Venezuela EnergyNet – Oil & Gas

11/19/2019

Venezuela's Oil Diplomacy Tosses Russia, China and the U.S. into the Same Sinking Boat

President Hugo Chávez deliberately wove China and Russia into the fabric of the Venezuelan oil industry. Now, as the Latin American country struggles, the two countries remain entrenched, as does the U.S., if only for geopolitical reasons.

Prepared at the request of the Center for Strategic and International Studies in Washington, DC. - By David Voght with Kirsten Froede, Joel Guedes and Patricia Ventura

The U.S.-Venezuela relationship has gradually devolved over the last several years. Venezuela was once a firm ally and oil supplier to the U.S.; some now consider it to be a threat to the North American country's security. China and Russia have stepped in as Venezuela's biggest allies—and recipients of its oil. There is a reason "ally" and "oil" regularly appear together in discussions of Venezuela: Venezuela's foreign policy has been based on oil diplomacy for decades. The country's economy has depended almost entirely on its reserves for at least that long. For Venezuela, foreign policy, economic survival, and energy are inextricably intertwined. This approach has changed the role of energy for all of those engaged with Venezuela, including the U.S.

Today the energy playing field is shifting. For better or for worse, the U.S. shale oil boom has created a perception of U.S. energy independence. By curtailing exports over the last year, Venezuela itself began to wean the U.S. of its reliance on Venezuelan crude. But Venezuela remains highly relevant to the U.S., which must continue to ensure proper energy source diversification, and, thus, energy security.

Venezuela will also continue to play a critical role in regional security—because of emigration, organized crime, and the drug trade. The Latin American country did not invent any of those issues, but it is certainly dogged by them now. And the presence of China and Russia in a country so close to the U.S. puts a new spin on Venezuela's significance as a geopolitical player.

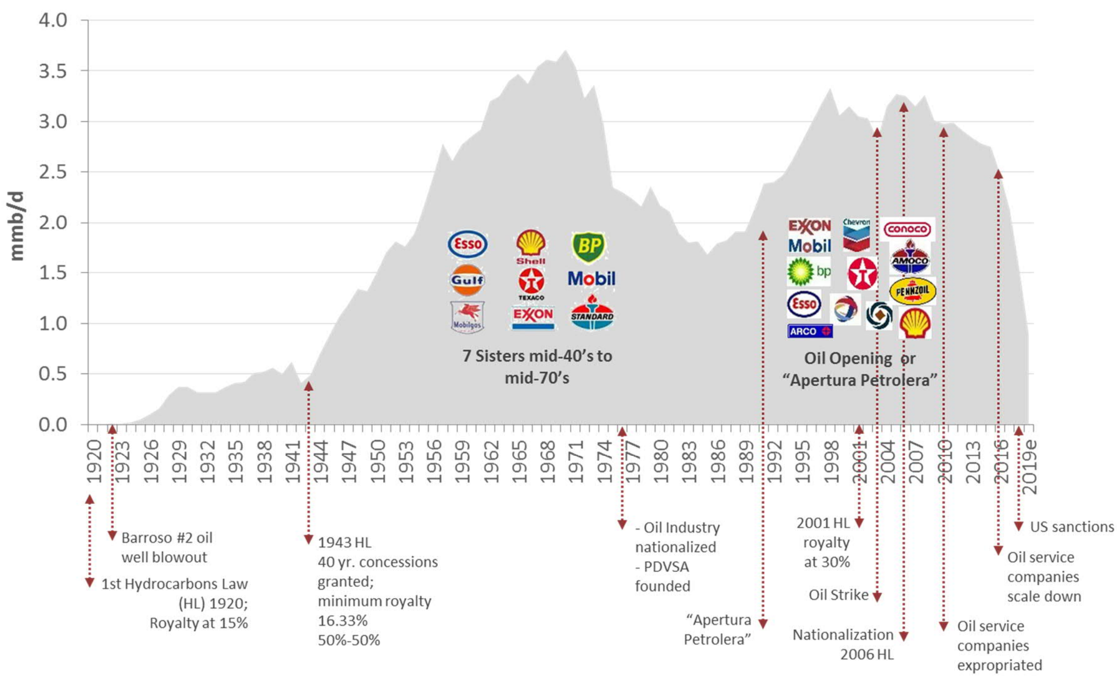
As such, the U.S. must be nimble enough to adjust to the rules of the game, many of which were laid out by Venezuela and its former president long ago.

