FIRST CENTENARY OF VENEZUELA AS A PETROLEUM EXPORTING COUNTRY*

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INTRODUCTION

The existence of hydrocarbons in Venezuela has always been well-known due to natural surface seepages throughout the country. Even before independence, hydrocarbons were mentioned among the minerals which belonged to the Crown, and which would subsequently pass to the dominion of the Republic subject to a concessionary regime.

But the domestic market for hydrocarbons was historically insignificant, and it was only in 1907, when the concessions were granted that were to transform Venezuela ten years later into an oil exporter. And it took only until 1928 for Venezuela to become the most important oil exporter in the world, a position which it would hold until 1970.

However, throughout the period under consideration, the domestic market for hydrocarbons became increasingly significant and currently, this market is very important for the national petroleum industry. But for domestic consumers, the hydrocarbons under national public ownership constitute a free gift of nature. The mining taxes and general taxes that the petroleum industry might incur on account of production for the domestic market, and the excise levies which might tax the national consumption of hydrocarbon derivatives, are all paid by national economic entities to the national government. In this sense, they are simply taxes, that is to say, nothing is paid in consideration for the natural resource itself.

In contrast, when Venezuela became an oil exporting country in 1917, petroleum had already revealed its potential as a source of an international ground rent. Taxes that the concessionaires exporting oil would pay to the national government, beyond the customary level of taxation prevailing in the non-oil sector of the economy, would constitute an international ground rent which, ultimately, would be paid by international consumers to the national government.

Hence, the prices of petroleum in the national and in the international markets are qualitatively different, quite apart from any quantitative differences that may exist. Export prices incorporate a component which expresses an international ground rent; in contrast, the domestic market lacks any such component given that petroleum is not a source of a national ground rent. Variations in levels of taxation in the domestic petroleum sector do not affect national income, though they may affect the national distribution of income. However, such variations in the petroleum export sector do affect national income and, hence, they also affect the international distribution of income.

Given the growing weight of petroleum as a source of an international ground rent throughout the years, Venezuelan petroleum policy revolved, and still revolves, around it.

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Even more, Venezuela's national economic policy revolved, and still revolves, around its distribution, that is to say, the task of putting this international ground rent to the service of national economic development. This national economic policy, since 1936, is known by the catchphrase '*sowing the oil*.'

In contrast, Venezuelan petroleum policy in consideration of the domestic market has historically been managed with indifference. However, in light of the increasing importance of the international ground rent in the export prices of Venezuelan oil, and given the rising importance of the domestic market, as we shall see, such indifference can no longer be tolerated.

STAGES OF PETROLEUM POLICY

Venezuela's petroleum policy went through two stages. The first one corresponded to the *concessionary regime*, with its institutional seat in the Ministry of Development until 1951, and in the Ministry of Mines and Hydrocarbons thereafter. It was followed, from 1976 onwards, by the *regime of reserved activities***,** which was to have its institutional seat in Petróleos de Venezuela S.A. (PDVSA).

In parallel, these two periods can also be distinguished as far as 'sowing the oil' is concerned. During the first period, the country in its capacity as owner of the natural resource was united *vis à vis* foreign concessionaires, and obtained ample benefits from the sowing of oil. Asdrúbal Baptista has estimated that between 1922 and 1978, the annual rate of growth in per capita gross domestic product was close to 5%. At the same time, the petroleum industry, a modern industry characterized by extraordinary dynamism, spread throughout the length and breadth of the country, fostered and accelerated the urbanization of the country, as well as attracting qualified immigrants.

During the second period, in contrast, the politics of Venezuela tacked sharply to the right. The nationalization of the petroleum industry meant that the popular vote would no longer be required to confront foreign concessionaires. The government set itself the target of productively investing the whole of the international ground rent, while current expenditures would have to be covered with general taxes. In other words, productive investment was purported to be the sole legitimate use of the international ground rent, thereby denying the country the benefits of its consumption. But an international ground rent, in itself, knows of no uses other than the consumption – whether productive or not – of imported goods; or its accumulation in the reserves of the Venezuelan Central Bank or else as private sector savings abroad. This is because an international ground rent represents nothing other than a capacity to import without any counterpart from the national productive economy. Despite this, the promoters of this policy doggedly insisted that the corresponding imports would contribute nothing to the economic development of the country; on the contrary, they would negatively affect national production. Furthermore, as a practical matter, they insisted not only in investing the whole of the current international ground rent, but also the expected international ground rent of the future by indebting the country when petroleum prices were at their historical maximum, so as to guarantee that there would be no turning back.

