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Inter-American Dialogue
LATIN AMERICA ADVISOR

Featured Q&A *With Our Board of Advisors*

Q An executive from British Petroleum said last week that Mexico would have to collaborate with oil industry players to gain the technical expertise and investments needed to explore a potentially vast wealth of deep sea oil reserves. Do you see foreign oil companies participating in Mexico's deep sea oil exploration and production under current investment terms? Will Mexico enact reforms to make investment more attractive to companies? What type of reforms need to be passed?

A Guest Comment: Jose Alberro: "Foreign oil companies have made it clear that they will not participate in deep-sea oil exploration and production in Mexico unless it is carried out through risk contracts and/or joint ventures because they possess proprietary technology they are not willing to share except if they share in the upside. A decade and a half ago, the same argument applied to 3D and 4D technology. It is now accessible. Energy legislation in Mexico is the most obsolete in the world: it creates unnecessary monopolies in refining, marketing, or in petrochemical production, and its mechanisms for transparency and accountability are weak, to say the least. As a result, Pemex is one of the most inefficient oil companies, and rent seekers have successfully draped themselves in brash nationalism to block change. Arm twisting by BP or even Petrobras will not push Mexico into enacting the reforms they demand. And well it shouldn't. Pemex's highest priority should be to become a world-class company in terms of efficiency, profitability, and accountability, lest once the sector is opened it disappears into foreign hands, like the banks and railroads. The big difference is the big reserves and the big neo-Ricardian rents. The challenge is for stakeholders to overcome greediness and immobilism so Mexico can leverage its hydrocarbon base to both foster its own productivity-led economic growth and increase energy security in North America."

A Guest Comment: Roger Stark: "Traditional paradigms for cross-border energy investment are effectively broken. Governments

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PHOTO OF THE DAY

Venezuelan President Hugo Chavez on Friday declared that socialism is the solution in Venezuela. See related story, page 2.

Photo: ABN.

Inside This Issue

NEWS BRIEFS

Colombia Extradites Rebel Leader "Sonia" to the United States

The Colombian government said Friday it had ordered the extradition of imprisoned FARC rebel leader Omaira Rojas Cabrera, known as "Sonia," to the United States for trial on drug trafficking charges. Rojas, who managed the FARC's finances, was captured last year.

Source: Colombian government, Reuters.

Exxon Mobil May Seek Arbitration Over Venezuelan Royalty Tax

US oil giant **Exxon Mobil Corp.** may seek international arbitration to resolve a dispute with the Venezuelan government over royalty taxes. Last week, Venezuelan Energy Minister Rafael Ramirez said the government would not negotiate an increase in royalty taxes on four heavy oil joint ventures with Exxon Mobil, which requested a meeting with Ramirez to discuss the government's unilateral rate increase for the ventures from one percent to 16.67 percent. [Editor's note: look for a related Q&A in this Friday's issue of the *Latin America Advisor*.]

Source: Reuters.

Mexico's Femsa Posts 2.666 Billion-Peso Q4 Net Income

Mexican beverage maker **Femsa** on Friday reported a 2.666 billion-peso ($US 241 million) fourth-quarter profit, up 41 percent from the same period of 2003, due to a one-time tax benefit, foreign exchange gains, and a gain in monetary position. Femsa said revenues grew 6.1 percent to 24.625 billion pesos, led by 26.1 percent growth at the company's **Oxxo** retail chain. For full-year 2004, Femsa's net income totaled 9.249 billion pesos, up 88 percent from 2003.

Source: company statement.

Economic News

Argentina Concludes Debt Swap Amid Optimism About Success

The Argentine government declared its historic debt swap over on Friday, Reuters reported. The government and analysts expect a broad majority of creditors to accept the offer, despite bondholders' concerns about the almost 70 percent in losses on their investments. The government of President Nestor Kirchner refused to improve the terms of its offer, which asks bondholders to exchange $102.6 billion in defaulted debt for $41.8 billion in new debt in what would be the biggest sovereign haircut in modern history. Analysts estimate a 70-80 percent acceptance rate, the threshold they say is needed to declare the restructuring a success. "We will have a good result with the debt swap," Kirchner said. "It is not something that makes us happy but something that shows what we can do." Amid optimism about the debt swap, the local MerVal index of leading stocks surged 4.6 percent to close at a record-high 1,600.32 points on Friday, past the previous record close of 1,557.77 on February 18. Argentine investors are optimistic about pending renewal of foreign investment and reductions in private-sector financing costs, Argentine daily *La Nacion* reported today. However, the government still faces legal battles with investors who did not participate in the debt exchange.

