Venezuela's Petroleum Fiscal and Contractual Regime Flexibility Provisions

10 years of the 2001 Hydrocarbons Organic Law: A View of the Current State of Affairs

By Carlos Bellorin*

Background

The year 2011 marks the 10th anniversary of the approval of the Venezuelan Hydrocarbons Organic Law (hereinafter HOL). This law, which was passed on 13 November 2001, and started on the path to full implementation in 2006[1], is the most influential hydrocarbons law since the 1943 Hydrocarbons Law, which in turn is considered a landmark in terms of legislation enacted during Venezuela's modern times. Generally the law regulating hydrocarbons in Venezuela has been regarded as fundamental for the country's interests, and the second only to the Constitution in terms of legislative significance[2].

The full implementation of HOL in 2007 occurred at the same time as the Law on the Effects of the Migration[3] was passed. The Law on the Effects of the Migration is the final piece of legislation that ended the migration process or forced renegotiation of the contracts signed in the framework of the Oil Opening[4] plan implemented during the 1990s. This article gives an account of the provisions that have been added or implemented during the last four years to make the conditions of the Venezuelan hydrocarbons fiscal and contractual regime more appealing to foreign investors[5].

Nowadays, the most pressing issue for Venezuelan hydrocarbons policy is to increase the country's production levels, which have been decreasing in the last 10 years or so. The principal strategy to achieve this objective is to develop the huge heavy and extra-heavy oil reserves of the Orinoco Oil Belt, but this entails huge investments. This delvelopment requires that the heavy and extra-heavy crude produced must be upgraded in a special facility in order to reduce their gravity and extract their high sulphur, coke and heavy metals content before being commercialised.

These Orinoco Belt projects, as with any project involving the development of "primary activities"[7], can only be carried out directly by the state, or through a joint venture, or Empresa Mixta (hereinafter EM), in which the state has control over decision making as holder of greater than 50% of the shares. This type of company is the only form of association through which foreign investors are allowed to participate in "primary activities".

The main constraints on such projects are the high costs involved[8] combined with a "government take" of 94%[9]. The break-even price has been estimated at US$44 per barrel (for the WTI) for new projects[10]. The size of the required investment, coupled with Venezuelan NOC PDVSA's inability to carry-out these projects independently have led the Ministry of Energy and Petroleum to look for partnerships with foreign firms that can bring financing, technology and managerial skills to the country. To this end, the "government take" has had to be lowered and terms made more flexible[11]. As a result of the terms "sweetening" and after three years of negotiations, five new EMs were formed (see Table 1).

Below is a brief explanation of the provisions that have been added in order to give some flexibility to the Venezuelan hydrocarbons contractual and fiscal regime, which can be characterised as being typically regressive. It is important to notice that the majority of the flexibility provisions are designed to apply during the early stages of the process, during the construction of the upgrading facilities that these projects require, where the majority of costs occur. The below commentaries are not intended to be an exhaustive list of the flexibility options included in Venezuela's hydrocarbons fiscal and contractual regime, and instead we focus on the most important of the provisions.

Royalty

The HOL allows the royalty rate to be lowered from 30% to a floor of 20% in the case of mature fields or Orinoco Oil Belt extra-heavy oil fields. The partners in these projects must prove that the exploitation is not commercially viable under the "regular" (30%) rate. The provision also states that the regular rate can be entirely or partially reinstated "until reaching again 30%, when it is demonstrated that the commerciality of the deposit may be kept with said reinstatement."[17]

A common provision included in almost all[18] of the "new" Orinoco oil belt EM contracts[19] is a stipulation that the Ministry of Energy and Petroleum "shall grant" the reduction of the royalty and extraction tax[20] to the EM when certain

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See footnotes at end of text.

Empresa Mixta	Area	Block(s)	Estimated Production (barrels p/d)[12]	PDVSA (CVP[13]) Partici-pation	Minority Shareholders[14]
PetroMacareo	Junín	2 (247,77 Km2)	200,000	60%	Petrovietnam 40%
PetroUrica	Junín	4 (324,42 Km2)	400,000	60%	CNPC 40%
PetroJunin[15]	Junín	5 (424,30 Km2)	240,000	60%	ENI 40%
PetroMiranda[16]	Junín	6 (447,86 Km2)	450,000	60%	*Consorcio Nacional Petrolero SRL* (Russian companies consortium) 40%
PetroCarabobo	Carabobo	1 (382,86 Km2	400,000	60%	Repsol 11%; Petronas 11%; ONGC Videsh 11%; Oil India Ltd. 3.5%; Indian Oil Corporation Ltd. 3.5%
PetroIndependencia	Carabobo	2,3 and 5 (554,54 Km2)	400,000	60%	Chevron 34%; Mitsubishi Corp. 2.5; Inpex Corp.2.5%; Suelopetrol 1%

Table 1

New Orinoco's Oil Belt Empresas Mixtas basic information

conditions are met. Simply, the reduction must be granted once the basic engineering studies[21] of the project have been concluded and the revised cash flow projections have been adjusted (on the basis of the new engineering study results), which indicates that the investment cannot be recovered in a period equal to or shorter than seven years from the beginning of commercial production of upgraded crude oil.

