



1300 Connecticut Ave N.W. Suite 800
Washington, DC 20036

Tel: 1 (202) 872 1199
Fax: 1 (202) 872 1219
E-mail: info@pfcenergy.com
Web: www.pfcenergy.com

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Reference: The State of Democracy in Venezuela

Comments on the status of the oil industry in Venezuela and its impact on the country's international and domestic politics

Putting Venezuela into context

Simply put, Venezuela matters because of its substantial oil reserves, its strategic location and its regional economic importance.

- First in terms of reserves, Venezuela is the “Saudi Arabia” of Latin America. Its reserves are approximately 78 billion barrels, just below those of Saudi Arabia, Iran, Iraq, Kuwait and the United Arab Emirates. But Venezuela has more oil than Russia which positioned itself as a potential replacement for Middle East oil.

Before the oil workers' strike of December 2003, Venezuela produced around 3 million barrels per day (mmbd). The state oil company, PDVSA, plans to increase production to reach up to 5 mmbd by 2009. Most of Venezuelan output is exported to the United States. Venezuela captures approximately 12% of the US market.

- Venezuela's geographic location is of strategic importance. It takes only 4 to 5 days travel by oil tanker from Venezuela to the Gulf of Mexico, while oil from the Middle East takes around 45 days to arrive in the US.
- Most of Venezuela's oil is exported to the Gulf of Mexico's refineries where PDVSA, through its subsidiary CITGO, has ownership in various large refineries¹. These refineries are specifically built for Venezuelan heavy crudes, alternative sources of supply are the Mexican Maya crude, which suffers from capacity limitations, and Middle Eastern crudes which take longer to import. Venezuela also has a 50% equity interest in Hovensa refinery located in St. Croix, U.S. Virgin Islands².

Is Venezuela a reliable supplier to the US?

There are three reasons that Venezuela is a reliable supplier to the US and the Atlantic Basin markets. First, Venezuela's economy is critically dependent on oil export revenues. While the oil sector accounts for only 22% of Venezuela's economy, over 70% of budget revenues come from oil earnings. Given that budget expenditures account for 30% of GDP, the indirect dependence on oil is even greater. This was clearly evident during the January 2003 oil strike—the decline in real GDP during 2003 due to an eight-week oil production stoppage was nearly 10%.

Second, the government of President Hugo Chavez is banking on high oil prices and sufficient oil revenues to fund hugely expanded social programs. His government sees oil income as the means towards achieving political objectives. This is also evident in its cooperation with OPEC. As a result, without oil exports the Chavez government will not be able to achieve its socio-economic goals.

Third, the government of Venezuela, for strategic reasons would like to be the energy supplier of choice to the Western Hemisphere. Through Citgo it has substantial assets in the United States, which are directly dependent on Venezuela's crude oil exports. PDVSA also has substantial

¹ Lake Charles (Louisiana) and Corpus Christi (Texas), as well as the joint Lyondell-Citgo (Houston, Texas).

² Amerada Hess owns the other 50%

agreements with specific refiners to process Venezuelan crudes, exclusively. A stoppage in exports will severely damage these assets.

The Sustainability of Venezuelan Oil and Gas Production and Exports

The Venezuelan government has taken a keen interest in expanding its oil and gas sector.

President Chavez has increasingly called upon foreign direct investment in the energy sector. Due to the maturity of Venezuela's principle basins and their declining productivity, PDVSA reportedly plans to spend \$38 billion in the 2004-2009 timeframe in order to increase production from 3.4 mmb/d³ to 4.9 mmb/d⁴. Other key objectives of PDVSA's business plans include:

- Aligning PDVSA's goals to the national development plan;
- Strengthening exploration and production activities;
- Strengthening OPEC's position in the world oil markets;
- Improving oil recovery rates;
- Improving the value of Venezuelan crude;
- Re-defining the internationalization strategy of PDVSA; and,
- Using oil investments for local and national development.

Since we expect OPEC to successfully keep oil prices above \$35 a barrel this year, and certainly over \$25 a barrel in the next several years, the government of Venezuela and PDVSA will have sufficient funds to finance most of these projects. Currently, the PDVSA budget is designed to operate at US\$20 a barrel oil, thus providing the development plans a sufficient cushion. Certainly there are serious concerns that the fiscal stance of the government is excessively expansionary and that a sharp fall in oil prices could result in cut backs in spending, possibly even by PDVSA. But the government has maintained relatively good relations with the international oil companies and is planning to engage them in part of the oil and gas sector expansion plans.

³ Note that as mentioned earlier, PDVSA reported production is not credible and numerous oil information sources report oil production in Venezuela as being around 2.4 MMBOD

The government has also recognizes that PDVSA, particularly since the strike in 2003 after which 18,000 workers were fired, has critical skill deficiencies, which foreign companies can help overcome. Since the strike PDVSA has struggled to regain productivity levels and there are serious concerns in the industry whether it will be able to carry out future development plans even if there are sufficient funds available.

