THIRD OPEC INTERNATIONAL SEMINAR

OPEC IN A NEW ENERGY ERA: CHALLENGES AND OPPORTUNITIES

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FULL SOVEREIGNTY OVER OIL

Excellencies, ladies and gentlemen. It is a honour to be here as a speaker in this prestigious Third OPEC International Seminar. I have been requested to say a few words regarding "The Role of Energy in Developing Countries". Being Venezuela an oil producer and developing country, I will allow myself to talk about our own experience, where oil plays a crucial role in our developing possibilities.

This brief exposition talks about the path that we in Venezuela have had to tread in recent years to re-establish full sovereignty over the management of our petroleum resources, a tough process which, under the leadership of President Chávez, has required the mobilization of all our people in defense of our main resource, in an uncompromising confrontation with transnational interests and their domestic political agents. We believe that this experience can be turned into a modest contribution on our part for our fraternal oil exporting countries, because it constitutes a timely lesson for them, as Venezuela was a laboratory, a terrain upon which was unleashed a sophisticated strategy conceived by think tanks in consumer countries in order to wrest from us the sovereign control of our natural resources and, in consequence, to liquidate OPEC. This so-called "Apertura" policy was based on the globalisation of the natural resource and was disguised by reference to a modern school of thought according to which the National State, in its role as overseer of the rate of production and enjoying complete tax sovereignty over its natural resources, is presented as an anachronistic concept, which hinders the access of capital to natural resources for the exploitation and free trade of petroleum.

In our country, this anti-national strategy counted with the backing of an unexpected ally: our own national oil company, PDVSA. This company, like a veritable Trojan Horse, implemented one by one the elements of the "oil opening", dismantling our traditional oil policy and leading to an open and violent confrontation with the Venezuelan state. Two years ago we were still reeling from the impact that this confrontation had caused both in our minds and in the oil market at large, especially as regards to its climax in extraordinary events which are well known to all. In April 2002, PDVSA's top management promoted a military coup d'etat; and between December 2002 and January 2003, the company promoted yet another coup, this time economic in character and predicated on the paralysis of oil exports. After causing severe huge damages and losses for more than 14.7 billion dollars, to our oil industry, the top management failed in both opportunities and, ultimately, its members lost all their positions within our national company, and the State was able to re-establish control over PDVSA.

The fact is that the PDVSA of old had fallen prey to a strategy of agency capture on the part of certain consuming countries and international oil companies. Instead of serving the interests of the Nation in its capacity as owner of the natural resource, PDVSA tried to impose and implement policies conceived by those actors. In essence, PDVSA tried to become a "global energy corporation", for the sole benefit of the consumer in *developed* countries, identifying itself ideologically with their modes of thought and turning a blind eye to the typical and inconvenient problems of a dependent country like our own. From 2003 onwards, the Venezuelan state recaptured its agent, and now the new PDVSA is full of pride to serve the Nation, as a definitely national oil company, not only as regards the generation of rents and royalties which are so important for any oil exporting country, but also in the execution of economic and social policies defined by the national government and related to the distribution of such rents: the *sowing of the oil*.

Recapturing the agency did not imply simply the substitution of management cadres by new ones, and the recuperation of production. No; it provided us with the opportunity to re-establish the foundations of our sovereign oil policy, to enforce our Constitution and legal framework adopted in 1999 and 2002, and to dismantle the whole scaffolding of the "oil opening", which had been erected by the PDVSA of old.

The first aspect of this process involved the return to the Venezuelan State, through the Ministry of Energy and Petroleum, of the leadership of Venezuela's oil policy, strengthening OPEC and subordinating the national oil company to the decisions of the Venezuelan state. Through the strengthening of both the Ministry of Energy and Petroleum (traditional institutional seat of Venezuelan oil policy) and other control organs of the State, it has been possible to recover gradually the various fiscal contributions of PDVSA to the National treasury, to make more transparent the administration of the enterprise, to render the company more accountable to the Venezuelan State, its sole shareholder, and to align the investment plans and the expansion of the oil industry with our national development plans. This new situation has allowed us to begin a process of revision and adjustment of the legal framework applicable to all those businesses undertaken under the auspices of the "oil opening", and where the old PDVSA either had a stellar role or else played the part of a "fiscal shield" on behalf of the multinationals. In particular, we want to touch upon the Internationalisation policy, the Operating Service Agreements and the Associations in the Orinoco Oil Belt.

