

Venezuela and U.S. Sanctions: Some Considerations

BY IGOR HERNANDEZ

Since 2015, when President Obama issued Executive Order (E.O) 13692, the U.S. government has imposed several sanctions on Venezuelan government officials and the National Oil Company, Petroleos de Venezuela (PDVSA).

Initially, the sanctions were targeted at “persons involved in or responsible for the erosion of human rights guarantees, persecution of political opponents, curtailment of press freedoms, use of violence and human rights violations and abuses in response to antigovernment protests, and arbitrary arrest and detention of antigovernment protestors, as well as the significant public corruption by senior government officials in Venezuela”. These sanctions prevented from engaging in any transactions or dealings with the individuals included in the E.O, among other restrictions.

Later, in 2017, President Trump issued E.O. 13808, that “prohibits transactions by a United States person or within the United States related to certain new debt of PDVSA and certain new debt or new equity of the Government of Venezuela”. In addition, E.O, 13808 “prohibits the purchase by a U.S. person or within the United States of most securities from the Government of Venezuela”.

These sanctions come at a time when oil production in Venezuela has shown a sustained decline and PDVSA faces a critical situation financially and operationally. Problems in the Venezuelan oil industry are a consequence of years of mismanagement in the industry and were only aggravated with the decline in oil prices that started in 2014. As we will show, financial sanctions have further deteriorated oil activities in the country, not only because of the reduction in financing options for the company, but by introducing additional constraints on daily operations.

One of the implications for PDVSA is that it restricts the ability to get financing through bond issues and loans coming from U.S. institutions. This was one of the main financing mechanisms used by the company in recent years. According to PDVSA’s financial statements, financial debt, including bonds and loans, went from less than US\$ 3 billion in 2006 to US\$ 39 billion

in 2017. Initially, the reason behind much of the growth in debt was to alleviate pressures on the exchange rate market, particularly between 2007 and 2011¹. This is because in the initial offering, dollar-denominated bonds could be purchased in bolivars (the local currency) and then sold in foreign markets. Investors in U.S. markets accounted for a significant part of the final holders of these bonds. Later, as the debt to suppliers grew, PDVSA started to issue promissory notes in order to replace some of the existing debt with providers. With the sanctions in place, PDVSA does not have access to U.S. capital markets, which constraints the possibility of getting financing through this mechanism. Moreover, even if some of the suppliers are not U.S. companies, they also suffer negative consequences from the sanctions. This is because sanctions reduce the liquidity of any promissory notes given by PDVSA, as U.S. financial institutions cannot engage in secondary market transactions involving PDVSA or other issues from the Government of Venezuela.

PDVSA was also involved in financing agreements with several partners in the joint-ventures (JV) operating in the country. For instance, PDVSA and Chevron, which are partners in the Petroboscan JV, signed an agreement by which Chevron could finance PDVSA’s share of capital and operating expenditures through loans. The payments of these loans were collected through an offshore account that essentially deducted the loan payments from the oil receipts coming from Petroboscan, with the remainder being distributed among the partners. This structure not only allowed to maintain operations but reduced the credit risk of the projects from this JV by allowing Chevron to have more financial and operational control of the project². Sanctions would then impair the capacity of further extending this agreement, which could affect the recovery of production, which was initially targeted at increasing production to 127,000 barrels per day (bd).

Another aspect by which operations are affected by sanctions are the problems related to U.S. oilfield service providers such as Halliburton. Given the cash flow problems

Igor Hernandez is a Graduate Fellow at the Center for Energy Studies, Baker Institute, Rice University.

See references at end of text.

experienced by PDVSA, payment delays to Halliburton amounted to approximately US\$ 1 billion by 2016, which were written-off by Halliburton between these last two years³. Given the sanctions, PDVSA does not have the option to delay their payments to Halliburton, as this would be considered financing, which is prohibited by the sanctions. With this, the liquidity in the short term operations is further constrained, but this also means that Halliburton would have to reduce their operations whenever they fail to receive payments from PDVSA. This would imply that regions in which they operate could see accelerated declines in the extraction rate.

Sanctions not only have implications for U.S. companies operating in Venezuela, but has also made partners in upstream activities more cautious in their relations with PDVSA. Given that one of the sanctioned individuals was the CFO of PDVSA, Simon Zerpa, foreign oil companies funding projects in Venezuela, such as China National Petroleum Corporation (CNPC), and financial entities negotiating with PDVSA were avoiding signing agreements that could involve Zerpa, according to some market reports⁴.