Venezuela's Evolution into a Global Interest with Newfound Allies

The 1922 blowout of the Barroso #2 well put Venezuela on the map. By 1928, the country had become the world's leading oil exporter, and its role in global geopolitics was cinched.

Venezuela has had two major production booms since 1922. The first followed the granting of several concessions to foreign (mostly U.S.) oil companies in the context of the 1943 hydrocarbons law reform. With the massive participation of the major oil companies, once known as the Seven Sisters, Venezuela's oil output expanded rapidly. It reached 3.5 mmb/d by 1969. But as concessionaires' contracts drew to a close, and industry nationalization appeared on the horizon, investing tapered off in the 70s. Oil production began to decline. Venezuela's oil industry was nationalized in 1976, and international participation fell silent. It was not until the *Apertura Petrolera* (oil opening) of the 1990s that massive investment from numerous oil majors took hold; Venezuelan crude production then spiked from 1.82 mmb/d in 1987 to 3.16 mmb/d in 1997.

Private Sector Critical for Crude Output Expansion



Source: BP/PDVSA/IPD *Figure 1*

Then, it happened. Hugo Chávez was elected Venezuela's president in 1998. To decrease his country's dependence on the United States and other western influences, he gradually reengineered Venezuela's geopolitical policies to achieve a multi-polar solution for his leftist regime. Those policies led Venezuela, and Hugo Chávez in particular, to fully engage Russia and China. Over time, the Latin American country made billions of dollars in investment deals with the two countries.

Venezuela's relationship with the United States may have been only moderately functional while Chávez was in office, but commercial interests between the two countries, namely the contributions of U.S. oil majors and service companies, helped maintain relative peace. For years, Venezuela had been a reliable crude supplier to the United States. When oil output steadily rose in the early 90s, exports to the U.S. surged to over 1.2 mmb/d. Those volumes held steady until 2005, when the Chávez administration started to signal that operating service contracts would be migrated to PDVSA-controlled mixed companies. At that point, foreign investment slowed to a trickle once again.

Today, Venezuelan crude exports to the U.S. have all but ceased, for a variety of reasons, not the least of which is U.S. sanctions. IPD estimates that Venezuela's crude output averaged 750 – 800 kb/d in September 2019, down from the 1.43 mmb/d of January. The dramatic decline in the first quarter of the year was due to poor management, PDVSA's inability to pay service companies, national power outages, and widespread theft. But as U.S. sanctions began to take their toll, export bottlenecks developed, causing storage shortages and forcing production to be shut in.

China and Russia, however, continue to receive Venezuelan oil. The two countries remain bound to Venezuela; their financial ties, developed under President Chávez' efforts to foster market diversification, play a role in keeping them there. The goals associated with their presence, however, differ.

China's Reckoning

While China's relationship with Venezuela was propelled by the advent of the Orimulsion business in1992, President Chávez' relationship with the country began with his first visit to Beijing in 1999. The budding relationship eventually led to a number of loan-for-oil agreements that the two countries signed between 2007 and 2011. At the time, it was thought that China's efforts would secure long-term energy supply from Venezuela. For Chávez, the agreements provided critical financial support shortly after international oil companies completed a major investment cycle, and a chaotic contract migration process that triggered a rather sharp crude production decline had taken hold.

The multi-billion dollar Chinese loans required Venezuela to buy goods and services from China. The China Development Bank (CDB) issued the loans. China National Petroleum Company (CNPC) facilitated crude lifting, and the proceeds were deposited directly into the CDB. IPD calculates that China and Venezuela signed 171 bi-lateral and trade agreements and agreed to some US$ 50 billion in loans between 2004 and 2014.

