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## The Venezuelan Oil and Gas Sector – Are there still Opportunities in the Era of Petronationalism?

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*Editor's Note: This is Part 2 of a two-part series on the Venezuela oil and gas sector.)*

### Conversion from Operating Agreements to Jointly Owned Enterprises ("Empresas Mixtas")

Implementing its strategy of obtaining full national sovereignty over natural energy reserves (Plan Soberanía Plena), in 2005 the Venezuelan government announced that the thirty-two (32) oil fields that were in production under operating agreements entered by PDVSA during the three rounds of the oil liberalization program in the 1990s, would be required to convert to jointly owned enterprise contemplated under the new 2001 Hydrocarbons Organic Law.<sup>1</sup>

In April 2006, the Law for the Regularization of Private Participation in Primary Activities under the Hydrocarbons Organic Law<sup>2</sup> was enacted. This legislation declared the termination of the existing operating agreements, the obligation to convert to the new form of jointly owned enterprise to comply with the Hydrocarbons Organic Law, and the prohibition of any new contract for the granting of rights to private parties in the exploration, production, storage, and initial transportation activities in connection with

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liquid hydrocarbons or in any production related benefit, except in the form of a minority investor in a jointly owned enterprise. According to this law, the Republic of Venezuela directly, or by means of a company 100% owned by it, shall resume the activities performed under the operating agreements, notwithstanding the possibility to incorporate jointly owned enterprises to that effect.

In January 2007, PDVSA took control of the thirty-two (32) oil fields, of which thirty (30) were converted to the new form of enterprise and two (2) were terminated with PDVSA taking over. Under this program, PDVSA, through its subsidiary, Corporación Venezolana del Petróleo ("CVP"), controls the majority stake in all the projects.<sup>3</sup>

The remaining two (2) operating ventures that elected not to convert to the new form of enterprise were those belonging to Jusepin and Dacion fields controlled by Total/BP and ENI, respectively. PDVSA, through CVP, entered into an agreement with the companies Total Oil and Gas and BP Venezuela Holdings to terminate all rights, shares, or claims related to the terminated operating agreement corresponding to the Jusepin Field in the Monagas State. In contrast, in November 2006, ENI initiated an arbitration proceeding against Venezuela before the International Centre for Settlement of Investment Dispute ("ICSID") after the unilateral termination by PDVSA of the operating service agreement in the Dacion area.<sup>4</sup> Later in February 2008, ENI reached a settlement with Venezuela. Under the terms of the settlement agreement, ENI will receive compensation in cash based on the net book value of the asset.<sup>5</sup>

Conversion of Orinoco Belt Association Agreements and Profit Sharing Agreements to Jointly Owned Enterprises (Empresas Mixtas)

In early 2006, the Venezuelan government announced the mandatory conversion of the Orinoco Belt association agreements and risk profit sharing agreements into jointly owned enterprises. PDVSA entered into those agreements during the oil liberalization program of the 1990s.

The royalty payments, established by Article 41 of the 1943 Hydrocarbons Law, that apply to the four association agreements were reinstated at the 16 2/3% rate. Moreover, the statute allows the National Executive to temporarily reduce royalty rates for active projects whose degree of maturity calls for such measure. The statute further allows the National Executive to increase the lowered tax to the original rate when, according to its judgment, the conditions that prompted the reduction no longer apply. The National Executive had established royalty payments applicable to the four association agreements at the minimum level of 1%. In September 2004, the MENPET proposed that royalty payments were reinstated at the 16 2/3% rate. The reinstatement was subsequently implemented, and the measure was then accepted by the majority of the foreign private companies involved in the associations.

Later in 2006, the Income Tax Law was reformed to eliminate the exceptions to the applicability of the 50% income tax rate. The Income Tax Law imposes a 50% income tax rate on companies performing hydrocarbon exploitation and related activities such as refining and transportation or the purchase or acquisition of hydrocarbon and its derivatives for exportation purposes. However, before the 2006 reform, companies formed under association agreements, pursuant to the former Organic Law that Reserves the Industry and Marketing of Hydrocarbons to the State,<sup>6</sup> had a maximum applicable tax rate of 34%.

