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# “FULL SOVEREIGNTY OVER OIL”: A DISCUSSION OF VENEZUELAN OIL POLICY AND POSSIBLE CONSEQUENCES OF RECENT CHANGES

*B. Seth McNew\**

## I. INTRODUCTION

VENEZUELA holds within its soil an enormous amount of the commodity most sought after by developed nations of the world: oil. Today, “Venezuela is the world’s eighth largest crude oil exporter . . . [and] ranks among the top ten countries in the world in the size of its proven oil reserves—oil that has been proven to exist in the ground and could be produced.”<sup>1</sup> Throughout much of this century, oil has played a major role in the economy and politics of Venezuela, with each controlling regime making their own attempts to capitalize on the country’s vast oil reserves.<sup>2</sup> Upon being elected in 1998, Hugo Chávez, the current president of Venezuela, followed suit and once again sought to change the laws governing the country’s oil industry.<sup>3</sup> The policy of the Chávez administration has been a quest to achieve “Full Sovereignty Over Oil,” a policy that stresses national control over the oil industry and a greater return from all oil endeavors operated on Venezuelan soil.<sup>4</sup> Because this policy calls for foreign oil companies to pay more in income tax and royalty payments while simultaneously giving up some control over

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1. U.S. GOV’T ACCOUNTABILITY OFFICE, REPORT TO THE CHAIRMAN OF THE U.S. SENATE COMMITTEE ON FOREIGN RELATIONS: ISSUES RELATED TO POTENTIAL REDUCTIONS IN VENEZUELAN OIL PRODUCTION 1 (2006), available at <http://www.gao.gov/new.items/d066668.pdf>. [hereinafter GOV’T ACCOUNTABILITY OFFICE REPORT].
2. See RAFAEL DARÍO RAMÍREZ CARREÑO, REPORT TO THE NATIONAL ASSEMBLY OF VENEZUELA: A NATIONAL, POPULAR, AND REVOLUTIONARY OIL POLICY FOR VENEZUELA 1 (2005), available at [http://www.mem.gob.ve/noticias/prensa/English\\_version.pdf](http://www.mem.gob.ve/noticias/prensa/English_version.pdf). [hereinafter REPORT TO THE NATIONAL ASSEMBLY OF VENEZUELA].
3. GOV’T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 1.
4. Rafael Darío Ramírez Carreño, Minister of Energy and Petroleum of Venez., Speech at Third OPEC International Seminar, OPEC in a New Energy Era: Challenges and Opportunities: Full Sovereignty Over Oil (Sept. 2006), available at [http://www.pdvsa.com/index.php?tpl=interface.en/design/biblioteca/readdoc.tpl.html&newsid\\_obj\\_id=2990&newsid\\_temas=110](http://www.pdvsa.com/index.php?tpl=interface.en/design/biblioteca/readdoc.tpl.html&newsid_obj_id=2990&newsid_temas=110) [hereinafter Speech at Third OPEC International Seminar].

their oil ventures, it is likely that these new laws will cause some change in foreign investment in the Venezuelan oil industry.<sup>5</sup> This paper will discuss a brief history of the oil industry in Venezuela, the changes made by the Chávez administration, and the possible repercussions of these changes on foreign oil investment within the country.

## II. A BRIEF HISTORY

Foreign companies have been involved in the commercial production of oil in Venezuela since the outset of that process in the early 20th century.<sup>6</sup> Throughout the history of oil in Venezuela, the Venezuelan government has given “concessions” to private multinational companies.<sup>7</sup> These concessions allowed for private companies to contract with the Venezuelan state for the exploration and production of oil.<sup>8</sup> Although these companies were required to pay taxes and royalties to the Venezuelan government, they were in no way under its direct control.<sup>9</sup>

This foreign involvement in the oil industry continued even after the Venezuelan government created the Corporación Venezolana de Petróleo (CVP) in 1960.<sup>10</sup> While CVP did have some traits of a privately owned entity, the decision-making power of this company actually rested with a directive council headed by the Minister of Mines and Hydrocarbons.<sup>11</sup> In essence, the company was controlled by the Venezuelan government and was created in an attempt to give the government more control over the oil industry within the country.<sup>12</sup> Although the desired result may have been more control for the Venezuelan government, the petroleum industry had been so saturated by international companies in the past that even “[t]he creation of the [CVP] . . . was not able to modify the predominately foreign character of the Venezuelan oil industry.”<sup>13</sup>

Beginning in 1976, however, Venezuela officially changed its oil policy and nationalized the oil industry.<sup>14</sup> One major part of this nationalization was the creation of a new national company, Petróleos de Venezuela, S.A. (PDVSA).<sup>15</sup> But, instead of doing away with the previous oil con-

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5. WATSON, FARLEY, & WILLIAMS, *VENEZUELA OIL & GAS BRIEFING* 1 (2006), [http://www.wfw.com/pubs/WFW\\_Venezuela\\_Oil\\_and\\_Gas\\_Briefing\\_May\\_2006.pdf](http://www.wfw.com/pubs/WFW_Venezuela_Oil_and_Gas_Briefing_May_2006.pdf) (hereinafter *VENEZUELA OIL & GAS BRIEFING*).