Certain EM contracts have been more specific in regards these conditions, for example PetroUrica and PetroMiranda conditions establish that the company's activities will be oriented to reach an Internal Rate of Return (IRR) of 18% and 19%, respectively, that will allow for a seven-year investment payback period counted from the first commercial production of upgraded crude oil.

Also, in both PetroUrica and PetroMiranda, conditions are established that the basic engineering studies will be carried out using a Class 3 cost estimate[22].

The royalty and extraction tax are for temporary application, and apply upon the commencement of commercial production of upgraded crude oil and until such time as the EM has recovered its investments. In this event, the royalty and oil extraction tax must be reinstated to their "regular" rates.

Income Tax

According to the Income Tax Law, the income tax rate for hydrocarbons activities is 50% and cannot be lowered. However, there is no obstacle in the Income Tax Law to reducing the taxable base.

Accelerate Depreciation and Losses Carried Forward

A provision which lowers the taxable income has been included under the conditions for those formed in connection to the Carabobo Bid Round[23], namely PetroCarabobo and PetroIndependencia. Under this provision:

- the EM investments in assets (CAPEX) for the development of hydrocarbon primary activities[24] will be entirely deducted in the fiscal year that they are incurred;
- the investments made in connection to hydrocarbons upgrading will be deducted during a ten-year period using the straight-line method; and
- the net operating (OPEX) losses incurred by the EM in any fiscal year could be carried forward to be deducted over the subsequent ten fiscal years from the fiscal year in which they had been incurred[25].

Extra-heavy Oil Production and Refining Integrated Project

Generally, all of the Orinoco Oil Belt EMs have been conceived as vertically integrated production and upgrading projects paying royalties and taxes as single business entities. However, a new business model called Extra-heavy Oil Production and Refining Integrated Project (hereinafter integrated project) has been introduced for the development of the Junín 5 block. This business model establishes that two EMs will be formed: one for the production of extra-heavy oil and the other for the refining of this production. These two EMs have been called PetroJunin and PetroBicentenario, respectively. This project, which will be carried-out by PDVSA and ENI subsidiaries, bears comparison with a horizontally integrated business model, and is the first to be implemented in Venezuela breaking with the traditional model. The integrated project's raison d' etre is to benefit from the provision of the Income Tax Law Article 11 (second paragraph), which establishes that companies exclusively carrying-out hydrocarbons refining activities or the upgrading of heavy and extra-heavy oil are exempted from the 50% rate of petroleum income tax, instead being liable to the non-petroleum rate of 34%, making both projects more tax and cost efficient. In consequence, the "production" EM will be liable to pay an income tax rate of 50%, while the "refining" EM pays 34%, although both belong to a comprehensive integrated project with the same partners.

Participation Bonus

According to the provisions of the "new" Orinoco Oil Belt EMs, the participation bonus[26] is a payment that the foreign partners must pay to the state for the right to participate in the project. The participation bonus is calculated at US$1 per recoverable barrel[27] up to the non-state partner participation[28] (see Table 2).

Empresa Mixta	**Area**	**Block(s)**	**Recoverable Production Reserves (Mils Barrels) (20%*Orignal Oil in Place)**	**Participation Bonus (US$/1,000,000)**
PetroMacareo	Junín	2 (247,77 Km2)	1460	584
PetroUrica	Junín	4 (324,42 Km2)	2250	900
PetroJunin[15]	Junín	5 (424,30 Km2)	1615	646
PetroMiranda[16]	Junín	6 (447,86 Km2)	2500	1000
PetroCarabobo	Carabobo	1 (382,86 Km2	2762.5	1105
PetroIndependencia	Carabobo	2,3 and 5 (554,54 Km2)	1250	500
Total		**2381.75Km^2**	**11837.5**	**4735**

Table 2
Empresas Mixtas Participation Bonuses

While the participation bonus seems similar to a signature bonus, they differ in the timing of their payments. Signature bonuses are usually paid in cash, up-front, upon the contract signature. The participation bonus payments in Venezuela have been divided into several instalments that are payable throughout the life[29] of the project. For example, the participation bonus for the project PetroUrica (US$900 million) is payable as shown in Table 3.