Amid the dazzle given off by the abundance of money, the policy of limiting the sowing of oil to investment valiantly ignored the elementary fact that the investment capacity of a country is limited by its own level of development, its human capital and, therefore, by its managerial capacity. In Venezuela, that managerial capacity, as a matter of fact, was in decline not only due to the nationalization of the petroleum industry but also on account of the simultaneous nationalization of other important industries (for example, iron) and services (for example, banks).

These policies led, inevitably, to a major crisis, with high levels of external debt. The way ahead would lead to a post-rentier Venezuela. Between 1977 and 1999, the annual per capita gross domestic product growth rate turned negative, to the tune of -2%. Further, starting in 1981, Venezuela became a country of emigration. The counterpart of these policies was the transformation of the regime of reserved activities, under the auspices of PDVSA and its affiliates, so that oil would no longer be a source of an international ground rent.

However, this process ended in the electoral debacle of 1998, the demise of the Fourth Republic and the victory of Hugo Chávez with his Fifth Republic Movement. These developments started a third period of great confrontations.

In what follows, we shall analyze some of the most relevant characteristics of the historical experience throughout Venezuela's first century as an oil exporting country in order to draw conclusions which will be pertinent for the second century, already under way.

I. CONCESSIONARY REGIME

I.1. EXCLUSIVE NATIONAL JURISDICTION

The concessions granted in 1907 by the President of the Republic, General Cipriano Castro, to Venezuelan nationals, would wind up in the hands of foreign companies. Nevertheless, according to Venezuelan legislation, the foreign concessionaires would be subject to exclusive national jurisdiction like any Venezuelan citizen: a constant throughout the concessionary regime. The relevant legislation left no room for doubt. Thus, according to the 1943 Hydrocarbons Law – the most important among all the relevant laws of this period – every title had to include the following lines:

> "Any doubts and controversies of whatever nature that may ensue because of this concession and which cannot be amicably settled, shall be decided upon by the competent courts of Venezuela, and in accordance with its laws, and for no reason nor for any cause shall they give rise to foreign claims".

I.2. TAX SOVEREIGNTY

Mining laws and corresponding concession titles provided for specific *mining taxes* for the entire duration of their validity. This notwithstanding, concessionaires would also be subject to general sovereign taxation, which at the time mainly took the form of customs duties. But in December 1908, with the support of the US government, General Juan Vicente Gómez overthrew Castro. The result of this shift of power was new legislation, granting fiscal stability to all concessions.

After the death of Gómez in 1935, this situation would come to be seen as unacceptable. With the 1943 Petroleum Reform, on the basis of a new Hydrocarbons Law all concessions would thenceforth be subject again to tax sovereignty. Quite apart from mining taxes, this Law provided that the concessionaires, “shall pay all general taxes, of whatever kind". The companies, for their part, insisted to no avail that to this phrase be added the following rider: “that will equally affect all companies”. (Report of Manuel R. Egaña and Rafael Pizani, Presidential Advisors, January 1943). On the other hand, however, all concessions were renewed for a period of forty years, but subject to a very significant rise in mining taxes.

The fundamental instrument to collect any windfall profits which could arise would be the Income Tax Law, enacted in coordination with the Petroleum Reform. The applicable rate, set at 12% in 1943, would reach 72% in 1975, by means of successive sovereign reforms.

I.3. CORPORACIÓN VENEZOLANA DEL PETRÓLEO

In 1960, Venezuela set up its first national oil company, Corporación Venezolana del Petróleo (CVP) and, in 1967, it reformed the 1943 Hydrocarbons Law in order to create a bespoke regulatory space for it. CVP would not be granted concessions, but *assignments*, without a defined duration. On this basis, CVP would be able to subscribe agreements and form mixed enterprises with private companies, but limited to a term of up to 30 years, and as long as the agreed conditions were more advantageous to the Nation than simple concessions. Moreover:

> The Chambers of Congress in joint session, duly informed by the National Executive of all pertinent circumstances, will approve the bases for contracting under the conditions they will deem fit.

In particular, the Law specified that CVP, as well as any and all agreements that it might subscribe, would be subject to exclusive national jurisdiction and to sovereign taxation. This sought to head off any possible maneuver on the part of the private companies to enter into contractual relations with CVP that could, even indirectly, impinge on Venezuela's sovereign rights.