6. GOV'T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 10.

7. Oil Concessions: Sovereignty Concessions, [http://www.pdvsa.com/index.php?tpl=interface.en/design/readmenuhist.tpl.html&newsid\\_obj\\_id=1942&newsid\\_temas=13](http://www.pdvsa.com/index.php?tpl=interface.en/design/readmenuhist.tpl.html&newsid_obj_id=1942&newsid_temas=13) (last visited Oct. 8, 2007).

8. *Id.*

9. *Id.*

10. REPORT TO THE NATIONAL ASSEMBLY OF VENEZUELA, *supra* note 2, at 2.

11. *Id.*

12. *See id.*

13. *The History of Venezuela and Its Oil*, 6 ALEXANDER'S GAS & OIL CONNECTIONS, Issue 12, July 2, 2001, <http://www.gasandoil.com/GOC/news/ntl12749.htm>.

14. GOV'T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 10.

15. Petróleos de Venezuela, S.A., From Privatization to Nationalization of the Venezuelan Oil Industry, [http://www.pdvsa.com/index.php?tpl=interface.en/design/readmenuhist.tpl.html&newsid\\_obj\\_id=1869&newsid\\_temas=13](http://www.pdvsa.com/index.php?tpl=interface.en/design/readmenuhist.tpl.html&newsid_obj_id=1869&newsid_temas=13) (last visited Oct. 8, 2007).

cessions granted to private transnational corporations, the PDVSA merely absorbed the fourteen existing entities and made them subsidiaries.<sup>16</sup> The rationale behind this process was to leave the daily activities of the oil industry as unchanged as possible.<sup>17</sup> "The transnationals' managing boards became part of these 'new' subsidiaries management teams, while the technical and professional teams remained unaltered."<sup>18</sup> Upon completion of this process, the oil activity of Venezuela was, in theory, placed under the control of the PDVSA and ultimately under the control of the Venezuelan government, PDVSA's sole shareholder.<sup>19</sup> But because the private concessionary entities were left largely intact, the "nationalization" of the oil industry did much less to actually "nationalize" the industry than anticipated and instead left a substantial amount of power in the hands of transnational managing boards that had formerly controlled the oil industry in Venezuela.<sup>20</sup>

As might be imagined, the "nationalization" of the oil industry was short-lived, and Venezuela soon began allowing foreign involvement in the production of oil once again.<sup>21</sup> "[B]eginning in 1992, the Venezuelan government reopened its petroleum industry to foreign and private Venezuelan oil companies in what is known as the 'Apertura.'"<sup>22</sup> The Apertura consisted of the Venezuelan government signing thirty-two operating service agreements that allowed for the involvement of private foreign and Venezuelan companies in the production of oil in fields that were at the time considered "marginal or high risk."<sup>23</sup> The idea was that these foreign companies would assist the PDVSA in the production of oil but would not have rights as to the volumes, reserves, or prices of crude oil.<sup>24</sup> The companies were to be remunerated only for their production costs plus a service fee.<sup>25</sup>

The operating service agreements were only one aspect of the Apertura; PDVSA also entered into four joint ventures with foreign oil companies to begin producing oil from the Faja region, also known as the Orinoco Oil Belt.<sup>26</sup> This region of Venezuela holds one of the largest oil reserves in the world, but the oil is a lesser quality, extra heavy crude.<sup>27</sup> Because this crude is of a lesser quality, the process of extracting the oil and preparing the oil for final refining is expensive.<sup>28</sup> These four joint

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16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. GOV'T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 10.

22. *Id.* at 11.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.* at 11.

27. Bernard Mommer, *The Value of Extra-Heavy Crude Oil from the Orinoco Belt*, MEES 47:11, Mar. 15, 2004, [http://www.soberania.org/Archivos/doktor\\_mommer\\_orimulsion.pdf](http://www.soberania.org/Archivos/doktor_mommer_orimulsion.pdf).

