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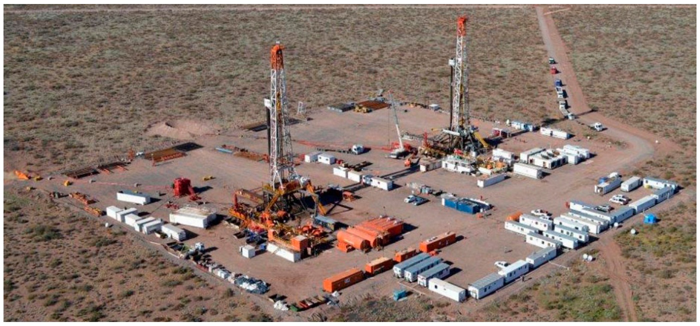
FEATURED Q&A

Will Investors Leave Vaca Muerta Amid Lower Oil Prices?



Lower international oil prices may result in a drop in investment in Argentina's Vaca Muerta shale oil and gas formation, pictured above. // File Photo: Argentine Government.

Q Oil prices plunged last month following failed negotiations on production cuts between Saudi Arabia and Russia, prompting the Middle Eastern country to vow an increase in production, oversupplying the market amid falling demand for crude due to the coronavirus pandemic. What short-term and long-term effects will the fall in prices have on the development of Argentina's Vaca Muerta shale formation? How likely are international companies to refrain from making big investments in the area in the period ahead? Should the Argentine government continue to bet on the development of Vaca Muerta, a cornerstone of President Alberto Fernández's strategy to boost revenues amid a worsening recession?

A Jeremy Martin, member of the Energy Advisor board and vice president for energy and sustainability at the Institute of the Americas: "For a sense of how difficult and fraught with peril the short term is for Argentina and Vaca Muerta, think of Alberto Fernández as captaining the Andrea Gail. Plummeting oil prices combined with an aggressive posture from the Fernández government to confront the spread of the coronavirus have had almost an immediate impact. Rigs are being further idled while fuel demand—the main revenue stream for YPF—has fallen through the floor. Argentina is surely not alone, as companies across the region have accelerated investment cuts for 2020. Research firm Welligence estimates that the average reduction in investment across Latin America is 43 percent, far outpacing the global average. This surely translates to international oil

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TOP NEWS

OIL & GAS

Petrobras Cuts Production, This Year's Expenses

The Brazilian state oil company said it would cut production by 200,000 barrels per day and reduce 2020 operating expenses by $2 billion.

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OIL & GAS

S&P Downgrades Mexico Sovereign Rating, Pemex

The credit ratings agency downgraded Mexican state oil company Pemex's stand-alone credit profile from b- to ccc+.

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OIL & GAS

Venezuela Output Hits 5-Month Low as Rosneft Exits

Venezuela last week registered its lowest level of crude production in nearly five months, just as Russian oil giant Rosneft announced it was withdrawing from the country in a coordinated sale of assets to an undisclosed firm that the government of Russian President Vladimir Putin controls.

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Putin // File Photo: Russian Government.