I.4. FISCAL EXPORT VALUE

In 1970, oil production in both Venezuela (the most important oil exporter in the world for 42 years) and the USA (the most important oil producer in the world for 100 years) reached its historical peak due to the depletion of their conventional oil reservoirs. This meant that the booming petroleum demand which got underway that same year would have to be covered from much more distant sources. Hence, as well as a significant rise in oil prices, freight rates also went up significantly, albeit with very pronounced ups and downs. Therefore, in December 1970, a *Fiscal Export Value* was introduced in the Income Tax Law. This was an export tax designed to deal with circumstantial variations in prices, and the Executive was authorized to set the Fiscal Export Value and change it in accordance with variable conditions. In 1973, with the market in turmoil, the Executive came to set it on a monthly basis.

I.5. CONCLUSIONS

The concessionary regime was very successful. By 1970, Venezuela was already well positioned to tax away any windfall profits that might arise with the change in the complexion of the world petroleum market getting underway at the time.

But in 1973, the companies jumped the gun, by suggesting their immediate nationalization.

II. REGIME OF RESERVED ACTIVITIES

The international petroleum companies had their own ideas about how the new regime needed to be structured, and they succeeded in imposing them. The Organic Law Reserving to the State the Industry and Commerce of Hydrocarbons put an end to the concessionary regime, as of 31 December 1975 (1975 Nationalization Law). The concessionary regime was thus replaced by the *regime of reserved activities,* completely set apart from the previous regime. Thus, the valuable historical experience on the subject matter, accumulated throughout seven decades, was extirpated from the national consciousness as if it were a cancerous tumor.

Each of the most important concessionaires were transformed into a national company, presided over by the top echelon of Venezuelan executives which had been trained by the multinationals over the space of decades, not only technically, but also ideologically and politically. Thus, Creole (Exxon) turned into Lagoven, Shell de Venezuela into Maraven, etc. These national companies were organized as affiliates of Petróleos de Venezuela S.A., a holding company with the State as sole shareholder. One of these affiliates absorbed all of the smaller concessionaires and it was in this company that CVP's personnel was also absorbed. CVP itself simply disappeared.

The 1975 Nationalization Law authorized PDVSA and its affiliates to enter into operating agreements "provided ... that in no case these actions affect the very essence of the activities so assumed". It also authorized PDVSA and its affiliates to enter into association agreements which, however, would require "previous authorization by both Congressional Houses, acting in joint session ... under the conditions they will deem fit once the Nacional Executive has furnished them with pertinent information of all surrounding circumstances".

In 1989, Venezuela, crushed by the external debt acquired during the years of booming oil prices, was forced to turn to the International Monetary Fund for assistance. The Fund made (informally) a condition of its assistance that the country would once again open the petroleum sector to private foreign investment. It was thus that the *Oil Opening* policy began.

II.1. OPERATING SERVICES AGREEMENTS: RE-PRIVATIZATION OF PRODUCTIVE ACTIVITIES

Pursuant to instructions from the National Executive, the affiliates would enter into the first operating services agreements in 1991. According to these agreements, the contractors, under the supervision of the affiliates, would produce oil, but the oil produced would always be the property of the affiliates, and the contractors would be paid exclusively for their services. The National Congress, in turn, accepted these models, thereby leaving the affiliates free to decide, at their sole discretion, all other terms and conditions.

Thus, without further ado, reserved activities were privatized, and PDVSA and its affiliates assumed full control over the assigned areas. By 2005, there were 32 operating services agreements producing around 500 thousand barrels of oil per day. These agreements covered an area of 43,6 thousand square kilometers and were directly granted by the affiliates without any reference being made in the *Official Gazette*, as was established legal practice. These agreements had a limited term, but were renewable without limitation. Even more, taking advantage of the fact that they were formally not considered producers of oil, all of them would identify themselves in their income tax returns as mere service providers, subject to the non-oil income tax rate of 34%, as opposed to the income tax rate of 67.7% applying to oil producers.

This concept of 'operating services agreements' would also have an effect on the associations. These would also not carry out directly the reserved activities, which would usually be the responsibility of an operating company especially created for this purpose and under the supervision of the partners. Hence, entering into association agreements the reserved activities would also be privatized.

II.2. ASSOCIATION AGREEMENTS: COMMERCIAL INTERNATIONAL ARBITRATION

In 1991, Lagoven presented to the National Congress the first association project aimed at producing and liquefying natural gas (Cristóbal Colón Project). Maraven joined Lagoven in 1993, with two additional association projects, though these concerned the Production and Upgrading of Extra-Heavy Crudes from the Orinoco Oil Belt. These three projects were accompanied by two documents, one making reference to the "Pertinent Circumstances", the other to the "Proposed Conditions". In this way, PDVSA and its affiliates made a preemptive once and for all move with their conditions, which the National Congress would then have to approve as a *sine qua non* requirement.