Chinese Loans to Venezuela			
Tranche	**Agreement**	**Amount (US$ million)**	**Disbursement Date**
A	11/6/2007	4,000	Q1 08
B	2/18/2009	4,000	Q2 09
Great Fund	8/23/2010	20,255	Q3 10, Q2 11
A (renewal)	6/18/2011	4,000	Q3 11
B (renewal)	2/27/2012	4,000	Q3 12
C	9/22/2013	5,000	Q4 13
A (renewal)	7/21/2014	4,000	Q4 14
B (renewal)	7/21/2014	5,000	Q4 15
	Total	**50,255**	

Source: Venezuelan Official Gazette / PDVSA annual reports *Table 1*

The agreements covered agricultural, technological, and industrial development, as well as infrastructure, defense, and oil industry investments along the entire value chain. Power plant, housing, and agricultural projects were undertaken. Defense equipment, including aircraft, arms, and radar was sold. Cell phone and drilling rig factories (really warehouses) were built to assemble parts imported from China. But relatively few significant structural investments were made. Many operations never even commenced. China's risk was perfectly calculated. Loans were short-term. Most non-oil endeavors were tied to Chinese imports rather than expensive infrastructure in Venezuela. Imports became unsustainable as Venezuela's economy worsened, leading to facility closures.

In 2015, President Maduro announced a new US$ 20 billion loan from China. The funds would be used primarily to renew the Tranche B revolving credit, financially back PDVSA operations, and strengthen Venezuela's international reserves. However, it does not appear that the loan was ever executed, purportedly because much of the funds were tied to project benchmarks that were never achieved. China's colossal investment strategy was now at a crossroads with the growing disjointedness of Venezuelan politics.

From 2007 to 2010, CNPC entered into four joint venture oil agreements with PDVSA, all located in the Orinoco Oil Belt.

CNPC Joint Ventures with PDVSA						
Mixed Company	**Incorporation Date**	**CNPC Stake**	**PDVSA Stake**	**Production Target kb/d**	**Production kb/d***	**Field(s)/Block(s)**
Petrolera Sinovensa	2/1/2008	49.90%	50.10%	330	51	Sinovensa
Sinovenezolana	11/28/2006	25.00%	75.00%		0	Intercampo/Caracoles
PetroUrica	12/14/2010	40.00%	60.00%	400	0.5	Junin 4
PetroZumano	6/11/2007	40.00%	60.00%		0.3	Zumano

Source: Venezuelan Official Gazette / PDVSA *Table 2*
** Production average for September 2019 according to PDVSA*

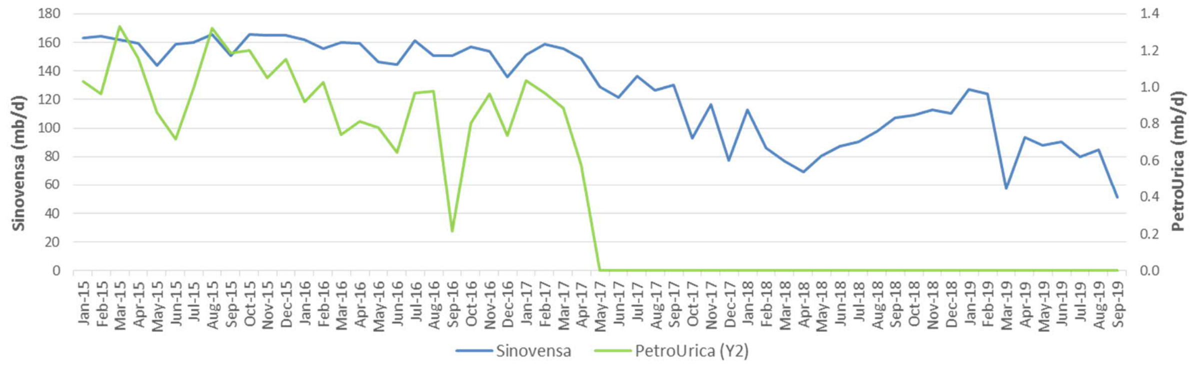
Although China maintains stellar diplomatic relations with the Venezuelan government, CNPC has consistently faced the same challenges as other foreign oil companies in the Latin American country. Venezuela's economic crisis has taken its toll on project finances. Numerous issues, including human resource limitations, power outages, lack of equipment, and theft affect all oil projects in Venezuela. The Chinese joint ventures have not been immune.