Pursuant to Presidential Law Decree N° 5,200 for the Conversion of the Orinoco Belt Association Agreements and Oil Risk Profit Sharing Agreements into Jointly Owned Enterprises<sup>7</sup> and to conform to the Hydrocarbons Organic Law, the Orinoco Belt Association Agreements (Petrozuata, S.A., Sincrudos de Oriente, S.A., Sincor, S.A., Petrolera Cerro Negro, S.A., and Petrolera Hamaca, C.A.)<sup>8</sup> and the oil risk profit sharing agreements (Golfo de Paria Oeste, Golfo de Paria Este, and La Ceiba blocks) had to be converted into entities in which the CVP or other PDVSA affiliates hold an equity participation of at least 60%. Orifuels Sinovensa, an association agreement company consisting of PDVSA's affiliate, Bitumenes del Orinoco, S.A. ("Bitor"), China National Petroleum Corporation, and Petrochina Fuel, also had to convert to jointly owned enterprise.

A four-month term was granted to the private parties in the agreements to negotiate the terms and conditions for new jointly owned enterprises with the Republic. If the parties did not reach an agreement within the four-month term, then PDVSA would take over the operations.<sup>9</sup> In addition, the law provides that the infrastructure, transportation, and upgrading services belonging to the strategic associations would be of open access and would not otherwise be restricted per the guidelines to be enacted by the MENPET.

In October 2007, legislation concerning the effects of the conversion from association agreements and risk profit sharing agreements to jointly owned enterprises was enacted.<sup>10</sup> Under the new law, all association and risk profit sharing agreements that converted to the new

form of enterprise were terminated at the moment the corresponding transferring presidential decree was published. According to the law, all rights and assets corresponding to such agreements that belonged to private companies that did not reach an agreement to convert to the new form, were transferred to the newly incorporated jointly owned enterprise. In those cases where none of the private parties reached an agreement to convert, all rights and assets corresponding to such agreements were transferred under the reversion principle to the PDVSA affiliate in charge of the negotiation. The agreements that did not convert were terminated as of the publication of this law.

PDVSA took control of three (3) of the four (4) Orinoco Belt association agreements and two (2) of three (3) risk profit sharing agreements.<sup>11</sup>

Although Chevron, Statoil, Total, ENI, and BP agreed to the handover, ExxonMobil and ConocoPhillips chose to reject the terms of the new joint ventures. ConocoPhillips participated in the Petrozuata (50.1%) Association, the Ameriven (40%) Association, the Golfo de Paria Este risk profit sharing agreement, and the Golfo de Paria Oeste risk profit sharing agreement. ConocoPhillips was the only private participant in the Petrozuata Association. ExxonMobil participated in the Cerro Negro association and the La Ceiba risk profit sharing agreement, along with Petro-Canada. By October 2007, ConocoPhillips, ExxonMobil, the Overseas Private Investment Corporation ("OPIC"), and Petro-Canada were unable to reach an agreement with PDVSA's affiliate, CVP. Consequently, PDVSA officially announced that it was taking over the operations of Petrozuata, later renamed Petroanzoátegui, and La Ceiba field.

In September 2007, ExxonMobil announced that it filed an arbitration claim with the ICSID against the Government of Venezuela.<sup>12</sup> In February 2008, a United States federal court issued temporary injunctive relief sought by ExxonMobil, freezing US\$ 300 million worth of PDVSA's assets.<sup>13</sup> Subsequent court orders in London, the Netherlands, and the Dutch Antilles froze up to US\$ 12 billion of PDVSA's assets in those jurisdictions. ExxonMobil claimed the injunctions were necessary to ensure payment if it prevails in the arbitration.<sup>14</sup>

In contrast, Venezuela's Minister of Energy and Petroleum (who also serves as PDVSA's chairman) characterized Exxon's legal actions as "judicial terrorism," and declared the multi-billion dollar freeze of PDVSA's assets as totally "outside the parameters of the arbitration."<sup>15</sup> President Chávez, upset with the temporary injunctions, threatened to withhold oil exports to the United States. Later, Venezuela's Minister of Energy and Petroleum, called for ExxonMobil to drop its hostile judicial actions in the United States, Dutch, and British courts against PDVSA, and return to the framework of international arbitration. The British judge reversed the temporary injunction in March and ordered Exxon Mobil to pay court costs.<sup>16</sup>

In November 2007,<sup>17</sup> ConocoPhillips also announced that it was considering filing a request for international

arbitration for compensation for oil operations seized by Venezuela. The arbitration claim was finally registered in December 2007.<sup>18</sup>

### **Other Jointly Owned Enterprises**

In June 2007, the incorporation of the jointly owned enterprise Petrozumano was announced, whereby PDVSA will hold a 60% interest and CNPC Venezuela B.V. will hold the remaining 40%. The company was later incorporated in November 2007.<sup>19</sup> The company was assigned the operations of the fields Zumano in the States of Anzoátegui and Monagas.

