

VENEZUELA CASE STUDY



Oil Sovereignty Policy: An opportunity for development



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Introduction

Recently, given the increase in oil prices since early 2001, some countries have expanded their government take from oil and gas producing fields, applying less favorable tax regimes, evolving over time to be able to generate greater revenue for the nation. Examples of this are Algeria, Argentina, Bolivia, China, Ecuador, Russia, UK, US and Venezuela. In the case of Venezuela, old regimes were replaced and gave rise to the creation of joint ventures and modifications in tax percentages.

Studies done by Wood Mackenzie, based on an oil price of 55 \$/bl, showed that about US\$ 260 trillion are transferred from International Oil Companies (IOCs) to governments. The largest percentages were observed in Russia and the UK (55%) and Bolivia and Venezuela (30%) each.

The intention of this work is to identify each of the characteristic features of tax contributions legally implemented for companies engaged in drilling and marketing of hydrocarbons in Venezuela, since the seventies to the approval of the new legislation in the oil sector during the last decade (1999-2009).

Specifically, this working paper will elaborate on the previous oil exploitation system in Venezuela, called **“Oil Opening Plan”**, in the nineties, reviewing its terms and conditions for the establishment of operational agreements and strategic associations in the Venezuela oil sector. Then, an analysis will be made of the current scheme, known as the **“Oil Sovereignty Policy”** (new Hydrocarbons Law 2002), including a description of the new tax framework, and a comparison between the Oil Opening Plan and the current oil policy. Also, this paper will cover the economic and social impacts of the migration of the strategic associations and operational agreements, into joint ventures, with PDVSA¹ having the majority shareholding, as an indicative that the sovereignty policy in the Venezuelan oil sector has become an opportunity for development.

Oil Tax Regimes and Government Take

Historically, most governments in oil producing countries have tried to obtain the greatest possible benefits from exploitation, development and production of nonrenewable natural resources (oil and gas). Multiple benefits can be derived: creation of new jobs, technology transfer, and investment opportunities; however, the most significant benefit is associated with the generation of greater revenue for the country through the exploitation of these natural resources. These benefits associated with the resource exploitation are called **Government Take**. The Government Take is an economic indicator that shows the relation of benefits between the revenues of the State and of the Oil Company, during a determined period.²

In this regard, governments can explore their energy potential by means of exploration, production and marketing operations through National Oil Companies (NOCs) or the participation of IOCs.

¹ Venezuela's national oil company

² It is also considered as the percentage of economic resources produced by Oil Companies, net of the investments made (CAPEX) and operation costs (OPEX) that the state perceives as oil rent or taxes.

In the case of operations conducted by IOCs, governments have developed a wide range of agreements that allow them to guarantee higher revenue and increased benefits for the nations. These agreements include: *oil concessions*³, *shared production contracts*⁴ and *risk service contracts*⁵. These three kinds of agreements include variations based on the tax systems applied in each oil country. In this context, the oil regime together with the tax system are the variables that deserve mention in the analysis of the Government Take, with the ultimate purpose of maximizing the value of government revenue.

It is widely known that many governments have changed their tax schemes aiming at greater profitability from upstream projects, through the revision of service contracts and shared production activities. The following has been observed:

- The most evident trend has been introducing taxes on windfall profits to guarantee a larger part of additional benefits for the nation, as a consequence of increases in price levels.
- Greater State's control over resources, with a greater direct or indirect participation by the State in the oil activity. This case includes Venezuela, Algeria and Russia, which through their regimes have tightened tax terms for investors and/or international companies

³ They generally are reflected in tax systems through royalties and partnership tax (known as Income Tax in the Venezuelan case). However, there are other modalities of revenue that the government receives from the petroleum industry, which include especial exploitation taxes, tax on windfall profits, property and export right taxes.

⁴ According to this regime, the State has a direct participation through NOCs and service companies. In this sense, contractor companies finance and carry out operations associated with the exploitation of oil and gas, with the aim of recovering their costs through the allocation of a portion of the production. In this kind of regime, service companies have to make certain payments to the State through the modality of royalties and taxes on windfall profits.

⁵ In this regime national or international service companies are granted the right to explore fields at their own expenses by national oil companies (NOCs); in the event that deposits are discovered, the NOC will provide the payment of services rendered by the national or international service company. In this regard, this is a risk contract, because the company runs the risk of finding or not oil or gas deposits in the area/field allocated to it for research.

- Another trend observed is the upward adjustment of royalty rates in oil concessions, as well as establishment of export rights.