28. GOV'T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 11.

ventures, in which the foreign oil companies held a majority share, began producing this extra-heavy crude in 1997 and, by 2005, were producing about 600,000 barrels per day.<sup>29</sup>

Throughout the entire Apertura, with the signing of the thirty-two operating agreements and the four joint ventures operating within the Orinoco Belt, the PDVSA negotiated lower taxes and royalties to attract private enterprises under the premise that marginal oil fields were more risky and costly to operate.<sup>30</sup> In order to accomplish this feat, the PDVSA had to skirt around existing laws that provided for minimum tax and royalty payments for oil companies operating within Venezuela and a minimum amount of control for the Venezuelan state.<sup>31</sup> Because the PDVSA manipulated the existing nationalization law to create advantageous terms for private investment, it is these operating service agreements and joint ventures in the Orinoco Belt that have led to the sweeping changes in oil policy launched by the Chávez administration.

### III. THE PREVIOUS ARRANGEMENTS AND CHÁVEZ'S CHANGES

It is important to note that, throughout the Apertura, the law nationalizing the oil industry was still in effect. This law, passed in 1976, exclusively reserved to the Venezuelan state the rights to the exploration and production of oil.<sup>32</sup> The Chávez administration claims that the operating service agreements entered into during the Apertura were contrary to this law because they, in effect, allowed multinational private corporations to become involved in the exploration and production of oil.<sup>33</sup> These operating agreements were structured in such a way that the multinational corporations were not "oil producers," but were merely contractors providing a service for the Venezuelan PDVSA.<sup>34</sup> Therefore, instead of actually exploring for oil or producing oil, the contractors "did not explore for oil, but merely rendered the service of exploring; they formally did not produce oil, but merely rendered the service of producing it."<sup>35</sup>

Although the Chávez government claims that this arrangement was in direct conflict with the nationalization law existing at the time, others insist that these operating agreements were completely within the bounds of the law.<sup>36</sup> These contractors, unlike companies operating under the normal exploration and production scheme in which the company be-

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29. *Id.*

30. Gregory Wilpert, *The Economics, Culture, and Politics of Oil in Venezuela*, Aug. 30, 2003, <http://www.venezuelanalysis.com/analysis/74>.

31. Speech at Third OPEC International Seminar, *supra* note 4.

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. Oliver L. Campbell, *Venezuela's Hydrocarbons Policy: From Service Contracts to Joint Ventures*, Apr. 19, 2006, <http://www.venezuelanalysis.com/analysis1702>.

comes the owner of all or part of the oil that it produces, never had any rights to the oil they harvested.<sup>37</sup> Instead, all rights to the oil were completely vested within the PDVSA, and the contractors were paid for the cost of production plus a service fee.<sup>38</sup>

Classifying these companies as service providers, however, allowed for more than simple involvement in the oil industry; it also allowed for considerable tax and royalty breaks unavailable to "oil producers."<sup>39</sup> Because these contractors were not oil producers, they did not pay the 67.7 percent income tax rate—the rate applicable to oil activities at the time they were created—instead, they only paid the 34 percent income tax rate applicable to non-oil activities.<sup>40</sup> Moreover, these companies were receiving a complete royalty holiday because royalties were to be paid by the producer, in this case PDVSA, rather than the service providers, the foreign oil companies.<sup>41</sup>

The Chávez administration had similar concerns with the four joint ventures in the Orinoco Belt that the PDVSA entered into with foreign oil corporations during the Apertura.<sup>42</sup> In order to incentivize foreign investment, the PDVSA capped the royalties to be paid by these projects at 1 percent, as opposed to the 16.6 percent maximum available at the time.<sup>43</sup> Likewise, these associations were only subject to a 34 percent income tax rate—the rate normally applicable only to non-oil activities.<sup>44</sup> Moreover, in all four joint ventures, the foreign companies held the majority share.<sup>45</sup> As the present minister of oil and petroleum pointed out in a report to the National Assembly of Venezuela, "Indeed, in all association contracts it was explicitly stipulated that under no circumstances would PDVSA be allowed to become a majority partner."<sup>46</sup>

In recent years, the Chávez administration has made it a priority to remedy what they see as problems with these agreements and has made numerous changes to bring all oil operations within Venezuela more in line with a policy of nationalized control of the country's petroleum resources.<sup>47</sup> As Chávez has said, "Little by little we will fix deviations, deactivate domination mechanisms that were set a long time ago and are still here. We are going to start by deactivating them all, with the purpose of recovering Full Oil Sovereignty."<sup>48</sup> One of the first aspects of this idea they call "Full Sovereignty Over Oil" was to strengthen the control the

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37. *Id.*

38. *Id.*

39. Speech at Third OPEC International Seminar, *supra* note 4.

40. REPORT TO THE NATIONAL ASSEMBLY OF VENEZUELA, *supra* note 2, at 15.

41. *Id.*

42. GOV'T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 11-12.

43. *Id.* at 11.