Petrolera Sinovensa (Sinovensa), an extra heavy oil blending project, is the only joint venture that has produced for CNPC. The project was originally designed to manufacture 300 kb/d of Orimulsion, a bitumen and water blend, in the mid-90s. In 2004, PDVSA decided to halt Orimulsion production and agreed with CNPC to continue developing the block under a diluted crude oil (DCO) production scheme. PDVSA agreed to provide the diluent (Mesa 30), which came from the El Furrial field in the North Monagas oil district. But Sinovensa spent years producing less than 100 kb/d when PDVSA did not comply with the diluent supply agreement.

In June 2013, Sinovensa garnered structured financing under a Remediation Plan concept designed by PDVSA and one of its mixed company partners. The JV closed a deal for a 10-year, US$ 4.02 billion loan at Libor + 5.8% from the CDB. The project was to boost its output from a 135.4 kb/d yearly average in 2013 to 330 kb/d by the end of 2016. However, PDVSA's latest financial statements suggest that Sinovensa had only executed US$ 1.6 billion of the CDB credit facility, roughly 40% of the total planned investment, by 2017. The project increased production to 160 kb/d through most of 2015, but average annual production started to fall by Q1 2016 due to management inefficiencies and lack of diluent. In Q4 2018, CNPC and PDVSA agreed to a deal whereby CNPC would increase its stake in Sinovensa by 9.9%, effectively raising total holdings to the maximum allowed by Venezuelan law, 49.9%. In exchange, the company was the first joint venture partner in Venezuela to be given operational control of its mixed company. With this control, and improved diluent supply, CNPC was able to start lifting Sinovensa production, topping 120 kb/d in February 2019. Then, two national power failures in March knocked 60 kb/d of production offline for the month. The company has yet to fully recover that output.

Despite massive reserves in the Junin 4 field, operated by CNPC-PDVSA joint venture PetroUrica, well productivity proved to be only about 25% of that anticipated. CNPC had originally hoped to produce 400 kb/d from 2.9 billion barrels of extra-heavy oil reserves. Today the project is completely shut in.

Petrolera Sinovensa and PetroUrica Production 2015 – 2019 (September)



Source: PDVSA / IPD Latin America *Figure 2*

There is no evidence that China has disbursed additional funds to Venezuela since Q4 2015. IPD estimates that Venezuela currently owes China approximately US$ 13.7 billion. Since U.S. sanctions were announced in January 2019, Venezuela has tried to redirect some 500 kb/d of crude exports from the U.S. Gulf Coast to China and India. However, in August 2019, CNPC stopped lifting crude directly from Venezuela, apparently in compliance with the U.S. OFAC prohibition against compensating PDVSA directly for crude sales. This event would suggest that Venezuela has defaulted on its debt with China not even two years after the Asian country offered a two-year waiver on principal as Venezuela struggled with low oil prices and falling production.

In August 2019, Rosneft exported more than 500 kb/d of Venezuela crude to China's independent refiners. In September, it became known that Venezuelan crude was reaching Malaysia, where it was being "blended" for re-export to China.

Standing by Long-Term Goals

It is impossible to assess how much money China may have made or lost during the first twenty years of its relationship with Venezuela. Certainly a good deal of the country's loans flowed back to Chinese engineering, construction, and technological companies, even as their efforts failed. China structured most of its loans to Venezuela as short-term, in order to mitigate risk. Venezuela made its payments according to plan until 2016.

But today there is very little to show for the effort. Chinese firms have announced the suspension of activities due to lack of payment. Many are going home with their hands empty. Investments in the oil industry clearly failed to produce the intended results. Sinovensa production is likely to be quite erratic for the foreseeable future, probably hovering around 70-90 kb/d.

