

RISK ASSESSMENT: ECUADOR'S XI OIL TENDER

This assessment is an overview of legacy issues, and current economic, legal, social, and environmental risk factors faced by companies interested in submitting bids for Ecuador's Ronda Sur Oriente oil lease auction.

Legacy Liabilities

The more than ten million acres of Ecuador's southeastern Amazon that are divided into 21 oil blocks have been the site of some of the fiercest conflicts between local indigenous groups, the state, and oil companies. Ecuador has previously offered the majority of the blocks currently included in the XI Round, but received no bids and was forced to cancel the tender.

Several companies—the Atlantic Richfield Company (ARCO), Burlington Resources, ConocoPhillips, Compania General de Combustibles (CGC) and Perenco—held rights to develop hydrocarbons in two blocks now included in the Ronda Sur Oriente. Both blocks were paralyzed in force majeure for close to a decade due to indigenous resistance, and all companies were forced to pull out. The blocks have been re-packaged, newly delineated, and incorporated into the tender, but leave a legacy of litigation, intervention by the Inter-American Human Rights Court and Commission, shareholder action and arbitration claims.

Questionable Reserves

Estimates of potentially recoverable crude vary wildly and may not be commercially viable. A Business Monitor International (BMI) New Energy research report published in January 2013 forecasts that proven oil reserves in Ecuador peaked in 2011 and will begin to decline in 2014, while total oil production peaked in 2012 and will begin to decline at an average rate of 1.81% between 2013 and 2017. A significant reduction in net exports has been predicted, with an average yearly decline of 15%. The report has determined that opening 13 new oil blocks in the southern Ecuadorian Amazon will be insufficient to reverse this trend. Current projections show that recoverable oil reserves in the XI Round area would only extend Ecuador's oil production for two years. Lack of industry infrastructure and plans to transport crude via the North Peruvian Pipeline creates further instability, as the pipeline extension plan will likely meet opposition and major ROW (right of way) issues.

Legal Risk

Numerous court cases have been brought against the Ecuadorian government and companies operating in the Ecuadorian Amazon, including but not limited to Chevron and Ivanhoe Energy. Recently, an Ecuadorian court found Chevron liable for \$19 billion in damages for its environmental and public health disaster in the northern Amazon. The Inter-American Court of Human Rights (IACHR) ordered the Ecuadorian government to pay over \$1.34 million to the Kichwa community of Sarayaku for improper consultation

prior to licensing operational rights in their territory. Legal risks to companies bidding in the XI Oil Round are extremely high given unified claims of improper consultation in affected indigenous territories. Companies have faced legal injunctions that have led to work slippages, project delays, and new litigation using Ecuador's progressive Constitution that declares nature a rights bearing entity.

Social Risk

The lands up for auction within the Ronda Sur Oriente are millions of hectares of ancestral territory of seven indigenous nationalities: Shuar, Achuar, Kichwa, Shiwiar, Andoa, Sápara, and Wuaorani, all of whom have repeatedly rejected oil extraction plans on their lands. These nationalities are actively coordinating with the regional indigenous confederation CONFENIAE, and the powerful national indigenous umbrella group CONAIE. CONAIE is responsible for the ousting of several former presidents, stopping free trade agreements, and leading major uprisings to influence public policy. All groups are pledging to actively resist the Ronda Sur Oriente and any drilling related activities on any lands of the seven indigenous nationalities.

Recently, Minister of Non-Renewable Natural Resources Wilson Pastor excluded five blocks from the round due to indigenous opposition. Several months of attempts to consult the local indigenous populations were rebuffed, and the state was unable to properly conduct a consultation process in accord with Decree 1247 and the standard set by the Inter-American Court on Human Rights in the Sarayaku v. Ecuador case, which the current administration of Rafael Correa has stated it will respect.

