

# Venezuela's oil model: Is production rising or falling?

**High oil prices keep profits up, but output may be down.**

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**CARACAS, VENEZUELA** – In recent weeks, both Bolivian president Evo Morales and Ecuador's president Alfredo Palacio have taken a page out of Venezuelan populist president Hugo Chávez's natural resources manual.

It's the page that features politicizing the oil and gas industries and nationalizing them - keeping more of the petro dollars at home but alienating longtime foreign investors. A good model? Many oil industry analysts are skeptical.

While the government denies it and high oil prices mask it, analysts say Venezuelan oil production is declining. Since Chávez took over in 1999, production in the state-run oil fields has fallen almost 50 percent, say analysts at PFC Energy, a global energy consulting firm based in Washington, D.C., who spoke on condition of anonymity rather than risk the wrath of the Venezuelan government.

During the same period, no new significant oil reserves have been discovered. And with new, smaller profit margins for outside companies, foreign investors are now slowing the rate of investment in the jointly run oil and gas fields.

"The outlook for increases in the future is starting to go up in smoke and we see a petroleum industry in contraction," said Luis Giusti, the former president of Petroleos de Venezuela (PDVSA), in an interview earlier this month with Venezuela's Union Radio. "The day the prices change, the situation is going to be evident once and for all," he said.

The Venezuelan government and PDVSA declined repeated requests for comment. Official figures show oil production has bounced back after a 2002 strike and decline, but oil analysts doubt the veracity of those figures.

It's not clear how many fields are operated solely by PDVSA because the company reports production totals without details as to how many fields or wells are under their control and how many are operational.

But such claims of a poorly managed oil industry don't seem to bother the neighboring countries.

On May 1, Morales announced that "foreign companies will not be able to steal from Bolivia any longer," and summarily nationalized the country's gas industry. A week later, in the middle of a contract dispute, Mr. Palacio endorsed the confiscation of assets of the US company Occidental Petroleum Corp., the biggest producer of hydrocarbons in Ecuador.

The moves played well at home. Bolivia and Ecuador, like Venezuela, are countries where anti-Americanism is on the rise and poverty is often blamed on foreign companies, who, according to the argument, are exploiting the natural resources, making exorbitant profits and leaving insufficient money behind for anti-poverty programs.

And yet, while popular, and clearly profitable initially, such nationalizations - and more particularly the way in which they are carried out - are unwise, say critics, and are likely, in the long-term, to hurt those who are applauding now.

"These are politically and ideologically inspired moves and are not in the national best interest," argues Orlando Ochoa, an economist at Caracas' Catholic University. Presidents Morales and Palacio should look carefully at Venezuela's example and take heed, he suggests. "It's clear this oil-rich country is moving backward and eventually it will all end badly."

That Venezuela, the world's fifth-largest oil exporter, is moving backwards is not clear to everyone.

The state oil company, PDVSA, reports production of 3.3 million barrels a day. There is no way to independently confirm this, and most outside analysts, including the International Energy Agency, say PDVSA's numbers are inflated and production is closer to 2.6 million barrels per day. The Financial Times reported this month that Venezuela's shortfall in production is such that it was actually forced to strike a \$2 billion deal to buy about

100,000 barrels per day of crude oil from Russia to avoid defaulting on contracts - a claim the Chávez government says is false.

But whatever the real output, Venezuela - because of the high price of oil - is raking in more petrodollars than ever before. When Chávez came into office in 1999, the country reported production of 3.5 million barrels per day and, with oil selling at about \$15 per barrel, was making just over \$18 billion a year. This month, with oil at about \$70 a barrel, PDVSA Finance Director Eudomario Carruyo told Reuters he expects revenue to top \$85 billion this year. PDVSA officials have reportedly said that oil production will increase to 4 million barrels per day by 2012.

Furthermore, in part thanks to Chávez plowing billions of these petrodollars into new housing, free medical care, adult literacy projects and other social programs, Venezuelans perceive the industry to be exceedingly robust now. "Normal people don't care about whether production is 3.3 million barrels per day or 2.6. For them, the oil is huge and forever," says Alfredo Keller, an independent pollster in Caracas.

The problem, says Mr. Ochoa, is that politicizing the industry has rotted it, and served both to empty PDVSA of its best professionals, and to scare foreign partners away from new investment.

"It is generally safe to assume a pretty steep fall in PDVSA production over the last few years," says Jack Sweeney, a former analyst at Stratfor, a private intelligence agency, and today an independent consultant in Caracas. "There is no investment in maintenance or repairs ... They don't know what they are doing. They have old oil wells and it takes money to keep their capacity up, and they are not investing [in them]."