OIL AND GAS NEWS

Venezuelan Crude Output Hits 5-Month Low as Rosneft Exits

Venezuela last week registered its lowest level of crude production in nearly five months, at about 670,000 barrels per day (bpd), Reuters reported Monday, citing documents and two people with access to output data. As of Monday, Venezuela's largest producing region, the Orinoco oil belt, produced an average of 364,930 bpd in March, according to an internal report dated March 27, plus some 420,340 barrels produced there last Friday. The region had an output of nearly 500,000 bpd in January, according to private estimates. Production in the western Zulia region was at nearly 150,000 barrels last Friday, and Venezuela's northeast oilfields produced 100,000 barrels after an explosion at a pumping station earlier in March left some 40,000 bpd offline, an oil workers' union leader told Reuters. Numbers show that a period of relative stabilization in terms of crude production in Venezuela seems to be coming to an end. From November through February, the country's output remained between 865,000 bpd and 912,000 bpd, according to the government's reports to the Organization of the Petroleum Exporting Countries, or OPEC. The coronavirus pandemic, which has hit global demand for crude, and the plunge in oil prices in March, in combination with U.S. sanctions against state oil company PDVSA, have left Venezuela struggling to cover its public budgets. President Nicolás Maduro in March confirmed that the South American nation is selling its oil below production costs. At the same time, PDVSA is struggling with overflowing inventories of unsold oil as exports fall and its portfolio of customers continues to shrink amid sanctions. There are growing concerns among analysts that oversupply of oil amid dwindling demand will cause the world to soon run out of room to store the unneeded barrels of oil, with storage facilities, refineries, terminals, ships and pipelines possibly reaching capacity, CNN reported. That has not happened since 1998, according to Goldman Sachs. "Demand is falling so fast relative to supply that very soon many producers' main issue is not going to be whether they can ensure operating profit but rather if they can find an outlet for their crude," analysts at JBC Energy wrote in a report released Tuesday. They also suggest loading all extra crude onto ships as an alternative, noting that even that might not be enough to store the surplus. This, in turn, could push prices down further, even to below zero. "The price is trying to go to a level to force companies to keep the oil in the ground," Jeff Wyll, a senior energy analyst at Neuberger Berman, told CNN. "If it has to go negative to incentivize that behavior, then it will," he added. Brent crude is likely protected from this, because it's priced on an island in the North Sea where tank storage is accessible, but other grades of crude are not. In Venezuela, last month's drop in oil production came after the administration of U.S. President Donald Trump sanctioned two units of Russian oil giant Rosneft that had served as intermediaries for PDVSA crude. Rosneft on Saturday announced it was withdrawing from Venezuelan projects through a coordinated sale of assets to an undisclosed firm that the Russian government controls. It is unclear how the move will affect Rosneft's projects with PDVSA, Reuters reported. Rosneft spokesman Mikhail Leontiyev told Reuters the decision to end operations in Venezuela was a measure to protect the company's shareholders. "We defend the interests of our shareholders and did it in an effective way," he said. "And to whom the risks go is not an issue for us. The main thing is that the risks are leaving us," he added. The change of ownership implies that any potential U.S. sanction on Russian-controlled oil operations in Venezuela would target the Russian government directly.

S&P Downgrades Mexico Sovereign Rating, Pemex Credit

Credit ratings agency S&P on March 26 downgraded Mexican state oil company Pemex's stand-alone credit profile to ccc+ from b-,

NEWS BRIEFS

Petrobras Announces Production Cuts, Slash in Expenses for 2020

Brazilian state oil company Petrobras said Wednesday that it was cutting oil production by 200,000 barrels per day, a volume that includes the reduction announced last week, due to the fall in demand of oil and oil products. Additionally, as part of the company's efforts to cut 2020 operating expenses by $2 billion, Petrobras said it would save around 700 million reais (about $133 million) from personnel expenses by postponing payment and reducing working hours, among other measures. Petrobras said it would continue monitoring market and operational constraints as well evaluating any potential increases or decreases in demand.

Venezuela Still Providing Fuel to Cuba Despite Severe Shortages at Home

Venezuelan state oil company PDVSA has maintained fuel supply to political ally Cuba in spite of a severe fuel crisis at home, Argus Media reported Monday. According to a loading schedule seen by Argus, four Cuban-owned tankers loaded nearly 800,000 barrels of crude and other products in Venezuela over the weekend. The buyer listed was Cubametal.

