

Argentina, YPF and the Confiscation of Repsol's Assets – One Year On

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By Fredrik Erixon, Director and co-founder of ECIPE, www.ecipe.org

It is a great pleasure to be in Madrid for today's conference. I have worked on economic matters related to Argentina since the early 1990s, when I teamed up with an economics professor, who advised the then government of Argentina on how to combat hyperinflation through monetary reforms and reforms of the ossified economy, such as privatising YPF, what then was called the "worst ever performing state-owned company in history" by a prominent observer. The project was successful for while – but the wheel is now coming full circle, and for the past year I have once again been working on issues related to inflation in Argentina and the fate of YPF.

It is roughly a year ago since Cristina Fernández de Kirchner, the President of Argentina, introduced the bill that allowed the government to expropriate the 51-percent share in YPF, an energy company, held by the Repsol Group. The asset grab, done without any compensation to the owner, was sold to the public as a move to boost energy production, and more generally to improve the authority the government command over its deteriorating macroeconomic performance. It is important to remember that context. While the debate in Argentina focused much on returning a national champion back to the ownership of the people, the asset grab was predominantly justified, on false ground though, as a legitimate move by a government who claimed the previous majority owner had misbehaved to such an extent that expropriation was the only way out.

The "anniversary" of Argentina's expropriation of Repsol's share in YPF marks an historic event, even by the standards of Argentina's policy on investment protection. It is far from the first time in Argentina's post-crisis era that the government has resorted to foul expropriation of assets in order to boost its own standing. Argentina remains one of the most frequent respondents in cases of investor-state dispute settlement in the World Bank's International Centre for Settlement in Investment Disputes (ICSID). Investment protection in Argentina is ranked low in the World Bank's Index on doing business; last year it continued to fall and the country is now in the same place as Russia and Syria, countries hardly known for their hospitable investment policies. Generally, the Wall Street Journal Index on economic freedom now considers Argentina to be a "repressed" economy.

Yet the expropriation stands out for a number of reasons. First, the value involved is very big. The government grabbed assets that, using stock-market valuations before rumours of the pending expropriation started, were worth more than 10 billion US dollars. That is a big sum for Argentina. For those of you who have followed debate about Argentina's legal tango with holdout creditors from its debt swap will know that there are fears about an Argentinean sovereign default because of a court order that Argentina should pay 1.33 billion USD to these funds. The country is cash-strapped and

has to engineer its inflation statistics to avoid paying the full inflation-adjusted sum to these companies that have borrowed money to Argentina.

Second, no compensation was offered to the owner – assets were simply confiscated.

Third, the expropriation concerned a critical part of the country's production. Unlike most other investment disputes that Argentina has with foreign owners, this one does not concern the country's sovereign default in the early 2000s but an important part of the real economy.

Fourth, the government claimed it was a necessary move to boost Argentina's oil production, but as it came only two months after Repsol YPF had significantly increased the estimated reserves in the shale oil finding it did in 2010 in Vaca Muerta, it is quite obvious that the government wanted to seize an oil reserve that could generate significant revenues. Had Repsol YPF already started production in Vaca Muerta, the value of the assets held by the Repsol Group at the time of the expropriation would have been valued higher than 10 billion US dollars.

There are other factors that help to explain President Fernández' action. Argentina's political leadership is increasingly moving the country back to its past of economic populism. Steeped in the Peronist political tradition, the government has recently radically increased state intervention in the economy. Late last year, Bloomberg's Ian Mount succinctly summarized Fernández' policy: "In a desperate gambit to save local jobs and central bank reserves, the government has since 2010 implemented a series of economic regulations that seem to mix purposeful self-delusion -- akin to closing the window shade and claiming it's nighttime -- with discredited economic theories last taken seriously during the era of black-and-white television."

Furthermore, Argentina's macroeconomic conditions have weakened considerably in the past years. The government has responded to the return of high inflation with a raft of market and trade restrictions like price controls, export restrictions, import-substitution measures, and a wide use of local-content requirements. Yet this medicine is now making the patient even worse. President Fernández' expropriation of Repsol's controlling stake in YPF is a case in point. The government claimed at the time of the expropriation that it would boost oil production and turn its trade deficit in oil and gas into a surplus, which would help to generate much-needed foreign currency to the country. It said that the previous owner had pursued a strategy depleting the company of capital to invest in new oil production and forcing it to court other international partners for production in the new shale reserves.