In addition, the incorporation of the jointly owned enterprise Petrolera Bielovenezolana, S.A.<sup>20</sup> was authorized in December 2007. CVP holds a 60% interest and the Association of Producing Companies Belorusneft holds the remaining 40%. The company was assigned the operations of the fields Guara Este in the Anzoátegui State and Block 10 Lago Medio in the Zulia State.

Finally, in January 2008, the incorporation of the jointly owned enterprise Petrolera Indovenezolana, S.A. was authorized. CVP holds a 60% interest and the Indian Ongc Videsh Ltd. holds the remaining 40%.<sup>21</sup> The company was assigned the operations of the fields San Cristobal in the States of Anzoátegui and Guárico.

### **Supply Agreements**

Venezuela has entered into various supply agreements with Argentina, Uruguay, Cuba, and certain other Caribbean nations. In March 2007, during the First South American Energy Summit, PDVSA and Petroecuador extended an agreement reached between Venezuela and Ecuador earlier in February 2007 by entering into a gasoline purchase-sale agreement. Petroecuador will furnish PDVSA with a monthly gasoline supply during a one-year term, subject to monthly adjustments in volume of a maximum of 100,000 bpd. In return, the Venezuelan state oil company will supply the same amount of refined oil to Ecuador.<sup>22</sup>

In November 2007, PDVSA and the China National United Oil Corporation ("Chinaoil") entered into an agreement for the supply of fuel oil to the Chinese market. On that same date, Venezuela entered into an agreement to supply China with 500,000 bpd of crude oil and oil-products starting in 2010, increasing to 1 million bpd by 2011 or 2012 (in 2007, Venezuela supplied approximately 350,000 bpd to China).

### **Amendment of the Hydrocarbons Organic Law**

In May 2006 (later republished in August 2006), the 2001 Hydrocarbons Organic Law was partially amended.<sup>23</sup> Article 2, which assigned gaseous hydrocarbons regulation to the Gaseous Hydrocarbons Organic Law, now provides that the exploitation of gas reserves associated to crude oil will be governed by the Organic Hydrocarbon Law (this provision was already included in the 1999 Gas Hydrocarbon Law).

As a consequence of the reform, under article 33, the

Venezuelan National Assembly has to approve not only the terms and conditions for the incorporation of the jointly owned enterprises, but also any subsequent modification to those terms and conditions (after hearing the favorable opinion of the MENPET and the Energy and Mines Commission of the Assembly). The new article 33 adds that the jointly owned enterprises will be governed by the Hydrocarbons Organic Law and in particular by the terms and conditions contained in the accord enacted by the National Assembly authorizing the incorporation of the same.

The option to reduce royalties to 16 2/3% in the Orinoco Belt bitumen projects was ruled out, and two (2) new taxes were implemented: the tax on extraction and the tax on exportation registry. The tax on extraction is equal to one-third (1/3) of the value of all liquid hydrocarbons extracted from any reservoir (calculated using the same base to calculate the royalty paid in cash),<sup>24</sup> payable on a monthly basis together with the royalty, by the operating company extracting such hydrocarbons.<sup>25</sup> The tax on exportation registry is equal to 0.1% of the value of all hydrocarbons exported calculated on the selling price.

### **Special Contribution on Extraordinary Oil Prices in the International Oil Market**

In April 2008, the Law for the Special Contribution on Extraordinary Oil Prices in the International Oil Market was enacted by the National Assembly.<sup>26</sup> The special contribution will take effect when the crude oil price rises above US\$ 70 per barrel, based on the Brent crude reference price. The amount of the contribution per barrel will be equal to 50% of the difference between the referenced averaged monthly price and the maximum price of US\$ 70 per barrel, and will increase to 60% when the price reaches US\$ 100 per barrel or more. The special contribution is to be paid to the Fondo de Desarrollo Nacional ("National Development Fund" - "FONDEN")<sup>27</sup> by those companies which export crude or refined oil or oil products.<sup>28</sup> According to the law, these companies will have the right to discount from their total exports the volume of any imports of these products to Venezuela.

### **Conclusion**

Venezuela has leveraged its large hydrocarbons sector to assert a stronger economic and geopolitical role in Latin America and the Caribbean than many US observers even a few years ago thought possible. The sheer volume of Energy Cooperation and Integration Agreements entered into with countries in Latin America and the Caribbean speaks to this development. Such agreements are one indication that although the United States remains Venezuela's large export market, Venezuela is working to diversify its dependence on any single market. However, notwithstanding the heated rhetoric exchanged between Washington and Caracas,<sup>29</sup> the countries still have an economic relationship of mutual dependence and it is not clear that the current high oil prices have altered this fundamental reality.

