

## **Venezuela: *Apertura Gas Natural?***

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The structure of the oil and gas sectors of many Latin American countries negotiated at the time of nationalization has come under increasing pressure during the decades of the 1980's and 1990's and that pressure continues today. Upon nationalization, ownership rights to all hydrocarbons were reserved to the state, and state-owned oil and gas companies were established to develop those resources on the state's behalf. The sovereign companies would provide a level of fiscal revenue to their governments in the form of royalty and taxes which would be used for national economic development needs. Profits retained by sovereign companies would be used to develop the hydrocarbon sector. This model is inherently conflict-ridden because each party can have radically different views concerning the appropriate level of the government "take" and the appropriate level of profit and reinvestment required by the company.

Perhaps more importantly, however, is the fact that a crucial implicit assumption underlying this model has been proved false: oil and gas "rents" would be sufficient to adequately fund the investment needs of both the state and the company. Decades of spectacular economic mismanagement by governments, including contracting debt at unsustainable levels, coupled with boom-bust commodity price cycles, resulted in a situation in which many state-owned oil and gas companies in Latin America did not have sufficient capital to develop their country's oil and gas reserve base and the associated infrastructure. These impediments had a negative impact on economic growth in general.

However, governments often could not or would not relax the fiscal burden on the companies and significant increased borrowings by the companies were not a viable option. As a result, many Latin American governments have had to consider an alternative unthinkable at the time of nationalization: private foreign investment would be required to develop countries' hydrocarbon resources and commercial frameworks would have to be established to attract that investment.

Despite significant political resistance in some cases, many Latin American governments have approached this problem pragmatically. In the early 1990's Argentina opened all segments of its oil and gas sectors to private domestic and foreign investment, and privatized state-owned YPF. Argentina has perhaps gone the furthest in terms of the government completely exiting the commercial side of the oil and gas business and restricting its role to ensuring adequate legal and regulatory frameworks. In 1997, Brazil addressed the problem by permitting Petrobras to retain all of its production assets and properties where significant investment had been made as of that date, but allowed private domestic and foreign exploration in both oil and gas on unexplored acreage pursuant to an auction process. Even Mexico, where sentiment against foreign participation in the hydrocarbon sector is perhaps strongest, is experimenting with very limited foreign participation in its gas sector through the Multiple Service Contracts awarded in 2003. Problems continue to exist in all of these new commercial frameworks, but they do demonstrate varying degrees of adaptation to economic realities in a key economic sector.

Perhaps the most surprising addition to the ranks of pragmatic natural gas policies adopted in Latin America is that of the left-leaning government of Venezuela's fiery populist and nationalistic Hugo Chávez. As in Brazil, state-owned *Petróleos de Venezuela S.A. (PdVSA)* will continue to be owned by the government and will continue to play a significant role. Unlike in Brazil, however, the Chávez government has established two completely different commercial frameworks, one for each of the oil and the natural gas sectors. PdVSA will be the controlling participant in upstream oil exploration and development, although foreign

participation will be permitted on a minority basis. However, private foreign and domestic investors will be able to take up to a 100% participation in all segments of the non-associated natural gas chain including exploration and production, transmission, storage, distribution and marketing. For the first time since 1961, foreign companies can explore for and produce non-associated natural gas as controlling entities, without approval from the Venezuelan legislative body. Foreign participation will be administered by the Ministry of Energy and Mines (MEM) under a licensing process. The two hydrocarbon sectors are subject to completely different fiscal regimes as detailed in the table below.

	<b>Petroleum*</b>	<b>Natural Gas (Non-Associated )</b>
<b>Royalty Rate</b>		
Conventional Crude	30%	20%
Extra-Heavy Crude	20%	
Bitumen	16.67%	
<b>Income Tax Rate</b>	50%	30%
<b>Private Ownership</b> _(Domestic & Foreign)	Up to 49%	Up to 100%
<b>Required State Participation</b>	51%	None

\* including associated gas

In his 1998 presidential campaign, Chávez strongly opposed the “*apertura petrolera*” which had been implemented by PdVSA and previous governments in order to rapidly ramp up oil production with the participation of foreign investment. The vision underlying that policy was the development of the oil sector as an economic “locomotive,” which would foster the development of connected upstream and downstream industries where Venezuela had or could develop a comparative advantage. Despite his harsh opposition to the “*apertura petrolera*,” Chávez has nonetheless adopted its vision and applied it to the politically less sensitive natural gas sector with the goal of reducing dependence on oil revenues and generating a new wave of connected economic development in industries such as petrochemicals, LNG, steel, aluminum, cement and gas-fired electric generation.<sup>1</sup> Moreover, in terms of opening the sector to foreign investment, Chávez’ “*apertura gas natural*” goes much further than the more limited foreign oil sector participation permitted under the “*apertura petrolera*.” However, one can ask if the gas sector will continue to be politically less sensitive than oil if significant gas resources are developed with foreign capital.

