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Argentine Oil and Gas: New Opportunities?

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The Argentine Government is about to send a bill to Congress to overhaul national oil and gas legislation. Will it deliver credible incentives for new investment?

IN the last months the Argentine Government has been working on a bill to revamp the country's oil and gas legislation. Senior Government officials have stated that the purpose of this bill is to increase investment, offer a better regulatory framework for shale and off shore drilling and production, and to achieve energy self-sufficiency for the country. What is behind this initiative, and are its objectives really achievable?

Why the change?

During the last decade, the Argentine Government intervened heavily in the country's energy sector, with the stated purpose of ensuring supply for domestic demand at affordable prices. The cornerstone of this intervention was the introduction of taxes and restrictions on crude oil exports. With the consequent nosedive in profits for oil and gas producers, even in a global context of rising prices, exploration for new reservoirs was seen as economically unattractive.

A further disincentive to exploration was new approach taken by the Argentine provincial governments. On shore oil and gas reserves in Argentina are owned by the province where they are located. Each province grants administrative concessions to private oil companies for the right to exploit a reservoir, in exchange for royalty payments. During the last decade, terms for new concessions have also required the investor to grant a carried interest in the project to an oil entity owned by the relevant provincial state. Such carried interest is usually free of all costs, and therefore tantamount to an added royalty. This scheme was promoted by the late President Néstor Kirchner, and also used by the National Government for off shore projects developed through ENARSA (an energy entity controlled by the National Government).

Against this background, the country's reserves and production of petroleum and natural gas declined, while domestic demand for energy grew rapidly. This made Argentina, for the first time in many years, heavily dependent on energy imports, which required a disbursement of US$ 12.8 billion during 2013. Current estimations indicate that Argentina needs to import 20% of its energy demand.

In a country without a significant inflow of capital, this volume of imports took its toll in Argentina's commercial balance (the difference between the value of exports and imports), and can probably be singled out as one of the main causes for the steady dwindling of the Argentine Central Bank reserves. This forced the Government to introduce severe currency exchange restrictions and bans on general imports in 2011 and 2012.

Although the Government took some specific measures to promote more oil and gas production for the domestic demand, such as the Gas Plus Plan, the impact of such measures was still limited by 2012. A plan of a much larger scale was then devised.

The Government's first step: YPF

In November 2011, YPF—Argentina's largest oil and gas producer privatised in 1999—announced the discovery of one of the world's largest unconventional oil fields in Vaca

Muerta, Province of Neuquén. The Government then set its eyes on YPF; complaining about the decline in YPF's output, attributed to underinvestment and excessive dividends, on April 16, 2012, President Fernández de Kirchner introduced a bill to renationalise the company from Repsol. The bill was approved by Congress and signed into law on May 5.

A few months later, in August 2012, YPF announced that it was planning to invest US$ 32.2 billion between 2013 and 2017, 73% for upstream and 22% for refining activities. And in December of that year, YPF signed an agreement with Chevron to develop Vaca Muerta, with an initial investment of US$ 1.5 billion, which can be expanded to up to US$ 15 billion. In furtherance of this project, in July of 2013 the National Government offered certain benefits (more on this below).

The second step, the new bill

According to media sources, Miguel Galuccio, YPF's current CEO, convinced President Fernández de Kirchner that more investment (particularly in non-conventional resources) was needed to regain the country's energy self-sufficiency. With the aim of giving adequate incentives for this, since December 2013 the Government has been working on a legislative bill; although it has not been made public, media sources have indicated that the bill includes, among others, the following provisions:

- Investors will enjoy tax stability, and a cap on royalties at 12% and on any applicable provincial gross turnover tax (*impuesto a los ingresos brutos*) at 3%,

- Concessions of non-conventional resources will be granted for at least 25 years (and 20 for conventional resources), with possible 10 year extensions,

- In reviewing bids for new concessions, provincial governments will be required to prioritise bidders who offer higher investment commitments and production targets, rather than a higher level of carried interest for the relevant oil and gas provincial entity (in fact, the National Government would like to see those carried interests disappear altogether), and

- Projects with direct investment of at least US$ 250 million would enjoy the following further benefits:

    - Reduction in customs duties on imports of oil and gas equipment,

    - Ability to export up to 20% of production, free of export duties, and

    - Exemption from currency exchange restrictions on the proceeds from the exports mentioned in the previous bullet point.

  These incentives for projects of at least US$ 250 million reproduce the ones offered by the National Government in July 2013 in furtherance of the YPF-Chevron agreement on Vaca Muerta (with the exception that the direct investment threshold was US$ 1 billion). However, in the case of the 2013 incentives, they were granted by presidential decree, which according to some gives them a feeble legal base. If enacted, the bill would have the added benefit of solving this problem, by giving the benefits adequate statutory sanction by act of Congress.

It is evident from the above that the bill would force the provincial governments to resign important powers on their income derived from oil and gas production. National authorities have been discussing the terms of the bill with the oil and gas provinces (Jujuy, Salta, Formosa, La Pampa, Mendoza, Neuquén, Chubut, Rio Negro, Santa Cruz and Tierra del Fuego), grouped under the OFEPHi (the Federal Organisation of Hydrocarbon Producing States).

According to media sources, staunch resistance to the bill has been found in the Province of Neuquén, which has substantial carried interests under agreements with YPF, Exxon, Shell, Total and Wintershall, and does not want to resign its ability to freely tax production from Vaca Muerta. This position is said to be held not only by Jorge Sapag, the incumbent governor, but also his opposition.

If approved, will the new incentives be effective?

The Government has announced that it intends to send the bill to Congress in August. However, the Government is surely aware of four important factors that will weigh in any serious risk assessment:

a) President Fernández de Kirchner's term in office will end on December 10, 2015. Legally, she cannot be re-elected, and neither has she given her blessing to any potential successor, nor is there any clear alternative political contender. This creates uncertainty as to whether whomever takes office in December 2015 will work along the same political lines as the current administration,

b) Measures taken in the past years by the Argentine Government have given raise to doubts on any new assurances on the stability of benefits offered to investors. For example, the Mining Investments Act (Law No 24,196, the "MIA"), provided for a 30 year tax stability benefit for projects compliant with certain requirements set forth by MIA. However, in 2007 the Kirchner administration introduced new taxes on mining exports, which were applied even to mining projects on which the stability benefit had vested,

c) The new bill has not been warmly welcomed by Argentine provincial governments, as the new measures limit and curve on their oil and gas-related income. If a politically weaker National administration takes office in 2015, it may have a hard time facing provincial governments robustly lobbying for change, and

d) These risks may be perceived to be compounded by the uncertainty on the resolution of the current conflict between the Argentine Government and the holdout bondholders.

The following months will show how far the Argentine Government is able to go with the bill, and how the risks described above and their perception by investors resolve themselves.

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