Nevertheless, both private investors and Venezuela

face important challenges. For private investors, Venezuela has some of the richest reserves in the Western hemisphere and in this era of declining supplies and reserves, its potential and allure cannot be easily ignored. However, as evidenced by recent unilateral changes to drilling contracts, such opportunities also present greater risks in the form of juridical instability. Investors have reacted in different manners to this difficult environment – many, perhaps mindful of the long-term implications, have elected to accept their inferior, subordinated role and less attractive commercial terms, thereby selecting the pragmatic route, while others have decided to fight and withdraw from the country, rather than accept the new, unilaterally imposed terms. However, while many private investors have elected to stay, many are delaying new investments in the country, a development that could have profound implications for Venezuela, particularly if the price of oil drops.

By the same token, Venezuela too faces challenges. Arguably, a more polarized society than before, Venezuela has benefited from the dramatic rise in oil prices, thereby offsetting inefficiencies. However, some analysts contend that production still has not returned to pre-strike levels. In addition, Venezuela has courted national oil companies, particularly from countries that enjoy good relations with Caracas, to effectively replace some of the diminished private investment, but it is unclear whether these companies possess the technical, financial, and operating acumen to function outside their home markets (with the possible exception of Petrobras). Moreover, its national oil company, PDVSA is carrying out more non-energy roles, such as housing and food distribution, and it runs the risk of distraction from its core competency and managerial overload. Finally, PDVSA once enjoyed the reputation within Latin America as the finest national oil company in terms of managerial and technical competency, and it is not clear that it has been able to fully replace its dismissed personnel. In short, like many emerging markets, Venezuela poses that classic risk-reward conundrum and yet neither private investors nor Washington can afford to ignore it.

1 Earlier, in April 2005, the Venezuelan Tax Administration Authority (Servicio Nacional Integrado de Administración Aduanera y Tributaria - SENIAT) announced a change of interpretation on the applicable tax rate to the income obtained by the contractor-operators operating the thirty-two (32) oil fields that were in production under operating agreements. Under the new interpretation SENIAT taxed the income of the contractor-operator with the 50% tax rate applicable, according to the Income Tax Law, to companies performing hydrocarbon exploitation and related activities. Until then the contractor-operators was regarded as a services provider the operating agreements and, therefore, the applicable tax rate was 34% (corporate tax rate). The change of interpretation was then based on the grounds that it was inappropriate to consider as “service contracts” those agreements in which the party called to “render the service” was also liable for the investment of risk capital or, at least, without any assurance of recovery. In addition, article 22 of the Organic Hydrocarbons Law defines operating companies as those dedicated to the performance of primary activities, such as the exploration in search

for hydrocarbons, the extraction of hydrocarbons in their natural state, gathering, transportation and storage.

2 Ley de Regularización de la Participación Privada en las Actividades Primarias Previstas en el Decreto N°1,510, con Fuerza de Ley de Hidrocarburos published in the Official Gazette N° 38,419, dated April 18, 2006.

3 See the 2008 Supplement to the Latin American Matthew Bender Energy Law and Transactions for a chart illustrating the terminated operating agreements, the 21 new jointly owned enterprises, and their share participation.

4 See *Eni Dación B.V. v. Bolivarian Republic of Venezuela*, (ICSID Case N° ARB/07/4), pertaining to hydrocarbon rights, filed on February 6, 2007.

5 See [http://www.energy-business-review.com/article\\_news.asp?guid=3A5BD392-6C93-44D7-9DC5-5068901E98B7](http://www.energy-business-review.com/article_news.asp?guid=3A5BD392-6C93-44D7-9DC5-5068901E98B7) Eni said to be seeking to improve co-operation through the development of new initiatives, especially in the oil-rich Orinoco Oil Belt region of the country.

6 The exception ruled out from the Income Tax Law also included companies formed through the national interest contracts provided for in the Constitution, for the execution of vertically integrated projects oriented to the exploration, refining, industrialization, emulsification, transportation and commercialization of petroleum and extra-heavy crude, such as bitumen; and companies created and domiciled in Venezuela to perform integrated commercial activities related to the production and emulsification of natural bitumen.

7 Decreto con rango, valor y fuerza de Ley de Migración a Empresas Mixtas de los Convenios de Asociación de la Faja Petrolífera del Orinoco; así como de los Convenios de Exploración a Riesgo y Ganancias Compartidas, published in the Official Gazette N° 38,632, dated February 26, 2007.

8 The four association agreements for the improvement of extra-heavy crude in the Orinoco Oil Belt produced some 660 mbpd of extra-heavy crude, resulting in a production of almost 600 mbpd of improved crude. See <http://www.pdvsa.com>

9 According to the Decree, the process and negotiation for the transfer of activities had to be completed by April 30, 2007 and the process and negotiation for the conversion had to be completed by June 26, 2007. The terms and conditions were subject to the approval of the Venezuelan National Assembly.