In accordance with the proposed conditions, Lagoven and Maraven were under no circumstance allowed to have a majority shareholding in the association. Further, they were to guarantee their private partners that they would indemnify them, on "equitable terms", for the adverse economic consequences derived form a "discriminatory treatment" on the part of the State. Any dispute between the partners would be solved by international arbitration in accordance with the rules of the International Chamber of Commerce (ICC), headquartered in Paris. Moreover, PDVSA would guarantee the strict performance of the obligations assumed by its affiliates. Thus, in the event of an arbitral award favorable to foreign partners, the award could be enforced against crude oil and products stored outside of Venezuela as well as accounts receivable of the refineries which PDVSA had been acquiring through its internationalization policy since 1983. This policy thereby stands as a prelude to the *Oil Opening.*

Without a doubt, the sovereign rights of the State were to be kept in check through its national company making itself subject to international arbitration, albeit one supposedly commercial in nature. And amidst an acute political crisis due to the fall of the government of president Carlos Andrés Pérez, the National Congress approved the proposed framework of conditions.

INCOME TAX

The documents on "Pertinent Circumstances" left no room for doubt that these associations would only materialize if the applicable rate of income tax were the non-oil rate. To this end, the Income Tax Law was reformed in a parallel process by placing the associations for integrated projects, such as for liquefaction of natural gas and upgrading, in the non-oil section of the law. Thus, the applicable tax rate for these projects was to be 34%.

However, from one project to the next, the Framework of Conditions evolved in tune with advances in the Oil Opening policy itself. The next two upgrading projects presented before the National Congress in 1997, actually incorporated references to the non-oil tax rates in their Proposed Conditions. For example, in the last association project, the Cerro Negro Project also promoted by Lagoven, one of the Conditions established that:

> pursuant to... the Income Tax Law in force, THE PARTIES... shall pay taxes under the ordinary regime established in said law for companies and similar entities...

They would definitely pay income tax at the non-oil rate of 34%.

FISCAL REFERENCE VALUE AND VALUE ADDED TAX

These associations, upon their transfer to the non-oil section of the Income Tax Law in 1993, were also taken from the purview of the Fiscal Reference Value. At the same time, a Value Added Tax was enacted for the first time in Venezuela. This tax, by design, is only due in transactions involving national economic entities, and not when exports are at issue. Thus, on the one hand, the tax on oil exports would be eliminated and on the other hand, the tax burden over the domestic economy would increase.

ROYALTY

The “Pertinent Circumstances” informed the National Congress that these associations also sought a temporary reduction in the applicable rate of royalty. From a legal perspective, granting such a reduction was a faculty of the Executive. Sure enough, in 1998, the Ministry of Energy and Mines subscribed a Royalty Agreement with PDVSA applicable to the upgrading projects. The royalty rate would be reduced to 1% as soon as the upgrader would start operating, for a maximum of nine years. Thereafter, the statutory rate of one sixth would be reinstated, but this rate was now arbitrarily described as "the maximum presently permitted by the Hydrocarbons Law". In fact, the royalty rate had traditionally been a bidding parameter, meaning that much higher rates had been obtained in the past. But now, PDVSA was already preparing a reform to the Hydrocarbons Law which would have set a statutory maximum royalty rate of 5%.

CERRO NEGRO PROJECT

We shall next analyze the progress of the Oil Opening by reviewing in greater detail the Cerro Negro project. This was the last of the four upgrading projects to be authorized, and it would set the standard that the previous three upgrading projects would intend to emulate.

The documentation presented to the National Congress, which failed to make the required reference to 'pertinent circumstances’, established that the project was to derive an additional benefit from "Development Production". This would allow it to have all of the necessary production capacity in place by the time the upgrader got started. In the meantime, the development production was to be blended with a lighter crude oil that Lagoven would provide and the resulting blend would be sold for the benefit of the partners. Then, the project would produce, and upgrade, 120 thousand barrels per day of extra-heavy crude for 35 years. All of this would require an area of 295 square kilometers within the Cerro Negro area assigned to Lagoven.

As was the case in 1993, the framework of conditions approved contained not a single numerical figure, be it with reference to the area or to the volumes to be produced. However, in 1993, the authorization made still reference to the "Report Presented by the Bi-Cameral Commission for the Study of the Associations", which expressly summarized these "Pertinent Circumstances".