China may have overshot with Venezuela. It made a lot of loans à la EXIM Bank—to gain positioning for projects and service firms, among other things—to little avail. But the Asian country takes the long view. Ultimately, it seeks to expand its global influence. Right now, that means deepening its involvement with Africa and Latin America. And, as a country with a history of dynastic rulers, China does not necessarily see economic and social collapse as reason to abandon a government counterpart altogether. It is likely comfortable with the synergies between its politics and those of the Maduro regime. Chinese leadership has thus far stood by Maduro, though it will probably continue to take a more conservative stance with future financial exposure. Some hold that the Chinese government is concerned that Venezuela will default or refuse to pay back loans if the opposition takes power. While this fear is likely baseless, if the opposition can demonstrate that it will renegotiate Venezuela's debts in good faith, economic pragmatism could win, and China may change its mind. The Asian giant may not trust Interim-President Juan Guaidó… yet. But Guaidó representatives' conversations with CNPC and the Chinese government have begun to build what some are calling a "harmonious relationship."

Russia's Treasure

IPD estimates that between 2004 and 2011, Russia and Venezuela signed 58 bilateral agreements. The accords covered a variety of subjects, like science and technology, construction and engineering, agriculture, housing, and the power sector. The two countries also agreed on a double taxation treaty, closed billions of dollars in arms deals and even incorporated joint banking ventures.

The most important of the agreements led to the sale of PDVSA's 50% interest in the Ruhr Oel refining company in Germany for US$ 1.6 billion. The purchase of Russian Evrofinance Mosnarbank, one of Russia's largest commercial banks, by Gazprombank and Venezuela's national development bank, FONDEN, reflected the strategic importance of bilateral financial integration. This investment has proven invaluable in circumventing U.S. sanctions today.

Russian oil companies Rosneft, Gazprombank, Lukoil, Gazprom, and Surgutneftegaz have had various degrees of success since entering Venezuela.

In 2006, Gazprom won an offshore natural gas license to exploit the Urumaco I block in the Gulf of Venezuela. It later renounced the license in 2013, following studies that proved block development uneconomical.

On May 10, 2012, Gazprombank and PDVSA incorporated the Petrozamora mixed company. The plan was to produce 110 kb/d from the Bachaquero and Lagunillas areas on the east coast of Lake Maracaibo. The project began to produce in July 2012. Production topped out at 148 kb/d in February 2016. On March 15, 2019, Gazprombank announced the sale of its 40% stake in Petrozamora to an unspecified buyer. At the time of the sale, the project was producing 95 kb/d.

In June 2010, a consortium made up of Rosneft, Lukoil, TNK-BP, Gazprom, and Surgutneftegaz incorporated the PetroMiranda extra heavy oil joint venture with PDVSA. The plan was to produce 430 mb/d of a 26° API Syncrude blend. Following a merger with TNK-BP in 2010, and the purchase of the Gazprom and Surgutneftegaz stakes in 2012, Rosneft consolidated a 40% stake in the joint venture.

Rosneft's takeover of TNK-BP also gave the Russian NOC a 16.67% share in PetroMonagas (Rosneft purchased an additional 23.33% of PetroMonagas shares in March 2017), 40% in PetroPerija, and 26.67% in Boquerón. And with that, Rosneft was officially and squarely on the Venezuela map, with key participation in five joint ventures.

Rosneft Joint Ventures with PDVSA

Mixed Company	Incorporation Date	Rosneft Stake	PDVSA Stake	Production Target kb/d	Production kb/d*	Field(s)/Block(s)
PetroMonagas	2/21/2008	40.00%	60.00%	240	50	Cerro Negro
PetroMiranda	6/22/2010	40.00%	60.00%	450	0	Junin 6
PetroVictoria	11/14/2013	40.00%	60.00%	400	1.1	Carabobo 2
PetroPerija	9/21/2006	40.00%	60.00%	NA	3.4	DZO
Boquerón	10/11/2006	26.70%	60.00%	NA	1.6	Boquerón