Financial diversions to social programs and the critical lack of skills could open up substantial opportunities for the foreign oil companies. These opportunities for the private sector will focus on the development of the marginal fields, expected to reach 530,000 b/d of production in 2005⁵. Other investment opportunities include the development of the extra heavy crude oil from the Orinoco belt, expected to produce around 579,000 b/d from four projects currently in operation. These projects tend to offer better terms than the more conventional oil producing projects and have received investment from the largest of the US energy companies⁶. Production sharing agreements are another option for private companies, although four of the ten blocks secured under these arrangements have been returned to PDVSA because of lack of commercial discoveries.

The government is also pushing for the development of the country's vast natural gas resources, estimated to be around 148 trillion cubic feet (tcf). The government passed a gas law which is considered fairly attractive and interesting for foreign companies. The push for gas development is based on an energy substitution strategy aimed at reducing domestic crude oil consumption in order to increase oil exports. Additional gas production will also be used for Liquefied Natural Gas (LNG) production so as to diversify exports and increase external earnings. Venezuela plans to become a major exporter of LNG to the United States and hopes this will be another means of supplementing its already large oil exports to its North American customer.

⁴ PDVSA 2004-2009 Business Plan

⁵ PFC internal estimates

⁶ ExxonMobil, ChevronTexaco, and ConocoPhillips

The two main LNG projects are the “Mariscal Sucre” and “Plataforma Deltana”. Mariscal Sucre is a US\$2.5-3 billion project with PDVSA having a 60% equity share. It involves the development of 10 tcf of proven gas from offshore Venezuela and the construction of a liquefaction facility with a capacity of 4.7 mm tons/year.

The “Plataforma Deltana” project includes the exploration and development of four offshore blocks awarded to BP, ChevronTexaco (2 blocks, one in partnership with ConocoPhillips) and Statoil. PDVSA carried the initial phase of the project, which included seismic studies and the drilling of four exploratory wells. The gas resources of Plataforma Deltana would be commercialized through expansions at Mariscal Sucre, a Greenfield LNG project dedicated to those reserves, or a potential joint development agreement with Trinidad allowing the gas to move to the Atlantic LNG facility.

Oil and gas expansion plans are complex exercises. The uncertainties in geology, markets and commodity prices inevitably create delays. This is complicated by negotiations between governments and international oil companies. Despite this, two issues are quite clear. First, the government of Venezuela is committed to securing foreign direct investment fairly rapidly. It feels the competition, especially in the gas markets, from far flung producers and would like to take advantage of the country’s comparative advantages. It also is motivated by economic interests, which could be easily served by an expanding oil and gas sector.

Second, Venezuela an attractive target for foreign company investment because of the limited number of countries which have its vast resources and the even fewer number which are open to foreign investment. International oil and gas companies will invest in Venezuela and help raise its supplies of crude oil and gas. Negotiations will be protracted but in the end there is likely to be substantial investment by private companies, many of whom are US based, in Venezuela. As a result, Venezuela will remain a critical supplier to the Western Hemisphere.

The role of PDVSA and the government of Venezuela will be very important. This role will be enhanced if two requirements are met:

- The message coming out of Venezuela regarding sanctity of supply is totally unambiguous. We strongly believe that Venezuela is committed to being a responsible supplier to the full extent of its capabilities. But doubts persist in the international market and these are reinforced with inflammatory remarks from public officials. This should stop.
- The market requires total transparency regarding Venezuela's production output levels. This would also go a long way in allaying uncertainties in the oil markets. Unrealistic estimates are easy to detect because of "mirror statistics" and reduce the credibility of the oil producer.

Venezuela's key role as the hemisphere's critical oil producer is not just an issue for the immediate future, it has an important role to play over the medium to long term as well. Here again two requirements are necessary:

- Venezuela needs to provide more clarity on its fiscal policies. Venezuela's fiscal policies over the last several years have raised some concern in the international financial and investment world. Beyond concerns for macroeconomic stability, the oil and gas industry is concerned that not only will there not be enough money to maintain current capacity, but there will be a problem with expanding capacity to meet the regional demand requirements of the future. Clearly the government has shown a willingness to engage foreign companies to invest in expanding capacity as we noted above. We at PFC Energy have always dismissed talk that the government had a phobia about foreign investment.
- Venezuela needs to provide more flexibility in terms of the investment regime – specifically, the legal framework surrounding the oil sector. We think showing greater flexibility up front will enhance the long-term position of the government and its contribution to the region's energy security.

Let me reiterate that we believe the Venezuelans want very much to play the role of being the hemisphere's most important hydrocarbon supplier. And, they will—despite signaling problems and misperceptions – help us overcome the uncertainties emanating from the Middle East.