Fitch: Argentina's Shale Growth Constrained by Tight Regulation

December 20, 2011

Fitch Ratings-Chicago-16 December 2011: The recent discovery of large unconventional oil and gas reserves in Argentina opens up opportunities for new investment in the country's energy sector, but Fitch expects strict regulations to limit near-term growth potential for capex and hydrocarbon production. YPF S.A., Argentina's largest energy producer, recently announced that it had discovered reserves totalling 927 million barrels of oil equivalent (MBOE) in the Vaca Muerta shale formation of the Patagonia region. The find has focused attention on the ultimate scope of Argentine oil and gas reserves and the willingness of the government to loosen price regulations that have discouraged new investment by both domestic and foreign energy firms. Price caps on both oil and natural gas in the domestic market erode investment return potential, reducing the attractiveness of exploration and production investments in Argentina versus investments elsewhere, all else equal. We regard the shale finds as potentially significant for the long-term growth of oil and gas production in Argentina, but the absence of clear price incentives and rules is likely to slow new development activity and delay the type of large-scale boom in investment and production now being witnessed in North American shale plays such as Eagle Ford and Bakken. Under the current fiscal regime in Argentina, there are incentives for incremental oil production as defined by the "Oil Plus" program, which takes the form of fiscal credits that can be applied against export taxes. However, there is still considerable uncertainty over the granting of these credits by energy regulators. Credits are calculated based on production growth and replacement of total proven reserves relative to established baseline levels. Prices for domestic oil sales are capped by the export tax system, which effectively sets a ceiling of $42 per barrel when West Texas Intermediate (WTI) prices are above $60 per barrel. The Argentine Secretary of Energy may increase such prices based on the quality of oil sold and other factors. The separate "Gas Plus" regulatory framework provides price incentives for natural gas produced in new production projects. The price of such gas can be freely negotiated between parties and is not subject to the price caps for gas consumed by residential customers, power plants and vehicles. Industry leader YPF, with an issuer default rating (IDR) of 'B+' (one notch above the sovereign rating) has demonstrated a growing upstream focus in 2011, boosting reserve replacement rates. Capital spending for the 12 months ending Sept. 30 reached $2.7 billion, compared with $2.2 billion in 2010 and $1.5 billion in 2009. The company continues to pay out the bulk of net income in the form of a $1.2 billion annual dividend. YPF's majority owner, Repsol of Spain, sold 40% of its Brazilian unit to China's Sinopec in 2010. Chinese investment in Argentina's energy sector remains somewhat limited, but ready availability of Chinese capital and the continuing search for secure global energy supplies may lead Chinese oil companies to consider expanded investments in Argentina. Argentina has declined in importance as a global energy producer in recent years as reserve growth has waned. The country remains a net importer of natural gas. While potential exists for major shale development to reverse the declining production trend, we see the investment turnaround proceeding slowly, with regulatory risk still hampering new investment and rapid exploitation of new oil and gas discoveries. Contact: Bill Warlick Senior Director Fitch Wire +1-312-368-3141 Fitch, Inc. 70 W. Madison Chicago, IL 60602 Ana Paula Ares Senior Director Latin American Corporates +1-54-11 5235 8121 Media Relations: Brian Bertsch, New York, Tel: +1 212-908-0549, Email: brian.bertsch@fitchratings.com. The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.