Event	**Percentage**	**Amount (US$/1,000,000)**
10 days after the Transfer Decree[30] publication.	20%	US$180
10 days after the signature of the Basic Engineering Study contract.	20%	US$180
10 days after the non-state participant "final decision to invest" is made.	40%	US$360
1st year after the "final decision to invest".	5%	US$45
2nd year after the "final decision to invest".	5%	US$45
3rd year after the "final decision to invest"	5%	US$45
Upgraded production commencement date.	5%	US$45
Total	**100%**	**US$900**

Table 3
PetroUrica EM Bonus Payment Instalments

Conclusion

We could say that the Venezuelan regime is regressive in nature since it is loaded at the front-end and unrelated to the project's profitability rent-extraction instruments. These resource extraction mechanisms are in essence formed of the triumvirate of royalties, the participation bonus, and state participation. This article has explored how the income tax rate, royalties and the participation bonuses have been made less stringent. In addition, the participation, also allows some flexibility: the state's participation in all the established EMs to date has been to a level of 60%. Given that the law states that only 50% state participation in EMs is required as a minimum that means that in practice the Venezuelan government could (hypothetically) dispose of 10% in any existing project, if additional investments are required.

Apparently, the state's first goal has been achieved: namely, to attract and secure enough investment to carry out the above-mentioned projects. However, it is too early to say that the flexibility provisions have paid off—all the EMs discussed here been established during 2010. In consequence, the basic engineering studies contracts are either still to be agreed or still to be carried out.

In the short run, the projects are still to clear the first acid test that would be represented by the foreign partners making a positive definitive decision to invest[31]; this decision will be made based on the results of the basic engineering studies. Until such time, the improved attractiveness of EM conditions cannot be regarded as proved successful. The likelihood is that companies will push for further incentives and improvements in deal conditions in the future, depending on a number of factors including the movement of oil prices. What we can predict is that the balance will be in favour of the foreign partners. This situation may lead the Venezuelan policy and law makers to seek creative solutions once again.

In the longer run, the adaptability and flexibility of EMs' conditions have yet to demonstrate that the economic return is sufficiently balanced for both state and non-state participants under conditions of rapid, steep, and sometimes unexpected oil price fluctuations without triggering a contract renegotiation.

In the meantime, the continuous bargaining process that any given hydrocarbon upstream contract implies is taking place.

Footnotes

[1] On 24 May 2006, the HOL was partially amended and re-published in the Official Gazette No. 38.443. Briefly, the amendment had the effect of: a) including the associated natural gas under its scope of application; b) eliminating the definition *bitumen;* c) increasing the royalty reduction floor from 16$^{2/3}$% to 20%; d) establishing a new "extraction tax"; e) establishing the procedure for the "Mixed Companies" formation; f) establishing an investment requirement towards an indigenous development project equal to 1% of the pre-tax profits; and g) establishing a petroleum production marketing procedure.

[2] "*(…) it has to be considered that the legislation on hydrocarbons is one of the most important in the country, after the Constitution, because it must regulate, clearly and accurately, one of the foundations of the Venezuelan economy and society.*" 2001 Hydrocarbons Organic Law preamble/justification (*Exposición de Motivos*)

[3] The complete name being: "*Law on the Effects of the Migration to Mixed Companies of the Orinoco Oil Belt Association Agreements and the At-Risk Exploration and Profit-Sharing Agreements"* .

[4] A plan aimed to attract foreign investments into the country's hydrocarbons industry. It was called Oil Opening *(Apertura Petrolera)* because it was the first time after the *1975 Oil Nationalization* that foreign capital was allowed to participate in Venezuela's most important industry.

[5] For practical reasons we have used the term "foreign investor" when referring to minority shareholders participating in the Venezuelan hydrocarbons industry. However, it is important to clarify that domestic private investment in Venezuela in the hydrocarbons industry is allowed.

[6] The business model of the Carabobo blocks that were awarded in 2010 throughout a competitive bidding round requires the construction and operation of upgrading facilities in order to upgrade half of the estimated production of between 400-480 thousand b/d of 8º API to obtain approximately 180-220 thousand b/d of 32º API. Then the upgraded production must be blended with the rest of extra-heavy oil production to obtain about 360-460 thousand b/d of blended crude oil with a gravity oscillating between 16-22º API.

[7] According to the HOL these are the activities in connection to exploration, exploitation, initial gathering, transportation and storage of hydrocarbons.

