

Coronavirus, Oil and Latin America: The Urgency of Economic Diversification and Energy Transition

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Key messages

- If and when the price per barrel of oil recovers to USD 50, some of the oil produced in Latin American will barely cover its breakeven price.
- Companies are demanding temporary bailouts, requesting that governments subsidize them with breakeven prices over sale prices, and allow them to postpone tax and royalty payments and agreed investments. Such actions may be necessary to preserve jobs and ensure domestic energy supplies.
- Governments are considering lowering social and environmental standards, fast-tracking procedures and providing long-term subsidies to support ongoing projects and to attract new investments. For an industry already facing its twilight, these actions are not justified.
- Governments must urgently move ahead with economic diversification and energy transitions to ensure the availability of jobs, energy and fiscal incomes that the oil industry currently provides.
- It is unclear whether key actors will collaborate with energy transition strategies. For example, will oil companies transform into clean energy companies? Will governments use oil rents to fund diversification and energy transition programs?

INTRODUCTION

In the aftermath of the coronavirus pandemic, the prospects for oil in Latin America are not good. At today's oil price, and even at a projected future price of USD 50 per barrel, a share of current projects will barely meet their breakeven price. This is compounded by the declining global trend in investments fed by the sector's instability, concerns about global warming and increasingly lower costs of cleaner and sustainable energy sources.

At the same time, in many Latin American countries, companies are demanding that governments bailout projects that cannot continue producing profitably at current prices, citing concerns that closing them down will cause unemployment and energy scarcity. The Argentinian government has already taken such a step imposing a temporary minimum price of \$45 per barrel to help out producers impacted by the current low prices.

While some of these measures may be necessary in the short term, it does not seem to make sense to permanently subsidize the sector. This is especially true in a context in which public savings have been spent on social compensation and economic reactivation packages, fiscal incomes will fall, and spending should focus on strengthening other sectors, such as health.

In response to these short- and long-term concerns, governments need to accelerate the migration to cleaner and sustainable energy matrixes and to diversify their economies to provide the jobs, incomes and taxes that will be lost with the demise of fossil fuels. More broadly, officials should promote diversification to set the stage for more socially inclusive and environmentally sustainable growth.

IMPACT OF THE CORONAVIRUS CRISIS

The coronavirus pandemic and the oil price war between Saudi Arabia and Russia caused an extreme fall in demand and global oil prices. In some regions of the world, the pandemic has also resulted in the depletion of storage capacity, which has led producers to pay buyers to take production, something that has rarely been seen in the history of the oil sector.¹ In an attempt to mitigate damages to the oil sector, in Argentina, the government recently established the so-called “Creole barrel,” setting Argentinian-produced oil prices at \$45 per barrel. The measure is in effect until December 2020, but will be automatically suspended if the Brent price per barrel reaches \$50 for 10 consecutive days.² The government’s aim is to prevent oil companies operating in the country and supplying the domestic market from collapsing, which they are currently at risk of due to the low oil price in international markets.

The problem for Argentina, and for the rest of the countries in the region whose economies are heavily dependent on oil exports, is that the fall in demand and price does not appear to be a short-term one. Indeed, most projections agree that international prices will slowly recover but will only reach per barrel prices of \$45 to \$50 by 2025. Will Argentina have to maintain an artificial internal price until then? Who would bear these costs?

Figure 1 shows this fall in oil prices is the second to follow the supercycle that occurred from 2004 to 2014, during which time the price of oil went above \$100 per barrel. Indeed, between 2014 and 2016 the price fell to about \$40 per barrel for a short period of time, then recovered to reach \$70 per barrel in 2018. Along these ups and downs, corporate profits and government fiscal incomes grew and fell, but the vast majority of existing investments remained viable from a commercial viewpoint, generating income that allowed companies to cover operation costs, pay taxes and royalties and make profits.³

- 1 Jillian Ambrose, “Oil prices dip below zero as producers forced to pay to dispose of excess,” *The Guardian*, 20 April 2020, www.theguardian.com/world/2020/apr/20/oil-prices-sink-to-20-year-low-as-un-sounds-alarm-on-to-covid-19-relief-fund.
- 2 Diario gestión, Argentina fija en US\$ 45 precio de barril de crudo para proteger a productores locales, 19 Mayo 2020, in <https://gestion.pe/economia/mercados/argentina-fija-en-us-45-precio-de-barril-de-crudo-para-protger-a-productores-locales-noticia/#:~:text=El%20Gobierno%20de%20Argentina%20fij%C3%B3,de%20la%20pandemia%20del%20coronavirus>; and Boletín Oficial de la República Argentina, DCTO-2020-488-APN-PTE - Petróleo Crudo en el Mercado Local. Establécese Precio para Facturación de Entregas, 18 Mayo 2020, in www.boletinoficial.gob.ar/detalleAviso/primera/229470/20200519
- 3 Rystad Energy Database. Accessed 24 July 2020. www.rystadenergy.com.

