PROBLEMS OF INVESTMENT IN LATIN AMERICA IN THE PETROLEUM INDUSTRY†

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I. Introduction

Certainly these are tumultuous times. Recent newspaper articles depict a very grim picture for the business world. Boycotts, cartels, anti-boycott bills, nationalizations, election fraud, bribes, and pay-offs permeate every level of government. Business must go on, however, and the world must have sources of energy.

The political and economic situation of the world is not by any means settled. There are as many problems today as there were a hundred years ago. Although the problems we have now are of a different nature, their magnitude is ever increasing. Very little has been learned from history. First there was *Pax Romana,* then *Pax Britanica,* and a few years ago *Pax Americana.* What will be next—*Pax Islam*?

Latin America has not escaped from this tumultuous world. Indeed, since 1808, when Haiti was the first country to declare independence from Europe, Latin America has been very susceptible to world changes. For international business, change means that private foreign investment is no longer welcomed. At least it is not as welcomed as it used to be. The Latin American trend is to lessen foreign equity participation or to prohibit it altogether. However, since 1973, there has been another factor, namely, the oil embargo.

II. Ideological Problems in Formulating a Working Hydrocarbons Policy

Since 1938, when Mexico nationalized all the oil companies operating in the country and established the government monopoly Pemex, there have been throughout Latin America a myriad of positions and ideologies in formulating an oil policy. For example, Argentina has canceled petroleum operation contracts on two occasions when one political party or another took over the government. Peruvian nationalistic and semi-socialistic attitudes have changed abruptly to the extent that several companies have been allowed to enter the exploration scenario. In 1976, Brazil shocked the world when it opened its offshore basin to exploration by foreign enterprises.

The result, of course, is a tremendous and interesting job for attorneys.

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But the most important result is instability and the lack of a permanent energy policy that is divorced from politics and which obeys certain environmental and socio-economic rules. At one time, Latin America had the necessary capital to develop sources of energy. However, other needs were more pressing. In some countries the capital was invested in those sources which had a plentiful market outside of Latin America. As a result, the so-called "banana republics," coffee countries, and primarily agricultural countries emerged.

The situation existing since the 1920's between Latin America and the so-called industrialized countries is similar to the situation that existed between the North and South in the United States before the Civil War. But, of course, change has to take place and progress must continue. As the population increases and becomes more educated, the demand for energy rises. However, the exploration for petroleum is very risky. It requires a great deal of capital and demands technical skills that exist in only a handful of industrialized countries.

Nationalistic cries of "all belong to the State," "the State will take care of you," and "the State is a powerful person" have been heard throughout Latin America since 1938. Juan Peron, the Argentine dictator, acquired the local railroad from the British in 1946. The first step, he said, is to free Argentina from foreign control. Today the Argentine railroad is still the largest transportation system in Latin America; however, the deficit generated by it, estimated at 15 to 20 percent of the country's budget, is crippling Argentina.

This nationalistic attitude still hovers over Latin America today. Governments are very reluctant to change it. Politics and ideologies are intertwined with any hydrocarbons policy. The company that tries to explore for oil in a Latin American country must be prepared to invest a lot of time and money before even meeting the representatives of the government. Moreover, foreign companies, especially United States private companies, do not trust the host countries. They are somewhat uneasy about investing in countries that cannot maintain a certain level of political and economic stability, and will not recognize or honor the sanctity of the contract executed by the previous government. Nevertheless, companies are still interested in prospecting for oil in Latin America.

III. Drilling and Production Contracts

The type of contract used by most governments throughout Latin America at this time is a production sharing or service contract. In the 1950's and early 1960's another type, called a concession contract, was used. Under this contract, a private company rented the land from the government. If petroleum was discovered, the government was entitled to a small part; the rest was sold by the company to the government or taken by the company to its country or to another market.

Today with either the production sharing contract or the service contract, the company assumes all risk of exploration. If commercial exploitation is achieved, the companies are paid back out of the first production, (cost oil recovery). Usually the contracts are of the 70/30 type. This means that if there is an investment of ten million dollars in the total crude production, 70 percent of the production will go to the company and 30 percent will go to the government. After the cost is recouped, 70 percent will go to the government and 30 percent to the company. A private company may be in a delicate economic position if it enters into a contract whereby, after the recoupment period, it receives less than 15 percent of the production, excluding that from large fields. In fields of approximately 75,000 to 100,000 barrels per day, the split may be 91 percent and 9 percent for the company. If the company receives less than 15 percent, there is no incentive because there are no profits. There is not enough of the natural resource that can be used or sold elsewhere in the world. There are, of course, many types of splits which are used to accomplish the same result. For example, a company may recoup its capital from the first 60 percent up to a certain number of barrels per day of production. The ratio will decrease from 59 percent for the company and 41 percent to the government until it reaches the 70/30 split, or other indicated split.

