LATIN LAWYER NEWS

Vaca Muerta: the day after the day after

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Less than six months ago, Argentina's world-class shale play, Vaca Muerta, was booming. Since then covid-19 has hit Argentina, oil prices have nosedived, and lockdown measures have made companies close wells and stop new drillings. In preparation for the day after coronavirus, Martínez de Hoz & Rueda partner José Martínez de Hoz considers what Argentina should do to put Vaca Muerta and Argentina back on track.

Production of unconventional oil and gas in Argentina has consistently increased at very high rates year-on-year over the past five years. In a year-on-year comparison between December 2019 and December 2018, shale oil production increased 49%, while shale gas grew 257%.

One of the main topics of discussion during 2019 was the need to expand the capacity of crude oil and gas pipelines, since new gathering lines were being constructed or planned to extract the increasing volumes from Vaca Muerta and surplus capacity was narrowing.

The consensus was that, due to the limits of the Argentine domestic market, Vaca Muerta needed to find a global market for its production to sustain a full-scale development. A pilot LNG plant, such as floating liquefied natural gas (FLNG) facilities, was being commissioned at the port of Bahía Blanca on the Atlantic Ocean coast, almost 600 kilometres east of Vaca Muerta, and more ambitious programmes were under consideration. A public tender was launched to award the construction of a new US$1.8 billion gas pipeline connecting Vaca Muerta with the main industrial areas to free capacity in the existing system.

Even the election of a less business-friendly government, following the outcome of December's presidential election, did not dampen the plans for expansion. Discussions were held with the new authorities to enact a regulatory framework to provide credible safeguards for large-scale investments in long-term projects.

Covid-19 strikes

But during these negotiations, covid-19 reached Argentina and changed people's lives and the economy, as it did in the rest of the world. The impact on the economy is compounded by Argentina's pre-existing ailments, including a virtual default of its sovereign debts, high inflation and an ongoing two-year recession.

The government closed borders and imposed mandatory quarantine measures, including domestic travel bans and the cancellation of commercial flights on 20 March, with only a limited number of exceptions for essential activities. In the oil industry, these include teams maintaining ongoing production and plant operations, but new drilling and fracking came to a complete halt.

Following the measures, consumption of gasoline and jet fuel dropped by some 80% and diesel oil by 50% (alleviated at least by the soybean and corn harvest), while electricity demand reduced by 15%. In this context, crude oil demand dropped around 30%.

In the meantime, international crude oil prices plummeted by two-thirds, adversely impacting the profitability of current operations and the prospect of future investments.

Oil and gas producers in Argentina have tried to cope with the situation in different ways. Integrated companies or producers with storage or export capacity continued pumping during the last days of March. Crude oil production in the central province of Neuquén (where Vaca Muerta is) peaked in March, reaching 170,000 barrels per day.

But crude oil storage capacity in Argentina is very limited – around 17 million barrels, equalling about a month's production – and floating storage capacity is close to its limit (at least 5 Panamax vessels have been leased and are being used by several oil companies operating in the country). On top of that, the cost of international freights has soared.

Although some new gas exports to Chile have marginally helped, crude oil exports have been severely hampered by the abrupt plunge in crude oil prices, compounded in the case of Argentina by the existence of a 12% export tax.

Inevitably, refineries have reduced their production and several of them have closed. Some large producers have shut down wells, beginning with those with higher costs or in disadvantageous locations. YPF, the national oil company, has shut down 50% of the wells at its largest shale oil-producing field, and other producers are following the same path, especially those that do not own refineries or do not have export opportunities.

This situation is causing a rising number of disputes. Non-integrated companies that have not hedged their production are demanding a larger reduction of production or the total shut down of fields, since they have no market to place their production. Integrated operators resist this, as they need to supply their own refineries, which, because they are operating at low levels of capacity, cannot purchase from other producers.

Companies are also terminating many supply-and-service contracts and renegotiating others, which is affecting the entire business chain. The reduction in production, compounded by low prices, is also severely affecting the revenues that oil and gasproducing provinces collect via royalties (at a 12% or 15% rate in most of the unconventional and conventional concessions, respectively).

Argentina has a rigid labour law framework. Companies cannot lay off workers as rapidly as in the US and some other countries. Nevertheless, oil unions in some locations like Neuquén have agreed to significant, but temporary, salary reductions (approximately 40%) to avoid layoffs. In other locations, like the province of Santa Cruz in southern Argentina, the unions continue to resist this solution.

Where do we go from here?

In this context, the federal government and the industry are discussing measures to mitigate the situation, including the elimination or reduction of export and social security taxes. There is also a discussion about fixing a domestic crude oil price in the region of US$40 per barrel, like Argentina did during the oil crisis of 2014-2015.

These measures will at the most marginally mitigate a situation that is being driven by the covid-19 pandemic and its associated restrictions, within an international context. But the curve of infections in Argentina seems to be somewhat under control; the federal and provincial governments are beginning to ease some of the restrictions and they are planning to move further along this path. Neuquén, for instance, has already permitted activity in the construction sector to restart.

The relevant question, however, is what to do “the day after”? At some point the world economy and crude oil prices will start to recover, whether that is sooner or later. So how should Argentina try to attract investment to put Vaca Muerta back on track in a way that can make a significant contribution to the Argentine economy?

Large scale development of Vaca Muerta’s oil and gas resources, including the construction of midstream infrastructure and potentially LNG liquefaction facilities and other downstream projects needs to eliminate three fundamental risks associated with Argentina’s track record: (i) export taxes; (ii) export restrictions prompted by domestic requirements; and (iii) foreign exchange regulations restricting the free flow of capital investments, remittance of profits and repayment of loans, among other things.

In parallel with short-term policies to tackle the global emergency, Argentina needs to plan long-term and reinstate the discussions for designing a comprehensive political and legal framework to create stable and credible rules for eliminating the political and regulatory risks of investing in long-term projects. Although the success of any such framework will depend on the broader picture of Argentina's economic policies and the efforts of the government to regain credibility, the enactment of such framework has an important role that should not be underestimated.

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