
Chazen Society Fellow Interest Paper

Venezuela and ExxonMobil

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“It is impossible for capitalism to achieve our goals, nor is it possible to search for an intermediate way. I invite all Venezuelans to march together on the path of socialism of the new century.”

— Venezuelan President Hugo Chavez, October 30, 2005

In September 2006, ExxonMobil made a decision to walk away from its operations in Venezuela after the State assumed control of Venezuela’s oil fields and mandated a renegotiation of the terms for all foreign oil firms operating in the country. While other exploration and production companies decided to remain in Venezuela, events such as this, along with the increasing bellicosity of Hugo Chavez, have prompted mainstream media outlets such as CNN and the *New York Times* to claim that a wave of socialism is sweeping across South America. Election results in Ecuador, Bolivia and Argentina have prompted Hugo Chavez to agree, pronouncing that a Bolivarian revolution is overtaking Latin America.

Venezuela’s decision to assume ownership of oil-producing projects in the Orinoco River Basin, which holds the world’s largest reserves of heavy crude, and its mandate that companies with ownership in the area form joint ventures with Venezuela’s state-owned oil company led to a variety of responses. Of the six companies with operations in the region, all but ConocoPhillips and ExxonMobil agreed to the new contracts. As this paper will outline, this has led to poor results for both Venezuela and ExxonMobil.

Context

U.S. influence in Latin America has been on the decline over the past decade as high commodity prices have buoyed South America’s influence on the world stage. Perhaps recoiling

from U.S. influence or the right-of-center policies that led to economic problems in the late 1990s, many countries in the region have pushed to the left. Venezuela is generally portrayed as the socialist leader in the area, with governments in Ecuador and Bolivia (and sometimes Argentina) often viewed in alignment with Venezuela. Left-of-center governments in Brazil and Chile are more moderate results of stable political processes. Peru and Colombia have conservative governments that appear more closely allied with the United States.

Throughout this decade, populist leaders in South America have blamed the economic carnage in the region in the late 1990s and the current global economic crisis on policies and ideologies that originated in the United States. Several of the left-leaning governments elected recently drew support from anti-U.S. sentiment. At the same time as the political cycle was swinging away from the center-right governments elected in the 1990s, the George W. Bush administration focused its attention on other areas. The U.S. policy of democracy promotion lost credibility across the world, and especially in Latin America, as the double standards demonstrated by the United States toward authoritarian regimes harkened back to U.S. support for authoritarian regimes during the Cold War. Markets and democracy were seen, to some extent, as part of the same compromised package, undermining further the scope for democracy promotion and U.S. influence in general.¹

Broadly speaking, the region's global influence rose in the period following its financial troubles in the late 1990s and the early part of this decade. South America's share of global GDP jumped nearly 0.5 percent between 2003 and 2008 during a period of impressive growth for much larger economies in other parts of the world.² Combined with neglect from the United States, increased global clout gave the region the ability to begin to set its own policy agenda, rather than follow the lead of the United States. It should come as no surprise that Venezuela has assumed a regional leadership role, as it benefited from meteoric rise in oil and other energy export prices.

Chavez has concentrated presidential power as well as a supportive grassroots constituency with its own source of funding, derived from oil revenues. Multiple democratic institutions have been placed under the authoritarian power of the presidency, including the Central Bank, municipal governments, and State funding in the electoral process.³ President Chavez has also removed term limits for presidential re-election. On October 27th, 2009, Chavez announced that he can expropriate private enterprises at will because "the people gave him that

¹ The Economist Intelligence Unit ViewsWire. "Crunch Time for Democracy?" *The Economist*. 27 Oct. 2008. <http://www.economist.com/daily/news/displaystory.cfm?story_id=12498100>.

² IMF WEO Database.

³ Negroponte, Diana Villiers. "Venezuelan Constitution: From Socialist Charter to Authoritarian Rule." *The Brookings Institution*. 30 Nov. 2007. <http://www.brookings.edu/opinions/2007/1130_venezuela_negroponte.aspx>.

power.”⁴ Not only does it appear that Venezuela has used oil revenue to fund its shift toward socialism, President Chavez seems bent on instituting an authoritarian form of socialism that has proven unsuccessful for other nations.

