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What is the Outlook for Colombia's Oil Sector?

Inter-American Dialogue's Latin American Energy Advisor

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Q and A: What is the Outlook for Colombia's Oil Sector?

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In the wake of Colombia's ratings upgrade to investment status earlier this year and strong second-quarter profits, Colombian state-run oil company Ecopetrol announced last month that it would sell \$1.4 billion of stock to pay for investments aimed at doubling production. The company added that it would increase the number of shares more than seven-fold if demand exceeds expectations. Will the investment-grade rating lead to as strong demand for the shares as the company expects? What is the outlook for Ecopetrol and the Colombian oil sector in the short to medium term? What challenges does the Colombian oil industry face?

A: Rodrigo Villamizar, former Colombian minister of mines and energy:

"Ecopetrol's announcement will certainly increase the expectations of capital search for oil development. But the real question is if the outlook for Ecopetrol and the Colombian oil sector in the medium term meet. One thing thinks the donkey and other, quite different, he who saddles it, goes a popular saying. Ecopetrol's umbilical cord to the national budget and the straight-jacket imposed by its labor union are binding constraints to a really independent and autonomous expansion plan. The great success (more financial than industrial) of Pacific Rubiales reveals the frustration of a country with vast amounts of resources and little contractual room to play. The fact that the private sector has had a limited maneuver in the development of the oil sector (unlike, fortunately the gas and electricity sectors; supported by clear rules and regulations and under a more fair regulatory commission) says tons. The real challenges that the Colombian oil industry face has one name: private sector participation. The BP or even Statoil models are a better example of how to develop a natural resource like petroleum. More financial resources in the hands of Ecopetrol with obscure ties to the national budget and a shadow pension fund may not hinder what investors expect. But Ecopetrol has rich human resources at the top and bottom of the organization structure. They may convert snake oil into crude oil. Perhaps I am being overly pessimistic in not seeing that Ecopetrol could deliver wealth with more cash at hand. I truly hope I am wrong."

A: Luis E. Giusti, senior advisor at the Center for Strategic & International Studies and former chairman and CEO of PDVSA:

"During the past nine years, Colombia has done a masterful job with its oil industry. A strong, new institutional framework, including the creation of the National Hydrocarbons Agency,

combined with the contract based on a low royalty plus standard income tax, all against the backdrop of the policy of national democratic security, have attracted dozens of international oil companies, which in addition to many local companies are engaged in some 300 contracts. The partial public equity of Ecopetrol is the fourth pillar of a strong platform for Colombia in facing its oil and gas future, irrespective of good or bad times ahead. The new equity issue of \$1.4 billion would represent a very modest 1.6 percent addition to the current 10 percent equity, and will almost surely be short for the current strong appetite, no doubt reinforced by the country's investment grade and strong economic performance. I would expect that the size of an enlargement of that offering to meet additional demand would be fine tuned by Ecopetrol depending on the progress of the booking. The most important challenge facing the Colombian oil industry is the need for a few large discoveries, because the reserves are still modest at 2 billion barrels and the same holds true for gas with 4.5 trillion cubic feet. A distant second challenge, although very important, is represented by the lagging infrastructure of pipelines, terminals and roads."

A: Joydeep Mukherji, senior director in the sovereign ratings group at Standard & Poor's:

"Standard and Poor's raised Colombia's long-term foreign currency credit ratings to BBB- from BB+ in March. The upgrade reflected, among other things, favorable growth prospects and improving external liquidity, both of which are connected with the recent growth of the oil and gas sector. Colombia should continue to benefit from having pursued pro-investment policies in the energy sector while much of Latin America went the other way. The sector has been opened to foreign and private investment and the former regulatory role of Ecopetrol has been transferred to a separate regulator, creating a level playing field for the industry. Growing investment in energy and mining could boost Colombia's trend GDP growth rate by one percentage point over the next three years. FDI in oil and gas reached almost \$4 billion in 2010 and may exceed \$6 billion in 2011. Around 150 oil and gas firms operate in Colombia, including Ecopetrol, as well as many large global firms. The policy framework for attracting more investment is largely in place, although infrastructure shortfalls and bureaucratic impediments (such as delayed environmental clearances) constrain the pace of expansion. Colombia is likely to reach its goal of 1.5 million barrels per day in oil output by 2015. The government set a target of 920,000 barrels per day for this year, but production has already exceeded the target, reaching almost 930,000 barrels in July. Reserves of oil and gas have increased since 2007, mainly from further investment in existing fields (though not yet from major new discoveries), and exploration and drilling activity is likely to remain strong."

A: Daniel E. Velandia O., head of research at Correal in Bogotá:

"Colombia's investment grade status has increased the attractiveness of the local equity market in the last few months, although it had started to be widely counted on since mid-2010. In the case of Ecopetrol, the stake of relevant foreign investors and the ADR program in the company's equity has increased from 0.44 percent to 1.17 percent in the last year. Regarding the new issue, the stocks won't be available for foreign investors in the primary market, which implies that the investment grade status won't play a significant role in the process. However, these investors will most likely buy shares in the secondary market in the near future. It is expected the demand will

exceed the \$1.4 billion offered by the company as the liquidity in the local market and the risk appetite continue to be high. In general, the outlook for Ecopetrol and the Colombian oil sector seems promising in the short- and medium-terms as the oil-mining boom has just begun. In fact, the total oil production reached 929,226 barrels per day (bpd) in July, (a rise of 19 percent year-on-year). At the same time, FDI directed to the oil sector in the first quarter amounted to \$1.4 billion (a growth of 123 percent) and it's likely that these inflows will reach \$5 billion in 2011. Similarly, Ecopetrol reached a production of 727,200 barrels of oil equivalent per day (boed) in the second quarter (up 22 percent year-on-year), implying that the company won't have problems reaching its 2011-target of 750,000 boed. Thus, the company apparently will reach its target of 1 million boed in 2015 without difficulties. According to our models, Ecopetrol shares' target prices for 2011 and 2012 year ends are 3,970 pesos and 4,200 pesos, respectively (a rise of 7 percent and 14 percent from current levels). Although the lack of infrastructure is one of the main challenges, it is expected to be overcome gradually as several companies, led by Ecopetrol, are making significant investments in pipelines and refining capacity and efficiency."

A: Alicia Puyana, researcher and professor of economics at FLACSO-México and senior research associate at CERA:

"The upgrading of Colombia's rating to investment status has very much to do with the outcome of the 2010 presidential elections and the positive atmosphere the country has experienced since then. President Juan Manuel Santos, a highly intelligent and cultivated technocrat, belongs to one of the few traditional families of the Colombian ruling class. Colombians expected that Santos would re-establish the consensual governance that characterizes Colombian politics. Despite success combating the guerrillas, Colombians were tired of the confrontational character of Uribe policy making, the corruption and fights against the judiciary's power. Several problems will make it difficult to achieve all the expectations. One of them is the critical concentration of wealth and income. The Gini index of land concentration is 87 percent, one of the highest in the world. Ecopetrol has achieved success thanks to elevated world oil prices, but shares are highly over-priced and there is little prospect for shares to gain value. Their value could fall if prices fall. The first shares put on sale were grossly underpriced and were resold at high profit just a few days after. This effect faded. Today, the company does not have solid strategic planning and it is not clear what the prospects are in the long run. Colombian costs, exploration, lifting and transport to export ports are relatively high compared with Venezuela or even Mexico. The challenges are the lack of investments in research and development to develop heavy oil and new energies and to reduce costs."

The Energy Advisor welcomes responses to this Q&A. Readers can write editor Gene Kuleta at kuleta@thedialogue.org with comments.