

## The Venezuelan Elections: How Can PDVSA Recover?

Written by Gustavo Coronel  
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The Venezuelan oil industry can be pictured as a toothless tiger resting on its haunches before a huge slice of raw meat. The country sits on significant hydrocarbon resources that remain undeveloped due to severe management, technical and financial constraints driven by the application of a rigid statist ideology for what should be a commercial enterprise. To put this industry back on track a post-Chavez government will need to install a new petroleum industry management model.

When Hugo Chavez came to power in Venezuela in December 1998, oil production was around 3.2 million b/d. Today, best estimates of Venezuelan oil production place it at around 2.6 million b/d, a significant drop of about 600,000 b/d. If the strategic plan inherited by the Chavez administration from the previous management of Petroleos de Venezuela had been followed, current Venezuelan oil production would be at some 5 million b/d. The gap of 2.5 million b/d between plan and reality represents a true financial disaster for Venezuela.

### **The erosion of the Venezuelan oil industry under Hugo Chavez**

Since its creation in 1976 and up to 1998 Petroleos de Venezuela, PDVSA, the Venezuelan state owned oil company, was a reasonably well managed state corporation. A professional cadre of managers and technicians took care of the core business of the company and there was a rather clear separation of roles between the oil company and the state. In 2002 this model came to an end. Chavez named a Marxist economist as President of the company with little knowledge of the industry and much disdain for its managers who he had often referred to as 'unpatriotic technocrats.' His arrival led to a manager's revolt which caused the dismissal, by Chavez in 2002 and 2003 of some 22,000 managerial, technical and clerical staff which were some of the country's best and the brightest. This massive dismissal represented about 56% of total employees at the time and caused a collapse of the company's production in a matter of weeks. In a [speech](#) given to the National Assembly Hugo Chavez said that his naming of the company president had been a move designed to elicit the protest of the managers, so that he could take over the control of the company. After this maneuver he named as president of the company the Minister of Energy and Petroleum and effectively merged the technical and political arms of the Venezuelan petroleum industry into one.

The employees dismissed by Chavez have never been able to collect their severance pay and legal procedures that should have been followed were dismissed. Former employees have been blacklisted by the government and private companies active in Venezuela have been ordered not to employ them in the country. As a result there has been a significant exodus of these employees to other oil producing countries. Important clusters of Venezuelan oilmen and women can be found today in Canada, Colombia, the Middle East, Central Asia, Mexico and the US, mostly in Texas and Louisiana. Some have been spectacularly successful. Due to the efforts and know-how of the Venezuelan Diaspora, Colombia was able to increase its oil production significantly after their arrival.

Under ministerial control the oil company became politically driven and partly abandoned its core business. It became defined as a socialist enterprise, dedicating increasing amounts of time, effort and money to non-oil related activities. Eight affiliates were created to engage in food imports and distribution, housing construction, agriculture and meat production among other activities. The number of employees increased from about 39,300 in 2002 (See "La indoblegable sociedad venezolana", by Eddie Ramirez, Caracas, Editorial CEC, April 2010) to a

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current 115,000, many of whom were engaged in non-oil related activities. Oil income started to be diverted to a parallel government fund, bypassing the Venezuelan Central Bank and legislative monitoring (there are 65 members of the opposition in the National Assembly), a move lacking in transparency and accountability. This fund is managed by three people: The Minister of Energy and Petroleum, the Minister of Planning and Finance and President Chavez. Only they decide how this money is to be utilized. As a result two things have happened. One is that investment in the core business of the company has declined alarmingly and, two, the level of corporate corruption has increased significantly.

Investment in oil related activities have averaged \$9 to \$10 billion per year over the last four years--half of what the company needs in order to maintain production and existing facilities and only one quarter of what the company requires in order to expand production and build new facilities. In contrast, companies such as Petrobras and Exxon Mobil invest close to \$40 billion per year, which serves to increment their production and keep their facilities in good working order while Petroleos de Venezuela is being essentially de-capitalized. A comparison between 2011 net profits and investment levels of the three companies could be misleading. Petroleos de Venezuela shows a net profit of only \$4.4 billion and paid very little income tax since it charged to costs some \$30 billion given to the Executive (Chavez) for its use in "social" programs. In contrast ExxonMobil and Petrobras show net profits of \$41 and \$18 billion respectively but pay significant income tax.