Economic Data

To cut through the rhetoric, the obvious data to examine are the trends in the region’s governments’ involvement in their respective economies. Using the traditional GDP identity ($Y=C+I+G+X$), an increase in government consumption (G) as a share of the total economy could lead to crowding out of private investment or personal consumption, and thus could indicate increasing government control of the economy and private enterprise — hallmarks of a socialist movement. There has been no meaningful increase in this ratio over the last 10 to 15 years.⁵

However, Ken Peng, a China economist at Citigroup, contends, “one must keep in mind that the GDP component is only final purchases by the government. Wages, general and administrative costs are not included. Government capital expenditures are folded into gross fixed investment, not government consumption. So, the fiscal expenditure data are more relevant if one is looking for total government activity in the economy.”⁶ With these fiscal expenditures considered, the data tell a slightly different story from that presented above. Venezuela has seen reasonably-sized increases over the same period. Government expenditures as a share of domestic output have risen nearly 7 percent in the last decade.⁷ Economic statistics certainly do not tell the entire story, and it is possible for governments to mask increasing intrusion in markets from the data. But, in a region where populist rhetoric has reached a fevered pitch, the data provide a reasonable screen, and for Venezuela, the data point toward a shift toward socialization.

Nationalization of the Orinoco River Basin

In January 2007, Hugo Chavez announced the nationalization of Venezuela’s electricity, telecommunications, and strategic oil industries. These three areas encompass much of the infrastructure and potential for development in Venezuela. The debate over this action has been fierce. Many Western politicians and firms have characterized the Venezuelan president’s actions as expropriation. The Government’s Web site instead claims that past private ownership of these

⁴ Vazquez, Ian. “Chavez Declares Socialism ‘The Kingdom of God.’” *Cato @ Liberty*. 27 Oct. 2009. <<http://www.cato-at-liberty.org/2009/10/27/chavez-declares-socialism-the-kingdom-of-god/>>.

⁵ IMF World Economic Outlook Database and Haver Analytics.

⁶ From an e-mail conversation with Ken Peng, Nov. 18, 2009.

⁷ IMF World Economic Outlook Database and Haver Analytics.

industries made them insufficiently responsive to domestic needs, and the new nationalization plan aims to rectify this imbalance. Rather than nationalization, the Government claims it is buying back a few key strategic utilities and taking a majority government share in four heavy oil projects in the eastern Orinoco River basin.⁸

Regardless, many Western nations, people and, most importantly in this case, corporations, view this as a direct form of nationalization and an obvious breach of contract. ExxonMobil's 2008 10K states, "ExxonMobil's acreage holdings and assets were expropriated in 2007." This has put Venezuela's oil industry in a bind. As it stands, Venezuela's declining oil industry, specifically the state-owned oil company PDVSA, needs as much foreign investment as it can get. The nationalization campaign in 2007 put PDVSA in charge of the oil industry and several other sectors of the economy, and ever since, PDVSA has tried to attract foreign capital inflow but with little luck, and currently will take capital from whatever sources will provide it.⁹

ExxonMobil has since filed injunctions in several court systems to prevent PDVSA from disposing of the disputed assets. Hugo Chavez responded with his traditionally fiery rhetoric, threatening to halt oil shipments to the United States. However, such drastic measures seem unlikely as Venezuela still needs foreign capital providers. Since PDVSA took over operations of the country's oil industry, performance appears to have been poor. Reliable statistics are difficult to come by, but the anecdotal evidence is condemning. PDVSA has implemented a plan it claims will increase daily oil output to five million barrels per day by 2012, but little progress appears to have been made. In fact, Venezuelan officials maintain that daily oil production has held steady at roughly three million barrels per day, but sources such as OPEC claim production has dipped to around 2.5 million barrels per day and is declining from there.¹⁰ It appears that Venezuela could need the production expertise of Western oil giants in the near future, but it is unclear which companies will be willing to enter the market after watching their counterparts have their assets expropriated. This is especially true because the heavy oil of the Orinoco Basin is more difficult to extract and refine than the lighter oil found in the United States and Middle East.

The ExxonMobil Decision

According to ExxonMobil, PDVSA assumed the operatorship of the Cerro Negro Heavy Oil Project on May 1, 2007, acting in accordance with a nationalization decree issued by Hugo Chavez in February 2007. The project in the Orinoco basin had been owned by ExxonMobil,

⁸ Understanding Venezuela's Nationalization Plan. *Venezuela Information Office*.

<<http://www.rethinkvenezuela.com/downloads/Nationalization.htm>>.

⁹ "Venezuela: Oil, EU Immigration Policy and Empty Threats." *Stratfor Global Intelligence*. 20 June 2008.

<http://www.stratfor.com/analysis/venezuela_oil_eu_immigration_policy_and_empty_threats>.

¹⁰ "Exxon and Venezuela's Oil Company." *The Economist*. 14 Feb. 2008.

