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12-6-2010

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Inter-American Dialogue's Latin American Energy Advisor

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Recommended Citation

Inter-American Dialogue's Latin American Energy Advisor. "What Will Be the Effects of Ecuador's New Oil Contracts?." (2010). https://digitalrepository.unm.edu/la_energy_dialog/4

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Q and A: What Will Be the Effects of Ecuador's New Oil Contracts?

Citation: Inter-American Dialogue's Latin American Energy Advisor, November 6-10, 2010; pp. 1, 4, 6. Also online at **www.thedialogue.org.**

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Ecuador completed contract renegotiations Nov. 23 with several oil companies to replace profit-sharing agreements with flat-fee service contracts, but failed to reach an agreement with Petrobras and three other companies. How will the contract changes affect oil production in Ecuador? Is the government likely to make any alterations to the new policy? Will the contract changes lead would-be foreign investors to shy away from Ecuador?

A: José Luis Ziritt, president of Ecuador's Hydrocarbons Industry Association in Quito:

"With the flat-fee service contracts, it is in the companies' interest to raise production as fast as possible. Since companies are paid by the barrel they produce, to increase their profits they should rapidly increase production using the same infrastructure, if possible, and lowering their operating costs. In other words, the new contract stimulates the companies to be more efficient and increase production. With the contracts running from Jan. 1, we will probably start to see oil production increases around the third and fourth quarter of next year. The government is very confident in the applicability of this new type of contract, even in the case of exploration areas where they are willing to offer service fees that respond to higher rates of return to compensate for the associated risk. A service contract for exploration areas is very unusual, thus the success in attracting new investors in the next bidding process, announced to be launched in April 2011, is still to be evaluated. Yet the government is positive in getting the new foreign investment they are looking for. Even with a service contract that may not be as attractive as a production sharing contract, we cannot deny one encouraging factor that has attracted foreign oil investors to Ecuador: the profitability of the Ecuadorean oil basins."

A: Rene Ortiz-Duran, former minister of energy and mines of Ecuador and former secretary general of OPEC:

"Oil companies have already shied away from Ecuador. It is not new that Ecuador's government has had an unnecessarily hostile attitude toward the established international oil companies. The government misunderstood and misportrayed oil companies before the public as abusive. All of the companies have been very critical of the exploration and production contracts signed with former regimes. The hydrocarbons law was reformed last July to introduce the 'flat-fee service contracts,' however, it kept unchanged the modalities such as association, risk service contracts and participation contracts. In the meantime, the government provided information to the public which is 'half true.' Government-take referred only to the production sharing segment and nothing was said or told of the other companies' obligations, such as income, value-added, special consumption, price royalty, labor and community taxes. When everything was added, including production shared and the above mentioned taxes, they all amount to 70 to 87 percent government-take. Now, the government reaffirmed that the renegotiation has meant an increase of the government-take from 70 percent to 80 percent. This type of information politics has had a cost and will continue to have further costs. Ecuador will not increase oil production as desired and will not attract new investments. Further exploration to discover oil, develop those reservoirs and produce them for export cannot be achieved with such flat-fee service contracts. Finally, another hydrocarbons law reform is almost ready for approval by the legislature and the president of the republic. It will establish the 'exceptional ruling' in order to enable international oil companies and local, private oil companies to also participle in the future oil industry of Ecuador."

A: Ramiro Crespo, president of Analytica Securities in Quito:

"On Nov. 23, most major international oil companies agreed to new production contracts demanded by Ecuador. Repsol YPF, Eni's Agip, along with Andes Petroleum and PetroOriental—two Chinese-owned companies—and Chile's ENAP decided to stay. The government will now pay them a set fee per barrel of oil, however mostly in oil rather than cash. Previously, Ecuador applied the production sharing agreements used in most emerging markets. Petrobras and Noble Energy, which together accounted for some 20 percent of foreign output, will depart. All things considered, the terms of the new contracts are little different from a 2008 review, but for the first time since 2006, they are likely to remain stable in the longer run, given that they run eight to 15 years. The companies agreed to invest $1.2 billion through 2014, which will only stabilize the current declining rate of production in their fields. Since Rafael Correa took office in January 2007, foreign oil output has plunged to 162,000 barrels a day from 256,000. State-owned companies' investments have had limited success and overall output is estimated only to remain stable in 2011. The problem is considerable given that Ecuador, under Correa, has produced a fifth of the 4.5 billion barrels of reserves the country was estimated to hold, without significant exploration having gone ahead to replace them. It will take many more positive signs to revert the lost half-decade of oil production from Ecuador. A key test will be international tenders for new fields in April."

A: Paulina Durango, partner at Arizaga & Co. Abogados in Quito:

"With the signing of the new oil contracts, Ecuador begins a new stage in the production management and investment of the most important resource for the country's economy. This process has been lengthy and complex, and its greatest impact in the almost four years has been, without a doubt, the lack of investment by private foreign companies (which handle approximately 30 percent of national production) and the consequent drop in production. We must also take into consideration that the fall in production in Ecuador has coincided with a period of high oil prices, an average of above $75 per barrel in recent years. The renegotiation of the contracts entails a radical change from the participation model (profit-sharing agreements), where the benefits were linked to price, to a service delivery model (flat-fee service contracts) that establish a payment system based on real investment parameters, costs, expenses and a 'reasonable' profit, unlinked to the price of oil. Within the parameters of the renegotiation, we expect the state oil revenues to improve and that foreign investors will be given clear rules for investment, giving priority for the exploration of new wells that would increase their production. The failure to achieve agreements with Petrobras and EDC for the exploitation of blocks 18 and 3 (gas) pose a challenge for state companies Petroamazonas and Petroecuador, respectively. The lack of experience with gas fields in the latter case could open up the possibility of an international tender for companies that operate this block. It is hoped that the international community will take the renegotiations as positive signs that will assist in the development of the country."

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