The expropriation itself was arbitrary and clumsy and the combination of part-public ownership and subsidies and price caps is likely to prove untenable in Argentina. But the political support for greater public ownership of energy resources is intensely strong. While it is tempting simply to see Fernandez's Argentina as a bigger version of Hugo

Chavez's dysfunctional Venezuela, it is more useful to understand it on its own political terms

Public opinion strongly believes that Argentina is asserting no more than an arrangement that is taken for granted everywhere else in Latin and Southern America. Despite the external indignation, it is worth remembering that if the government can attract partners for the exploitation of Argentine gas reserves in particular, there is a strong chance that the Fernandez gambit will be interpreted as a success by her domestic audience and other governments keen to keep a grip on revenues as energy prices rise.

The nationalisation is a reminder that companies in the energy sector can rarely afford to see their relationship to their host jurisdictions as purely transactional. 90% of YPF's profits being paid out to shareholders as production in Argentina was falling may have been the private business of a privately-owned company, but it is also easy to see why it might be regarded as politically provocative, especially for a government that had just seen its desire to stake a claim to new reserve discoveries around the Falkland Islands rebuffed at the Summit of the Americas. The attempt by Repsol to negotiate the sale of its state to Sinopec was no less provocative.

None of this makes the Fernandez option rational or right. It is the product of a world view that is a complex mix of frustration and self-assertion. The decade since the Argentinian default has seen Argentina struggle to keep pace with its South American peers, especially Brazil. High growth rates cannot distract from the problem of rampant inflation and an unsustainable public subsidy bill. The failure to realise more from Argentina's energy resources is just one more frustration to add to the list. The centralised power of the Argentinian presidency provides considerable margin for translating frustration into policy. Frustrated governments, like frustrated people, have a tendency to lash out and a tendency to self-harm. Far from being erratic, Argentina is developing a dispiriting line in both.

38 Wigmore Street
London
SW1U 2HA
info@global-counsel.co.uk
+44 (0)207 656 7600

© Global Counsel 2013

Although Global Counsel makes every attempt to obtain information from sources that we believe to be reliable; we do not guarantee its accuracy, completeness or fairness. Unless we have good reason not to do so, Global Counsel has assumed without independent verification, the accuracy of all information available from official public sources. No representation, warranty or undertaking, express or implied, is or will be given by Global Counsel or its members, employees and/or agents as to or in relation to the accuracy, completeness or reliability of the information contained herein (or otherwise provided by Global Counsel) or as to the reasonableness of any assumption contained herein. Forecasts contained herein (or otherwise provided by Global Counsel) are provisional and subject to change. Nothing contained herein (or otherwise provided by Global Counsel) is, or shall be relied upon as, a promise or representation as to the past or future. Any case studies and examples herein (or otherwise provided by Global Counsel) are intended for illustrative purposes only. This information discusses general industry or sector trends, general market activity and other broad economic, market or political conditions. It is not research or investment advice. This document has been prepared solely for informational purposes and is not to be construed as a solicitation, invitation or an offer by Global Counsel or any of its members, employees or agents to buy or sell any securities or related financial instruments. No investment, divestment or other financial decisions or actions should be based on the information contained herein (or otherwise provided by Global Counsel). Global Counsel is not liable for any action undertaken on the basis of the information contained herein. No part of this material may be reproduced without Global Counsel's consent.