Political News

Chavez Says Socialism is the Solution in Venezuela

President Hugo Chavez on Friday rejected Western-style capitalism as an economic model and said socialism was the answer to widespread poverty in his country, Reuters reported. "So, if not capitalism, then what? I have no doubt it's socialism," Chavez was quoted as saying in an address to an international meeting on poverty in Caracas. The Venezuelan leader, who since taking office six years ago survived a coup in 2002 and a referendum on his rule in 2004, said his experience in office had convinced him that socialism is the solution, although he said previous attempts at socialism in other countries might not be the example to follow. "We have to invent the socialism of the 21st century." Chavez's declaration recalled Cuban President Fidel Castro's early 1960s declaration that his revolution was socialist, the beginning of four decades of hostile relations between Cuba and the United States. Chavez's critics say he is already steering Venezuela, where half the population lives in poverty, toward Cuban-style state control of the economy, while relations with the US have soured despite Venezuela's standing as the third-largest foreign supplier of oil to the US. Chavez on Friday repeated allegations that the US government plans to assassinate him, a charge which US officials have labeled "ridiculous," and denounced US President George W. Bush as "the big destabilizer in the world." In related news, Chavez said Friday his government would raise the minimum monthly salary by 25 percent this year to about 400,000 bolivars ($US 208), according to Reuters.

> "We have to invent the socialism of the 21st century."
>
> ***- Venezuelan President Hugo Chavez***

Fox Warns of New Economic Crisis Should One-Party Rule Return

Mexican President Vicente Fox warned Friday that Mexico could suffer a new economic crisis akin to the country's mid-1990s financial collapse should it return to the days of one-party rule, Reuters reported. "Let's be careful not to go back to the corruption, the opaqueness, and the authoritarian monopoly on decision-making that led us to that crash in 1994 and 1995," Fox was quoted as saying in an speech to bankers. Fox, whose election in 2000 ended 71 years of rule by the Institutional Revolutionary Party (PRI), also warned against populism, in an apparent reference to Mexico City Mayor Andres Manuel Lopez Obrador, a member of the leftist Party of the Democratic Revolution and the leading candidate in the run-up to Mexico's 2006 presidential contest. "Let's be careful with populism, careful with irresponsibility." Investors are concerned that, if elected, Lopez Obrador could turn away market liberalization in favor of a greater government role in Mexico's economy, especially following remarks earlier this month in which he said he would seek to restructure the country's debt. However, analysts expect Lopez Obrador would be more pragmatic once in office [Editor's note: see related Q&A in the February 24, 2005 issue of the *Latin America Advisor.*] The PRI's Roberto Madrazo runs a close second in polls behind Lopez Obrador.

Riggs Settles Spanish Lawsuit Over Hidden Pinochet Bank Accounts

Washington, DC-based bank **Riggs National Corp.** said Friday it has agreed to settle a Spanish lawsuit by paying $8 million into a fund for victims of former Chilean dictator Augusto Pinochet, Reuters reported. Riggs, which last month plead guilty to failing to report suspicious financial activity, including the concealment of millions of dollars deposited by Pinochet, agreed to the settlement in exchange for the dismissal by a Madrid court of criminal and civil claims against the bank and seven former and current directors. "This enables the institution to put the matter behind us," Riggs spokesman Mark Hendrix was quoted as saying. The settlement is a result of a suit brought against the US bank by Spanish Judge Baltasar Garzon, who has been on a campaign to prosecute Pinochet for crimes against humanity committed during his 1973-1990 regime, in which some 3,000 people were killed for political reasons. A 1998 search by Garzon for hidden Pinochet bank accounts at Riggs and other institutions was unsuccessful, but the Spanish judge's efforts got a boost last July when a US senate subcommittee investigation revealed that Pinochet had hidden as much as $8 million at Riggs. The revelations of the hidden bank accounts has also sparked probes in Chile, where Pinochet is accused of tax fraud and tax evasion.

The Dialogue Continues

A continuation of the February 22, 2005 Q&A

Q Among regions, Latin America ranks as the worst in terms of the difficulty of starting a business, the inflexibility of labor market laws, and the complexity of enforcing contracts, according to the World Bank. Why is this so? Do you see steps being taken to make it easier to operate a business in Latin America?