Background of the current oil tax policy

During the 1990s PDVSA designed an aggressive exploration plan to reduce the traditional depletion trend of its reserves of light and medium crude oil, by signing with IOCs strategic associations and operational agreements, in order to optimize production and leverage growth in traditional and new areas (Orinoco Oil Belt) by using cutting edge know-how and technology. The plan was called “Oil Opening Plan 1996-2009”, focused on three main activities:

1. ***Risk and profits sharing:*** A partnership where PDVSA takes part once the investor finds marketable reserves. These agreements were legally attached to the laws of the Republic of Venezuela, but they were subject to international arbitration through the International Chamber of Commerce based in New York. As for the tax system, only the payment of a royalty at a 1% rate applied. No municipal taxes or income taxes were acknowledged, to the detriment of the State interest in this activity, defined as high risk because it was based on exploration of new reservoirs.
2. ***Strategic association:*** A partnership entered into with investors who own cutting-edge technology and have financial capacity to develop the reserves of heavy crude oil at the Orinoco Oil Belt. PDVSA takes part from the very beginning of the project. Special terms and conditions applied on tax contributions.
3. ***Operational agreements***⁶: It refers to the agreements reached for 20 years of operation. PDVSA would hire an operator to carry out the work,

⁶ These agreements were not approved by the Venezuelan Congress, because their contractual activity was set forth in the civil and commercial laws in force at that time.

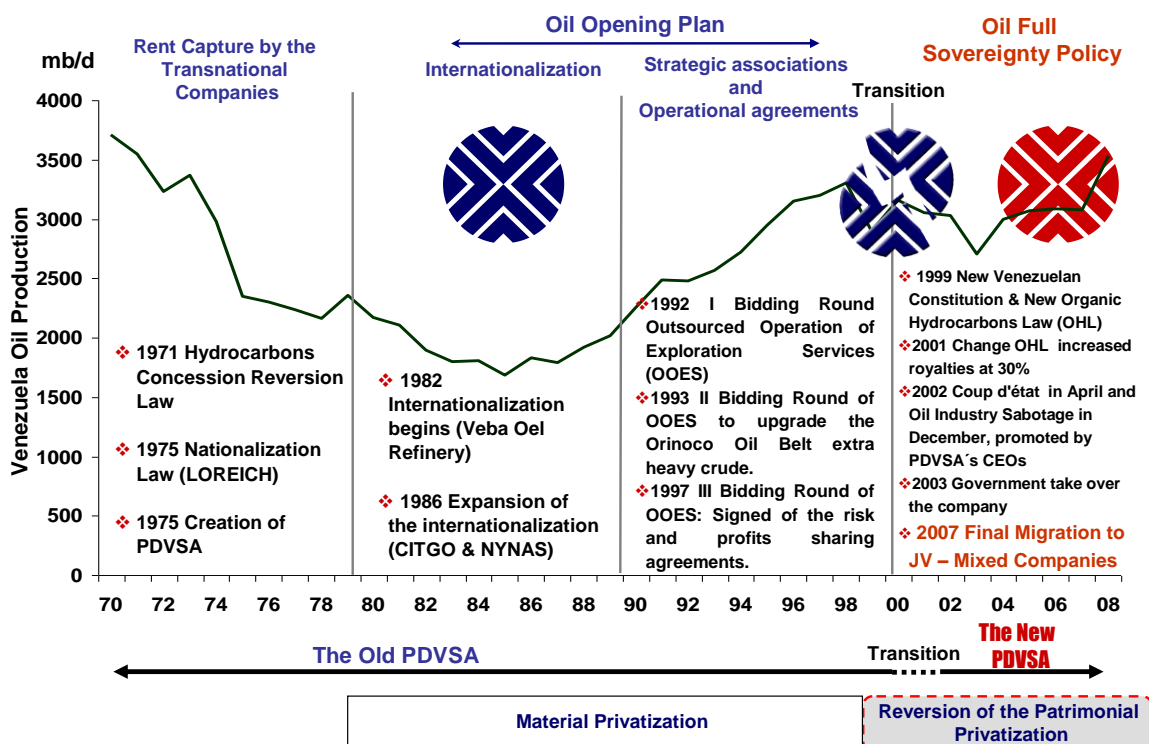
development or production on behalf of PDVSA, in exchange for payment in cash or in kind. According to the terms and conditions which regulated the operational agreements, PDVSA should pay operators for operation and capital fees, capital interests and production incentives. As a result, these agreements were very onerous. Since the agreements covered marginal wells, the production of which was considered unprofitable, no payment of royalties was provided. Therefore, operators were exempted of such payment and would pay only for taxes, contributions and tariffs as service suppliers⁷.