In contrast, in 1997 the National Congress was to approve first of all the framework of conditions, with the disclaimer that "the Bi-Cameral Commission for Energy and Mines of the Congress of the Republic has carried out a detailed analysis of the Framework of Conditions". Thereafter, the National Executive would send the association agreement to be signed to the National Congress, requesting confirmation that it was consistent with the approved framework of conditions and that, therefore, it would be authorized. That is to say, rather than summing up the 'pertinent circumstances' as it was legally required to do, the Executive would now overwhelm Congress with a document of hundreds of pages, drafted by groups of experts. In turn, Congress would no longer discuss the Project. Its role would be limited instead to approving the framework of conditions proposed by PDVSA and its affiliates. In other words, the association agreement would only have to comply with this framework rather than the specific 'pertinent circumstances' they were legally required to detail.

Nevertheless, the Bi-Cameral Commission, after having supposedly "carried out a detailed analysis of the Framework of Conditions ... having demonstrated that ... it is in compliance with the approved Framework of Conditions", recommended to the National Congress to grant the requested authorization, and something more: it also recommended to authorize "the execution of the association <u>and its annexes</u>". (Emphasis added)

Furthermore, even though the framework of conditions stipulated that the maximum duration of the association, counted from the day the first commercial cargo of upgraded crude was dispatched, would be 45 years, the association agreement established that "in the event of a change in Venezuelan law permitting this Agreement to have an indefinite term, the term of the Agreement shall automatically be extended until the depletion of the Designated Area".

Moreover, once the construction of an upgrader with 120 thousand barrels per day of processing capacity had been completed, "one or more of the Parties may, without requiring a unanimous decision by the Parties or the Board, contribute additional funds to the Project in order to increase the capacity of the Upgrader or to increase the production of Extra-Heavy Oil". In other words, such an expansion could happen without any participation by Lagoven and, needless to say, without any further authorization being required.

Finally, the 'Designated Area' was defined through the association agreement, specifically making reference to a one-page attachment delineating a block of 295 square kilometers within the Cerro Negro area assigned to Lagoven. This area would be the subject to the "Reservation and Dedication Agreement of the same date as this Agreement", which was not annexed to the association agreement delivered to the National Congress. In this Reservation and Dedication Agreement, the 'designated area' was identified as the *initial* area, and gave the partners the right to expand it by incorporating adjacent areas. In effect, the association agreement gave the partners rights over the whole of the Cerro Negro area under the control of Lagoven, amounting to 2,7 thousand square kilometers of the richest part of the Orinoco Oil Belt with proven reserves in the order of 12 billion barrels of extra-heavy oil. It goes without saying, this Reservation Agreement was also subject to international arbitration before the International Chamber of Commerce.

Last but not least, the association agreement stipulated that, if more than 50% of Lagoven were to be privatized, or the participation of Lagoven in the association were to be reduced below 12.5%, the affiliate would no longer be obliged to indemnify the private parties. But the reduction in PDVSA's shareholding in Lagoven, or in Lagoven's shareholding in the Cerro Negro Association Agreement, would require the consent in writing of its main partner, Mobil (today ExxonMobil). We can take it for granted that, before consenting to any such reduction in PDVSA's or Lagoven's shareholding, Mobil would demand the State to assume directly the obligation of paying those indemnities.

III. ARBITRATED SOVEREIGNTY

Sovereignty is conceptually a territorial concept: a sovereign Nation State is defined by the control that it projects over a given territory and all of its constituent parts. However, PDVSA and its affiliates agreed with the private investors to neutralize, albeit within certain limits, the exercise of such sovereignty. Furthermore, all of the approved frameworks of conditions established, misleadingly, that the guarantees that PDVSA and its affiliates might see fit to grant would not thereby commit the State and the exercise of its sovereign prerogatives.

In fact, between 1991 and 1993, in a process parallel to the authorization of the Cristóbal Colón Project, the government was negotiating the *Agreement on encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Republic of Venezuela.* This agreement was approved by the National Congress in August 1993, and immediately ratified by Interim President Ramón J. Velázquez. This was the first bilateral investment treaty ever ratified by Venezuela. Both the signatory governments offered, unilaterally and irrevocably, to the investors, nationals of the other signatory, the option to resort to arbitration under the jurisdiction of the World Bank's International Centre for the Settlement of Investment Disputes (ICSID), headquartered in Washington, and thereby subjecting themselves to an arbitrated sovereignty in a forum created by investors. The national investors from the other contracting state would only have to send a letter to the respective Attorney General, informing that they would accept the offer of the government to arbitrate. In the treaty, the definition of what constituted an investment, included:

> rights granted under public law, including rights to prospect, explore, extract, and win natural resources.