Corruption within the company has increased alarmingly due to several reasons. One is the abandonment of bidding procedures. Huge contracts are given directly, often to ghost companies owned by friends of the company managers. [Transparency is minimal](#). A May 2008 report by Transparency International analyzing 42 large international petroleum companies, ranked Petroleos de Venezuela as one of the

[least transparent](#)

. While Petrobras (Brazil) and Pemex (Mexico) showed high degrees of transparency in their financial and operational disclosures, Petroleos de Venezuela received a low ranking, together with Société Nationale des Petroles du Congo, Lukoil (Russia) and Sonangol (Angola). In presenting the report, the main researcher Juanita Olaya indicated: "In the case of Venezuela, they have a long way to go". In the same report the Venezuelan chapter of Transparency International was quoted defining the situation of Petroleos de Venezuela as "critical." Some

[specific cases](#)

of corruption linked to Petroleos de Venezuela include:

- A discovered briefcase of \$988,000 carried by Guido Antonini to Bueno Aires, which was meant for the presidential campaign of Cristina Fernandez. On the basis of the findings of the Miami trial of Carlos Kaufmann, Franklin Duran and Moises Maionica, the origin of the money was traced to Petroleos de Venezuela. It was established that Rafael Ramirez, president of the company, had been ordered by Chavez to keep Antonini silent on this matter, something that he was unable to accomplish;
- Corruption involving contracting, without bidding, of oil exploration drilling rigs for the amount of some \$75 million. This contract had been given by PDVSA to a Colombian outfit that had only three employees. Called by the National Assembly to explain this situation, then Exploration and Production Director of the company, Luis Vierma, said that this was true but "it was not his responsibility." He placed the responsibility on the Bidding Committee of the company. He

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emphasized that the president of the company, Rafael Ramirez, had a strong voice in the decision. Surprisingly Vierma admitted that PDVSA “had not checked the credentials of the winning company” due to the need to hire the rigs as soon as possible. The candid revelations by Vierma did not stop there. He added that the Board of the company had approved another contract for \$70 million to Constructora Bolivariana S.A., an Andean multinational that, at the moment of obtaining the contract, had only one employee. In addition, a contract to buy seven drilling rigs for \$2 billion was assigned to Cosmaca, a company that was only capitalized at one million dollars. Once it won the contract, this company simply sub-contracted the acquisition of the rigs.

- Corruption in the Gas Division of the company. A member of the national Assembly, Luis Tascon (now deceased), reported a \$99 million contract for a natural gas construction project to a company called Ecoinca. The PDVSA manager authorizing the contract happened to be the wife of the president of the winning company. However, the Chavez controlled National Assembly dismissed this case on the grounds that Ecoinca ‘was a patriotic company.’

- In early 2008 PDVSA created a subsidiary, PDVAL, to import and distribute food. This subsidiary uses Petroleos de Venezuela’s international offices to conduct searches for the acquisition of foodstuffs. Not only has this new activity opened the door to numerous opportunities for corruption in the acquisition, importing and distributing process but it has engaged the human and financial resources of the company that should have been utilized in the core activities of the company. Not surprisingly the levels of petroleum production of the company have kept declining steadily, while the volumes of commercial exports are at an all-time low. Elie Habalian, a former Venezuelan governor of the Organization of Petroleum Exporting Countries (OPEC), has said, “The company has transferred billions of dollars to funds controlled by the President [Chavez], and directly finances and runs a range of social projects. There’s a Ministry of Education—but PDVSA educates too. There’s a Housing Ministry, but PDVSA builds houses”. After the poor performance by Venezuelan athletes in the 2008 Beijing Olympic games Chavez ordered the oil company to take over the training of these athletes for future competition.

**The Chavez legacy** From 2007 through early 2009 Hugo Chavez has tried to increase state control of the oil industry. Mr. Habalian, quoted above, says: “[Mr. Chavez] decided that it would be a nifty idea to squeeze the remaining private oil companies operating in Venezuela and ordered the cancellation of the contracts signed in the 1990s, under which [the companies] were investing to develop deposits of very heavy crude. In their place would come joint ventures in which Petróleos de Venezuela (PDVSA), the state oil company, would wield the controlling share.” This Venezuelan government decision was unilateral. Compensation was based on book value and not on the current value of the properties. Most companies reluctantly accepted this situation in an effort to protect their large investments but ExxonMobil and ConocoPhillips resorted to international arbitration. Independent of the final results of the arbitration the effects of this dispute on foreign investments in Venezuela are already apparent: in recent years foreign direct investment into Venezuela has been negative. The cash flow situation in Petroleos de Venezuela appears to be deteriorating significantly. Payments by Petroleos de Venezuela to contractors and suppliers have experienced long delays, considered “serious” by the Venezuelan Petroleum Chamber, an organization that groups these service companies. Large contractors have been practically paralyzed their work due to this situation. Pending