Having to deal with the finance department while Zerpa acts as a CFO has also affected trading operations. For example, there are reports of problems in the reception of oil cargoes at their final destination, given that banks refused to issue letters of credit to PDVSA customers⁵. These letters are used to guarantee to a seller that a buyer will pay a specified amount on time when a shipment is accepted, and in the absence of these letters, customers would have to pay cash up-front, which could ultimately affect the liquidity position of these customers. This has also led to delays in deliveries as tankers are unable to unload while waiting for letters of credit. According to news reports⁶, companies such as PBF Energy and Braskem have already stopped buying directly from PDVSA, and in general, Venezuelan oil exports to the U.S. have shown a decline, going from 1.65 million barrels per day (mmbd) in January 1999, when Hugo Chavez took power, to 472,000 bd in February 2018, a decline of more than 70%. CITGO, the downstream unit for PDVSA in the U.S., is also unavailable to get letters of credit in order to buy crude oil so that they have to pay cash upfront to receive cargoes coming from destinations different than Venezuela. Therefore, their liquidity position becomes more constrained, affecting the situation of the entire holding.

Sanctions have been a factor leading to a

higher diversification among U.S. refiners, particularly in anticipation of further actions by the U.S. government towards the Venezuelan government⁷. This is also part of a trend observed in recent years, showing a significant substitution away from Venezuelan crude oil. The declining Venezuelan oil production constitutes a supply risk, and in some cases, there have been reports of problems with crude specifications that prevent their processing in U.S. facilities⁸. In the short term, one way for refiners to access Venezuelan oil without buying directly from PDVSA is through companies such as Rosneft. This is because of the existence of oil-backed loans from Russia to Venezuela, that allow Rosneft to access crude oil, which is later sold through intermediaries that include oil trading firms (given U.S. sanctions against Russia), so that eventually they reach U.S. refiners⁹.

In this environment, the Venezuelan government has tried to get around sanctions by issuing the Petro, which according to official sources is a cryptocurrency that is backed by oil reserves coming from one of the extra-heavy oil blocks in the Orinoco Oil Belt. It is not clear what would be the impact of this new currency on markets, for different reasons including the lack of clarity in the initial offering terms and the difficulty in placing a value on the Petro, particularly since it has features of a debt instrument rather than a cryptocurrency. Moreover, Venezuelan law explicitly prevents the use of oil reserves for backing any financial instruments, so it is not clear in which way the Government will honor a commitment if in fact the Petro is treated as a debt security. Also, the reserves included as collateral are included in an area that requires massive investments for their development, with a very high risk. Most of the projects in similar blocks in the Orinoco Oil Belt, that were allocated in 2010 and were supposed to have a combined production of 2.0 million barrels per day by 2019, never went beyond initial stages of development. However, the Venezuelan government has tried to push the adoption of this currency among service providers, and more recently, there have been news reports that the Venezuelan government has offered India a 30 percent discount on crude oil purchases if India uses the petro to make these oil purchases¹⁰. In this way, it might be that Venezuelan officials are trying to create a market for the Petro in foreign currency, in order to circumvent the use of U.S. financial markets to fund

their operations. This is why on March, 2018, President Trump issued E.O. 13827, that extends the reach of the sanctions to include transactions that could eventually be performed in digital currencies or traditional fiat currencies.

Since the enactment of the first sanctions, there has been speculation on how these actions could escalate in the future, in the absence of political changes in Venezuela. According to some analysts¹¹, there are at least two different mechanisms that could be used in the future and have severe consequences for Venezuela. First, there is the possibility that the U.S. government forbids the exports of crude oil and products to Venezuela. As of now, projects in the Orinoco Oil Belt require heavy naphta to dilute a large portion of the extra heavy oil output in order to export it. PDVSA also started to buy light crude in 2016 for the Isla refinery in Curacao, but also uses a fraction of this for blending with heavy crude oil. Finally, given the reduction in activity from local refineries, Venezuela increased their imports of gasoline, distillates and components. According to the Department of Energy figures, U.S. exports of crude and products to Venezuela were 136,000 bd in February 2018. Introducing a ban on U.S. exports would severely affect the production of extra-heavy crude oil, which comprises a large component of Venezuela's total crude oil production. In the past, Venezuela tried to use imports of light crude from Russia and Algeria, but this would not only come at a higher cost relative to light crude from the U.S., but it was also reported that the blending using these alternative sources in some cases did not fulfill refineries specifications and therefore could not be placed in the market¹².