Operators paid only municipal taxes and income tax at 34%, plus a conditioned royalty at 16.67% for being mature wells of very low or almost nil profitability. In addition, fees were fully paid in US dollars and deposited in the accounts held by operators in foreign banks. In this way, their income, including output volumes, was expatriated and not declared to the nation through the Central Bank of Venezuela (BCV).

⁷ In this way, PDVSA embark upon three biddings rounds for outsourced operations under agreements for valuable consideration of exploitation services. These operational agreements were aimed at reactivating and operating 32 oilfields for up to 20 years.



Path of the Venezuelan Oil Policy



The following are some weaknesses regarding the operational agreements:

- In the first and second bidding rounds for operational agreements, no payment of royalties was stipulated. Therefore, operators were exempted from paying royalties to the Nation⁸.
- The agreements were executed under rates and pricing formulas involving international benchmarks which surpassed the sale price of the domestic oil basket. Therefore, PDVSA would take up most of the risk. Further, the agreements did not provide for output cuts, including any cuts agreed at the OPEC.

⁸ There were also income tax exemptions on the assumption that non-recovered capital meant an expense that could be deducted in estimating the income tax.

- PDVSA should pay the royalties of the agreements resulting from the first and second rounds. As a result, operators provided nothing to the State despite huge income from drilling wells.
- These agreements were not subject to the Venezuelan laws and, consequently, they were not subject to the Bidding Law. This enabled contracting with related companies or partners of operators. Therefore, payment for services, works and goods went back to operators.
- The criteria for expenses and investment used in the first and second rounds were inconsistent with PDVSA accounting schemes. While there is at PDVSA a cost classification for investments and another one for expenses, some components in these agreements were considered capital, but labeled by PDVSA as expenses. This enabled operators to recover both by means of operating costs and capital the items referred to operating expenses.

Venezuela's new legal framework in the oil sector

After the approval of the Bolivarian Constitution of Venezuela by public referendum in 2009, the Organic Hydrocarbon Law was enacted, and two years later in 2001, it increased royalties at 30% from the previous 16%. Also, this law established the possibility to create joint ventures. According to the Organic Hydrocarbons Law, joint ventures are those created by the Venezuelan State, either directly through the President or by a Nation's company of its exclusive property, and other national or foreign companies, to develop exploitation activities associated with the search for hydrocarbons deposits, their extraction in natural state, their collection, transportation and initial storage, which are classified by the Law as primary activities reserved for the State.

According to article 22 of the Law, the State will maintain more than 50% of social capital and the companies will have 49% of the remaining shares. Since the State will have more than 50% of the stockholding, it will have a privileged position in the shareholder's meeting of the joint venture and will retain control of each and every decision made in the development of its own activities.

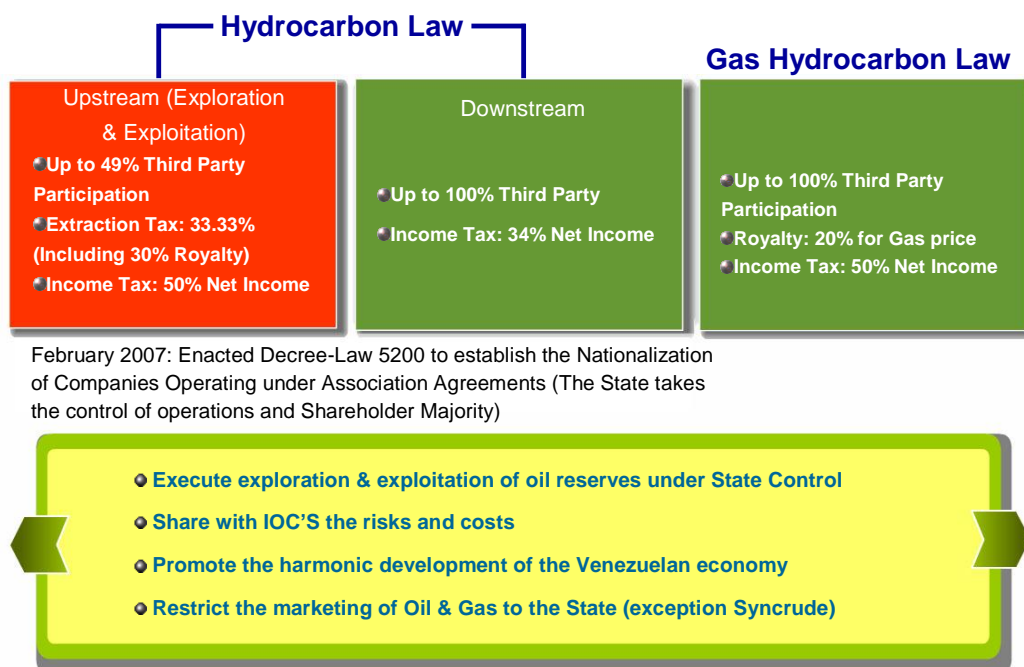
It is worth highlighting that the Republic will also own the oil deposits (oil reserves) where this activity is developed. Article 12 of the Constitution of the Bolivarian Republic of Venezuela calls for the following:

“Article 12: Mineral and hydrocarbon deposits of any nature that exist within the territory of the nation, beneath the territorial sea bed, within the exclusive economic zone and on the continental shelf, are the property of the Republic, are of public domain, and therefore inalienable and non transferable. The seacoasts are public domain property.”

Oil deposits belong to the Republic and the Venezuelan State, for its part, grants exploitation rights to joint ventures. These rights have an economic value that investor companies, either domestic or foreign, have reflected so far on their financial statements and that increases or reduces the value of their shares, depending on the size of the reserve contained in the deposit and the participation of these companies in the stockholding scheme of the joint venture. However, that exploitation right does not belong to investors but to joint ventures and the investor is only the owner of a determined number of shares.



Venezuela's Legal Framework: Building the New Oil Industry



Nowadays, the Organic Law of Hydrocarbons allows the possibility of private participation in business upstream until 49%, while in business downstream is allowed 100% of the private participation, with 34% of income tax. Likewise, the Organic Law of Gaseous Hydrocarbons allows a private participation until 100 % with royalties of 20% and 34% of income tax, in natural gas sector.

With the implementation of the new model, the most relevant change was introduced to the tax regime, mainly Income Tax, which was increased to a 50% rate, established by the new Organic Hydrocarbons Law that repealed the 34% aliquot of the previous scheme. Nonetheless, an exception was made for drilling and associated activities in the case of extra-heavy crude oil and non-associated gas, with a lower rate of 34%. In terms of royalties, the other main change was the 30% rate established on hydrocarbon and natural gas volumes produced.

Other contributions include:

- **Special Contribution on extraordinary Prices:** This contribution is applicable on revenues derived from the surplus difference when price of Brent marker barrel surpasses the level of US\$ 70/bbl.
- **Contribution to Endogenous Development:** A contribution of 1% of gross profits (before payment of Income Tax the prior year) is established for social development, according to the terms and conditions for the incorporation of joint ventures.

In this context, and within the framework of the Oil Sovereignty Policy, on April 12, 2005, the Ministry of Oil instructed PDVSA's Board to correct omissions or faults of each and every operational agreement concerning hydrocarbons, and to evaluate legal mechanisms to extinguish said agreements within a year. In order to achieve this, on March 31, 2006, the National Assembly (National Congress) passed and published in the Official Gazette No. 38410, the terms and conditions for the incorporation and operation of joint ventures, as well as the model contract for the conversion to joint venture that would be signed with the interested private entities (IOCs).

