Event Summary

Venezuela's Growing Risk to the Oil Market

September 14, 2016

##

Event Participants

- **Luisa Palacios** (main presenter), Senior Managing Director and Head of Latin America Macro and Energy Research at Medley Global Advisors and Center Fellow.
- **Christopher Sabatini**, Lecturer of International Relations and Policy at the School of International and Public Affairs.
- **Adrian Lajous**, former CEO of PEMEX and Center Fellow.
- **Antoine Halff** (moderator), Senior Fellow and Director of the Global Oil Markets Research Program at the Center.

Event Background

Venezuela has caught the attention of global markets recently with the disarray of its energy infrastructure and the myriad problems it has faced, from a crippling electricity crisis to bottlenecks at oil export terminals and stoppages at refineries. Without the critical oil revenue, Venezuela is facing profound social and political crises, creating the circumstance of a potential catastrophe to come. Beyond the humanitarian concerns that exist, Venezuela has become a supply risk for oil markets, not only because of the multiple operational challenges it has recently faced but also due to the spiraling impact of the steep oil production declines already suffered this year. The day before the event, Petróleos de Venezuela SA, (PDVSA), announced a debt-swap proposal trying to push back $7 billion in upcoming bond payments as the company and country is in a deep economic crisis.

Event Summary

Luisa Palacios identified the three biggest Venezuelan challenges as economics, politics and oil production and price. Afterwards, moderator Antoine Halff asked several questions to the panelist and open up the floor to Q&A to the 45 attendees who were present.

Economics

The livelihood of Venezuela economy is PDVSA earnings, which is in the $30 billion range but could be higher depending on the oil price scenario in H2 2016. For example, with a $10 increase in the oil basket price would result in an estimated $7 billion in incremental revenues. Oil exports accounts for more than 94 percent of total exports in Venezuela. This projected gross export revenue of roughly $30 billion must cover bond debt service of about $10 billion for 2016, leaving only $20 billion for imports of goods and services—including the cost of PDVSA's oil imports, which amounted to $6 billion in the first three quarters of 2015. The main reason for this debt build up is the government's extensive transfers from PDVSA to the central bank. Now PDVSA's cash flow cannot cope with all these external obligations, so the government has had no option but to decline the transfers by 70 percent this year. This has forced the government to tap into its international reserves, which have decreased by more than $4 billion so far this year, in order to pay for imports. The reserve is now $10 billion after being $24 billion in March 2015. Official inflation ended at 180 percent in 2015 and the IMF estimates it could close 2016 at 700 percent. As way of to buy time, the government announced that they intend to swap the debt notes due in October 2016, April 2017, and November 2017 in for new bonds that will mature in 2020. Ms. Palacios commented at the session saying "Venezuela has never defaulted and neither has any NOC, but if the swap does not go through – maybe we will see the first of both". Commenting on the hopelessness of the situation, Mr. Sabatini, said that "there are no economists in the current cabinet" of government.

Historically, China, which has been the second largest oil export market for Venezuela (after USA and before India) have also been a financial partner through the "loan-for-oil" program. This program has been estimated to be $5–6 billion annually, but paid using oil exports to repay the loan. Based on PDVSA 2015 financial report, they sent 579,000 b/d to China whereas 330,000 b/d amounted to for debt service. Considering the economic situation, the panelist agreed that China will possibly not renew the three year rolling "loan-for-oil" program as the uncertainties of their production and economic stability is uncertain.

Politics

PDVSA and the oil industry do not exist in a vacuum; they are deeply affected by the country's unprecedented economic, social, and political crisis" said Luisa Palacios. Absent a political resolution to the current crisis, Venezuela will represent a growing supply risk for oil markets in 2017. On the other hand, a political resolution, leading to a dramatic change in economic policies that address the current financing and economic crisis, could significantly improve the country's medium-term production outlook. Chris Sabatini, commented that "the government has put themselves in a straightjacket" meaning that the government has been sabotaging the country for too long and even if oil price will rebound, getting out of the jacket will take time and a lot of help.

Production and price

Venezuela's oil production declined by almost 230,000 barrels per day during the first six months of 2016. This is on top of PDVSA own data from 2008-2015 showing production loss of almost 500,000 b/d. It is assumed that the strains on PDVSA cash flow will reach such magnitude to prevent most capital expenditures, which will hit the maintaining or adding new production. Big and complex projects will take long time to the market and the market needs to be prepared for more potential production cuts if this political situation does get any better. Adrian Lajous used the opportunity during this section to discuss the low investment in the country. He said, "even though it might be very difficult to make any predictions, one thing is certain, and that is the time lag to get production back to pre-2010 levels will take much longer than anticipated, just look at other struggling oil states in the Middle East".

Worst-case scenarios for oil production cannot be ruled out and if production would fall in line with the country's average natural rate of decline, which according to industry estimates—and in the absence of official data—may be as high as 15–25 percent. This could imply a decline rate of 400,000– 550,000 b/d. During the discussion on production figures and forecasts, the panel shared a concern of reliability of data reporting. The consensus was that if it the numbers were not correct, it is just even worse that what is stated.

As production decline was not enough, PDVSA has now gone from a pure oil exporter to a significant light oil importer for blending. The problem is that marketing its heavy crude requires blending with imported light oil or diluents, which raises production costs. Currently, PDVSA's is facing problems secure light oil imports could jeopardize exports problematic logistical bottlenecks. The country's oil infrastructure simply cannot handle that amount of oil imports. The company has also had some trouble paying for its critically needed imports of light crude oil.

"Another sign of PDVSA's growing problems could be the widening of the price discount of its oil basket relative to WTI, which reached $8–9 per barrel on average in June 2016, from $3 last June" said Ms. Palacios.

To sum up the event, Moderator Halff said, "after the views presented tonight, the situation seems unfortunately and will take a turn for the worse before we see any recovery. Two important things must be fixed: country's debt problem and political leadership. The direst impact from Venezuela's oil production is yet to come and will affect the crude oil market and trade flows."