

**Tom Freije**

# Powering up: Latin America's energy challenges: the second Malvinas crisis?: Argentina and oil prospecting off the Falkland Islands

## Report

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## The Second Malvinas crisis? Argentina and Oil Prospecting Off the Falkland Islands



**TOM FREIJE**  
is the Energy Editor  
at the Economist  
Intelligence Unit.

“**G**OTCHA” was the iconic British tabloid title that greeted the sinking of the *Belgrano*, the Argentine battle ship, in one of the most controversial events during the brief but costly 1982 conflict between Argentina and the UK over the Falklands Islands. Never particularly sensitive, one wonders how the same paper would now greet a sizable oil discovery in the icy waters off the disputed archipelago in the south Atlantic. Some clues have emerged since the start of a drilling campaign in the waters around the Falklands by a group of London-listed oil companies, a development which Argentina has loudly protested.

The war is etched in the consciousness of both Britain and Argentina—the latter’s defeat remains a sour point. Buenos Aires has always claimed sovereignty over the Falkland Islands or *Islas Malvinas* and annually restates its claim. The return of oil prospectors to the islands has inflamed past grievances and Argentina has launched a concerted diplomatic effort, collecting the backing of fellow Latin American states as well as lukewarm support from the US. Diplomatic relations have certainly been strained but the chance of real conflict is remote – despite the jingoistic rhetoric which has been cranked-up in both Britain and Argentina.

However, the war of words masks far deeper issues in Argentina. The feeling that Argentina’s beleaguered president Cristina Fernandez de Kirchner is looking to score political points domestically by, yet again, kicking-up a fuss over the Falklands is hard to avoid. Legally the UK has little say over what decisions are made in Port Stanley, the tiny capital of the Falklands Islands, having devolved power over management of its surrounding waters in the mid-1990s. Additionally, Argentina turned its back on potentially benefiting from Falklands oil when Ms Fernandez’s predecessor (and husband) Nestor Kirchner revoked an agreement with the UK to cooperate over exploration in the islands surrounding waters.

Despite annual protest at the United Nations, Argentina has made little progress on the Falklands issue; residents of the islands argue they have the right to self determination and have little desire to be part of Argentina. Nor do they consider the islands a British colony. It’s a situation that is unlikely to change anytime soon. Perversely the arrival of oil prospectors offers Argentina an opportunity, namely the chance to reflect on the state of its own oil industry.

## SALT IN OLD WOUNDS

The seeds of this current falling-out were sown in the unsatisfying conclusion of the 1982 conflict. It was a war that irrevocably shaped the recent past of both Argentina and the UK. For Buenos Aires the wounds of that past defeat remain tender, yet defeat also hastened the country's move towards democracy. On the flipside it was a victory that cemented the position of the UK's then Prime Minister Margaret Thatcher. The following seven years had a transformative impact on the UK.

And herein an inherent parallel lies in this current 'crisis' – a leader struggling domestically seeking to make an issue of the Falklands. Ms Fernandez's efforts are disappointing. Argentines appear to be taking an increasingly dim view of her government, her personal popularity is low and recent votes have weakened her grip on office – her party and allies lost control of both houses of Congress in mid-term elections in 2009. In addition, Ms Fernandez's administrative style has been characterised by heavy-handed interventions in the economy and repeated feuds with other government institutions and with the private sector. These have hardly endeared her to business.

Most recently, she faced an institutional crisis over her firing of the Central Bank head (an effort she ultimately succeeded in) and her attempts to transfer Central Bank reserves to a special Treasury account (where she proved less successful). At the same time, the economy has been performing poorly and the public finances are growing increasingly precarious. As the 2011 presidential election approaches, Ms Fernandez is seeking to tap an issue that remains one of the few unifying grievances in

Argentina to enhance her domestic position. It is, however, hard to see the tangible benefits of such a strategy for the government. The loss of Congress has certainly created a more complicated situation for Ms Fernandez, whose legislative control will be lessened in the second half of her term regardless. Further she will be forced to negotiate with opposition forces for the first time.

How easy she will find a conciliatory approach remains to be seen. The governments of both Mrs Kirchner and her predecessor husband have been aggressive in style and compromise with the opposition has not been a feature. The likely result is legislative stalemate and heightened political tensions ahead of the 2011 presidential election. The potential domestic legislative gridlock could be even more damaging given then challenging fiscal and financial conditions Argentina is facing.

The government has prioritised economic growth, the restructuring of outstanding defaulted foreign debt and access to new international financing. None of these goals will be assisted by blocking shipping to the Falklands and reiterating territorial claims – whatever the merits of the arguments. In sum, the vehement protests smack of orchestrated distraction.

## LOVE THY NEIGHBOUR?

Meanwhile, the Argentine government's relationship with foreign oil and gas firms is far from stellar, and the country's own oil production is declining. The fact that the Falklands has been able to attract investment serves as a reminder to Buenos Aires that it could well do with spending some

time worrying about its own domestic oil industry. That the attractive terms offered by the Falklands islands, which are charging royalties of just 9 percent per barrel produced, have proved sufficient to entice independents to take the plunge is revealing. In contrast the two Kirchner administrations have done little to encourage private initiative in Argentina's domestic energy industry.