[8] Each project investments range between US$10 billion to US$18.7 billion.

[9] Manzano, Osmel and Monaldi, Francisco. "The Political Economy of Oil Contract Renegotiation in Venezuela" in William Hogan and Federico Sturzenegger, *The Natural Resources Trap. Private Investment without Public Commitment.* The MIT Press (2010).

[10] *Supra* note 6. For today's standards the Orinoco Oil Belt projects break-even price (BEP) is quite reasonable. For example, a consultancy firm established the BEP per barrel in US$69 for Brazil's offshore ultra-deep (PSA assumed terms) and US$75 for Canada's Tar-Sands Mining + Upgrading.

[11] A "flexible" fiscal regime is one that provides the government with an adequate share of economic rent under varying conditions of profitability. (Silvana Tordo. "Fiscal System for Hydrocarbons. Design Issues." The World Bank (2007)).

[12] These are the averages of the blended final output (extra-heavy oil production + upgraded output).

[13] PDVSA's affiliate "Corporacion Venezolana de Petroleo" ("CVP") which is 100% owned by the national oil company and it has been used as the corporate vehicle in the Mixed Companies formed with foreign partners.

[14] Parent companies.

[15] This is the only EM created under a different business model. This EM will only carry-out "production activities". Its sister company PetroBicentenario will carry out "refining activities" exclusively (see 2.2).

[16] The EM was called PetroMiranda in honour of Francisco de Miranda, a Venezuelan independence hero that also participated in the French Revolution and in the Revolutionary Wars of the United States of America. He was also a member of the Russian diplomatic mission in London at the order of Empress Catherine II (the Great) of Russia. It is said that he was also one of the favourite lovers of the Empress.

[17] Bellorin, Carlos. "The Petroleum Royalty Reduction in Venezuela. Short Comments on Recent Projects." *The Energy Law Advisor* **(2010)** http://www.cailaw.org/iel_advisor/industry_news/petroy_venezuela.html

[18] With the exception of PetroMacareo, in which Petrovietnam is the minority shareholder.

[19] This *Agreement* is drafted by the national legislative power and although technically not a law, is has the rank and hierarchy of a law as it is the direct application of the Constitution (L.E.Andueza "Legal Regime Applicable to the Mixed Companies of Article 22 of the Venezuelan Organic Hydrocarbons Law" in OGEL (Vol.6-Issue 3-2008) www.ogel.org

[20] This tax is 1/3 (33.33%) of all produced hydrocarbons. In practice, functions as an "additional royalty" of 3.33% for the Orinoco's Oil Belt extra-heavy oil projects since the royalty (30%) can be deducted. For practical reasons, if the royalty is reduced the extraction tax must be reduced in the same proportion. The Hydrocarbons Law establishes that the extraction tax could only be reduced up to 20%.

[21] Engineering discipline dealing with the projection and basic design of a structure. It is based in feasibility studies and in the determination of the most basic structure's requirements and costs. Is the previous step to the detailed engineering study.

[22] The AACE classification establishes five estimate classes (being Class 1 the most accurate) based on the degree of the project definition. Class 3 Cost Estimate project definition ranges between 10%-40%.

[23] The *Carabobo Bid Round* was the first to be launched by Venezuela in 12 years. Consequentially, the round is also the first one to be carried out by the current administration and under the terms of the current Hydrocarbon Organic Law. The bid round was originally launched on 30 October 2008 and its first Guidelines draft issued on 2 December 2008 but and it was not until 30 November 2009 that the definitive Guidelines were agreed and the bid round was ready to be carried-out. On 28 January 2010 the offers were submitted and the bid winners were announced on 10 February 2010.

[24] *Supra* note 6.

[25] This is a big fiscal incentive for the EM, since the Income Tax Law (Article 55) only allows carrying forward exploitation net losses for up to the subsequent three years from the fiscal year in which they had been incurred.

[26] Bonuses are considered the most regressive form of rent extraction.

[27] The recovery factor for the projects that have been formed has been established in 20% of the original oil in place.

[28] Revista Magna Reserva (2010). "Interview to Rafael Ramirez, Minister of Energy and Petroleum" by Alfredo Carquez Saavedra. www.pdvsa.com

[29] The EMs duration is 25 years with the possibility to be extended 15 additional years.

[30] Decree issued by the national executive transferring the right to carried out "primary activities" (see Supra note 7) to the EM.

[31] After the costs estimates and the basic engineering studies are carried out the foreign investors have 90 days to take their definitive decision to invest in the projects or pull out from the project.