

# Case study: Peru

Presidential candidates divided on gas deal renegotiation



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## PERU, KEY INDICATORS 2015

### POPULATION

31.4 million<sup>i</sup>

### GDP PER CAPITA (PPP)

\$12,500<sup>ii</sup>

### MAIN NATURAL RESOURCES

Oil, gas, copper, silver, gold

### RESOURCE RENTS AS % OF GDP

9<sup>iii</sup>

### POLITICAL SYSTEM

Presidential representative  
democratic republic

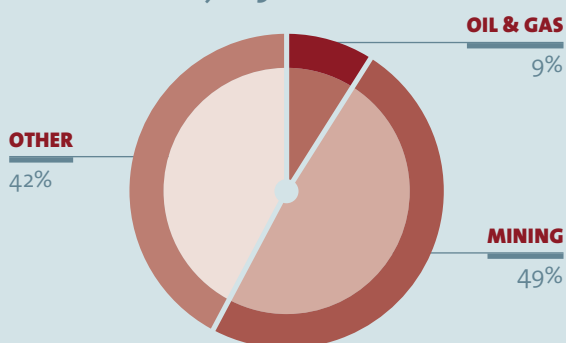
### RULING PARTY

Peruanos Por el Kambio (PKK)

### OPPOSITION PARTIES

Fuerza Popular (FP),  
Frente Amplio (FA),  
Acción Popular (AP),  
Alianza Para El Progreso (APP),  
Célula Parlamentaria Aprista (APRA)<sup>iv</sup>

### EXPORT SHARES, 2015<sup>v</sup>



<sup>i</sup> "DataBank 2015: Population, total," accessed 5 September 2016, World Bank (2015), <http://data.worldbank.org/indicator/SP.POP.TOTL>.

<sup>ii</sup> "DataBank 2015: GDP per capita (current US\$)," World Bank (2015), accessed 5 September 2016, <http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD>.

<sup>iii</sup> "DataBank 2015: Total natural resource rents (% of GDP)," World Bank (2015), accessed 5 September 2016, <http://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS>.

<sup>iv</sup> Congress of Peru, <http://www.congreso.gob.pe/eng/?K=371>.

<sup>v</sup> "DataBank 2015: Fuel exports as % of merchandise exports," World Bank (2015), accessed 5 September 2016, <http://data.worldbank.org/indicator/TX.VAL.FUEL.ZS.UN> and "DataBank 2015: Ores and metals exports as % of merchandise exports," accessed 5 September 2016, World Bank (2015), <http://data.worldbank.org/indicator/TX.VAL.MMTL.ZS.UN>.

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### Political system

Peru is a presidential representative democratic republic with a multiparty system and a unicameral parliament consisting of 130 seats. The president of Peru is elected for a single term of five years. The major parties in Peru<sup>103</sup> include Peruanos por el Kambio (PPK), a center-right political party created in 2014. PPK founder Pedro Pablo Kuczynski, an economist and the elected president of Peru, served as finance minister when the disputed gas field agreements analyzed in this case study were struck.<sup>104</sup> Founded in 1956 as a left-of-center political party with broad support until the 1980s, Acción Popular (AP) has since evolved into a center-right party with declining support. Fuerza Popular (FP) is a right-wing political party led by Keiko Fujimori, daughter of former President Alberto Fujimori, currently imprisoned for corruption and crimes against humanity. Finally, Frente Amplio (FA), a coalition of leftist parties and civil society movements, was created in 2013.

### Natural resource endowments and governance

The mining and hydrocarbon sector has a long history in Peru. Located between the regions of Ucayali in the central part of the country and Cusco in southern Peru, the Camisea field is the country's largest natural gas reserve. Despite being one of Peru's most valuable natural resource assets, the project took nearly 20 years to be developed since its discovery in 1984. In recent years, the Camisea gas field's future has sparked debate around the destination of Peruvian gas exports; the Peruvian state's role in an export deal increasingly viewed as disadvantageous for Peruvians; and the nature of deals between the state and extractive companies. As a result, all parties involved in the 2016 electoral race stated their positions on this matter, as energy related policies

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<sup>103</sup> Two other parties not mentioned in this study also managed to obtain congressional representation in this term: Partido Aprista Peruano (APRA) and Alianza por el Progreso (APP). Their campaign was marred by personal scandals of their presidential candidates, which required these parties to steer their campaigns into a defense front against multiple types of accusations. Therefore, their capacity to make technical proposals over the gas policy was limited.

<sup>104</sup> The word "Kambio" is written with the letter "K" intentionally, so that the party has the same initials as their leader Pedro Pablo Kuczynski.

came to the forefront of election debates. This case study analyzes the positions taken by presidential candidates and their parties on natural gas issues, and the processes through which they were formed.