<http://www.economist.com/world/americas/displaystory.cfm?story_id=10696005>.

which held a 42 percent stake. The decree also required ExxonMobil to convert the project into a “mixed enterprise” and allow PDVSA to increase its ownership interest. The decree further stipulated that the government would “directly assume the activities” carried out by the joint venture if ExxonMobil refused to accept these terms. ExxonMobil refused the deal, and on June 27, 2007, PDVSA expropriated ExxonMobil's interest in the Cerro Negro Project.¹¹

In reaction, ExxonMobil filed for arbitration with the International Centre for Settlement of Investment Disputes on September 6, 2007, for breach of contractual obligations under certain Cerro Negro Project agreements. According to ExxonMobil's annual report, the company is currently unable to assess the financial impact of the loss of the project and the property. In its consolidated financials, ExxonMobil still retains producing assets in the Cerro Negro with a net book value of approximately \$750 million. Moreover ExxonMobil lost 425 million barrels of proved reserves in Venezuela.¹² West Texas Intermediate (a type of crude oil used as a common benchmark for oil pricing) currently trades at \$73 per barrel. The heavy oil of Orinoco is worth less, but one can see that potential losses begin to add up very quickly. ExxonMobil obviously hopes to recoup much of the cost through international arbitration courts, but that is a colossal amount of money to have to write about in an annual report.

Conclusion

The emergence of Venezuela as a would-be regional leader poses some risks to the United States, especially if leaders in Ecuador, Argentina and Bolivia continue to respond favorably to Venezuela's overtures. Nevertheless, the U.S. foreign policy response remains largely routed in circumstance. The United States needs foreign oil and will continue to purchase it from Venezuela and other not-so-friendly regimes. Conversely, Venezuela needs the United States as the closest large-scale consumer of its energy resources and as a source of institutional and operational expertise in the exploration and production industry. Chavez also needs the United States as a foil to maintain his political rhetoric. Despite this often hostile rhetoric, Venezuela does not pose an overly serious geopolitical threat to the United States because of the symbiotic relationship mentioned above. The U.S.-Venezuelan relationship is unlikely to change substantially, barring a political shift in Venezuela or policy changes from other players in the region or elsewhere in the world.

Beyond the larger geopolitical implications, however, lies the question of foreign investment in Venezuela's beleaguered oil industry and what the role of foreign oil companies will be moving forward. Oil production in the region appears to be falling, while no new deposits

¹¹ 2008 ExxonMobil 10K.

¹² 2008 ExxonMobil 10K.

have been discovered since 1999. Rather than reinvesting profits from booming oil prices, the State has forced PDVSA to engage in redistributive projects such as building affordable housing and primary education.¹³ The Government appears to be gambling that the world's major oil producers will still be willing to invest when needed, despite the lack of contract enforcement and the threat of expropriation. Venezuela's economy, meanwhile, appears to be crumbling without the support of inflated oil revenues¹⁴ as does President Chavez's support at home.¹⁵ A continued shift down a socialist path will likely drive more western production firms away from Venezuela, further destroying Venezuela's already deteriorating oil production capabilities.

While ExxonMobil appears unlikely to reinvest in Venezuela anytime soon, its major competitors still retain operations in Venezuela and may be willing to expand in the future, as access to oil deposits becomes increasingly dear. Barring a further deterioration as mentioned above, ExxonMobil could find itself at a competitive disadvantage relative to its competitors, who clearly still find operating in the increasingly difficult Venezuelan market profitable. ExxonMobil is choosing to remove itself from operating in one of the world's largest oil sources, but in return, has eliminated all political risk and management diversion. Conoco's decision to follow suit provides some support for ExxonMobil. However, the truth of the matter is that Venezuela is likely to suffer as private firms reduce operations in times of low prices and to gain the upper hand as firms scramble to gain access to reserves in times of high prices.

¹³ "Exxon and Venezuela's Oil Company." *The Economist*. 14 Feb. 2008.

<http://www.economist.com/world/americas/displaystory.cfm?story_id=10696005>.

¹⁴ "The Weakening of the 'Strong Bolívar.'" *The Economist*. 14 Jan. 2010.

<http://www.economist.com/world/americas/displaystory.cfm?story_id=15287355>.

¹⁵ "Wolf Sheds Fleece: Hugo Chávez Worries Ever Less About Maintaining a Semblance of Democracy." *The Economist*. 28 Jan. 2010.

<http://www.economist.com/world/americas/displaystory.cfm?story_id=15393502>.