Internationalisation

Internationalisation is a name given to a policy of overseas investment focused on the vertical integration with refining, distribution and marketing activities in large oil consuming countries, implemented by the old PDVSA for a space of almost twenty years (1983 to 2002). Its driving purpose was to turn PDVSA into the "global energy corporation" through investments totalling more than 15 billion US dollars, and channelled in the main to the United States (through the Citgo circuit) and Germany (through the Ruhr Oel circuit). These investments were undertaken at a time when the Venezuelan State was undergoing one of its most severe economic crises, manifested in a process of massive decapitalisation and capital flight in which the Venezuelan national oil company, PDVSA, played a key role. PDVSA management adopted a strategy to put assets beyond the control of the Venezuelan State, abusing the "corporate veil" and tying up the new acquisitions to foreign legislation and financial covenants which effectively made shareholder control impossible.

During almost twenty years, the colossal investments in refineries abroad had not led to the repatriation of a single dollar in dividends to PDVSA's ultimate shareholder, the Venezuelan state. All dividends were recycled within the same structure, and were invested, spent and misspent abroad, thereby allowing PDVSA to accumulate assets over which its shareholder, the State, exercised no control. From 2003 onwards, though, it became possible to put an end to this situation, and now dividends from PDVSA's overseas businesses do reach the coffers of its shareholder. From 2004 to date, for instance, dividends distributed come to around 3 billion dollars, and we have begun a process of intensive revision of these overseas investments aimed not only at shedding non-core assets but also at using the proceeds thus generated to compensate the Venezuelan state for some of its past losses and capital.

A central aspect of the internationalisation policy which we are currently bringing to an end has to do with the fact that crude sold under the supply agreements with overseas affiliates and joint venture companies was invoiced at substantial discounts of between 2 and 4 dollars per barrel relative to open market prices. The formulae used in these contracts also allowed operating costs to be deducted from the price, which in turn allowed costs to be imported into Venezuela, thereby giving rise to the avoidance of tax in Venezuela (where the income tax rate for oil activities was much higher than the one prevailing in foreign jurisdictions).

In addition to this, PDVSA leveraged itself by means of financial instruments which incorporated these supply contracts as collateral, which meant that putting an end to the anti-national and perverse practice of granting discounts through the contracts entailed the restructuring of PDVSA's long term foreign debt, and its reduction from a level of 9 billion dollars to only 3 billion dollars. In some cases, private parties alleged acquired rights over the contractually conceded discounts, so putting an end to them has proved to be both difficult and time consuming. Nevertheless, as is eloquently demonstrated by our recent divestiture of our shareholding in Lyondell-Citgo Refining Company, we will not allow practical obstacles such as these to become excuses for not righting past wrongs. Furthermore, we will forge ahead with the scrutiny of each and every one of our remaining contracts and we will take the actions necessary to put an end, once and for all, to the possibility of discounts, by establishing a system of public and transparent price formulae for all of our crude oil and products exports.

Operating Services Agreements

Let us now turn to another element of the policy of systematic under-valuation of the natural resource instrumented by the PDVSA of old under the aegis of the "oil opening": the operating services agreements. These agreements lie at the very core of the question of how the access to the natural resource is to be regulated, and for the benefit of whom it is to be done.

Effective January 1st 1976 (the date in which the law nationalising the Venezuelan oil industry was promulgated), the exploration and production of oil have been activities exclusively reserved to the Venezuelan state. Since then, private parties have not been allowed to undertake these activities except in association with, and under the control of, the national oil company. But from 1992 onwards, the old PDVSA, already under the spell of foreign interests, resorted to all the considerable means in its power as well as to sophistries and "creative" interpretations of the Law in order to grant the Operating Services Agreements, taking over attributions with regard to granting access the natural resource which were the exclusive prerogative of the Ministry of Energy and Petroleum.