Maria Mercedes Febres was a senior engineer at PDVSA until 2000, when, she says, she "saw the writing on the wall," and quit. "Political appointees were taking over from qualified longtimers, and I knew it was going downhill," she says. Most of her friends stayed on, but their frustration with the political cronyism of the company finally exploded in a massive strike in 2002.

Chávez refused to negotiate and fired about 18,000 workers, many of them top engineers. "Most of my ex-colleagues left the country. They are oil professionals, but here, where the oil industry is in the hands of the state,

they were blacklisted," says Ms. Febres. After the firings, she says, the level of professionalism plummeted. "You need to exploit your oil efficiently - and for that you depend on technology and maintenance. We have neither."

Meanwhile, Venezuela's joint partners - companies such as ChevronTexaco, Royal Dutch Shell, and British Petroleum - are also perceptibly slowing production here. Last year, Chávez announced that these foreign companies, who had been invited into Venezuela in the 1990s to operate 32 marginal fields, were to have their contracts converted to joint ventures that give PDVSA majority stake and control of the board. With the exception of France's Total and Italy's ENI - who subsequently had their fields seized by PDVSA - all the companies accepted the new terms, including a sharp hike in the state's royalty share.

Oil minister and PDVSA director Rafael Ramirez promised output in these fields would soon rise rapidly. But, in fact, the opposite has happened.

According to industry reports, output has steadily fallen in foreign-operated fields. The largest drop was at Royal Dutch Shell PLC's (RDSA) Urdaneta field, where output fell to 43,400 barrels per day in March from 46,900 barrels per day in October.

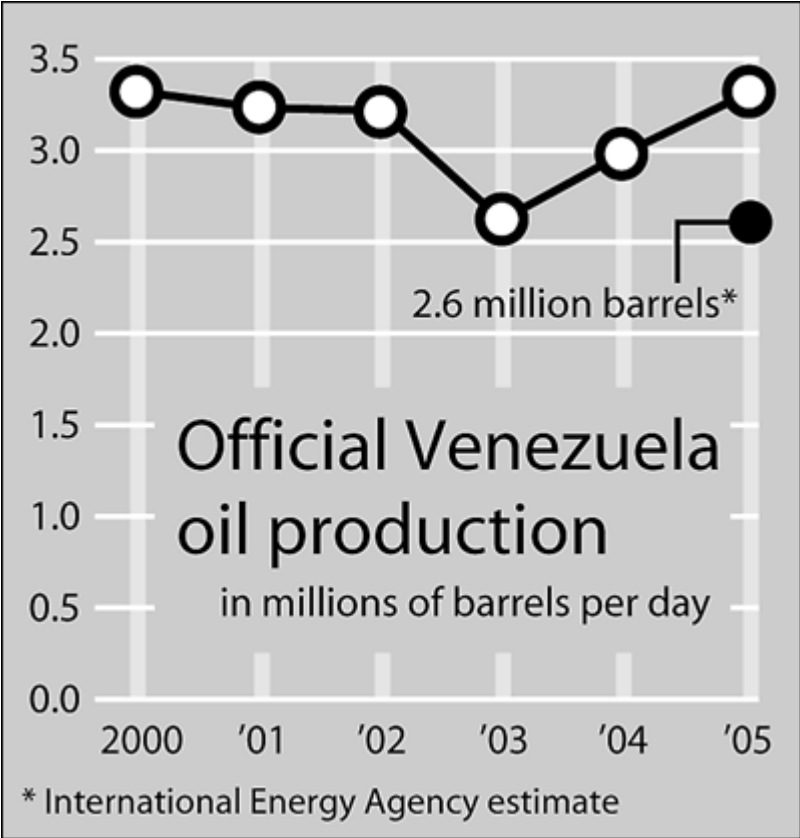
"Governments have the right to want a bigger part of profits," says Pietro Donatello Pitts, editor of Latin Petroleum. "It's the same all over the world and the big companies are not surprised. Latin American rates were the best in the world, so this was bound to happen."

But, while most companies, desperate for oil, won't pull out, they will slow their rate of investment. "When the rent goes up, you become wary of new investment; it's logical," he says.

The way Chávez approached the change, says Ochoa - telling companies they were breaking the law - scared investors. "The anti-imperialist rhetoric that came along with the announcements was the mistake," he says.

The Chávez nationalization model plays well in Ecuador and Bolivia. Ecuadorean officials say the country will receive an extra \$100 million per year in oil revenues due to the Occidental contract cancellation, and even more from a new 50 percent windfall tax on foreign oil companies.

Presidential elections take place in Ecuador in five months.



SOURCE: BP STATISTICAL REVIEW OF ENERGY; RICH CLABAUGH - STAFF