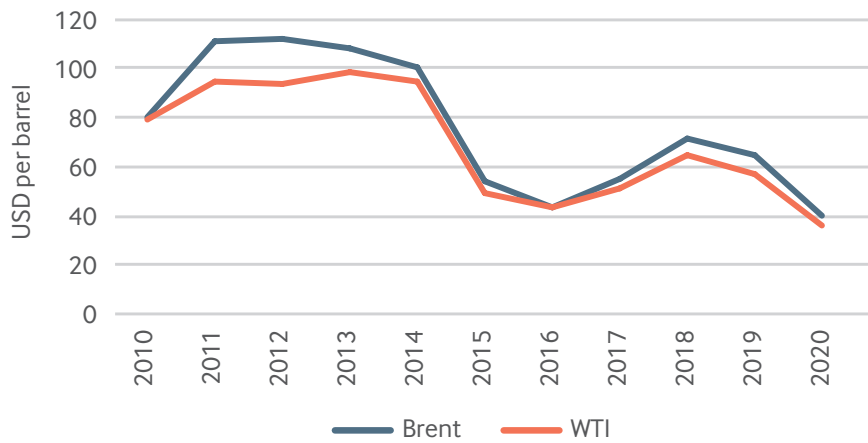


Figure 1. Oil prices , 2010-2020
Source: Rystad

THE LATIN AMERICAN AND CARIBBEAN REGION

In the Latin American region, some of the oil projects currently under production will barely meet their breakeven prices even if the sale price recovers to \$50 per barrel.⁴ This is the case, for example, for some of the currently-producing projects in the Brazilian Atlantic, the Peruvian Amazon, the Colombian Caribbean and Venezuela, where 20 to 40 percent of current projects would not be commercially viable under the \$50 per barrel scenario.⁵

Country / Area	Breakeven price range	Breakeven price average	Average projected sale price	% current projects breakeven price over sale price
Brazil Atlantic	170.00 - 5.10	45.50	50.00	31.40
Brasil Northeast	82.90 - 5.30	28.45	50.00	5.95
Colombia Andes	69.39 - 4.60	29.99	50.00	11.11
Colombia Caribe	68.20 - 6.50	31.77	50.00	20.00
Colombia Orinoquia	126.00 - 5.80	34.36	50.00	12.64
Mexico Yucatán	102.20 - 7.00	23.46	50.00	3.28
Mexico Central	250.00 - 7.60	26.33	50.00	6.82
Mexico Gulf	66.40 - 12.30	33.46	50.00	18.52
Peru Amazon	62.40 - 7.70	37.72	50.00	23.80
Peru Northern Coast	92.60 - 5.40	25.67	50.00	8.77
Ecuador Amazon	66.10 - 8.0	28.04	50.00	2.31
Guyana	35.70	35.70	50.00	-
Venezuela Eastern	250.00 - 8.00	41.97	50.00	21.57
Venezuela Western	250.00 - 10.50	56.06	50.00	41.46
Venezuela Orinoco	94.60 - 19.30	49.26	50.00	23.08

Table 1. Projects with breakeven price over projected sale price (USD)

4 Breakeven price means one that covers production costs, tax and royalty payments and a 10 percent annual return on investment.

5 Rystad Energy Database.

In terms of production volumes, in Peru, 30 percent of the Amazon's production (which is equivalent to 15 percent of domestic production) would barely cover break-even prices. Similar is the situation of 18 percent of Colombia Orinoquia's production (which is equivalent to 14 percent of national production) and of 13 percent of Brazil Atlantic's production, equivalent to 13 percent of that country's national production. In Venezuela, the figures are considerably more dramatic, as more than 35 percent of domestic production will not be profitable even at \$50 per barrel.⁶