By means of these wrongly named Operating Agreements, private oil companies in practice became oil produces within the area granted to them by the National Oil Company, in contravention of the Nationalisation law. This fundamental fact, however, was masked by legal sophistries which had the concept of "services" at their core. Thus, the so-called contractors ostensibly 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. The so-called contractors had no title to the oil they produced, which they merely *turned over* to PDVSA in exchange for their fees. PDVSA supposedly did not *buy* the oil, but merely *remunerated* the contractors for "services rendered" through diverse fees (OpFee, CapFee, stipends and incentives). Crucially, though, all these fees were indexed to sophisticated formulae linked – surprise, surprise – to the price of oil, and amounting to around 60 per cent of the market value of production (leaving the remaining 40 per cent to PDVSA and the National exchequer).

In January 2005, having recovered the control over our National Oil Company, we decided to put an end to this undignified charade, so inimical to the interests of our country. There existed at the time 32 Operating Services Agreements, producing between them around 500 MBD. As we have said already, the contractors on average received around 60 per cent of the market value of production, but there existed very significant variations within this spectrum. For instance, there existed a couple of cases where – hard as it might be to believe – the contractors were paid more than 100 per cent of the market value of the crude, meaning that the Nation suffered losses on each and every barrel of oil produced. In other cases, the contractors received payments amounting to more than 70 per cent of the market value of the crude, meaning that PDVSA suffered losses on each and every barrel of oil produced because it was subject to a 30 per cent royalty (because royalties have to be paid by the *producer* of the oil, and the so-called contractors were supposedly not producers but mere service providers). Some other so-called contractors received "incentives" amounting to 1 million dollars a day in payment for having reached a certain production level. Thus, by the year 2004, whereas the production cost of PDVSA's own production amounted to no more than 4 dollars per barrel, the production cost of oil extracted under the Operating Services Agreements reached 18 dollars per barrel, and PDVSA had to disburse more than 3 billion dollars by ways of fees, stipends and incentives.

It is worth pointing out, by the way, that based on the same sophistries and tergiversations outlined above, the so-called contractors did not pay income taxes at the rate applicable to oil activities of 50 per cent. As they supposedly were mere service companies, they had paid income taxes on the basis of the rate applicable to non-oil activities: 34 per cent.

The first step that we took in 2005 was to put an end to the situations of most flagrant abuse by limiting the total remuneration payable to the so-called contractors in such a way that PDVSA – let alone the Nation – could under no circumstance suffer losses derived from production. Then, in exercise of its attributions in income tax matters, the Venezuelan inland revenue service dictated that, given the essence of their activities, the Operating Services Agreements would henceforth be considered as oil producers (rather than service providers) for income tax purposes. This fiscal authority then applied the 50 per cent tax rate to all the income tax filings submitted for fiscal years not subject to the statute of limitations (that is, from 2001 onwards). These measures, very prudent in themselves, generated an additional tax income of around 1 billion dollars.

The government then proceeded to question, by means of solid arguments, the very legality of these agreements as a whole. At the same time, however, we offered the so-called contractors a way out: migration of the Operating Services Agreements to the terms of the new Organic Law of Hydrocarbons, which established clear rules for mixed enterprises with a majority shareholding by the state enterprise. To cut a long story short, the negotiations lasted for 15 months and culminated in the following accord: Operating Services Agreements became mixed enterprises, with their production being subject to a 33.33 per cent royalty and a 50 per cent income tax rate. Furthermore, in order to limit the systematic evasion of income tax obligations which the Venezuelan inland revenue service had detected, there was introduced a 50 per cent "shadow tax" on gross income. Thus, royalties and income taxes would be complemented, if necessary, by this "shadow tax" in a way that ensured that government take would never come to less than 50 per cent of gross income. Finally, PDVSA assumed a minimum shareholding participation of 60 per cent in each enterprise. Mixed enterprises were given the right to exercise the reserved primary exploration and production activities for a period of twenty years, within the areas determined by the National Executive (these areas in question were located within the confines of the Operating Services agreements areas, but their overall extension was reduced by approximately two thirds).

It should be made clear that mixed enterprises are *operating companies*. In other words, they are not a mere legal superstructure under which one day there might emerge something similar to the Operating Services Agreements of yore. Furthermore, the role of PDVSA within the companies is strictly that of a shareholder, and it has no role to play under the terms of so-called “stability clauses”. In other words, PDVSA will no longer act as a fiscal umbrella or, worse still, as a hostage, guaranteeing the payment of indemnities to private investors to compensate for any change in the fiscal regime determined by the sovereign National Assembly. The terms of the mixed enterprises do not allow international arbitration. or rather, to be more precise, private foreign capital can resort to international arbitration, but only against the government and not against the partner in the enterprises (PDVSA), and only on the basis of the Law of Investment Protection, a *general* law which applies equally to the oil and the non-oil sectors.