### **Structural reforms pave the way to exploitation of Camisea gas field**

Despite intense negotiations between the government and Royal Dutch Shell during the 1980s and early 1990s, licencing agreements to develop the Camisea gas field initially remained unsigned due to Peru's fragile investment climate. It was not until the mid-1990s when the adoption of a new hydrocarbon law introduced drastic structural reforms to the property rights regime that commercial activities began in Camisea. The law allowed the new hydrocarbons agency, Perupetro, to transfer all property rights to licence holders, and separated exploration and operation licences from transport and distribution contracts. In order to attract foreign investment and secure state revenues, the government created a specific ruling for the gas industry, establishing royalties in accordance with the price applied to the gas, and limiting the state from operating in the gas market to encourage competition.<sup>105</sup> For bidding purposes, the Camisea field was divided in two blocks: Block 88 (the largest) to meet internal energy demands and the smaller Block 56, which was dedicated to export. The main difference between the blocks' conditions is the price. Shell sells Block 56 LNG to Mexico at the U.S. Henry Hub spot price. As the U.S. started flooding the market with shale gas from 2010 - 2015, the Henry Hub price collapsed<sup>106</sup>, which had a direct negative impact on the royalties paid to the Peruvian government. The price of Block 88 is fixed for the domestic market (see box 2.5), and part of it is actually channeled to exports at the collapsed price.

The collapse in prices sparked a debate on renegotiating the export price from Peru to Mexico. This turned out to be difficult as the deal is not between the Peruvian and Mexican states, but between Shell and the Mexican government.<sup>107</sup>

### **Renegotiation of the Camisea gas deals becomes an election issue**

The debate on the Camisea deals started with the AP blaming the former government of ex-President Alejandro Toledo—including his former finance minister and current president Kuczynski—for cutting a bad deal for

<sup>105</sup> Law 27133.

<sup>106</sup> "The US shale revolution," *Financial Times*, 24 April 2015, <https://www.ft.com/content/2ded7416-e930-11e4-a71a-00144feab7de>.

<sup>107</sup> "Camisea natural gas: Peru's political football," *Peru Reports*, 28 March 2016, <http://perureports.com/2016/03/28/camisea-natural-gas-perus-political-football>.

### **Box 2.5** **Evolution of Peru's Camisea gas contracts**

Bidding for the exploration, production and transportation phases of Block 88 was finalized in 2000. Camisea Consortium and Transportadora de Gas del Perú (TPG) won those bids. This was followed by bidding for the second phase of Camisea, Block 56, launched in 2004. The Block 88 reserves were assumed to cover domestic demand, while Block 56 was intended for export. But there was no clear indication of Block 56's potential, as it remained largely unexplored. Due to uncertainty regarding the Block 56 reserves, international investors demanded 4.5 trillion cubic feet (tcf) of proven reserves to apply for a bidding process, while the government could only guarantee 2 tcf. In order to attract potential investors, the government put in a warranty of an additional 2.4 tcf from Block 88, intended for domestic use, until exploration of Block 56 ended.

Upon finalization of the exploration phase, it was clear that Block 56 did not account for the 4.5 tcf necessary for the financial feasibility of a transportation duct for export. As a result, the government decided to continue allocating gas from Block 88 for exports. Peru LNG, which is largely owned by the same members of the Camisea Consortium and TPG, won the bidding process to build and operate gas liquefaction facilities. For the export of gas from Block 56 the government signed four contracts in total:

- **The Peruvian state**, through Perupetro, signed a licencing deal with **Camisea Consortium** for the exploration, extraction and operation of Block 56.
- **The Camisea Consortium** signed a processing deal with **Peru LNG** for the liquefaction and storage of natural gas.
- **Peru LNG** signed a deal with **Shell** (and from 2013 with **Repsol**), the off taker that would trade the gas in foreign markets.
- **Shell**, being the off-taker, signed a deal with **Mexican government** (through the Federal Electricity Commission) to export 72 percent of the LNG produced from Block 56 to Mexico.

Peruvians. In a March 2016 statement, AP candidate Alfredo Barnechea suggested that the deal should be opened for renegotiation: "All contracts can be modified, including international treaties. Every contract can be modified when circumstances change, more so in the case of these fraudulent contracts handpicked/awarded by Mr. Toledo and Mr. Kuczynski."<sup>108</sup> Despite Barnechea's statements, it seems that within the AP there was no consensus on how to proceed with the renegotiation. Carlos Herrera Descalzi, former energy and

<sup>108</sup> "Barnechea arremete contra candidatos," *La Razón*, 3 March 2016, <http://cronologiapoliticadelperu.org/2016/03/03/barnechea-arremete-contra-candidatos/>.