PROJECT SNAPSHOT: Ecuador's XI Round Oil Auction

- Auction opened Nov. 28, 2012 @ SENAP Oil Conference
- 13 blocks for bid in Southeastern Amazon + 3 blocks for direct negotiation with state company PetroAmazonas (4 million hectares, 9.9 million acres)
- Blocks are "high risk" but "great potential" according to GoE
- Proven reserves: 100 million barrels
- Reserve estimates of 369 million - 1.6 billion
- 5 blocks removed from round due to indigenous opposition
- Crude to be exported using the Northern Peruvian Pipeline
- Tender to be open until May 2013
- Contracts expected to be signed by September 2013
- Production contracts, with state retaining 100% of oil produced
- GoE expects investment of \$1 - \$1.2 billion for the blocks
- Interested private companies include: Repsol (Spain), ENI (Italy), Andes Petroleum (China)
- Interested state companies: Peru, Colombia, Mexico, Turkey, Chile, Vietnam, Indonesia, Belarus, South Korea, China

Widespread protests marked the opening of the XI Oil Round, garnering major media attention in Ecuador and beyond. International opposition is rising, with a recent petition drive achieving over one million signatures.

Consultation Process

The Ecuadorian government claims that consent from affected indigenous communities in the southern Amazon was acquired by means of a proper consultation process. However, the communities themselves, along with CONFENIAE and CONAIE dispute these claims. They state that the consultation process was not conducted in native languages or in a manner consistent with local decision-making practices: a right granted by ILO 169 and Ecuador's Constitution. Nor was it free, prior, or informed as required by the Constitution. Legal challenges to the government's process are expected.

The Sarayaku v. Ecuador Precedent

On July 25, 2012, the Inter-American Court of Human Rights (IACHR) ruled that the Ecuadorian government pay \$1.34 million in damages and \$58,000 in legal fees to the Kichwa community of Sarayaku for ignoring the community's rights to proper consultation about development projects that would affect its land and for violating its rights to communal property and cultural identity. The case followed a contract signed between the Ecuadorian government and the Compañía General de Combustibles (CGC) in 1996 to explore for oil in lot 23, two thirds of which sit in Sarayaku territory. The court determined that the Ecuadorian government's consultation process failed to constitute proper consultation in accordance with international legislation and Ecuador's own Constitution; that military camps and more than a ton of explosives placed in Sarayaku territory violated the community members' right to freedom of movement; and that the company's environmental impact statement failed to take into consideration the spiritual, cultural, and social impact of operations. The ruling has set a clear precedent for extractive industry operations on indigenous territory without proper consent and demonstrates the implications for violating rights established by international and Ecuadorian legislation.

Environmental Risk

Ecuador has one of the highest rates of biodiversity of all Amazonian countries. A recent study shows 85% of the area slated for inclusion in the XI Round is intact primary forest with high levels of biodiversity and endemism. Best practices and new technologies will likely do little to reduce oil activity footprint due to the fragile nature of the ecosystems throughout this area and the dependence of local indigenous groups on forest and local water sources. Though rarely mentioned in industry circles and presentations to investors, thousands of acres are currently protected inside the oil concession area of Ronda Sur Oriente, which could prove a major stumbling block for any oil activity. The XI Round threatens Ecuador's plan to enter these

lands into an international REDD+ agreement, currently under negotiation as part of the UNFCCC climate negotiations and underscores a major policy contradiction between the Environmental Ministry and the Ministry of Non-Renewable Resources.

Political and Economic Risks of Ecuador

Ecuador is widely considered to be a poor business environment for foreign investment. Its reputation worsened after a 2009 sovereign debt default and has resulted in enduring exclusion from international capital markets. BMI's recent Risk/Rewards Ratings ranked Ecuador lowest in Latin America, along with Bolivia and Argentina, in upstream country risk dynamics. In addition, the Fraser Institute's Global Petroleum Survey 2012 ranked Ecuador as the 6th worst country in world to invest in and strongly recommends not pursuing investment.

Operational contracts for the extraction of petroleum in Ecuador have been consistently marred by charges of nepotism and corruption, including under the current administration. President Rafael Correa has been accused of signing illegal operational contracts with Ivanhoe Energy in Block 20, and his cousin, Pedro Guerra Delgado is currently under investigation in Miami for running Ecuador's Central Bank as president under a false diploma.

Current Minister of Non-Renewable Resources Wilson Pastor has been accused of similar if more extreme nepotism, his three other brothers and daughter all hold high positions in private companies with contracts with the Ecuadorian government worth millions. Questions have now also arisen around whether he has a university degree. A formal inquiry was filed with the Attorney General December 27, 2012, and to date no degree has been produced by Pastor.