Brazil Postpones All 2020 Energy, Transmission Bids

Brazil's ministry of mines and energy announced on Monday that it had indefinitely postponed all of its energy and transmission auctions initially scheduled for this year, Renewables Now reported. The decision is part of the government's response to the Covid-19 pandemic. Specifically, six tenders were rescheduled: both the new and existing energy auctions known as A-4 and A-6, as well as tenders for transmission lines and those aimed at supplying isolated areas.

while cutting the country's sovereign rating to BBB from BBB+ with a negative outlook, citing an expected economic hit from the Covid-19 pandemic and a plunge in oil prices. Mexico's economy fell into recession last year, shrinking 0.1 percent, and the coronavirus pandemic has sparked concerns of an even sharper downturn this year, Reuters reported. The downgrade, although widely expected, put pressure on the peso, pushing it down by 2 percent against the U.S. dollar on the news. The ratings agency said potential increases in "contingent liabilities from the energy sector could worsen the sovereign's debt burden and lead to a downgrade," adding that Pemex's financial profile had significantly weakened over the past five years, Reuters reported. More downgrades in coming months could prompt Pemex's bonds to fall into junk territory, possibly bringing a selloff by major investors whose mandates require them to hold investment grade assets. Mexico's finance ministry did not immediately reply to Reuters' request for comment. Analysts on average expect Mexico's economy to contract 3 percent this year, though some estimate a fall of more than 5 percent, El Financiero reported.

Fuel Demand Down in Latin America, Hits U.S. Exports

The Covid-19 pandemic has prompted demand for refined fuels in Latin America to quickly fall, leaving U.S. refiners without their main export destination, Reuters reported last Friday. The health crisis has nearly shut down worldwide air travel and has severely hit fuel demand, which could fall as much as 50 percent globally in coming months, according to the report. As coronavirus spreads in Latin America, governments have increasingly imposed travel restrictions, driving the region's largest importers to begin cutting orders of fuel cargoes. Mexican state oil company Pemex and Brazilian state oil firm Petrobras have both reduced the number of cargoes of gasoline and diesel to be imported in the coming weeks, Reuters reported, citing traders. This might in turn hurt U.S. refiners,

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companies continuing to defer new investments in Argentina's unconventional play until prices stabilize and climb above what is generally considered the breakeven price for Vaca Muerta, around $40 per barrel. Though prices have come down for development of Vaca Muerta, they are still less competitive than many other conventional and unconventional plays across the hemisphere. But markets are cyclical, and rebounds are part of the cycle. It is not a question of whether but rather how the Argentine government will focus on Vaca Muerta on the other side of the current crisis. It has no choice but to create a plan and strategy that accounts for the shock to the sector being absorbed; its continued need to derive earnings from oil and natural gas exports has only increased. The long-term impact should be a continued focus on infrastructure development, supply chain and logistic optimization and reducing overall production costs and investment risk. There are several companies, most notably YPF, that will likely emerge from this horrific moment much different than how they entered 2020. As one analyst noted—this will be a massive proofing for how oil and gas producers manage the energy transition."

A **Gerardo Rabinovich, second vice president at Instituto de la Energía "General Mosconi" in Buenos Aires:** "The current conditions have had a formidable impact on the oil industry and specifically on the Vaca Muerta project. It was conceived as a massive development capable of transforming Argentina into an oil and natural gas exporter. The plunge in international prices shows the fragility of such a hypothesis and puts a prolonged brake on investments needed to massively increase production. With crude prices at $30 per barrel and less than $3 per million British thermal units, Vaca Muerta is not competitive in the international market and must wait until conditions improve, if they improve. The brutal fall in demand as a result of the coronavirus pandemic will take time to recover, and it seems short-term prices will not return to the levels seen at the beginning of the year. YPF, the main operator of the deposit, has seen drilling and gas production begin to decline. This confirms that the Vaca Muerta project has been halted, and it will be very difficult for it to get back up again this year."

A **Víctor Bronstein, director of the Centro de Estudios de Energía, Política y Sociedad (CEEPYS) in Buenos Aires:** "Vaca Muerta's breakeven is at around $35-$40/barrel. Current crude prices, with Brent—which Argentina uses as a benchmark—at less than $30/barrel, mean that Vaca Muerta is not viable. YPF CEO Daniel González recently said that Vaca Muerta would be viable at less than $50/barrel. In the short term, it had already been suffering from a shortage of drilling equipment since last year, due to the previous administration's measures on freezing the price of crude barrels paid to producers. In 2018, Vaca Muerta had 74 drilling operations; in January, this number had fallen to 50, before the plunge in global prices. Some activity remains, because 60 percent of drilling operations belong to YPF, which continues to bet on shale development beyond structural problems and which has a breakeven that can be maintained for a while in the blocks already developed. We'll see how long it will be able to continue drilling at this level of prices. In the medium term, prices are expected to recover and Vaca Muerta to continue its development, which would imply investment of between $7 billion and $10 billion per year, though the international market remains volatile, and it is very difficult to make any projections. International firms have global portfolios. Before the price shock, Vaca Muerta was among their prospective investments. This has changed completely. Companies are reviewing their investments and costs. At the beginning of the year, $190 billion in new projects was expected; now this estimate