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payments by PDVSA increased to about \$12 billion by mid-2009. This situation, adds the Venezuelan Petroleum Chamber representatives, has become “a great source of corruption, as employees of the company extort contractors in order to accelerate payments”.

Particularly disturbing is [the case of Aban Pearl](#) , a drilling barge that sank in 2010, off the coast of Venezuela, while rented to Petroleos de Venezuela. This barge was contracted by the company to a ghost outfit incorporated in Singapore, owned by friends of managers of the company. The contract was for an amount of money considerably higher than the one actually received by the owner of the barge. A legal action taken by opposition legislators exposing this significant act of corruption has gone unheeded by Venezuelan judicial authorities.

Based on political ideology, ‘the need to reaffirm national sovereignty’ the company has also changed the pre-Chavez policy of outsourcing by a policy of owning most ancillary services. To this end, the Chavez government has taken over numerous small and medium sized contractors, both national and foreign, incorporating their employees into the company’s payroll. Few, if any, of these companies have been compensated. Within a matter of months after the takeovers the quality of these ancillary services declined and some activities, such as marine transport for Lake Maracaibo operations, have been partially paralyzed.

**A critical financial situation** In spite of high oil prices the financial situation of Petroleos de Venezuela can be defined as critical. This is due to the diversion of oil income to non-oil related government expenditures, the absorption of ancillary services, the significant increase in the number of employees and the potential financial liabilities generated by the numerous legal claims in international arbitration centers related to expropriations (there are more than a dozen such claims against Petroleos de Venezuela in the World Bank). The central government has resorted to using the company as its preferred vehicle to borrow money. The level of debt that stood at some \$2 billion in 2000 is now about \$50 billion, not including a \$22 billion in national debt owed to China, which is being paid with oil produced by the company. This debt, for all practical purposes, can also be said to be on PDVSA’s head.

### **Petroleos de Venezuela is unable to develop the oil resources of the Orinoco region**

All of the components mentioned above have led to the basic dilemma faced by the Venezuelan oil industry today, the inability to develop efficiently the important oil resources of the Orinoco Region, where some 120 billion barrels of proven reserves (estimated by using a Recovery factor of 10% of the oil in place) have remained essentially untapped since the government of Hugo Chavez arrived in power 13 years ago. Prior to Chavez’s arrival several international oil companies such as ExxonMobil, ConocoPhillips, Total and ChevronTexaco acted as contractors to the state company and had invested some \$16 billion in creating a network of facilities, including special refineries to upgrade heavy crude. As the price of oil increased the Chavez government decided to change the rules of the game, increased production royalties and forced a conversion of the existing contracts into joint ventures, in which the state company would have the majority of the shares-- 60%--and would exercise operational control. However, investments would be still the sole responsibility of the foreign partners to be compensated with future oil production.

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ExxonMobil and ConocoPhillips have not agreed to these new terms and have left the country while Repsol, Total and Statoil remained in subordinate roles. Chevron is the only US corporation active in the area. After the change in contractual terms a host of companies from ideologically friendly countries such as Russia, China, Iran, Vietnam, and Cuba, as well as from India, Spain and Japan, have signed contracts with Petroleos de Venezuela 'to develop' production in assigned blocks within the region. Four years after the signing of these contracts no additional upgraded production and little new heavy oil production has been generated. The reason seems rather clear. There is no trust in the Chavez government even among ideologically friendly countries. Foreign companies feel there is a risk that contractual changes could take place after large investments are made. After all, this has happened before.

**New Vision: a Post Chavez Venezuelan Oil Industry** The day after a new government is installed in Venezuela one of its top priority decisions will be how to manage the oil industry. Burdened with non-oil related activities, with four times more employees than required, with a heavy debt and a highly demoralized management team Petroleos de Venezuela seems to be beyond salvation. However, it might not be politically feasible to eliminate it from day one. There might have to be a transition period, in which the most critical human, technical, financial and managerial issues should be resolved, before a new management model can be put in place. Such a transition could well last between 12 and 18 months.