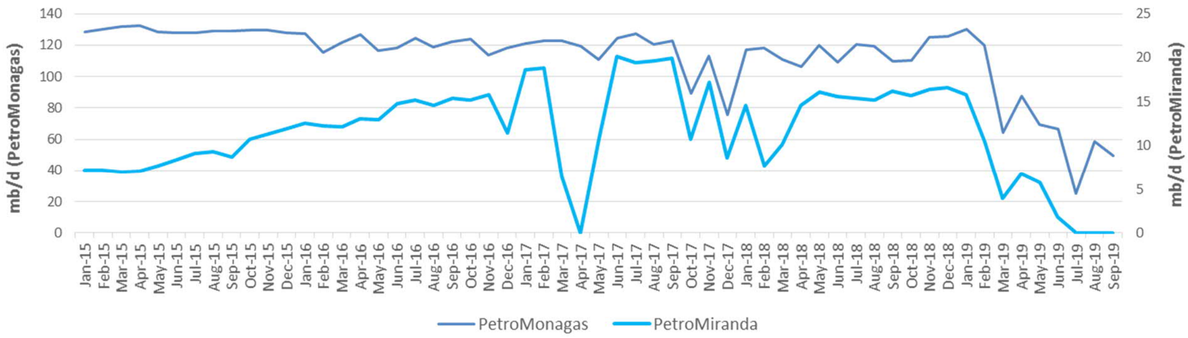
Source: Venezuelan Official Gazette / PDVSA *Table 3*

** Production average for September 2019 according to IPD Calculations*

In addition to the company's upstream oil assets, in December 2017 Rosneft also acquired a license to develop 6.5 trillion cubic feet of natural gas in the Mejillones and Patao offshore fields. Final investment decision is expected in 2020. The company has been assessing export options, including floating LNG and possibly pipeline supply, to Trinidad and Tobago.

Like CNPC, Rosneft has been unable to meet targeted production in its Venezuelan fields. As of September, PetroMiranda was shut in, and PetroMonagas was producing an average of 50 kb/d, depending on the availability of storage capacity at the Jose loading terminal, where Orinoco Oil Belt crude is dispatched.

PetroMonagas and PetroMiranda Production 2015 – 2019 (September)



Source: PDVSA / IPD Latin America *Figure 3*

While Rosneft's upstream operations in Venezuela have clearly buckled under the weight of Venezuela's political crisis, the company continues to profit from its close ties with the Maduro administration. Since U.S. sanctions were implemented in January 2019, Rosneft has essentially assumed control of PDVSA's Commerce and Supply department, directly lifting and trading upwards of 62% of the country's crude exports in Q3 2019.

But with an estimated 14.3 billion barrels of remaining reserves, according to PDVSA, any short-term downside to doing business in Venezuela would seem to be mitigated, as long as Rosneft feels its joint venture contracts are protected in the long-term. IPD calculates remaining reserves at roughly 24% of PDVSA estimates, when adjusted for current oil price and operational limitations. Those volumes are still more than sufficient to warrant Rosneft's continued presence in the country.

Between 2014 and 2017, Rosneft loaned PDVSA some US$ 7 billion through prepaid crude agreements. According to Rosneft quarterly reports, Venezuela still owed the company US$ 1.1 billion as of June 2019. IPD calculates that Rosneft lifted US$ 1.4 billion in crude cargos from Venezuela in Q3 2019, suggesting that the loan, backed by 49% of CITGO shares, could be entirely paid off, sparking the possibility that new cash could be made available to PDVSA. There are different opinions on how much money Venezuela owes the Russian sovereign for loans primarily earmarked for arms purchases.

Hewing to Financial Gain and Political Gamesmanship

Rosneft, led by President Vladimir Putin's close ally, Igor Sechin, is a very convenient political arm of the Russian state. Putin has used that vehicle to anchor Russian presence in close proximity to the United States. Rosneft may still be able to lift Venezuelan crude under the guise of debt repayment, which may allow the company to comply with current U.S. sanctions. But that strategy should be short-lived, particularly because PDVSA has likely paid off its debt with Rosneft. The company has publicly scrutinized U.S. sanctions, stating that they represent a de facto nationalization of Rosneft's assets in Venezuela. The U.S. has been hesitant, thus far, to impose secondary sanctions on Rosneft or Rosneft's trading arm.

Recent press releases suggest that Rosneft may be positioning itself to take over PDVSA operations. Some PDVSA insiders have intimated that Venezuela may offer the Russian company as much as 49% of PDVSA shares. Rosneft has denied any interest in making such a move. Beyond those assertions, several realities point to why that kind of action is unlikely.