Out of the thirty two so-called contractors, thirty finally accepted the conditions referred to above. Within this group one can find all sorts of international companies, both private and state-owned, and even small Latin American and Venezuelan private firms. In two cases it was not possible to reach an agreement, which led to the National government cancelling the Operating Services Contracts in question on the first of April 2006. However, I am pleased to announce that even in the cases where we could not reach an accord on the 31st of March 2006, we are negotiating, in an atmosphere of cordiality, economic termination agreements which are consistent with the general conditions that we had set out for migration. In other words, we believe that in the near future we will be able to say without any reservation that our success rate in this process was 100 per cent. However, within the overall process of implementation of the policy defined by President Chávez of building a new oil governance regime and dismantling the "oil opening", we still have to take a few important steps.

Associations in the Orinoco Oil Belt

The first of these steps involves the Associations for the upgrading of extra-heavy crude oil from the Orinoco Oil Belt, which currently produce around 620 MBD of raw crude which are transformed into 560 MBD of upgraded crude. Even though these Associations were reviewed and approved during the 1990s by the erstwhile National Congress, the Associations were characterised by legal and economic defects which are very similar to those underlined in our review of the Operating Services Agreements. Some of these defects have been remedied already. For instance, up until 2004, the Associations used to pay royalties at a rate of one per cent. This royalty holiday was revoked in October 2004, and the one sixth royalty rate was reinstated. In 2006, we introduced a supplementary export severance tax which will take the gross income levies paid by the Associations to a rate of 33.33 per cent. The Associations also used to be subject to an income tax rate of 34 per cent but, through a recently enacted reform to the Income Tax Law, we have increased their income tax rate to 50 per cent (in other words, the tax rate applicable to oil activities). Furthermore, we have already invited the four Associations to migrate to the new Organic Law for Hydrocarbons, in a process akin to that of the Operating Services Agreements. In concrete terms, this migration will entail PDVSA assuming a majority shareholding in the primary exploration and production activities, but not on the downstream (upgrading) side of the business.

Finally, to recreate in full the petroleum regime derived from the nationalisation, there is still pending the case of the three associations for so-called "Risk Exploration and Profit Sharing". These were formed in 1997 for the exploration and production of conventional (as opposed to extra-heavy) crude oil. These associations are yet to enter the production phase although they have made some significant discoveries. We intend these associations to be transformed through a migration process in a manner analogous to that of the associations for upgrading extra-heavy crude and, when this happens, we shall have achieved our goal of creating a new petroleum regime, in line with the policy slogan coined by President Chávez: *Full Sovereignty over Oil*.

To conclude, at the beginning of my exposition I pointed out that our experience in this process is at the disposition of other oil producing countries, our brothers, as a contribution to the strengthening of our respective national policies for the control and defense of our oil. After all, our own policy of Full Sovereignty over Oil draws its inspiration from the principles that gave rise to the foundation and growth of OPEC.

However, we believe that in our experience there is also to be found a message to the large oil consuming countries and the multinational oil companies; namely, that there cannot be stability in the international oil market if there is no stability within the oil producing countries, which in turn presupposes political and social stability, justice, and a truly national and fair distribution of the oil rent.

Our *Full Sovereignty over Oil* policy encompasses both the regulation of the extraction of oil in its capacity as a natural non-renewable and depletable resource, as well as the regulation of the industrial activities ancillary to this extraction. This policy does not exclude *per se*, as I hope my exposition will have made clear, the presence of foreign capital. However, for such a presence to be possible, foreign capital has to respect our sovereign rights. Obviously, we are not asking foreign companies to become spokespersons for our national oil policy in oil consuming countries. But, by the same token, we ask these companies to abstain from promoting within our country policies conceived by certain oil consuming nations with nostalgia for their colonial or imperial past. Foreign capital will be very welcome for as long as it dedicates itself to the industrial activities properly speaking in the pursuit of a reasonable and entirely legitimate return, but always accepting without reservations the legitimacy of our own aspiration for a proper remuneration for every barrel of this non-renewable and depletable natural resource that is severed, once and for all, from Venezuela's subsoil.

Thank you.