### **Towards a new management model**

#### *Current organizational aspects*

Today PDVSA completely controls the Venezuelan oil industry. The predominant legal figure is the joint company in which Petroleos de Venezuela owns at least 60% of the shares. Paradoxically, this system gives foreign partner companies ownership to portions of the oil produced whereas the previous system of service contracts did not. The weak financial situation of Petroleos de Venezuela has forced the company to demand that the foreign partners do all the investing required and be repaid in future oil production. Petroleos de Venezuela has the monopoly over activities but these activities are of a low quality due to the weak financial and managerial capacity of the company. A Venezuelan saying illustrates this situation: "Ni lavan ni prestan la batea" ("They neither wash nor do they lend the washing machine").

The government's regulatory agency is the Ministry of Energy and Petroleum. For some years now Petroleos de Venezuela and the ministry have been under one single head, a situation that has generated considerable politicization of the company. There is a deep, almost religious, belief among Venezuelan politicians that the oil industry is 'strategic and basic' and should be totally controlled by the state. This will be one of the paradigms that should be revised if a modern management model is to be installed. Today state ownership of the oil industry is pretty much set in concrete as part of the current Constitution.

#### *An alternative organizational model*

Upstream activities (exploration and production) should be conducted on the basis of flexible contractual agreements. There is no need to restrict the modalities of association between the nation and private capital to one or a few. They could range from concessions, as in Brazil and many other oil producing countries to service contracts, production sharing contracts or joint companies in which the state could have variable levels of participation. The underlying

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objective would be to eliminate the concept of state monopoly in the management of the Venezuelan oil industry.

Hydrocarbons in the ground should belong to the nation but hydrocarbons produced could be partially owned and freely marketed by the private sector, as agreed to in contracts.

The regulation of the industry could be shared by a Ministry, in charge of formulating energy policies, an independent Energy Council, which would advise on policies and mechanisms to operate the industry and a National Petroleum Agency that could represent the nation and supervise the contracts signed by the nation with the private companies. This Agency would not be operational only supervisory in nature. In this regulatory and supervisory scheme there would be no need to have a state-owned oil company.

The private partner in a concession, joint venture, service contract or production sharing contract will propose an annual program to the National Petroleum Agency within the policy framework and operational guidelines established by the Ministry and the Agency. Upon a commercial discovery the private partner will propose a development plan. The private partner could receive its compensation in oil, if so desired.

Private partners will be selected through bidding. Direct adjudication will not be allowed except in cases of national emergency defined as such by Congress. The selection criteria will include technical, financial and social and environmental improvement aspects.

All contracts will be subject to international arbitration. Few would invest in a country that claims to exercise national sovereignty over contracts with the private sector.

### *Improved revenue stream for the Venezuelan state*

A reorganized, liberalized oil sector would generate an improved revenue stream for the Venezuelan state. Oil derived revenue would come in multiple forms i.e. in the form of corporate income tax, potential royalties on produced-oil, social contributions by corporate partners paid on employees' incomes, the state's share in any production-sharing agreement, et al. A more independent Venezuelan oil sector could avoid paying derived income into national (non-oil related) social programs and could retain profits for reinvestment. Further Venezuela should establish a national sovereign-wealth fund to be structured with a portion of oil income similar to the one operating in Norway. In particular a national sovereign-wealth fund could become a formidable source of national income. There are about 37 national funds of this type active today all over the world, with about \$10 trillion in assets. The Norwegian Fund has about \$350 billion in assets, more than 10 times the current international reserves of Venezuela.

### **A concluding remark**

Venezuela is a mature oil country. It has an important cadre of solid managers and technical staff that could do an excellent job of supervision and monitoring of operators and as staff of a National Petroleum Agency. If supervision and regulation is efficient the concession system most probably provides the best combination of optimal national participation and minimum risk to the nation. The insistence in total state control over the oil industry has been a political imperative, one that has proven to be a failure, due to politicization and corruption. The most

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successful models of oil industry management exist in countries with moderate or no state operational involvement: US, Great Britain, Norway, Saudi Arabia. Countries in which state involvement is excessive and mostly exhibit failed oil industry management models: Argentina, Bolivia, Mexico, Indonesia and Chavez's Venezuela.

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