Energy + Power
RISK MANAGEMENT

LATIN AMERICAN GAS **By Caitlin Randall**

A Latin American natural gas derivatives market is not expected to develop soon, despite a deregulating market and major pipeline projects fuelling regional trade

What comes after the flood?

Latin America's natural gas markets are growing fast, as deregulation takes hold and a widening network of cross-border pipelines opens the way for a surge in regional trade. But this isn't likely to spill over into the derivatives market yet, analysts say. There are still several big obstacles to overcome.

First and foremost are the skimpy volumes of Latin America's natural gas spot markets, say analysts. This is mostly due to the preference for long-term contracts of one year or more on the part of gas distribution companies looking to recoup the high costs of building pipeline infrastructure.

"The gas pipeline companies see selling into spot markets as too risky," says one Buenos Aires-based gas industry source. "They have incredibly high investment costs and need long-term, steady financing, so they prefer long-term fixed contracts." This limits spot market trade and, in turn, the price risk that derivatives are used to hedge against, he adds. Even in Argentina, which leads the way in regional gas deregulation there is very little natural gas derivatives trading, analysts say. Its wholesale gas market was opened to competition in 1991, and more than 30 power companies have been privatised since then.

"We are very far away from a regional gas derivatives market. We don't even have a spot market yet [in Argentina], with 60% to 65% of production still in the hands of one player [the national oil company Yacimentos Petroliferos Fiscales]," says Hernan Ladeuix, an energy analyst with Crédit Lyonnais in Buenos Aires.

It is a similar picture in Brazil. Liberalisation of the energy markets began there in 1996 and now most of the power distribution companies are privatised. "For us, there are two key reasons holding back derivatives trade," says Sergio Baron, São Paolo-based risk manager at the state-owned oil company Petrobras. "The spot volumes are too low and for the next five years, we are obligated by law to link natural gas to the fuel oil price."

Mexico's gas derivatives market is also tiny at present. New government regulations allow consumers to buy from whomever they like, not just the state oil company Petroleós Mexicanos (Pemex). This is helping to increase derivatives use by gas distributors. "Mexico in a way is out of the loop in Latin America because of our geographical position," says Carlos Riveroll, head of risk management with Pemex International, the international arm of Pemex in Mexico City. He believes that because Mexico's natural trading partner is the US, price exposure is to movements in the US gas price.

Most of Pemex's hedging activity takes place on the New York Mercantile Exchange, using South Texas as a benchmark, adds Riveroll. "I can't foresee getting involved in a regional market that uses Brazil's or Argentina's natural gas price as a benchmark. All you have to do is consider the pipeline connections in geographical terms."

The northern Latin countries face a number of institutional bottlenecks in the deregulation of their markets

There is, however, room for optimism. Analysts say spot market activity should burgeon, as new pipeline projects are completed. There are now 2,137 kilometres (km) of pipeline under construction in Latin America (excluding Mexico and Central America), with 13,779km planned and proposed, according to industry sources. With more supply available, buyers from transnational pipelines will probably sell the gas onwards on a short-term basis. This should help create a more vibrant spot market.

Gas consumption in Venezuela, Mexico, Argentina, Colombia, Brazil and Chile is expected to increase to 185 billion cubic metres (bcm) in 2010 from 105.9bcm in 1996. Production among those countries and Bolivia is expected to increase to 204bcm in 2010 from 94.9bcm in 1996, according to figures from the World Bank and the *British Petroleum Statistical Review of World Energy 1997*.

"The big increase in gas consumption is going to be driven by the power and industrial sectors," says Chakib Khelil, a petroleum adviser to the World Bank in Washington DC. "Argentina is the most advanced in terms of establishing a regulatory and legal framework for a deregulated gas market. Brazil is on the way, as are other southern cone countries [Bolivia and Chile]. It's the northern Latin countries that are more fragmented, with Venezuela and Mexico facing institutional bottlenecks in the deregulation of their markets."

Argentina, Mexico and Venezuela boast around 80% of Latin America's proven 7.4 trillion cubic metres of natural gas reserves, according to World Bank figures. Some of the region's major users, including Brazil, Colombia and Chile, have few reserves. This imbalance in gas supply and demand between different Latin countries is spurring an integrated market with infrastructure that spans the region, say analysts.

One of the more ambitious projects to supply the Brazilian market – consumption in Brazil is expected to grow to 17bcm in 2010 from 5.3bcm in 1996, according to World Bank figures – is a $2 billion natural gas pipeline from the Bolivian city of Santa Cruz de la Sierra to Porto Alegre in southern Brazil. It is Latin America's biggest cross-border energy project to date, and will stretch some 2,000km. The first leg was inaugurated in February but the project has not been trouble-free. Economic turmoil in Brazil has delayed plans to convert or build power plants to run on gas, while a surge of new Bolivian gas field discoveries has left producers worried that supply could initially outstrip demand.

There have also been claims by environmental groups, in particular Amazon Watch and Friends of the Earth, that the pipeline will traverse primary tropical forests and pristine wetlands in the Bolivian amazon. They have targeted the project as one of the most environmentally damaging pipelines in the southern cone of Latin America. ■