The story of Spanish firm Repsol's tie-up with Argentine firm YPF in 1999, a year after Argentine oil production peaked, is a case in point. Hailed as something of a masterstroke at the time, Repsol paid US\$15 billion for YPF after it was partly privatised at the start of the decade. The purchase doubled the size of the company, which changed its trading name to Repsol YPF. But it all went sour three years later as the Argentine economy went into freefall. In the ensuing mess, Repsol was left with a pile of debt, raised for the purchase, and a business unit trapped in an economy being devastated by hyperinflation. Price controls meant that YPF was forced to sell its oil and gas for one-third of world prices.

Repsol has subsequently sought to reduce its exposure to Argentina by selling some of its YPF stake to Argentine banker Enrique Eskenazi, who has ties to former President Nestor Kirchner. There have also been regular rumours that Repsol would like to get shot of YPF, with reported Chinese interest. And all this despite the fact that YPF accounted for 64.7 percent of group output and 53.7 percent of group net crude oil reserves in 2008. That YPF has been something of a poisoned chalice has much to do with Buenos Aires. YPF's profitability has been stunted by low domestic gas prices, high oil export duties and erratic volumes.

It is a microcosm of Argentina's oil industry. Crude oil production, according to the BP Statistical Review, has fallen steadily since 1998 when output peaked at 890,000 barrels per day. Crude oil production in 2008 was 682,000 barrels per day and could well fall below 650,000 barrels per day this year. YPF will drill a well in Argentine waters later this year, in a consortium with Pan American Energy (majority owned by BP) and Brazil's Petrobras. But the Kirchners may wish to ask themselves why an extensive exploration programme is taking place right next door to Argentina's territorial waters.

For examples of how to do things better the Argentines could consider the example of the islands they so dearly want back. Also they could look north to Brazil or Colombia. Both have created frameworks enticing to foreign oil firms. The results have been striking in both cases. Brazil's Atlantic subsalt play is now considered to be one of the most exciting in the world, a new multi-billion barrel basin. Despite recent legislation to increase the state's say over its subsalt reserves, it is unlikely that the play would have been opened up without the 1997 law which attracted foreign companies, including Repsol. Colombia, too, has seen production and reserves rise rapidly following the government's concerted efforts to improve security and improve licensing terms. Despite a smaller proven reserve base, Colombia is expected to have overtaken Argentina as Latin America's third largest oil producer last year.

## MUTUAL BENEFITS

Successful development, assuming a commercial discovery, would be made far easier by Argentine support. It could also prove a boon for Argentine service firms and potentially its own oil industry. Argentina would be a logical processing base for Falkland's crude and, potentially even, a future market. Aware of this, Argentina has used its one real step of redress, announcing in early February that it would begin to require permits for any ships sailing from Argentina to the Falklands, or for those sailing through Argentina's territorial waters. Though perfectly entitled to follow this course of action, Argentina has much to gain from exploration in the southern Atlantic; after all, its territorial waters are vast.

Taking punitive action against the Falkland islanders – Argentina has also prevented a ship carrying pipes to the Falklands from leaving its ports – seems churlish. By slowing down exploration efforts in the region and making it logistically harder by restricting shipping Argentina is blocking what could ultimately prove a lucrative opportunity. Moreover, it is hardly as if oil exploration off the Falkland Islands is new. Exploratory wells were drilled off the Falklands in the late 1990s – of the six wells sunk, five showed signs of hydrocarbons – though with oil at around US\$10 per barrel further drilling was deemed unprofitable.

With oil above US\$75 per barrel the attraction of a large tract of unexplored acreage is understandable; especially one that has geology suggesting it could house vast oil reserves – 60 billion barrels according to a widely cited geologic sources. The companies leading the exploration effort,

Desire Petroleum, Rockhopper Exploration and Falkland Oil and Gas, are small, London-listed independent oil companies that bear the classic hallmarks of “wild cat” explorers.

Any find would transform the Falkland Islands' economic fortunes but, for now at least, this remains a distant prospect; the gap between initial exploration work and commercial production is great – exploration does not equal discovery, nor does a discovery lead inexorably to production. Surprisingly, this fact has largely been lost in the maelstrom of words exchanged since the arrival of a single rig, the Ocean Guardian, which will drill up to ten wells in the waters around the islands.

London is an easy target for an unpopular Argentine administration. But despite the vitriol being directed towards the UK, the decision about the terms and licensing of exploration was transferred from London to Port Stanley in the late 1990s. The Falkland Islanders' right to determine what activity takes place in its territorial waters was even recognised by Argentina in 1995 when it signed the Joint Declaration over Oil with the UK. The deal also included provisions for joint exploration around the islands. However, Argentina bailed on the agreement in 2007.

The success (or not) of Desire Petroleum's exploration program will provide Argentina with an indication of the resources potential in the southern Atlantic. With the first offshore drilling campaign of consequence scheduled to take place in Argentine territorial waters later this year, Buenos Aires may well wish to consider how it can attract more exploration instead of worrying about the Falklands sovereignty. ■