However, the Argentinian government has been proven wrong on all these claims. In fact, the expropriation has been a failure. On all the charges that the government threw against the former owner to justify the expropriation, the current situation is worse. Neither Argentina's nor YPF's production has increased as consequence of the asset grab. While the government waxed lyrical about an alleged 2.5-percent increase in YPF's oil production in 2012, any discerning observer will soon detect that total output in 2012 cannot be compared with total output in 2011.

Strikes in Santa Cruz severely disrupted YPF's oil production between April and July in 2011. The drop in production makes total production for 2011 an unreliable benchmark

for output in 2012. If, however, production in the last quarter of 2011 is compared to the same period last year, YPF's production fell by about 8 percent in 2012, according to statistics from Argentina's Department of Energy. Total oil production in Argentina followed the same path.

Nor did the Argentina close its trade deficit in energy, which the government had promised. President Fernández accused the former owners of YPF for throwing away Argentina's self sufficiency in energy, and blamed them for the 3 billion US dollar energy trade deficit in 2011. Before 2011, Argentina had been running an energy trade surplus and the government now suggested the energy reserves of the country to be evidence enough for why the country should run a surplus.

Yet the energy surplus had been withering away for several years, and nothing suggests it has changed after the government grabbed the controlling stake in YPF. On the contrary, forecasts for 2013 suggest the energy deficit to climb up to 5 billion US dollars, partly (but far from only) because of the recent damages by flood and fire in YPF's La Plata refinery. According to the same estimate, the country's energy import went up by almost 50 percent in the first two months this year, compared with the same period last year.

None of this is surprising. Current oil production in Argentina is primarily based on old discoveries with shrinking reserves. The main problem for the sector is rather that energy policy has deterred investment into new fields by artificially depressing energy prices and an uncertain system for license approvals. And the most damaging consequence of the confiscation is that the government has undermined efforts to fund new production in the giant oil shale reserve, Vaca Muerta, discovered by Repsol in 2010.

The expropriation has created a very uncertain investment environment, to say the least, for potential partners in Vaca Muerta. The costs for production are high because of the technical and geological difficulties to extract the oil, and the previous owners had started forming partnerships with other oil firms to start full production. The government did not like this strategy, and generally claimed the company should have invested its profits rather than paying dividends to shareholders. Never mind the dividends were part of a deal engineered in 2007 by the Kirchners to get Petersen Inversiones to take up a minority stake in YPF, Argentina now claimed it could radically boost investment into the new fields on its own.

However, the government has had to back down from this brazen attitude, and is now back to the strategy employed by the former owners to get other investors to join in. But that strategy is not exactly going stellar. A few international firms have pledged to invest smaller sums with YPF for pilot projects in Vaca Muerta, but the big deal between YPF and Dow concerns the gas reserves. Still, they – and others – remain wary of teaming up with a company whose owners may well confiscate their assets once the big investments have been made.

The expropriation has put Argentina's government in a difficult position. Given the need to access foreign sources of capital to invest in new oil production – which is important for Argentina's economy – it is difficult to see how the government could engineer a solution that would be more favourable to the Argentinian government, let alone the Argentinian economy. In the worst-case scenario, YPF will not be able to start

production in critical new fields because it cannot fund new investments. In a best-case scenario, investors will demand much higher yields in return for investing capital in a very unpredictable investment environment, plagued by the recent expropriation and, among other things, regulations and foreign exchange restrictions making it difficult to repatriate capital. Naturally, investors are wary of putting their money into countries and companies with records like Argentina and YPF. If they at all are going to consider it, the return on investment has to be far above normal yields.

This expropriation has defeated its purpose. The only way for Argentina to enable its energy sector to grow at its potential is by welcoming foreign investors. Yet that will not happen until Argentina overhauls its international economic policy – and pays the former owners of YPF a fair price for what it confiscated.