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which last year exported 2.9 million barrels per day of fuel to Latin America and the Caribbean, according to the U.S. Energy Information Administration. The region is the biggest buyer of U.S. refined products. Pemex, Mexico's largest importer, had already cut fuel imports by about 14 percent in January, to 733,600 barrels per day (bpd), according to official data, in detriment to companies such as ExxonMobil, BP and Valero Energy, said Michael Upchurch, chief financial officer at U.S. railroad company Kansas City Southern, an active shipper of fuels to Mexico. The Latin American country, which bought 1.19 million bpd of fuel from the United States last year, retail demand shrank 15 percent over the past two weeks even as gasoline prices plunged. "Most opportunistic purchases motivated by falling prices have disappeared as the largest importers in the region don't have large capacity to store gasoline or diesel," an unnamed trader told Reuters. U.S. refiner Phillips 66 said last week that some of its Latin American customers were asking if they could cancel purchases, a move that has led the company's refineries to operate at reduced rates.

POLITICAL NEWS

U.S. Moves Ships Toward Venezuela in Anti-Drug Operation

U.S. President Donald Trump announced Wednesday that he was moving Navy ships toward Venezuela in an effort to strengthen anti-drug operations in the Caribbean, the Associated Press reported. The move follows U.S. federal prosecutors' indictment last week of Venezuelan President Nicolás Maduro and several other top Venezuelan officials on charges of drug trafficking and conspiring with the Revolutionary Armed Forces of Colombia, or FARC, rebel group. "As governments and nations focus on the coronavirus, there is a growing threat that cartels, criminals, terrorists and other malign actors will try to exploit the situation for their own gain," Trump said at the daily White House press briefing on the coronavirus pandemic. "We must not let that happen." The deployment of ships is one of the largest military operations in the region since the 1989 when the United States invaded Panama and removed Gen. Manuel Noriega from power.

ADVISOR Q&A

Which Economic Reforms Will Win Approval in Brazil?

Q Brazilian Economy Minister Paulo Guedes last month urged the leaders of the country's Congress to speed up the government's agenda for economic reforms as the economy appears increasingly threatened by the coronavirus pandemic. In response to the outbreak, the administration of President Jair Bolsonaro is also pushing other reforms including allowing businesses to cut workers' hours and wages by as much as half, which the government said would help save jobs. What are the most important reforms that Latin America's largest economy needs now? Which reforms are most likely to win approval in Congress, and which are a tougher sell? How much support does President Jair Bolsonaro have among the country's legislators?

A Erich Decat, partner and political analyst at XP Investments: "Due to the coronavirus outbreak, the congressional discussion about the government's economic reforms announced late last year has been halted. It means that future tax cuts, privatization, a new system for regulating public service and changes to the 'federative pact' aiming to redesign the distribution of finances between the states and the federal government are all in second place. Currently, legislators are engaged only with one issue: how to minimize the impact of Covid-19 on the health system and simultaneously reduce its effect on the economy. Over the last two weeks, Brazilian authorities have announced emergency measures trying to put society and business at ease. In a Saturday conference call with XP Investments, Economy Minister Paulo Guedes said the government intends to inject 800 billion reais ($156 billion) into the economy. Some of the intended measures would have to be approved by Congress, which wants to score political points with the solution. How long will lawmakers keep the economic reforms on the backburner? Today, nobody knows. If the crisis lasts until June or July, as some Brazilian health authorities believe, the chances of voting on structural reforms in 2020 diminish. From these months onward, lawmakers will also be paying attention to the municipal elections, which take place in October. And after the elections, Congress may well focus on the succession of the speakers of the lower house and the Senate. Therefore, the coronavirus pandemic might push the reform debate to 2021, when new congressional players will orchestrate it."