With the largest proven, probable and possible gas reserves in South America, participation in Venezuela’s gas sector could represent a significant investment opportunity for foreign companies, but there are still issues to be addressed. Currently all of Venezuela’s gas production is associated with oil production and the primary consumers are PdVSA for reinjection to maintain oil production and petrochemicals, also controlled by PdVSA. Associated gas exploration and production is governed by the regime for oil. As a result, all gas production in the near term is likely to be controlled by PdVSA and future production of associated gas may be hindered by the more onerous fiscal regime as well as OPEC production quotas.

The development of a domestic gas market supplied by new non-associated gas production could be impaired by the controlled minimum gas commodity prices (\$0.40/MMBtu for

<sup>1</sup> Similarly, a proposal submitted by the Mexican Energy Ministry (SENER) in April 2004 to reform the current Pemex tax regime includes different tax structures for crude oil and natural gas: 75% for crude oil and 15% for natural gas. Mexico is also trying to stimulate non-associated natural gas production. The proposal does not, however, include any provisions for permitting private investment in the sector. The proposal is under consideration.

residential – \$1.25/MMBtu for industrial) for the domestic market which will remain in effect through 2007. Venezuelan officials have indicated that it is their current intention to keep minimum domestic gas prices controlled at the marginal cost of production, approximately \$.90/MMBtu. There is some opportunity for negotiated prices: private producers of non-associated gas can negotiate sales contracts directly with end-users, such as gas-fired power producers. Some private producers of onshore non-associated gas indicate that they expect gas sales prices for electric generators to settle in the \$2.00-\$2.50/MMBtu range. Nevertheless, most foreign interest is likely to focus on developing non-associated gas for LNG projects with export markets in the near and medium term.

Foreign response to the first licensing round for non-associated gas areas with access to domestic markets only (a policy constraint in the licensing round) in 2001 was modest: only seven companies bid, five of which were Latin America-based companies, and only six of the eleven areas on offer received bids. Foreign interest in offshore non-associated gas areas with production destined for LNG export projects has been much more pronounced, although Trinidad and Tobago currently have a timing advantage with respect to U.S. and Caribbean markets. A 15% internal rate of return will be allowed in the transmission, distribution and storage sectors. However, new infrastructure will not materialize without new non-associated gas supplies, and that supply source is uncertain given the restrictive pricing policies on the demand side.

Another possible impediment in establishing a robust and competitive domestic gas market in Venezuela is PdVSA's current controlling position in all segments of the natural gas chain. In addition to being the only current gas producer, PdVSA Gas controls all current gas transmission and a significant percentage of gas distribution assets. PdVSA ultimately may have to divest a good portion, if not all, of these assets. Either through deliberation or oversight, the Chávez government's 1999 Constitution may have paved the way for partial privatization of PdVSA: although the holding company PdVSA must remain in government hands, the privatization prohibition does not apply to operating subsidiaries. Although the near-term privatization of any part of PdVSA appears unlikely, it is not clear that the company can finance the \$5 billion investment in the downstream natural gas sector alone that it says it requires through 2008 while it is also funding \$600 million for an Agriculture Trust as it has been required to do in 2004.

All of these issues could undermine the achievement of the Chávez gas vision.

Unfortunately, given the current political turmoil, it is not clear that these issues will receive much near term attention. Nevertheless, since the spring of 2003, PdVSA and MEM officials have undertaken a huge public relations offensive with the purpose of creating foreign investor interest in Venezuela, particularly the gas sector. Despite Chávez' political rhetoric, *"the truth is that this government has treated investors with preferential treatment, and has been careful not to alienate investors too much. You've had this ironic situation where Chávez has been knocking on foreign investors' doors and telling them: Come to Venezuela"* (PetroleumWorld.com, 12/31/03). However, the success of Chávez' pragmatic gas vision depends on the details of implementation and as one observer of the current energy situation in Venezuela notes *"Policy is one thing and practice can be completely different."*