Country / Area	Percentage of current territory production breakeven price over sale price	Percentage of current national production breakeven price over sale price	Average projected sale price
Brazil Atlantic	13.44	12.82	50.00
Brasil Northeast	2.17	0.05	50.00
Colombia Andes	3.94	0.86	50.00
Colombia Caribe	32.65	0.86	50.00
Colombia Orinoquia	18.65	14.08	50.00
Mexico Yucatán	0.02	-	50.00
Mexico Central	0.20	0.01	50.00
Mexico Gulf	2.96	2.46	50.00
Peru Amazon	30.40	15.42	50.00
Peru Northern Coast	10.76	2.03	50.00
Ecuador Amazon	0.84	0.84	50.00
Guyana	-	-	50.00
Venezuela Eastern	46.35	10.02	50.00
Venezuela Western	72.98	15.78	50.00
Venezuela Orinoco	4.98	2.24	50.00

Table 2. Volume of production with breakeven price over projected sale price (USD)

Some companies may be in the financial position to wait to see if prices rise beyond the \$50 projection and some governments may want or need to offer concessions for some time. However, in many cases, companies may not have the capacity or the will to wait for better prices and/or governments may not want or be able to bail them out for more than a short time. In the first scenario, current production may continue, which may deplete fiscal resources. However, in the second scenario, companies may abandon some investments that are no longer profitable, materializing the peril of "stranded assets."⁷

Globally, as figure 2 shows, investment in exploration has been falling and it appears that it will continue to fall due to uncertainties caused by slower economic growth, instability and a horizon defined by anti-global warming agreements and

6 Rystad Energy Database.

7 CEPAL, Andrés Arroyo, Estado de situación y perspectivas de los hidrocarburos en la región, en Ricardo Sanchez, editor, La bonanza de los recursos naturales para el desarrollo. Dilemas de gobernanza, CEPAL, Santiago de Chile: 2019; James Cust, David Manley, and Giorgia Cecchinato, *The unburnable wealth of nations* (IMF, 2017), www.imf.org/external/pubs/ft/fandd/2017/03/cust.htm; David Manley, *Oil Companies Face Stranded Assets, But Producer Countries Have It Worse* (NRGI, 2017), resourcegovernance.org/blog/oil-companies-face-stranded-assets-producer-countries-have-it-worse.

energy market trends that favor clean energy.⁸ In a way, the coronavirus pandemic and the resultant global economic recession has accelerated energy trends that—in response to the threat of global warming—were already ongoing due to a global movement towards clean energy.

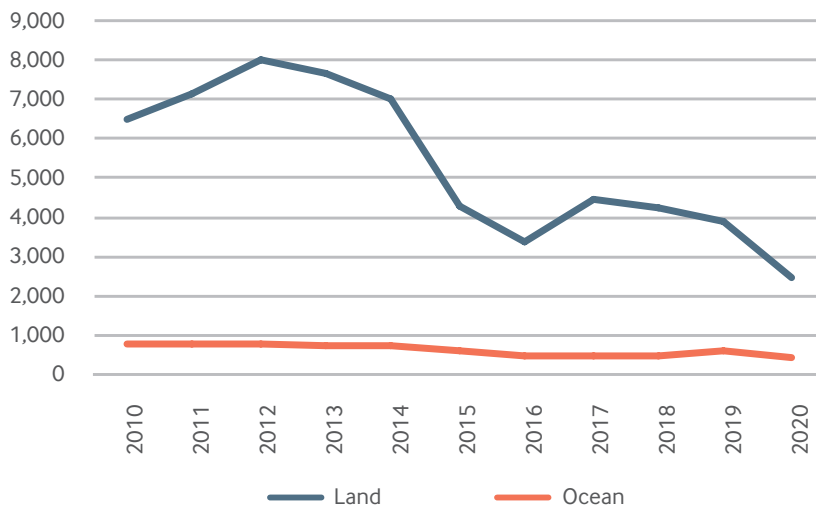


Figure 2. Exploration wells drilled globally, 2010-2020

COLOMBIA, PERU AND MEXICO

Private oil companies in Colombia and Peru are calling for the state to directly intervene in reducing internal transportation costs or by directly subsidizing companies that claim to be failing.

In Colombia, entrepreneurs point out that their after-tax production costs are between \$40 and \$45 barrel and that selling at that price does not allow them to recover the invested capital nor make new investments.⁹ The Colombian Petroleum Association (ACP) has called for the government to intervene to lower internal transportation costs from production sites to ports and refineries. The ACP publicly protested against the transportation concessionaire’s first proposal to postpone payments but apply penalties. Following this, some companies have reached bilateral agreements with the concessionaire, but the ACP notes that these are short-term arrangements that do not solve the bottom line problem.¹⁰

In Peru, the Peruvian Hydrocarbons Society (SPH) has proposed some temporary and extraordinary measures.