"Currently, legislators are engaged only with one issue: how to minimize the impact of Covid-19..."
— Erich Decat

EDITOR'S NOTE: More commentary on this topic appears in Tuesday's issue of the Latin America Advisor.

NEWS BRIEFS

Cuba Halts Arrivals of International Passenger Flights Amid Virus' Spread

Cuba said Tuesday that it was suspending the arrival of international passenger flights and asking all foreign boats to leave the island's waters as part of its response to the Covid-19 pandemic, Reuters reported. It had already partially closed its borders, prohibiting the arrival of foreign tourists and departures from the island. Cubans and foreigners with Cuban residency could return to the island but were required to spend 14 days in quarantine at state isolation centers, but the new measures seem to close this door, according to the report. Cuba currently has 212 confirmed cases of coronavirus and six confirmed deaths related to the disease.

Brazilian States Defy Bolsonaro's Call to Relax Quarantine Measures

All but three of Brazil's states have refused to follow President Jair Bolsonaro's direction to end quarantines and relax social distancing measures amid the Covid-19 pandemic, The Guardian reported. Bolsonaro has downplayed the threat of the virus in Brazil, which has 6,931 confirmed cases of it and 244 reported deaths.

Chile Slashes Benchmark Interest Rate to Lowest Level Since 2009

Chile's central bank on Tuesday dropped its benchmark interest rate to 0.50 percent, the key rate's lowest level since 2009, Reuters reported. Policymakers cut the rate, warning of a "severe" contraction in March due to the Covid-19 pandemic. Earlier that month, the central bank cut the key rate by 75 basis points to 1 percent in an emergency session after the first cases of the illness were reported in the South American country.

"The Venezuelan people continue to suffer tremendously due to Maduro and his criminal control over the country, and drug traffickers are seizing on this lawlessness," U.S. Defense Secretary Mark Esper said after Trump's announcement, the AP reported. The goal of the deployment is to nearly double the U.S. counternarcotics capacity in the hemisphere, said Esper, adding that 22 partner nations would support the effort. The operation has been planned for months, but it has become more urgent following last week's U.S. indictments of Maduro and other top government and military officials. The United States is offering a reward of as much as $15 million for information leading to Maduro's arrest and/or conviction and rewards of $10 million and $5 million for the others named in the indictment. Venezuelan Communications Minister Jorge Rodríguez called the deployment a "desperate attempt to distract attention from the tragic humanitarian crisis" in the United States caused by Covid-19. Maduro has called the U.S. charges against him "a collection of dirty, false accusations."

Peru's Vizcarra Calls Up Reservists to Enforce Quarantine

Peruvian President Martín Vizcarra has called up nearly 10,000 army reservists to return to barracks as part of the government's efforts to enforce a mandated quarantine aimed at containing the spread of coronavirus, the military said on Wednesday, Reuters reported. "They are graduates who served the Army, and we hope that some 10,000 will return," Colonel Martín Tisoc, the army's head of human resources, told the América Televisión channel, Reuters reported. At the Chorillos military headquarters in Lima, hundreds of reservists lined up to register and undergo a medical examination. If they pass, they will begin a "retraining" period before going on patrol, Tisoc said. As of Wednesday, reserve soldiers will be deployed gradually, La República reported. The government's call comes due to the high number of people who are failing to comply with social distancing measures and imposed curfews. As of Tuesday, Peru's police and military had detained some 36,000 people, Vizcarra said. The president recently extended the state of national emergency and nighttime curfew for an additional two weeks, until April 12. Despite the strict measures, the country's confirmed cases of coronavirus have continued to increase, reaching 1,323 with 47 confirmed deaths from the virus. [Editor's note: See the Advisor's **interview** with Dr. Jarbas Barbosa of the Pan American Health Organization.]