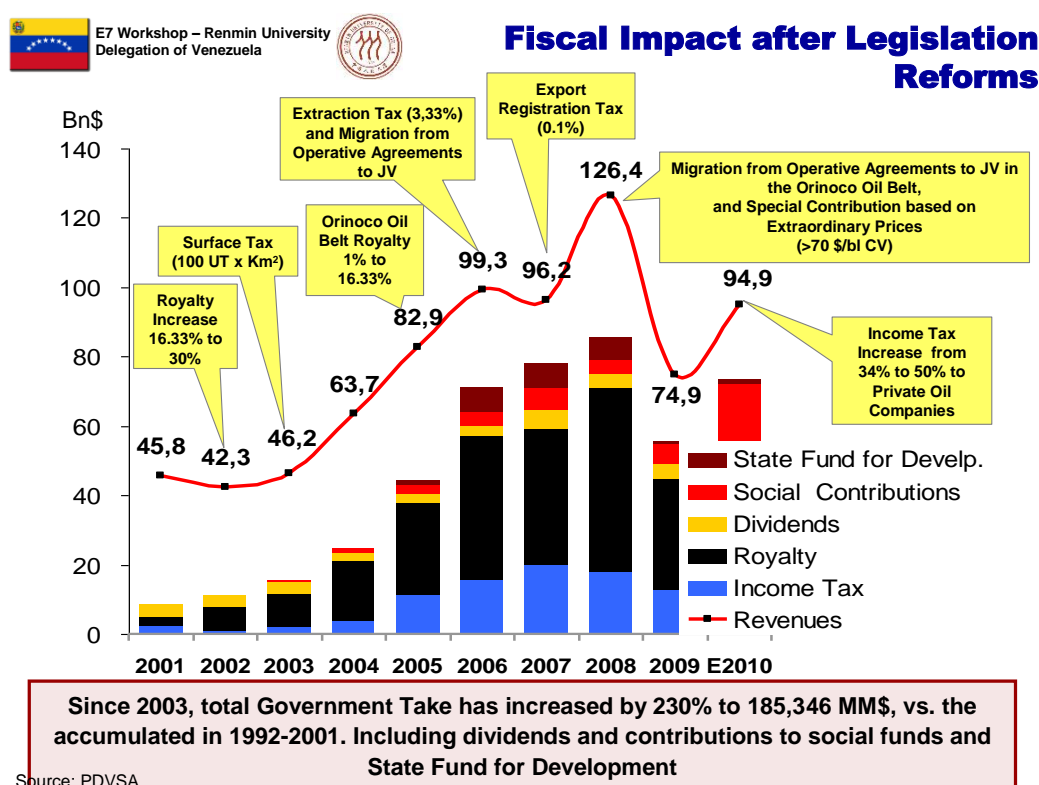
This meant the automatic extinction of operational agreements from March 31, 2006, without oil companies having any right to compensation, except the payments corresponding to the first quarter of 2006. Additional, it was agreed that assets operated as of that date by these operational agreements were immediately made available to joint ventures (JV) for the development of their activities.

Year 2007 defined the end of the process to create the new joint ventures within the framework of the nationalization of the Orinoco Oil Belt, as per the Decree-Law on Migration to Joint Ventures of the Association Agreements of the Orinoco Oil Belt, No. 5200, dated February 26, 2007, which meant a historic step toward the

consolidation of National Sovereignty in the oil sector. With the migration from operational agreements to joint ventures, the Venezuelan State regained control over oil operations, and increased tax collection.

Economic Impacts of the New Oil Legislation

The legislation reforms implemented since 2003 has increased Government Take by 230%, compared to the accumulated 1992-2001, reaching a total amount of US\$185 billion (including dividends and contributions to social funds and Fund National Fund for Development, FONDEN, (created by the President in 2005))⁹. Only from higher contributions from royalties, income tax and extraction tax, the Nation has received an additional contribution of more than US\$4 billion during the period analyzed.



⁹ The National Oil Company, PDVSA, transfer each year special contributions directly to the National Fund for Development, which is responsible for the financing of main investments projects on infrastructure, defense, education, health, external debt service, among others. Likewise, PDVSA also contribute to the financing of several funds for social development.

It is worth mentioning that one of the responsibilities of the JVs is to support development in areas close to their oil fields, as well as other social programs, such as education, health, infrastructure and services, and agricultural production. JV's social contribution amounts an aliquot of 1.11% of its gross revenue. Since the migration to JV in 2006 to 2009, the total social development contribution made by the new JV stands up US\$ 380 million dollars.

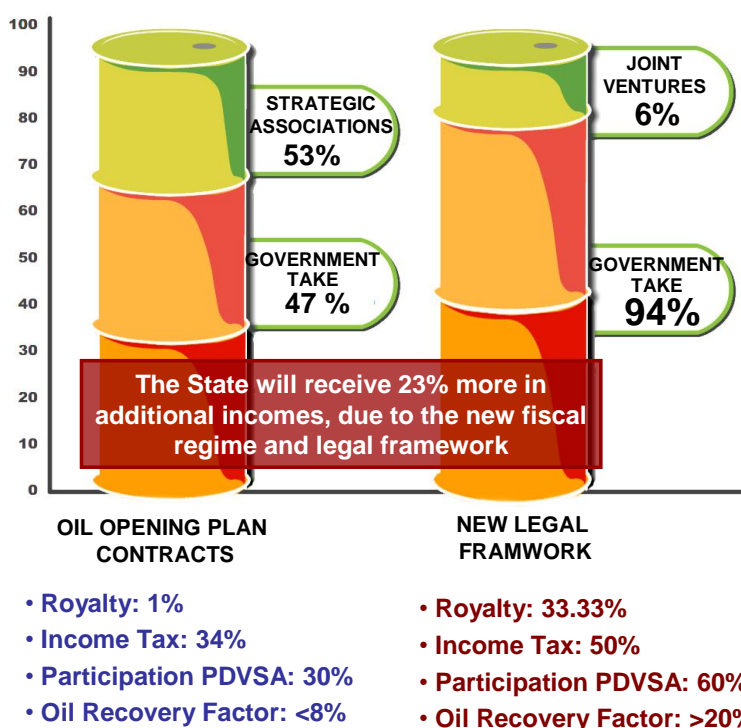
In summary, with the New Legal Framework and the migration of the operational agreements to joint ventures, the Nation has regained control over the oil industry, and has increased tax collection for social development programs. The State will receive 23% more in additional incomes, due to the new fiscal regime and legal framework.