- Suspend, postpone and/or split annual taxes and other contributions until July 2020 and wait for the price of crude oil to be recovered by that time
- Suspend royalty payments for a minimum period of 90 days

8 The Economist, “Investment in oil supply has collapsed. It may not roar back,” 13 June 2020, www.economist.com/finance-and-economics/2020/06/11/investment-in-oil-supply-has-collapsed-it-may-not-roar-back; and Rystad Energy Database.

9 *Forbes Colombia*, “ACP: empresas petroleras en Colombia operan a pérdida,” 22 April 2020, www.forbes.co/2020/04/22/economia-y-finanzas/acp-empresas-petroleras-en-colombia-operan-a-perdida/

10 ACP, Comunicado a la opinión pública, 30 Abril 2020, acp.com.co/web2017/es/sala-de-prensa/comunicados-de-prensa/1314-comunicado-a-la-opinion-publica-4; and ACP, Los acuerdos de financiación ayudan, aunque no resuelven el problema estructural del alto costo de las tarifas de transporte por oleoductos: ACP, acp.com.co/web2017/es/sala-de-prensa/comunicados-de-prensa/1348-los-acuerdos-de-financiaci-on-ayudan-aunque-no-resuelven-el-problema-estructural-del-alto-costo-de-las-tarifas-de-transporte-por-oleoductos-acp.

- Temporarily suspend compliance with other commitments, including investment plans, such as well drilling obligations and other activities for which profitability is not guaranteed
- Incorporate in the Fund for the Stabilization of Petroleum Fuels Prices¹¹—originally designed to protect consumers from abrupt price changes—a mechanism of band based compensations for producers during the current price situation, with the aim of ensuring the continuity of production operations

The final measure, which is similar to Argentina’s “creole barrel,” aims to keep the price per barrel at \$40 to sustain the activity of the companies.¹²

Mexican private oil companies face a different situation, as the vast majority are currently in the exploration phase. These companies have not requested that the government change their contract terms. On the contrary, they report on new investments in the sector and their strategy to increasingly contribute to domestic oil production.¹³ But they use arguments similar to those used by mining and oil private sector mining and oil guilds in other countries when discussing tax matters in times of crisis (“At the end of the day what is better, a tax regime with 90 percent royalties that delivers ‘0’ production, or allow a lower percentage for a limited time while the industry is recovering?”)¹⁴ or the need for more simple, less time demanding procedures to obtain the drilling permits.¹⁵

MEDIUM- AND LONG-TERM CHALLENGES

While today’s oil market presents short-term challenges to avoiding both a social crisis in the areas dependent on resource extraction and a collapse in the supply of this energy on which these economies depend, it also poses a longer-term dilemma.

How will Latin America respond to that fact that a portion of its oil production simply will not be able to generate the profits that investors expect? What will happen if, under the current circumstances, investment in exploration falls even more in the face of the demand and cost-price outlook for the following years? And, how will governments respond to demands for subsidies in a context of budget deficits resulting from spending in compensation and reactivation packages and from declining oil revenues and subsidies?

As we have seen, the immediate demands of business guilds such as the ACP in Colombia and SPH in Peru aim to defer tax payments and royalties, delay investment plans and ask governments to lower or temporarily subsidize costs. Business guilds have focused their appeals on governments’ need to avoid a disruption in the domestic energy supply and sustain direct and indirect employment associated with the sector.

11 Sociedad Peruana de Hidrocarburos, “SPH propone medidas extraordinarias para impedir el cierre de los campos de producción de petróleo,” 5 May 2020, in www.rumbominero.com/noticias/hidrocarburos/sph-propone-medidas-extraordinarias-para-impedir-el-cierre-de-los-campos-de-produccion-de-petroleo.

12 Felipe Cantuarias, Presidente SPH, “El reto para el sector hidrocarburos,” prensa.imedia.pe/custum/notas.php?cod=12027836&pass=c7c675b646c.

13 Insight Mexico, “Sector privado cumple con resultados,” 1 January 2020, insightmexico.mx/amexhi; AMEXHI, “La industria privada continua cumpliendo sus compromisos con México,” 5 July 2020, twitter.com/AMEXHI_Oficial/status/1279802426279645190; AMEXHI, Boletín 9, June 2020, www.amexhi.org/newsletters/newsletter-junio

14 Pulso Energético, “Impactos del COVID-19 en el sector energético,” 13 April 2020, pulsoenergetico.org/impactos-del-covid-19-en-el-sector-energetico.