10 Ley sobre los Efectos del Proceso de Migración a Empresas Mixtas de los Convenios de Asociación de la Faja Petrolífera del Orinoco, así como de los Convenios de Exploración a Riesgo y Ganancias Compartidas published in the Official Gazette N° 38,785 dated October 08, 2007.

11 Please see the 2008 Supplement to Matthew Bender Energy Law and Transactions for a chart showing the terminated agreements, the new jointly owned enterprises, and its share participation.

12 See *Mobil Corporation and others v. Bolivarian Republic of Venezuela*, (ICSID Case N° ARB/07/27), registered on October 10, 2007.

13 See also “Exxon’s Wrathful Tiger Takes on Hugo Chavez,” The Economist, February 16, 2008.

14 See <http://www.venezuelanalysis.com/news/3179>

15 Idem. Energy and Petroleum Minister Rafael Ramirez contended that ExxonMobil’s former assets in Venezuela were worth less than \$1 billion, contrary to the company’s multi-billion dollar claim.

16 See [http://english.eluniversal.com/2008/03/20/en\\_eco\\_art\\_exxon-pdvsa-battle-e\\_20A1448123.shtml](http://english.eluniversal.com/2008/03/20/en_eco_art_exxon-pdvsa-battle-e_20A1448123.shtml)

17 See <http://www.reuters.com/article/marketsNews/idLTA>

N0139317320071101?rpc=44

18 See ConocoPhillips Company and others v. Bolivarian Republic of Venezuela, (ICSID Case N° ARB/07/30), registered on December 13, 2007.

19 See Decree N° 5,670 authorizing the incorporation of the jointly owned enterprises Petrozumano, S.A., published in the Official Gazette N° 38,801, dated November 1, 2007; Presidential Transferring Decree N° 5,672 transferring the right to operate in the corresponding area to the jointly owned enterprise Petrozumano, S.A., published in the Official Gazette N° 38,807, dated November 9, 2007.

20 See Decree N° 5,842 authorizing the incorporation of the jointly owned enterprises Petrolera Bielovenezolana, S.A., published in the Official Gazette N° 38,830, dated December 12, 2007; Presidential Transferring Decree N° 5,787 transferring the right to operate in the corresponding area to the jointly owned enterprise Petrolera Bielovenezolana, S.A., published in the Official Gazette N° 38,840, dated December 28, 2007.

21 See Decree N° 5,873 authorizing the incorporation of the jointly owned enterprise Petrolera Indovenezolana, S.A., published in the Official Gazette N° 38,874, dated February 20, 2008.

22 See [http://www.abn.info.ve/go\\_news5.php?articulo=89390&lee=17](http://www.abn.info.ve/go_news5.php?articulo=89390&lee=17).

23 Ley de Reforma Parcial del Decreto N° 1,510 con Fuerza de Ley Orgánica de Hidrocarburos published in the Official Gazette N° 38,443, dated May 24, 2006, reprinted for material mistake in the Official Gazette N° 38,493, dated August 4, 2006.

24 The basis used to calculate the royalties in cash is the price of the corresponding hydrocarbons volumes measured at the production field at the market value or a convented value, or absent such values, at a fiscal value fixed by the liquidator.

25 When calculating this tax, the taxpayer has the right to deduct

royalty amounts paid, including additional royalties being paid as special advantage. The taxpayer has also the right to deduct from the extraction tax, any amount paid for any special advantage annuity, but only in periods subsequent to the payment of such annuity.

26 Ley de Contribución Especial sobre Precios Extraordinarios del Mercado Internacional de Hidrocarburos published in the Official Gazette N° 38,910, dated April 15, 2008.

27 Back in 2005 the Law of the Venezuelan Central Bank ("BCV") was amended (Official Gazette N° 38,232, dated July 20, 2005) to provide for the incorporation of a national fund (later incorporated as the FONDEN). According to the BCV Law, after discounting operating and investment expenses, PDVSA must transfer any remaining amount to this fund. The Fund will be used to finance education and health programs; to improve the profile and amount of the public debt and to attend strategic situations. The Fund was initially incorporated with a US\$ 6,000 contribution from the BCV.

28 In addition, any contributions made to the FONDEN under the Venezuelan Central Bank Law will be deductible.

29 For a recent article that examines the relationship between Washington and Caracas and the triumphs and setbacks of the Chavez Administration, see Daniel Wilkinson, "Chavez's Fix," by [The Nation](#), March 10, 2008.

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