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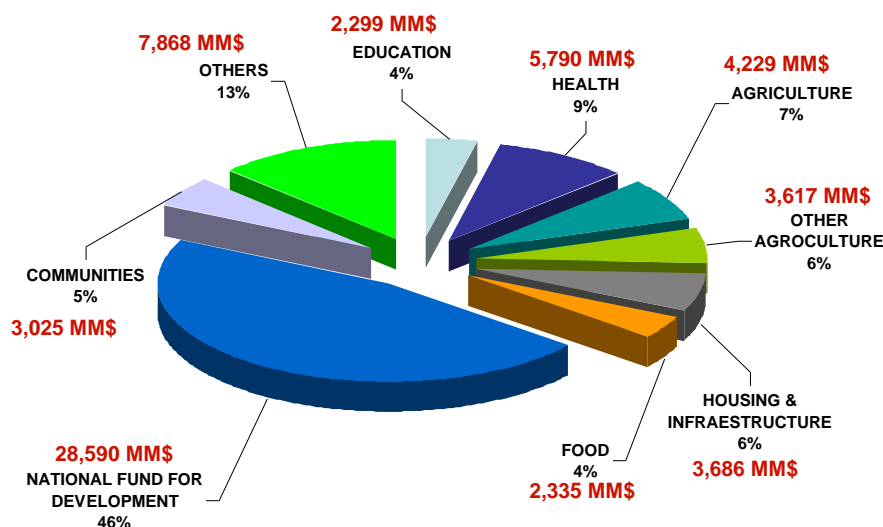


Oil Rent Distribution Venezuela





PDVSA's Social Contributions 2004 - 2010



**PDVSA has been helping to improve Venezuela's social development.
PDVSA's social contribution amounts 61,439 MM\$ in 2004 - 2010**

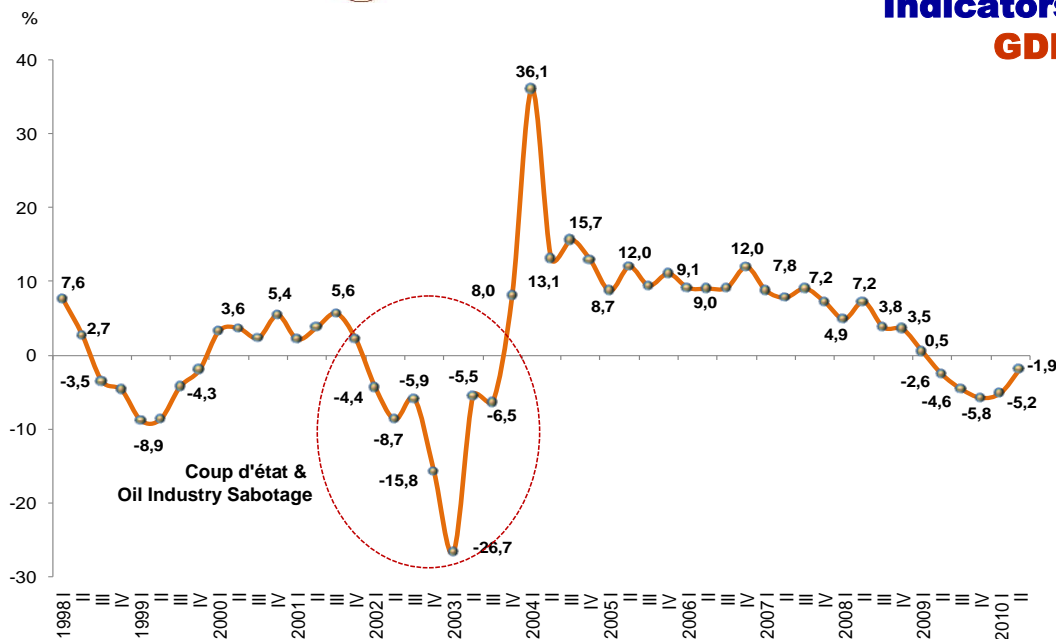
Source: PDVSA

All these additional incomes have been invested in several social projects in different sectors, such as: infrastructure, transport, education, health, sport and housing, which have had a positive impact on the macroeconomic and social indicators of Venezuela. A quick review of the last decade shows evidence of these important improvements.