15 Pulso Energético, “El camino hacia la madurez regulatoria,” 26 Mayo 2020, pulsoenergetico.org/el-camino-hacia-la-madurez-regulatoria.

In some cases, these may be valid arguments in the short term, as indeed an abrupt collapse of the oil industry would have negative economic and social consequences to which governments are not ready to respond. However, the real problem has to do with the medium and long terms: should countries continue to bet on projects that may not be commercially sustainable and promote private investments (or invest themselves) in exploration in an industry that has a bleak future? Should governments diminish fiscal, social and environmental standards to make competitive an industry that faces such an adverse future? Does additional oil investment make sense in the face of catastrophic global warming?¹⁶

NRGI has already argued against government subsidization of the oil sector, questioning the possibility of more “race to the bottom” policies and pointing out that governments should not inject scarce public resources into state-owned enterprises or subsidize private companies that are not profitable today nor likely to be in the future, given migration towards a new global energy matrix.¹⁷

Conversely, a strategic response to the current global energy situation calls for concrete and urgent answers to the problems that a collapse of oil production would generate in dependent countries and territories.

- Accelerate domestic energy transitions to replace oil (and gas) as an internal energy source, so that it does not affect countries’ energy supplies.
- Diversify sources of employment, income, exports and government revenue in territories and countries that now depend on oil extraction, refinement and exports.

The importance of oil to each country’s economy will determine what each country needs to do to diversify its energy mix, balance its economy and the roles of governments and companies.

For countries where oil exports are relatively more important, diversifying the economy will demand a great effort to replace oil revenues. As figure 3 shows, Colombia and Mexico are the fourth and fifth countries most dependent on these exports, while Peru is among the least dependent. Venezuela is by far the most dependent, but this graph does not show it because information is only available up to 2014.¹⁸

16 Damian Carrington, “Leave fossil fuels buried to prevent climate change,” *The Guardian*, 7 January 2015, www.theguardian.com/environment/2015/jan/07/much-worlds-fossil-fuel-reserve-must-stay-buried-prevent-climate-change-study-says.

17 Andrew Bauer and David Mihalyi, “Coronavirus, the Oil Crash and Economies: How Can Governments of Oil-Dependent Countries Respond?” Natural Resources Governance Institute, 8 April 2020, resourcegovernance.org/blog/coronavirus-oil-crash-economies-how-governments-respond; Juan Luis Dammert, “¿Una nueva carrera hacia el fondo? Desafíos de gobernanza para el sector minero en América Latina en tiempos de COVID-19,” Natural Resources Governance Institute, Documento de Trabajo, 11 June 2020, resourcegovernance.org/sites/default/files/documents/desafios_de_gobernanza_minera_covid-19_-_documento_de_trabajo.pdf.

18 *Oil rents (% of GDP) - Colombia, Venezuela, RB, Peru, Mexico, Ecuador, Brazil, Bolivia, Argentina* (World Bank, 2011), data.worldbank.org/indicator/NY.GDP.PETR.RT.ZS?contextual=region&end=2017&locations=CO-VE-PE-MX-EC-BR-BO-AR&name_desc=true&start=2017&view=bar.

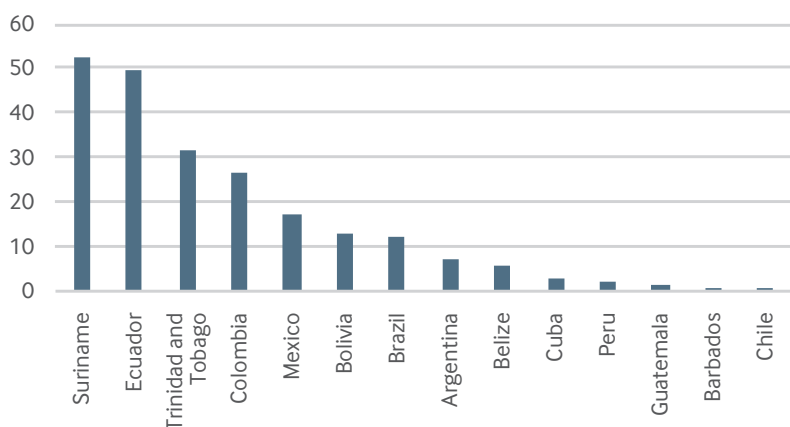


Figure 3. Oil rents as a percentage of GDP, 2017

For countries whose energy consumption is more heavily dependent on oil and fossil energy in general, the challenge of the domestic energy transition will be significant. Figure 4 shows that Mexico faces a greater challenge than that faced by Colombia and Peru, whose energy matrices are less dependent on fossil fuels.¹⁹