44. Speech at Third OPEC International Seminar, *supra* note 4.

45. REPORT TO THE NATIONAL ASSEMBLY OF VENEZUELA, *supra* note 2, at 18.

46. *Id.* at 9.

47. Speech at Third OPEC International Seminar, *supra* note 4.

48. Petroleós de Venezuela, S.A., True Nationalization, <http://www.pdvsa.com> (select "Full Sovereignty," then "True Nationalization") (last visited Oct. 8, 2007).

state had over the PDVSA.<sup>49</sup> But as Chávez attempted to bring the PDVSA under state control, he found a significant amount of opposition within the company itself.<sup>50</sup> This opposition culminated in a strike in late 2002 and early 2003 that led to a complete overhaul of PDVSA and included the termination of the employment of 18,000 of the strikers.<sup>51</sup>

With a newly formed PDVSA, a national oil company that was securely under the direction of the Venezuelan government and the Ministry of Energy and Petroleum, Chávez began making changes to the operating service agreements and joint ventures involving foreign oil companies.<sup>52</sup> In 2005, the Venezuelan Inland Revenue Service announced that the operating service agreements would no longer be considered contractors, but would instead be considered oil producers and would pay the income tax rate applicable to that activity of 50 percent.<sup>53</sup> At the same time, the government sought to bring these agreements into accordance with the new Organic Law for Hydrocarbons, which called for “mixed enterprises with a majority shareholding by the state enterprise.”<sup>54</sup> In other words, the operating agreements would become joint ventures between PDVSA and multinational corporations. In general, the changes can be summarized as follows: “PDVSA being given a 60 [percent] controlling stake in the new ventures, an increase in income tax rates payable . . . to 50 [percent] from 34 [percent], [and] an almost doubling of royalty payments” from 16.6 percent to 30 percent.<sup>55</sup>

The totality of these changes results in what is known as the “50-50 principle.”<sup>56</sup> These joint ventures, the PDVSA and foreign oil companies combined, “will have to pay the government at least 50 [percent] of the market price for every barrel produced through royalties and taxes.”<sup>57</sup> If the tax and royalties combined are insufficient to meet this 50 percent mark, the venture must cover the rest.<sup>58</sup> This policy insures that Venezuela will receive at least half of the price obtained per barrel.<sup>59</sup> Needless

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49. Speech at Third OPEC International Seminar, *supra* note 4.

50. Robert Collier, *Chavez Drives a Hard Bargain, But Big Oil's Options Are Limited*, SAN FRANCISCO CHRON., Sept. 24, 2006, at A1, available at <http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2006/09/24/MNGNSLBRUG1.DTL&type=printable>.

51. *Id.*

52. Speech at Third OPEC International Seminar, *supra* note 4 (“From 2003 onwards, the Venezuelan state recaptured its agent, and now the new PDVSA is full of pride to serve the Nation . . . [with] regards [to] the generation of rents and royalties which are so important for any oil exporting country.”).

53. *Id.*

54. *Id.*

55. VENEZUELA OIL & GAS BRIEFING, *supra* note 5, at 1 (noting that royalty payments had previously been increased in 2002 to 16.6 percent under the direction of Chávez.)

56. Raul Gallegos, *Venezuela's Orinoco Majority Stake Seen By December*, DOW JONES NEWSWIRES, Aug. 29, 2006, [http://www.rigzone.com/news/article.asp?a\\_id=35657](http://www.rigzone.com/news/article.asp?a_id=35657).

57. *Id.*

58. *Id.*

59. *Id.*

to say, this new structure will greatly reduce the profit available to foreign oil companies operating within these agreements.