For example, Venezuela's GDP has improved over the last 10 years, with the exception of the years 2002-2003, due to the Coup d'état (April 2002) & Oil Industry Sabotage promoted by the CEOs of PDVSA (December 2002-February 2003). Afterwards, it showed a historic trend of 22 consecutive quarters of growth between IQ 2004 - IQ 2009. For 2010, IMF expects a GDP growth of 3.3%, and a similar number for 2011 and 2012. Also, we can see improvements on other economic indicators, such as: unemployment rate and welfare expenditure as percentage of total expenditure, among others.



Venezuela's Macroeconomic Indicators **GDP**



- **Historic trend: 22 consecutive quarters of GDP growth between IQ 2004 – IQ 2009.**
- **IMF expects a GDP growth of 3.3% for 2011.**

Source: Central Bank of Venezuela

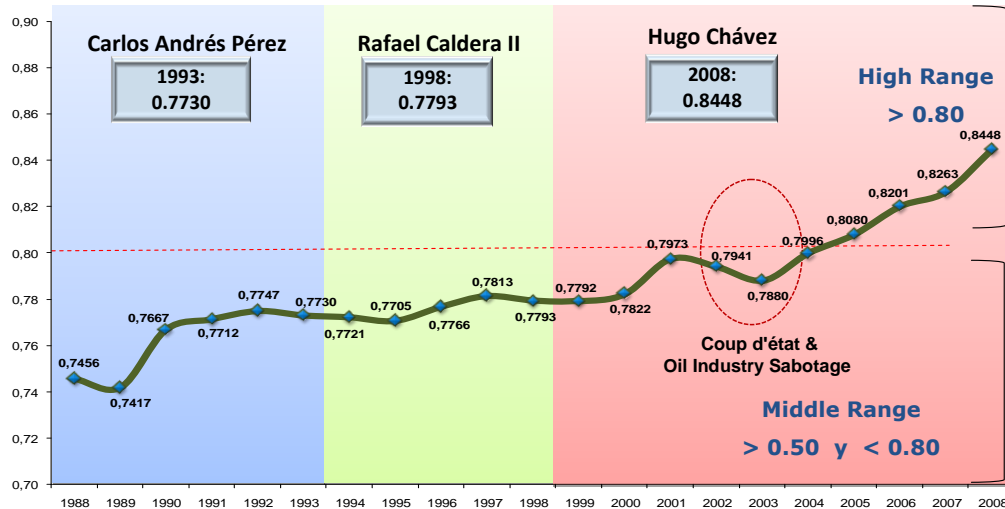
As well, the social impact of greater government take is tangible when we analyze the most important social indicators, like: the human development index, the Gini coefficient, and the percentage of people on poverty condition. Among the achievements that deserve to be mentioned are:

- Venezuela has achieved one of the UN Millennium Goal, by reducing the amount of people on poverty condition by half in 2009.
- Venezuela has eradicated the analphabetism in 2007 with the Mission Robinson, which brought basic education to the people.
- Venezuela is located at 2nd place among Latin-American countries, and 5th worldwide, with the highest rate of university enrollment.