It was accepted, then, that the exercise of primordial sovereign rights by the State in reference to the national territory or any of its components, could be submitted to ICSID arbitration by Dutch investors as a simple investment dispute. Both parties would nominate their respective arbitrators and jointly designate a third arbitrator; absent an agreement, the latter would be designated by the president of the World Bank. It was only about defending the rights of foreign investors. These bilateral investment treaties typically fail to even mention the interests of the *territorial* State in its capacity as ultimate owner of all natural resources.

Moreover, the definition of a “Dutch investor” depended on Dutch legislation. Pursuant to that legislation, it sufficed to have somewhere in the corporate chain, between the parent company and the investing company in Venezuela, a Dutch company with a post office box in the Netherlands, serviced by some lawyer and subject to minimal taxation. Thus, in Venezuela, not only Royal Dutch Shell qualified as a ‘Dutch investor’ but also Chevron (USA), CNPC (Popular Republic of China), ConocoPhillips (USA), ENI (Italy), ExxonMobil (USA) and Statoil (Norway), among others.

Between 1993 and 1998, Venezuela signed, approved and ratified a dozen bilateral investment treaties of this kind.

As things turned out, international petroleum prices collapsed in 1998, in no small part due to the reckless expansion of production on the part of PDVSA and its affiliates, as well as their steadfast refusal to cooperate with the OPEC quota system. International ground rent in oil, on a per capita basis, reached its lowest point since 1933 (exception made of the years of the Second World War, when German submarines obstructed Venezuela’s exports). This low point was the appropriate moment to take the next step implementing Oil Opening. In 1999 Venezuela enacted the *Law for the Protection and Promotion of Investment.* This law created the legal possibility that the government would directly assume fiscal stability guarantees.

Moreover, the new Bolivarian Constitution promulgated in December of the same year confirmed in Article 302 that “the State reserves for itself ... [all] petroleum activity”; and Article 303 specified that “the State is to conserve the totality of the shares of Petróleos de Venezuela, S.A.”, that is to say, of the ultimate parent: a holding company that never produces a single barrel of oil, conceived as a regulatory entity of the regime of reserved activities. In sharp contrast, shares of the affiliates, which do produce petroleum, would be open to being privatized, because the Constitutional phrase cited above was followed by this rider: “exception made of the affiliates, associations ... enterprises and any other which has been constituted or will be constituted as a consequence of the development of the businesses of Petróleos de Venezuela, S.A."

Between 1999 and 2008, Venezuela would go on to sign, approve and ratify another dozen bilateral investment treaties.

III.1. CONCLUSIONS

PDVSA assumed the role of guarantor of a limited fiscal stability, thereby neutralizing the effects which might be derived from the exercise on the part of the State of its sovereign prerogatives, at least to a point. Under this arrangement, the foreign investors dodged the thankless task of having to ask the State itself to limit the exercise of its sovereignty by subjecting it to international arbitration. Such a request would have provoked a major political discussion, and the very purpose of interposing PDVSA between the State and the foreign investors was to prevent such a thing from happening. Years later, PDVSA and its affiliates – and no longer the foreign investors – would predictably request that the State shoulder their obligations, adducing circumstantially convenient arguments in favor of their progressive privatization. Such was the scenario that was being prepared in 1999.

In hindsight, it is evident that the regime of reserved activities was handled by PDVSA and its affiliates in such a way as to pave the way for the complete re-privatization of such activities. Further, by subjecting the sovereign right of the State to international arbitration in forums created by the process of globalization of capital, PDVSA and its affiliates were to serve as *catalysts* in this transformation; and PDVSA would ultimately be reduced to its function as the new seat of regulatory power over the sector.

IV. PETROLEUM EXPORTS AND INTERNATIONAL GROUND RENT

But Hugo Chávez triumphed in the elections held in December 1998. Nevertheless, with oil fiscal income at its lowest, PDVSA thought that it would still be able to control the situation. However, as the new government reestablished the cooperation with OPEC and national production cut back accordingly, prices soon began to recover. In November 2001, the government enacted a new *Organic Law of Hydrocarbons*, repealing both the 1975 Nationalization Law and the 1967 Hydrocarbons Law. The statutory royalty rate was increased to 30%, though at the same time, the Income Tax Law was reformed to reduce the rate applicable to the oil sector to 50%.