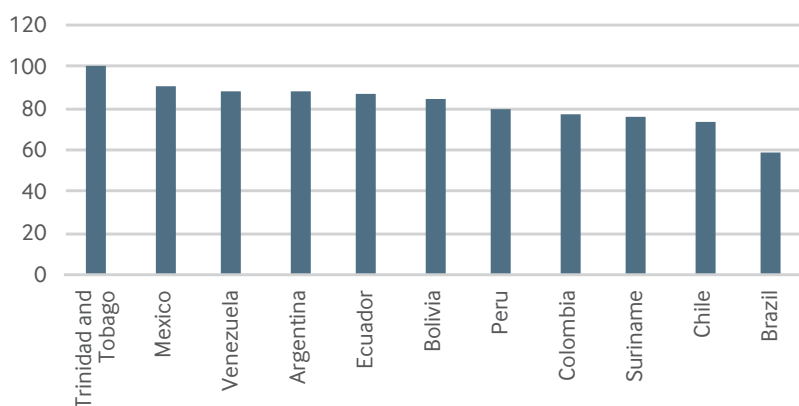


Figure 4. Fossil fuel consumption percentage of total energy consumption, 2014

Finally, in both cases, a transitional question arises. Can the current oil industry contribute in any way to the achievement of these objectives? Governments and companies should explore the following strategies.

- Companies now engaged in oil extraction, processing and export could evolve into companies dedicated to the generation of clean and sustainable energy. Several of the world’s big oil companies are already investing in these alternative energies. In the case of state-owned enterprises, this change depends quite a bit on the political decision of governments.
- Governments could devote some of the tax revenues generated today by oil activities to boosting energy transition and inclusive and sustainable economic diversification.
- Companies and governments should see that other sectors of the economy share and benefit from the infrastructure and services built and provided to enable oil exploitation.

19 Fossil fuel energy consumption (% of total) - Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Trinidad and Tobago, Suriname, Venezuela, RB (World Bank, 2014), data.worldbank.org/indicator/EG.USE.COMM.FO.ZS?end=2013&locations=AR-BO-BR-CL-CO-EC-MX-PE-TT-SR-VE&name_desc=true&start=2013&view=bar.

CONCLUSION

The global recession and the oil sector price war have likely accelerated irreversible trends in the oil sector. There are drops in production, especially in Peru and Colombia, and in the royalties and taxes generated by these activities. The national impact of this decline in oil revenues is directly proportional to the weight of the activity on exports and domestic tax revenues.

In response to this situation, companies are asking governments to defer payments of taxes or royalties, reduce transportation costs (Colombia), postpone investment commitments and to compensate companies that are already producing with breakeven prices over sale ones. They argue that governments need to comply in order to sustain employment and energy supply and thus avoid negative social and economic impacts of an abrupt collapse of the domestic energy supply.

However reasonable some of these demands are in the short term, questions arise about their temporality and the medium- and long-term challenges facing the sector.

It is unclear for how long governments can artificially sustain these activities, now that they have spent much of their savings, will see their tax revenues diminished by the recession, and are already taking debt to fund social compensation programs, economic recovery packages and improvements in public health systems.²⁰

In the medium term, the crisis has also led to a drop in resources allocated to oil exploration, deepening an ongoing trend that responds to the decrease in the relative costs of clean and sustainable energy and the progress of the global energy matrix transition. Of course, oil prices are unlikely to decline continuously and there still may be short term booms in demand, prices and investments, but the overall trend is clearly downwards.

Instead of subsidizing non-viable projects and continuing to promote investments in a sector that seems to have no future, governments should accelerate domestic energy transitions and economic diversification strategies so that the demise of oil is accompanied by concrete alternatives for employment, public revenue generation and energy supply. The question is how, and what role, if any, the oil industry could play in this process of change.

ABOUT THE AUTHOR

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²⁰ CEPAL, Informe especial COVID-19 no. 5, Enfrentar los efectos cada vez mayores del COVID-19 para una reactivación con igualdad: nuevas proyecciones, 15 July 2020