A second, more recent, round of changes sought to bring the four joint ventures in the Orinoco Belt under the same framework proposed by the Organic Law for Hydrocarbons. In 2004, the royalty holiday that was granted at the commencement of these joint ventures was brought to an end and a 16.6 percent royalty was reinstated.<sup>60</sup> This 16.6 percent royalty levied on these four projects was recently increased to 33.3 percent in May of this year and was followed by an increase in the income tax for these endeavors from 34 percent to 50 percent in August.<sup>61</sup> In all probability, PDVSA will be given a majority stake in all of these projects by December of 2006, bringing these projects in line with the provisions set fourth in the Organic Law for Hydrocarbons.<sup>62</sup>

#### IV. THE NEW POLICY'S EFFECT ON FOREIGN INVESTMENT

It is still unclear how much of an effect these changes will have on foreign investment,<sup>63</sup> however, it is clear that the new policy will significantly decrease the profits of foreign oil companies operating in Venezuela, as they are "shouldering a greater burden of the costs, while seeing a smaller share of revenues."<sup>64</sup> After the initial conversion of the operating service agreements into joint ventures, some companies chose to voluntarily return their oilfields to the PDVSA rather than to operate them as joint ventures, while others, including ExxonMobil and Statoil, "sold their stakes in oilfields rather than accede to the forcible imposition of the new legal framework."<sup>65</sup> This relatively peaceful process leads analysts to wonder just how much the oil companies are willing to take. But if the companies wish to continue operating within Venezuela, they virtually have no choice but to accept the new framework. Two European oil companies, Total and ENI, refused to convert their operations into joint ventures and Venezuela quickly seized their oilfields.<sup>66</sup>

Upon hearing of the August tax hike on the oil ventures in the Orinoco Belt, ExxonMobil stated that it was "concerned with the unilateral decisions taken by the Venezuelan government to change the fiscal terms of the Cerro Negro strategic association agreement, which the National Assembly approved."<sup>67</sup> In 2004, after the increase in royalty rates, EXX-

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60. Speech at Third OPEC International Seminar, *supra* note 4.

61. Natalie Obiko Pearson, *Analysts: Venezuela Move Hurts Profits*, INT'L BUS. TIMES, Aug. 31, 2006, <http://au.ibtimes.com/articles/20060830/analysts-venezuela-move-hurts-profits.htm>.

62. *Id.*

63. VENEZUELA OIL & GAS BRIEFING, *supra* note 5, at 2.

64. Pearson, *supra* note 61.

65. VENEZUELA OIL & GAS BRIEFING, *supra* note 5, at 2.

66. Collier, *supra* note 50.

67. *Exxon Mobil Concerned About Venezuela Oil Tax Hike*, PETROLEUMWORLD.COM, Aug. 30, 2006, <http://www.petroleumworld.com/story06083113.htm> (Cerro Negro is the name of the joint venture operating within the Orinoco Belt in which Exxon owns a 41.7 percent share).



onMobil threatened international arbitration, but eventually backed down.<sup>68</sup> Unfortunately, this may become commonplace due to the fact that the Orinoco belt of Venezuela holds one of the world's largest oil reserves, estimated at 1.3 trillion barrels of extra-heavy crude.<sup>69</sup> According to Gersan Zurita, an oil industry analyst, these tremendous reserves will be the driving force behind the foreign oil company's actions.<sup>70</sup> Speaking about the recent increases in taxes, royalties, and control for PDVSA, Zurita said, "It's a very delicate situation. It involves more than just these contracts . . . The biggest incentive (for the companies) is to preserve access for the future. These are enormous reserves."<sup>71</sup> With so much at stake, both for Venezuela and for foreign oil companies, it remains to be seen how profound of an impact Venezuela's quest for "Full Sovereignty Over Oil" will have on international investment and the oil industry in general.

## V. CONCLUSION

Throughout the history of oil in Venezuela, foreign companies have played a significant role, in one way or another, in the exploration, drilling, and production of oil.<sup>72</sup> Despite previous attempts by the Venezuelan government to nationalize the oil industry, this foreign involvement has remained constant.<sup>73</sup> However, the Chávez administration is making a more serious attempt to bring the oil industry directly under the control of the Venezuelan government. In so doing, foreign oil companies are losing control over their oil projects while simultaneously paying more to the Venezuelan government in taxes and royalties.<sup>74</sup> This being the case, it remains to be seen if the foreign investment that, for so long, played an integral part in the oil industry in Venezuela will continue to fill that role.

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68. VENEZUELA OIL & GAS BRIEFING, *supra* note 5, at 2.

69. Collier, *supra* note 50.

70. *Id.*

71. *Id.*

72. GOV'T ACCOUNTABILITY OFFICE REPORT, *supra* note 1, at 10.

73. REPORT TO THE NATIONAL ASSEMBLY OF VENEZUELA, *supra* note 2, at 2.

74. VENEZUELA OIL & GAS BRIEFING, *supra* note 5, at 1.

# Updates