Needless to say, the *Organic Law of Hydrocarbons* was immediately applicable only to PDVSA and its affiliates. But there was no doubt that oil as a source of an international ground rent was making a comeback, which was totally unacceptable for PDVSA and its affiliates. They therefore took part in a failed military *coup d'état* in April 2002. PDVSA then turned from the military to economics, launching an economic *coup d'état* in December 2002 by having its tankers blockade the ports of export and calling the whole industry to an unlimited work stoppage. But this coup would also fail. Finally, in August 2004, the political opposition resorted to a *presidential recall referendum*, which ultimately ended with the victory of President Chávez. It had taken five years for President Chávez to consolidate his electoral victory of December 1998.

In October 2004, the government put an end to the 1% royalty rate that had been granted to the four upgrading associations (which at the time were producing around 600 thousand barrels of extra heavy crude oil per day), reestablishing the usual rate of one sixth. Later, in 2005, the government declared that those 32 operating services agreements were actually illegal given that they were producing oil without having been authorized to do so by the National Congress. But Venezuela offered them a way out: migration to the new *Organic Law of Hydrocarbons*, being transformed into mixed enterprises. Needless to say, these new mixed enterprises would be subject to exclusive national jurisdiction. The corresponding negotiations concluded in March 2006. They would have a term of 20 years, pay a royalty of one third and, of course, be subject to the oil income tax rate of 50%. CVP – reactivated in 1995 as a special purpose affiliate – would hold at least 60% of the shares. Only two companies did not accept migration: Total and ENI. But these companies reached an amicable settlement in terms of the compensation they were entitled.

In May 2006, given the sustained rise in prices, the government reformed the Organic Law of

Hydrocarbons introducing an extraction tax equivalent to another royalty of one sixth, but limiting the total due to one third. Consequently, all the producers of petroleum would henceforth pay the same effective royalty rate of one third.

However, the government did not declare association agreements to be illegal as they had been duly authorized by the National Congress. Therefore, they continued to be governed by the 1975 Nationalization Law and the 1967 Hydrocarbons Law. Nevertheless, the government never ceased to point out that all of the association agreements had serious legal flaws, specifically failing the requirements of either the Nationalization Law or the Hydrocarbons Law. Thus, in 2005, the government started negotiations with the associations over their *voluntary* migration to the new *Organic Law of Hydrocarbons*. These negotiations failed and therefore, in early 2007, the government announced their obligatory migration. The corresponding negotiations would conclude in June 2007 and, generally speaking, the resulting mixed enterprises would follow the same patterns already established by the recently created mixed enterprises.

These negotiations reached a successful conclusion. However, two companies, ConocoPhillips and ExxonMobil, not only refused to migrate but were not interested either in reaching an agreement with the government on the compensation due. They chose instead to resort to international arbitration in an attempt to get arbitration tribunals to confer upon them rights that they did not in fact hold.

IV.1. INTERNATIONAL ARBITRATIONS

Let us concentrate once again on the Cerro Negro Association Agreement. Lagoven and ExxonMobil each hold 41 2/3% of the shares, and Veba (a German company, later acquired by British Petroleum) the remaining 16 2/3%. Authorized production was 120 thousand barrels per day. Based on the corresponding framework of conditions, certain 'discriminatory measures' taken by the national government would give rise to the payment of compensation from Lagoven or PDVSA. However, this framework also established that this would apply only up to a certain price level, to be determined by the partners themselves in the association agreement. The partners set this price level by referring to the price of North Sea Brent Blend; the threshold price would be US$27 per barrel in 1996 dollars, to be adjusted by the implied US Gross Domestic Product deflator. That is to say, if profits could be attributed to a price level higher than this, the government would be free to tax them away without thereby triggering any obligation on the part of Lagoven or PDVSA to pay compensation. However, for that to be true, two conditions had to be met: (1) the price had to exceed the threshold price as defined for a continuous, *uninterrupted*, six-month period; and (2) the average of the realized prices exceeded the threshold price during the fiscal year.

In other words, based on the threshold price, the profit space was divided into two. At lower price levels, Lagoven guaranteed its private partners a degree of fiscal stability such that the profit levels that they would be able to realize would depend, on the one hand, on the usual variations in market prices and, on the other hand, on their own performance. But beyond this level, it was assumed that returns would be in windfall profit territory due to the scarcity of the natural resource and not to any entrepreneurial initiative and, hence, the Venezuelan State, as the owner of the natural resource, would be free to tax the windfall away.

The threshold price determined by the partners was exceedingly high and it looked very improbable that it would ever be met in reality. Nevertheless, this was exactly what happened beginning in 2005; in fact, for a couple of years, the market price was more than double the threshold price, and President Chávez did not hesitate to tax the corresponding windfall profits.