ECONOMIC NEWS

Mexican Economy Expected to Shrink 3.9% This Year

The Mexican economy is expected to shrink by as much as 3.9 percent this year, the finance ministry announced Wednesday in an annual economic report that is used to guide the budget, El Economista reported. The estimate, which has an upper limit of 0.1 percent growth, includes a "drastic" impact from coronavirus, the ministry said. A rebound next year could bring between 1.5 percent and 3.5 percent growth, it added. The announcement came with a promise of more measures to address the economic consequences of the fast-spreading coronavirus, with President Andrés Manuel López Obrador vowing to help small businesses and workers, Reuters reported. He also urged companies to continue paying employees, telling them to act with their "consciences." He said some major firms had already pledged to protect their work forces in the crisis, without providing further details. In a public health emergency, Mexican labor law allows companies to put staff on the minimum wage for a month. Many have criticized what they see as a weak and delayed governmental response to the Covid-19 pandemic.

The finance ministry expects a rebound in 2021.

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has fallen to just $60 billion, of which half will go to onshore projects. As such, international investment in Vaca Muerta can be significantly reduced. The government must take measures to create the conditions that allow for the continued development of Vaca Muerta. Though there is a pause now given the mandated quarantine, the government has a series of upcoming bills to favor investment, and it is also reviewing the implementation of the so-called 'barril criollo,' which fixes the price per barrel independently of international prices at a level at which investments are made possible, while awaiting for a recovery in crude prices."

A **Ignacio Rooney, principal, upstream, for Latin America at Wood Mackenzie:** "We believe Vaca Muerta's short-term outlook will be two different tales when considering oil and gas areas. For oil, we expect investments to concentrate on areas that already are in the development phase. We are seeing this as YPF doubles down on its three flagship assets, Loma Campana, La Amarga Chica and Bandurria Sur, despite the price context. Our analysis shows that YPF is running at the low end of the breakeven oil cost curve in Vaca Muerta, taking advantage of productivity and cost efficiency gains it has achieved. We expect to see YPF moving further down the learning curve during the downturn and improving its position once the market recovers. However, international players who were mostly running pilot or early development programs will wait for better prices. Regulation will also be key for them, as issues such as price and export incentives could favor investment decisions. For gas, the key topic is that there is not sufficient domestic demand for the potential the play has. Prices have gone as low as variable costs during the summer months under an over-supplied market. Added to this, recent drilling activity has decreased significantly. New markets will need to be developed for Vaca Muerta's gas, which will become tougher under competitive international LNG prices. Still, Vaca Muerta is among the few opportunities that Argentina has to attract foreign direct investment and restore economic growth. A competitive and stable framework could sustain activity in the short term and lay the groundwork for growth once markets stabilize."

A **Isabella Alcañiz, associate professor in the Department of Government and Politics at the University of Maryland** "Because of the devastating human and economic effects of the unfolding coronavirus pandemic, analysts predict a global recession. Around the world, economies are contracting at lightning speed as a direct result of mandatory closures and shelter-in-place policies. Argentina is vulnerable, as its economy was already in a recession, saddled with foreign debt and inflation. President Alberto Fernández, sworn in less than four months ago, is now facing a new and overwhelming challenge with the coronavirus pandemic. The new administration was staking an economic recovery on the further development of Vaca Muerta, but with the fall in oil prices and growing concerns among investors—which are expected to worsen if the global economy heads into a recession—this no longer seems viable in the short and medium terms. The dire reality is that all political, economic and technical resources in Argentina right now will have to go to fight Covid-19 in order to save lives. President Fernández has acted swiftly, implementing tight restrictions on movement and enforced quarantines, but public health experts predict hard weeks ahead. Once the global health crisis is reined in, and some of the economic uncertainty dissipates, the Argentine government can reassess what to do about Vaca Muerta and its broader energy policy."

The Advisor welcomes comments on its Q&A section. Readers can write editor Gene Kuleta at gkuleta@thedialogue.org.

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