The service contract, on the other hand, can be divided into two types of contracts. One is the "service per se," or drilling contract, whereby the host government pays a flat sum for the services performed. The other is a drilling contract with a buy-back clause or what is now being called the "Brazilian" type. In this case, the contractor assumes all risk. If a commercially exploitable reservoir is discovered, it receives a pay-back in cash extended over a period of fifteen years at a certain interest rate, and it has priority in buying oil at a price lower than the on-going market price. This is a peculiar contractual arrangement, but some Latin American countries like it as a way to preserve their nationalistic attitudes.

IV. Oil Production in Specific Latin American Countries

Latin American countries may be divided into three groups with respect to oil production. The first group comprises fifteen countries, including Belize, Costa Rica, The Dominican Republic, El Salvador, French Guiana, Guatemala, Guyana, Haiti, Honduras, Netherlands Antilles, Nicaragua, Panama, Paraguay, Surinam, and Uruguay. All of these countries have very little or no production and provide the greatest access to foreign investment. Uruguay is the only country that limits all operations to the state monopoly called ANCAP.[1] Nevertheless, in 1976, Uruguay awarded a production sharing contract to Chevron, a foreign company.

All the countries in the first group are in desperate need of energy

1. Administración Nacional de Combustibles, Alcohol y Portland.

sources. However, political instability and a lack of capital and technology make it virtually impossible for oil exploration to be undertaken by either the state-owned companies or their respective governments. The foreign exchange drain in these countries is certainly crippling their dreams to become economically solvent.

Two examples will best illustrate the problems that arise when nationalism interferes with the implementation of a responsible hydrocarbon exploration and exploitation policy. In 1973, when one particular country opened its territory for international public exploration, forty-seven companies submitted bids. At all times the parties were negotiating, they were in close contact with the country's director of hydrocarbons. All of the papers had been properly submitted and everything proceeded as normal. Suddenly, on the last leg of the negotiations, the Minister of Economy abruptly fired the director of hydrocarbons with the excuse that the director was not pursuing the policy the government had set. The end result was that after two and a half years of negotiations, forty-seven companies were left with no direct contact in the government. This happened in 1974. Since then, the government has not replaced the director of hydrocarbons and has not set a course for its new policy.

A second example of the difficulties encountered in implementing a responsible hydrocarbons policy also occurred in 1974. About ten companies submitted all the necessary documentation to the national petroleum commission of a Latin American country in response to that country's international call for exploration of its offshore areas. All papers and financial agreements were approved by the government. The particular contract submitted by one company was good for the country, and it left an adequate margin of profits for the company. At the last negotiation meeting, the petroleum commission requested that the company commit a certain number of wells somewhere in the area of interest. The company's response was that before the wells could be committed, seismic studies had to be done. In this way, at least an educated decision could be made as to the location of the wells. However, the petroleum commission's goal was to hurry up and drill somewhere offshore. The company was told that if it did not agree to drill immediately, other companies would be found to do it. After six months, the first company retired entirely from the negotiations. Other large and small international companies followed suit. The result was that because of bad management and ineffective policies, this particular country has, as of today, neither a viable hydrocarbon policy nor an exploration program. All the petroleum must be imported, resulting in a tremendous drain of foreign exchange which is badly needed in other areas of the economy. These are just two examples from countries in group one, illustrating that a stable or consistent energy policy divorced from politics is urgently needed.

The second group of countries is comprised of Argentina, Peru, Brazil, Chile, and Cuba. These countries produce a certain quantity of oil, but not enough to satisfy their internal consumption. If all the countries in North America were included, the United States would be in the second group. In 1976, the United States imported 55 percent of the oil it consumed.