A Guest Comment: Grey Warner: "As a company that has been doing business in the health care arena in Latin America and the Caribbean for many years—over 50 years in some countries—we have found that certain enabling conditions are essential for attracting investment, encouraging economic growth and development, and for improving the health of citizens across the Hemisphere. When considering places to invest, or to deepen existing investments, we look for countries that provide effective intellectual property protection for pharmaceutical products; undertake health care reform that supports free-market approaches based on competition and choice; put in place efficient, effective, and transparent regulatory systems; promote transparency and ethical business practices in society as a whole and in the health sector in particular; and support free trade. Consistent with the findings from the Heritage Foundation /*The Wall Street Journal* 2005 Index of Economic Freedom, we find that these countries also tend to be more competitive on the global market. Latin Americans are no less industrious than citizens in other regions of the world. However, in recent years countries such as Singapore have made incredible progress in creating a business environment that embraces these conditions and consequently have attracted billions of dollars in investment, including the health sector. Additionally, governments in Asia and elsewhere have also seen the value of innovation, and play a crucial role in supporting development of vibrant life sciences sectors through funding basic research, encouraging public/private partnerships, and creating business environments where both can thrive. We believe Latin America is equally capable of replicating Asia's success story."

Grey Warner *is Senior Vice President for Latin America at Merck & Co.*

Economic Freedom in Latin America and the Caribbean

Country Rankings, 2005 (155 total countries ranked)

Country	Ranking	Country	Ranking
Chile	11	Guyana	79
El Salvador	24	Guatemala	85
The Bahamas	25	Colombia	88
Barbados	32	Brazil	90
Trinidad & Tobago	40	Honduras	110
Uruguay	43	Paraguay	111
Belize	47	Argentina	114
Bolivia	50	Ecuador	114
Panama	52	Dominican Republic	121
Costa Rica	54	Suriname	140
Peru	56	Haiti	145
Jamaica	60	Venezuela	146
Nicaragua	65	Cuba	149

Source: Heritage Foundation /The Wall Street Journal *Index of Economic Freedom*

Featured Q&A
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understandably wish to both maintain control of their resources and maximize revenues from their exploitation. Mexico's 'service contract' format reflects these priorities (and Mexico's own constitutional constraints). However, Exxon Mobil, BP, and other potential investors rejected Mexico's deep-water tender on the grounds that such contracts do not provide adequate risk-adjusted returns. Other super majors and independents are likely to follow suit. Few new proposals have been advanced to break the impending logjam, but one not-so-new idea may merit further consideration: Using public-private partnership (P3) models to facilitate risk sharing and attract debt-capital necessary to make deep-water operations profitable. Attracting debt-capital facilitates higher returns for investors, while the P3 model allows the governments or parastatals (in this case Pemex) to exploit the country's energy resources without violating constitutional constraints. The Mexican deep-water case highlights a current theme in Latin America. Even the most resource-rich countries need foreign investment, technology, and know-how to effectively monetize their resources. In this context, cross-border energy integration is not only central to maintaining the region's economic vitality, but also supports democratic institutions and the rule of law. Preventing further regional disintegration requires replacement of traditional structures with alternatives that properly balance investor concerns against the desire of Latin American governments to own and control their natural resources. To achieve a win-win result, oil and gas stakeholders must re-evaluate existing investment structures to avoid a mutually destructive continuing slide in cross-border energy trade."

A **Guest Comment: Rob Cordray:** "Although the current multiple service contract (MSC) investment vehicle has not attracted the quantity of international oil company (IOC) investment that was anticipated, it is a reasonable step forward and should continue to function as a vehicle to attract investment in the Mexican oil and gas sector. This is particularly true for development opportunities, such as the initial MSC rounds in the Burgos Basin, where the risk of not encountering commercial hydrocarbons is considerably lower. However, the MSC contract structure makes it very difficult for IOCs to justify investment in the Mexican deep-water sector. In some respect, this is due to the inability to book reserves, which for many companies was a limiting factor in participation in the initial MSC rounds. The particular problem here is that deep-water exploration is exploration, which compounds the issue raised by a lack of IOC participation in the upside of any discovery, which is reserved for the state, while simultaneously being exposed to all of the downside (dry hole/non-commercial discovery). This risk/reward imbalance is a major hindrance to any substantial IOC investment. The task going forward is largely a political one, particularly a legislative movement around a change in the Constitution to allow IOC access to the upside part of the risk/reward equation, likely the only way to truly attract the best participants. However, the current focus of the energy sector is on fiscal reform of Pemex income and investments, and any near-term movements toward a wholesale change of the Constitution would dilute this effort at best, and could likely derail the fiscal reform entirely. This, in combination with the rapidly approaching presidential elections, makes it unlikely there will be any real resolution to this issue until after 2006."

Jose Alberro *is an Economic and Energy Consultant affiliated with LECG, LLC. He was the first Director General of Pemex Gas and Basic Petrochemicals.*

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Rob Cordray *is a Senior Analyst in the Upstream Competition Group at PFC Energy.*

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