Venezuela's Macroeconomic Indicators

Human Development Index

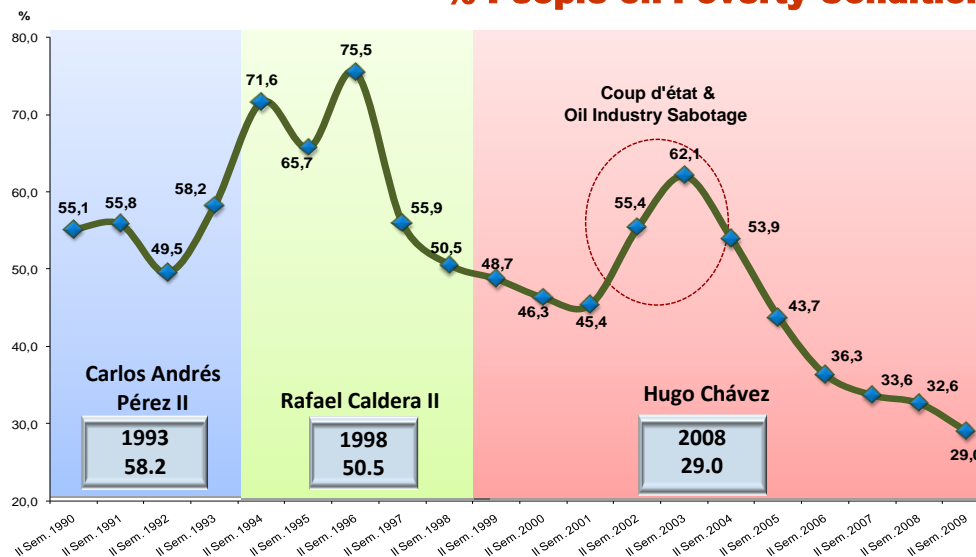


Source: Statistic National Institute of Venezuela



Venezuela's Macroeconomic Indicators

% People on Poverty Condition



The Millennium Goal was achieved in 2009, standing at 29%.

Source: Statistic National Institute of Venezuela

In relation with the uses of government take and State Development Fund, the following example can be mentioned:

- **Health:** Venezuela has spend a lot of resources strengthening the health sector, by creating Primary Health Centers on Poor Neighborhoods, Integral Diagnosis Centers, Popular Clinics, and building the Latin-American Child Cardiology Hospital, among other initiatives.
- **Education:** Venezuela has increased the enrollment rates in the primary, secondary and tertiary levels of education, by creating the Bolivarian University of Venezuela, and strengthening the Technical University of the National Army, both with several headquarters along the country.
- **Transport:** Important investments have been done in the transport sector. For example, the construction of 6 different subway lines in 3 mayor cities; 1 train; 2 different railways; 3 cable cars in the Capital of the Country, among others.
- **Sports Facilities:** Venezuela was the host of the Cup America 2007, the oldest soccer tournament in the world, for which built 9 new soccer stadiums of more than 30.000 people each.
- **Infrastructure & Technology:** The Nation has built the second bridge over the Orinoco River and has launched a satellite; and is building the third bridge over the Orinoco River, 2 different railways along the country, and other facilities.
- **Power Plants:** Venezuela has built one hydroelectric power plant along the Caroni River, with a total cost of US\$ 2.5 billion, which added 2,280 megawatts to the national electric system. And is constructing a new hydroelectric power plant in the Caroni River, which will add 2,000 megawatts by 2014, with a total cost of US\$ 5.9 billion.

Conclusions

Throughout the 20th century Venezuela has evolved in terms of how it manages its oil policy as the country's main source of revenues, and has one of the best developed tax systems, which aims at optimizing revenue and providing a higher value to oil resources, and at the same time searching for the greatest benefit through adjustments intended to preserve its sovereignty.

Whereas IOCs are primarily exploiters of natural resources solely for the profitability, NOCs are social contributors to the overall sustainable development of the countries which own them. PDVSA has become in an example to follow. Nowadays, more than in the past, Venezuela's Oil Industry is an engine for the development of the country and its people. PDVSA, under the new legal system, has contributed to improve the welfare of all Venezuelans people by building infrastructure, financing health programs, housing and food, which has resulted in an increase in the human development index of the country standards.

PDVSA is an efficient company, which has strategic objectives beyond maximizing the return on capital for shareholders, such as: a) the redistribution of oil wealth to society at large, b) the ensure energy security, including domestic supply of fuel, and d) the promotion of socio-economic development through industrialization policies and social equity.

The positive impact felt after the migration from the previous associations and production agreements, born under the Oil Opening Plan scheme, to the new joint ventures, within the framework of the new Hydrocarbons Law, has guaranteed more control by the State over profitability in hydrocarbon drilling and marketing.

Upon the implementation of the new Hydrocarbons Law and joint venture scheme, the most relevant change is found in the tax regime, especially the Income Tax with 50% rate and the elimination of the 34% aliquot (association agreements).

For its part, PDVSA assumed control of joint ventures as the majority partner, thereby making it possible for the State to be more involved in all matters related to the design of investment plans, budgets and disbursements, among other things, and at the same time maintaining the orientation and assuring greater profitability and benefits for the State from the oil activity.