The other possibility would involve the U.S. government banning all imports of crude oil and products coming from Venezuela. Historically, the U.S was the main destination for Venezuelan exports, not only because of its location relative to other large markets, but also because it has a sufficiently complex refinery system to process heavy and extra-heavy crude oil. If we consider the main destinations for shipments currently: U.S, China, Russia and India, U.S can be considered the largest source of cash flow for Venezuela. The reason is that shipments to China and Russia, are used to service the debt from previous loans and therefore, do not involve new inflows for PDVSA or Venezuela as a whole. Moreover, India's oil

imports are in the lowest level in 5-years, and there is speculation that the fraction of India imports coming from Middle East could increase in the future. All of this suggests that the financial consequences for Venezuela in the very short-term would be massive.

Even if Venezuela could manage to market their oil production out of the U.S. in response of a potential embargo, the cost of doing so will be higher given the location of alternative markets. There is also a concern among U.S. refiners on the Gulf Coast that in this scenario, their operations could be impacted in the short-term, which could translate to gasoline markets. Although U.S. imports from Canada have increased over recent years, some reports indicate that there will be a point when deeper modifications will be required in refineries to accommodate greater volumes of the Canadian heavy crude¹³, which suggests that the diversification strategy has some limit in the short term, and large refineries, which rely more on imports from Latin America, may have smaller margins given an increase in prices of heavy crude grades.

Venezuelan oil production has shown a decline from an average of 2.6 mmbd in 2004 and 2005, when most of the investments planned in the nineties were finished, to a production of 1.4 mmbd in April 2018, the lowest extraction rate since 1949. Years of mismanagement and changes in the rule of law, including expropriations and steep increases in government take, among other problems involving lack of investments, were part of the explanation of this downward trend, even before sanctions were enacted. The short term operations have also been affected by the large scale of the economic crisis the country faces, as the IMF estimates that Venezuela is expected to contract by 15 percent in 2018, following a cumulative 35 percent contraction over 2014-2018. Monthly inflation is already around 80%, which translates into an annualized inflation of 13,779%¹⁵. This has led to a large number of oil workers leaving the industry and a significant reduction in economic activity. Moreover, the Venezuelan government started a process leading to the removal and prosecution of a number of PDVSA executives and replaced the board of directors with members of military forces with no previous experience in the oil sector. This has not only affected the relations between PDVSA and its partners, but it has also affected administrative procedures such as procurement, given that employees are now

concerned about facing corruption charges without apparent justification. More recently, claims and seizure of assets executed by companies such as Conoco-Phillips have also introduced a new layer of concerns for PDVSA, which already has several debt instruments in default. Forecasts about oil production reflect increasing concerns related to supply, with the IEA estimating production at 1.38 mmbd by the end of 2018, while Bank of America suggests that the decline in Venezuela's oil production could be one of the factors leading to an oil price of \$100 per barrel.

The dramatic collapse of oil production in Venezuela suggests that even in the absence of sanctions, the industry and the economy will continue collapsing. Based on this assumption, some analysts¹⁶ believe that extending the sanctions have the risk of backfiring, as the Venezuelan government could use the sanctions as an excuse for the entire crisis affecting the country. This could influence public opinion ahead of the presidential elections to be held in Venezuela on May 20th. These elections are not recognized by the U.S. government, given the many objections regarding the legitimacy of the procedure and situation of human rights and overall crisis in the country.

As the economic and political crisis worsens in Venezuela, there is uncertainty about the next steps the U.S. government will take regarding sanctions. What seems to be a more evident reality for oil markets is that in the absence of a change in the current political regime, oil production capacity in Venezuela will continue to decline. Even if a resolution of conflict exists and comprehensive reforms are designed and implemented, there are many challenges that the oil industry in Venezuela will need to address, given the high dependence of the country on fossil fuels exports and the increasing competition in energy markets in general.