mines minister, also from AP, was more cautious and proposed a reconciliation process between investors: "...when one party (to a contract) feels aggrieved, it proposes an amendment to the counterparty. This process is resolved through the mechanisms established for that purpose: direct negotiation, arbitration or going to the judiciary. Also, when the state is one of the parties, it is because there are public goods or interests involved. Therefore, regarding contracts that affect the common good, the state not only has the right but also the moral obligation to request a renegotiation and subject [the contract] to the rules of the game. Renegotiation does not mean imposing or expropriating, confiscating much less."<sup>109</sup>

**As the gas problem became central to the public debate, political parties endeavored to better define their positions.**

As the debate continued, the Frente Amplio coalition went further to challenge the property rights now transferred to the companies by virtue of the actual licence contracts. The party opened a debate over who owns the Camisea gas and whether the hydrocarbon laws passed in the 1990s are a good deal for the Peruvian state and people. Verónica Mendoza, FA presidential candidate, made the use of the Camisea natural gas for national development one of her main campaign messages. For FA, the renegotiation of gas export contracts involves changing the entire Peruvian gas policy as ruled by the Organic Hydrocarbon Law (26221). At the start of the election campaign, in January 2016, she said: "The gas has to be used for national development and not for looting by a few companies... the construction of the Peruvian Southern Gas Pipeline will allow the people of Cusco and the macro southern region to use this resource for industrialization and job creation."<sup>110</sup>

The other two main parties, Fuerza Popular and Peruanos por el Cambio, were inconsistent insofar as their position on the sector. The gas issue does not appear in the government plan<sup>111</sup> (election manifesto) of the FP,<sup>112</sup> which is a conservative political party promoting private domestic and foreign investment. From this perspective, questioning one of the largest private investment projects in the country was not part of its original electoral agenda. But when facing PPK in the second electoral round, FP candidate Keiko Fujimori turned to the gas issue to undermine the PPK's image: "Kuczynski 'gave away' the

<sup>109</sup> "Debate: ¿Es posible renegociar el contrato del gas de Camisea?" *El Comercio*, 4 March 2016, [http://elcomercio.pe/opinion/colaboradores/debate-posible-renegociar-contrato-gas-camisea-noticia-1883781?ref=flujo\\_tags\\_517047&ft=nota\\_3&e=titulo](http://elcomercio.pe/opinion/colaboradores/debate-posible-renegociar-contrato-gas-camisea-noticia-1883781?ref=flujo_tags_517047&ft=nota_3&e=titulo).

<sup>110</sup> "Verónica Mendoza sobre Camisea: '¿Dónde está el bendito gas?' [VIDEO]" *LaMula*, 29 January 2016, <https://redaccion.lamula.pe/2016/01/29/veronika-mendoza-sobre-camisea-donde-esta-el-bendito-gas-video/redaccionmulera>.

<sup>111</sup> A government plan or election manifesto is a technical requirement for any Peruvian party who wishes to enter the presidential race. It is a planning document in which parties lay out their policies for implementation, if they were to be elected for government. In practice some parties submit quite technical documents such as the 2016 government plans of the PPK and FA parties; others are not as specific.

<sup>112</sup> Keiko Sofía Fujimori Higuchi. "El Plan de Gobierno de Fuerza Popular representa un compromiso con el futuro del Perú," *Plan Perú*, [http://keikofujimori.pe/#yt\\_spotlight7](http://keikofujimori.pe/#yt_spotlight7).

gas. We will investigate the contract and renegotiate it for the benefit of the country. [Kuczynski] has made the Block 56 exclusive for export and changed the laws, so that the Block 88 can also be exported and trading was done in the worst way. The cheapest price was used as reference. Therefore, he gave away our gas, and we will investigate and renegotiate the contract considering the interests of the country.”<sup>113</sup>

When confronted with the gas issue during his presidential bid, the PPK’s Kuczynski had to respond. In April 2016, he said that the project was originally developed assuming more gas production, but since then “the energy framework has changed, the price of raw materials has fallen, and in particular the price of natural gas collapsed.” In another intervention, he stated that his priority was to expand domestic consumption through the construction of a southern pipeline to popularize the consumption of natural gas in households: “My government will deliver, because we will subsidize the installation of domestic gas connections and use the cheapest gas for Peruvians.”<sup>114</sup>

The difference between the PPK and FA positions is that the first is based on the assumption that reserves would be large enough to cover gas production that satisfies both internal and external demand. Conversely, FA thinks the gas export deal does not serve Peru and gas production should be redirected to domestic consumption, thereby covering the energy needs of a larger part of the country.