First, Rosneft has played it safe with regard to Venezuela's rule of law. Beyond the debatable transfer of 23% of PetroMonagas shares, the company has not undertaken any projects that require opposition-led National Assembly approval (which the Maduro administration would not be able secure) in compliance with Venezuela's hydrocarbons legislation.

In addition, current Venezuela law simply would not allow Rosneft to assume any formal stake in PDVSA. Article 303 of the Venezuelan Constitution explicitly states that the "State shall retain all shares of Petróleos de Venezuela, S.A. [PDVSA] or the organ created to manage the petroleum industry…"

And for those who are concerned that Rosneft may eventually take ownership of Venezuelan reserves, Article 3 of the Venezuelan Organic Hydrocarbons Law states that "Every existing hydrocarbons deposit within the boundaries of the national territory… belongs to the Republic and is a part of the public domain, and is, therefore, not subject to transfer or to prescription."

Beyond the legal challenges, socio-political turmoil would undoubtedly erupt if the Maduro administration were to backtrack on the core *chavista* message of sovereignty by giving PDVSA to Russia.

Finally, there are Rosneft's own limitations. The company simply does not have the financial muscle to execute such a takeover. Nor would it be willing or able to invest the billions of dollars needed to shore up PDVSA operations.

Of course, politics is frequently more powerful than logic, and only time will tell how the PDVSA-Rosneft relationship plays out.

Energy as a Strategic Tool

U.S. interests in Venezuela have evolved over the years, even as its relationship with the Latin American country has deteriorated. The focus has shifted from preserving American companies' commercial interests, which happened to coincide with the country's energy security priorities, to managing the fallout of a failed state. Venezuela's economic collapse has created one of the greatest humanitarian crises ever to afflict the region. Lawlessness has emboldened drug trade and created a safe haven for terrorists. And two rival nations of the U.S. have become entrenched in its traditional sphere of influence through the deliberate, oil-induced incentives that Hugo Chávez created.

The U.S. will not resolve Venezuela's problems alone, or immediately. For now, it obviously considers sanctions to be the best way to drive change. It may be partially right. But taking sanctions too far could result in irreparable damage to productive assets in Venezuela's oil industry, creating entirely unworkable economic prospects for the next government. And there is more to the picture. The Maduro regime has reportedly begun to diversify away from above-board trade that is vulnerable to sanctions to activities that sanctions cannot touch, like narco-trafficking and illegal gold mining. As such, pressure for a peaceful and democratic solution to the Venezuelan crisis must stem from broad international consensus. But the most likely suspects, including the European Union and Venezuela's own neighbors, many of which are bearing the brunt of the crisis, have maintained an anemic and disjointed approach.

All this makes Russia and China instrumental when it comes to Venezuela. China is not actively supporting Maduro, but will not intervene on behalf of Guaidó, either. That leaves Russia.

Rosneft certainly possesses too much business acumen *not* to see the writing on the wall. While certainly volatile, Venezuela's crude output, along with Rosneft's revenue, is on a clear downward trend. For now, Rosneft has shifted its operations from upstream to crude marketing, and continues to make money. But when production finally flatlines, Russia will have to ask itself what it can do to salvage its lucrative upstream business—and whether a political poke in Uncle Sam's eye is reason enough to continue supporting the Maduro regime.

An orderly political system in Venezuela is vital to the long-term stability of the region. And regional stability is critical to the U.S. While many may now believe that the U.S. achieved energy self-sufficiency via the recent shale boom, diversification of energy supply will always be a cornerstone of U.S. energy security. For both of these reasons, U.S. policy must support the maintenance of a foothold in Venezuela.

The thread that ties U.S., Russian, Chinese, and other interests together in Venezuela is the energy industry. Politics usually follows economic interests. As long as Venezuela's political stalemate continues, everyone's economic interests in the country are also frozen. That dynamic alone should be enough to provoke thought. China, Russia, and the U.S. are all positioned to influence that change which, given their antagonistic relationship, could keep the stalemate firmly in place. Or, the promise of the benefits all players, including the Venezuelan people, would reap if Venezuela's oil machine were on sure footing once again could be— should be— enough to prompt a solution.