References

¹ "Venezuela: PDVSA issuance counteracts dollar shortage". Euromoney, March 31th, 2011. <https://www.euromoney.com/article/b12kif90wnpsmm/venezuela-pdvsa-issuance-counteracts-dollar-shortage>

² Hernandez, I. and Monaldi, F. (2016). "Weathering Collapse: An Assessment of the Financial and Operational Situation of the Venezuelan Oil Industry". Center for International Development. Harvard University. https://growthlab.cid.harvard.edu/files/growthlab/files/venezuela_oil_cidwp_327.pdf

³ Krauss, C. "Halliburton Writes Off Remaining \$312 Million Invested in Venezuela". New York Times, April 23, 2018. <https://www.nytimes.com/2018/04/23/business/halliburton-venezuela-pdvsa.html>

⁴ Ulmer, A. and Parraga, M. "U.S. sanctions on Venezuela oil company CFO tangle financial deals: sources". Reuters, August 30, 2017. <https://www.reuters.com/article/us-venezuela-oil-sanctions/u-s-sanctions-on-venezuela-oil-company-cfo-tangle-financial-deals-sources-idUSKCN1BA1M6>

⁵ Parraga, M. "Exclusive: Bank jitters over Venezuela stall oil delivery to U.S. refiner". Reuters, August 17, 2017. <https://www.reuters.com/article/us-venezuela-oil-cargo-exclusive-idUSKCN1AX2AA>

⁶ Parraga, M. "Exclusive: PBF's split with PDVSA grows as U.S. refiner halts direct deals". Reuters, October 11, 2017. <https://www.reuters.com/article/us-pdvsa-pbf-energy-contract-exclusive/exclusive-pbfs-split-with-pdvsa-grows-as-u-s-refiner-halts-direct-deals-idUSKBN1CG24N>

⁷ "As Venezuela oil sanctions approach, US Gulf Coast refiners diversify". Platts, April 4th, 2018. <https://www.platts.com/es/latest-news/oil/washington/as-venezuela-oil-sanctions-approach-us-gulf-coast-10340178>

⁸ Kassai, L. and Tobben, S. "Venezuelan Oil Output Heads to 29-Year Low". Bloomberg, November 20th, 2017. <https://www.bloomberg.com/news/articles/2017-11-10/venezuelan-oil-output-heads-to-29-year-low-as-cash-crunch-grows>

⁹ Parraga, M. "Exclusive: Bank jitters over Venezuela stall oil delivery to U.S. refiner". Reuters, August 17, 2017. <https://www.reuters.com/article/us-venezuela-oil-cargo-exclusive-idUSKCN1AX2AA>

¹⁰ "Venezuela Offers India Crude Oil On 30% Discount, Only If It Agrees To Pay In Cryptocurrency". Indiatimes. April 29th, 2018. <https://www.indiatimes.com/news/venezuela-offers-india-crude-oil-on-30-discount-only-if-it-agrees-to-pay-in-cryptocurrency-344424.html>

¹¹ Mortlock, D. and Monaldi, Francisco. "Venezuela: What Are the Most Effective US Sanctions?". Atlantic Council Report. August 9th, 2017. <http://www.atlanticcouncil.org/publications/articles/venezuela-what-are-the-most-effective-us-sanctions>

¹² Parraga, M. "Exclusive: Venezuela ends Algeria oil imports due to logistical, price issues – sources". Reuters, February 5th, 2015. <https://www.reuters.com/article/us-venezuela-oil-imports-idUSKBN0L92KQ20150205>

¹³ "One Third of the U.S. Gulf Coast Heavy Oil Market Could Be Supplied by Canada by 2020, IHS Markit Report Says". IHS Markit, April 10th, 2018. <http://news.ihsmarkit.com/press-release/energy/one-third-us-gulf-coast-heavy-oil-market-could-be-supplied-canada-2020-ihs-mark?hootPostID=65fc5072a5c42a73ed522c75b5754c98>

¹⁴ "Latin America and Caribbean: Seizing the Momentum". International Monetary Fund. May 11th, 2018 <http://www.imf.org/en/News/Articles/2018/05/10/NA051118-Latin-America-and-Caribbean-Seizing-the-Momentum>

¹⁵ "Venezuela annual inflation nears 14,000 pct – legislature" Reuters, May 7th, 2018. <https://www.reuters.com/article/venezuela-economy/venezuela-annual-inflation-nears-14000-pct-legislature-idUSL1N1SE0UM>

¹⁶ Myers Jaffe, A. and Mares, D. "Why Oil Sanctions Against Venezuela No Longer Make Sense". Council on Foreign Relations Blog, April 27th, 2018. https://www.cfr.org/blog/why-oil-sanctions-against-venezuela-no-longer-make-sense?utm_medium=social_share&utm_source=fb