As the gas problem became central to the public debate, political parties endeavored to better define their positions. The results, nevertheless, varied. From the start, the FA opposed the continuation of gas exports, proposing the renegotiation of contracts with Mexico in order to suspend exports and reroute gas for domestic consumption and industrialization. Also, the FA proposed renegotiating the existing extraction/production contracts from licences to service contracts. Both the AP and FP, more cautiously, proposed that the government would assume a more central role in the renegotiations between the off taker (Shell) and Mexico’s Federal Electricity Commission. PPK, true to its initial stance, ruled out renegotiation and proposed the scaling up of production in order to boost domestic consumption.

### **From electoral campaigning to policy agendas**

The PPK won the June 2016 presidential elections and now has an electoral promise to keep. However, the party’s position on whether the government

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<sup>113</sup> “Keiko Fujimori ‘PPK regaló el gas de Camisea’ (VIDEO)” *Correo*, 18 May 2016, <http://diariocorreo.pe/edicion/arequipa/keiko-fujimori-ppk-regalo-el-gas-video-673543>.

<sup>114</sup> “PPK: ‘Renegociaré el contrato de exportación del gas de Camisea,’” *Inforegion*, 20 March 2016, <http://www.inforegion.pe/219613/ppk-renegociare-el-contrato-de-exportacion-del-gas-de-camisea>.

will renegotiate the export contract was imprecise; there is no reference to a renegotiation of contracts in its government plan. Political realities—it is only the third-largest party in the congress—are prompting the PPK government to build bridges with other parties. Therefore, during his inaugural speech, Peru’s Prime Minister Fernando Zavala of PPK announced that a renegotiation of contracts would take place under his administration.<sup>115</sup> This renegotiation would most likely imply a direct political agreement with Mexico, modifying the existing contract between the Federal Electricity Commission and Shell in order to reduce export volumes and secure better prices, in line with AP and FP positions. Expectations that his economically liberal government will take the additional step of changing the current contracts to service contracts, thus asserting state sovereignty over the extracted resource, are low.

A few months into the parliamentary session, most other parties seem to be backtracking on electoral promises. Despite initiating the renegotiation debate, the AP did not include it in its government plan, nor has it been central to its parliamentary agenda. Similarly, after the election campaign ended with Fujimori’s Fuerza Popular winning an absolute majority in congress (despite being defeated in the presidential race), the issue has disappeared from FP’s legislative agenda, potentially reducing the pressure on the PPK. Consequently, FA is the only party that regards the gas deals as central, both in the face of public opinion and in congress. Given its political weight and popularity in the polls ahead of the upcoming regional elections, it will seek to put pressure on other political parties, foremost the PPK.

### **Populism and personal politics inhibit evidence-based energy policy**

In the 2016 campaign, government plans covered a wide array of subjects with little detail. Policy proposals were generally broad, tackling subjects deemed relevant to a majority of the electorate (such as employment, economic growth and public safety) without a radical departure from previous policy or positions. Peruvian political parties, as in the rest of Latin America, depend heavily on the personality and gravitas of their leading candidates.<sup>116</sup> Policy positions are typically designed by a small group of members of the party management, meaning that intra-party discussion is quite limited. This is the result of structural weaknesses within the political party system, wherein political parties function more as electoral machines rather than platforms for debate.

<sup>115</sup> “Premier Zavala anuncia el inicio de la negociación del gas de Camisea,” *La República*, 20 August 2016, <http://larepublica.pe/impres/politica/795643-premier-zavala-anuncia-el-inicio-de-la-negociacion-del-gas-de-camisea>.

<sup>116</sup> See, for example, <http://www.globalsecurity.org/military/world/peru/political-parties.htm>.



The PPK and FP parties fall into this description, as they were mainly created to sustain the presidential candidacy of their leaders. Their policy positions during the election campaign were not the result of a deliberative process structured around the interests of grassroots supporters.<sup>117</sup> The PPK position on gas policy was in line with the track record of its candidate and the party elite, and the FP position shifted depending on its political adversary. By contrast, the AP, a more traditional party, and the FA coalition built more nuanced positions through intra-party discussion in order to achieve programmatic agreements. The AP initially brought the Camisea case to public knowledge and the FA rapidly echoed its importance. The latter had already included a detailed programmatic proposal on gas policy in its government plan.

Despite programmatic weaknesses, the shift in the election debate's focus to gas issues was bound to have repercussions for the winner of the elections. The Camisea gas export deal involves many different stakeholders including another sovereign country, two business conglomerates, and local governments dependent on subnational revenue transfers and citizens that feel they are not benefitting from gas production. This translated into a debate that involved a confusing landscape of parties aligned with different stakeholders. Inter-party dialogue on this issue was limited to a handful of civil society-organized electoral debates. These lacked technical details and only a few of them were televised. Therefore, possibly the biggest outcome of the election debate on Camisea is the fact that Peru's new government cannot ignore issues concerning the gas field's exploitation.

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<sup>117</sup> It is worth noting that despite following a leader-oriented type of organization, Fuerza Popular has managed to amass the largest political base of the country.