From this second group, two countries have been selected to illustrate the problems they now face, and the problems the United States might also face in a few years. In 1976, Argentina had an internal consumption of approximately 15.5 million cubic meters of oil.[2] Of this, Argentina produced almost 14 million cubic meters of oil. This means that Argentina had to import about 1.5 million cubic meters to satisfy internal consumption. This, translated into barrels, amounts to about 25,000 barrels per day.[3] According to petroleum technicians, Argentina has sufficient oil reserves to last until 1989 and gas reserves to last until 2005. Nevertheless, in 1989 the deficit will climb to about four or five million tons per year. Yacimientos Petroliferos Fiscales, the Argentine oil company, plans to drill nineteen offshore wells between 1970 and 1980. However, an all-out drive to find oil on the continental shelf has been ruled out for the time being because of the current financial squeeze. They simply lack the financial resources to do it.[4]

The other example is Brazil. Having 110 million inhabitants, Brazil's demand for oil is continuously growing; thus, it has problems that are similar to those of the United States. However, the energy picture is worse in Brazil, and it is going to worsen. Petrobras, the state-owned oil company, produces at this time about 200,000 barrels per day. The internal consumption of Brazil, as of 1976, amounted to 850,000 barrels per day. This means that in 1976 there was a deficit of 650,000 barrels which had to be imported in order to satisfy internal consumption. By 1979, however, Petrobras and other economic and financial institutions have projected that the internal consumption will reach 1.3 million barrels per day. According to a recent plan published in 1976, Petrobras foresees that, at the current rate, the production of oil in Brazil will not exceed 200,000 barrels per day. This means that by 1979, there will be a deficit of 1.1 million barrels per day. Given the current price per barrel,[5] Brazil will have to spend approximately 15 million dollars per day to buy oil. That amounts to over one half trillion dollars a year. Where will this money come from?

Most Latin American governments do not have the money to explore, and their economies cannot generate the necessary money to buy. These countries need an autonomous entity, divorced from politics and government, which could set a progressive energy policy acceptable to both the country and the foreign investor. Apparently the Brazilian government has

2. One cubic meter is equivalent to one ton (2240 pounds).
3. One barrel is about forty-two gallons.
4. After this speech was given, Argentina opened for international bidding the offshore area of Tierra del Fuego.
5. At this writing, the current price is approximately thirteen dollars per barrel.

realized this because last year it opened its offshore areas to foreign exploration.

The countries that are really well-off are the six oil exporting countries that constitute the third group. They occupy a broad spectrum that ranges from an unqualified state monopoly in Venezuela and Mexico, to a competitive blend of private enterprise and state entity in Colombia, Bolivia, and Ecuador. In Trinidad Tobago, the state plays the even more pragmatic roles of licensor, shareholder, or co-venturer.

V. Conclusion

The nationalistic trend that hovers over the countries of Latin America will probably diminish in the near future to permit the exploration and exploitation of hydrocarbons. The governments know they lack the capital, skills, and technology, and the industrialized countries know that they lack the natural resources. Thus, the countries of the world have the essentials for a mutually beneficial relationship which can be achieved not for the enrichment of a few, but for the benefit of all concerned.

Questions and Answers

Question: Are there any technological institutes in Latin America that are equipped to train people in the technology necessary for the production of oil? Why are the Latin American countries still so dependent on American know-how?

Answer: Most likely, none of the countries in Latin America can either build or use an offshore platform. For example, one particular country had purchased a platform from France at a cost of 65 million dollars, but they did not know how to use it. They had to have someone come to teach them how to use it. In order to develop their technology, the state monopolies should send their technicians to learn in other parts of the world. There are no institutes or schools where solely petroleum technology is taught.

Question: Under the present type of service contract, it appears that companies would make only a small profit. Is this so?

Answer: Integrated companies will make money because they are integrated and somewhat more efficient. For example, a company could obtain 100,000 barrels of oil and still lose $100,000 in the process. But as the oil goes downstream, through refineries, the oil may be converted, after an elaborate process, into chemicals. The company allocates the oil so that part of it is used to produce gasoline, and another part is used to produce chemicals which can be sold at a higher profit. Therefore, the integrated company can recoup its exploration losses by producing several different products.

Question: Are not companies very insecure about the pay-back provisions by which the government is supposed to make yearly remittances, when there may be fifteen different consecutive governments?

Answer: Yes, but that is a risk one has to take. All petroleum policies are mingled and intertwined with politics. If one government falls, the one that succeeds it might just cancel the contract. In Argentina this happened twice. Nevertheless, it is necessary to continue exploration and production there because the oil is needed. Right now, the United States is importing 55 percent of the oil it consumes. There is now enough oil to meet this country's present demand, but it is not known for how long this will continue. The only way to cut consumption and conserve fuel is to raise the price. President Carter has proposed a 25 cent increase. Europeans are paying $1.90 and in some countries up to $2.20 per gallon.