But ExxonMobil filed for arbitration before the International Center for the Settlement of Investment Disputes against the Bolivarian Republic of Venezuela on the basis of the bilateral investment treaty with The Netherlands. As we have already pointed out, this treaty did not mention that the *territorial* State might have an interest in taxing away these windfall profits in the form of an international ground rent. (In fact, none of these treaties does).

And now ExxonMobil argued that the limits on compensation set out in the association agreement would only apply in favor of Lagoven and PDVSA, but not in favor of the Republic, as the Dutch treaty did not contemplate such limitations. Conversely, Venezuela highlighted that, pursuant to this treaty, the compensation due had to be determined on the basis of the hypothetic market value of the association agreement; and the limitations established within it would obviously have full incidence on its market value. In general, a bilateral investment treaty grants rights to foreign investors in terms of the legal options that they can resort to in defense of their property rights, but these property rights are defined by domestic law. Despite this, the arbitration tribunal, in its final award dated October 2014, sided with ExxonMobil and rejected the arguments based upon the limitations on compensation provided for in the association agreement. Put another way, the Republic would have no right to reserve a sovereign space for an international ground rent.

Compensation due was determined to be 1.4 billion dollars plus interest counted from the date of expropriation (June 2007). In contrast, in the arbitration that ExxonMobil filed against PDVSA before the International Chamber of Commerce, the final award of December 2011 (taking into consideration the aforesaid limitations) had come to a figure that was less than half that amount (with the proper adjustments made for the differences in effective dates).

For the Republic, this result was wholly unacceptable, above all for a *qualitative* reason, as it was predicated on the notion that a bilateral investment treaty might create property rights over and above those originally granted under national law. Venezuela therefore initiated annulment proceedings before the International Centre for the Settlement of Investment Disputes. Such a procedure involves an *ad hoc* committee of three arbitrators, all designated by ICSID, and none by the parties. It is for this reason that this procedure is typically an uphill struggle rarely crowned with success. Nevertheless, Venezuela took the decision to pursue an annulment because a fundamental principle was at stake. In its decision of March 2017, the Committee accepted the arguments of the Republic, and annulled the 1.4 billion dollars in compensation.

As far as ConocoPhillips – partner in two upgrading association agreements – is concerned, the corresponding arbitrations before the International Chamber of Commerce against PDVSA and its respective affiliates, and before the International Center for the Settlement of Investment Disputes against the Republic, are ongoing, and no final award has yet been rendered. In the case of the arbitration that ConocoPhillips started against the Republic before ICSID, the arbitrator designated by Venezuela had to resign his appointment on grounds of ill health. The arbitrators appointed by ConocoPhillips and ICSID agreed to reject his resignation and thereby denied Venezuela the right to appoint a new arbitrator and, instead, ICSID would nominate one. Hence, even the pretense of an arbitration is not being respected: the acceptance of the Republic to be bound by the result of a supposedly neutral proceedings is now incarnated in an arbitrator in whose designation Venezuela had no say whatsoever.

V. DOMESTIC MARKET FOR HYDROCARBONS AND TAXES

The prices for hydrocarbons in the domestic market and in the export market are *qualitatively* different. As far as the former are concerned, governments have always been keen on keeping these prices low, whereas in the export market there has always been an interest keeping them high. This qualitative difference is determined by the international ground rent, which once again reached a historic peak towards the end of the first decade of the 21st century. Furthermore, with the subsequent collapse in the exchange rate of the bolivar, the refinery gate prices of the main petroleum products – automotive fuels – actually became negative, meaning the quantitative difference grew to the widest amount ever. This has given rise to massive smuggling, largely waterborne. The resulting losses to the country can be prudently estimated at US$ 2,000,000,000 per year.

There have been proposals to increase domestic prices to parity with international price levels based on the relevant exchange rates. This would not only bring smuggling to an immediate end but would also mean that Venezuela would stop losing two billion dollars on account of not being paid the corresponding international ground rent. This amount would actually be collected at the refinery gate. Furthermore, it would then be possible to eliminate value added tax, a tax created in the context of the Oil Opening and which is much more expensive to collect.

However, such proposals must face an incontrovertible reality: national consumers do not pay for the national natural resource, because they are the owners. The fact is that notwithstanding the actual realized price that they might pay at the pump, they will never be paying for the natural resource. But they will always pay, whether directly or indirectly, the cost of production. Whatever is paid over and above, or below, such costs, or below are simply taxes, or subsidies.

VI. SOWING THE OIL

The emergence of oil on the stage of history goes hand in hand with the development of capitalism and its technological advances. At the beginning of the 20th Century, petroleum was already a significant figure per unit of the world's Gross Domestic Product, and which would globally grow quickly until well into the 1970s.

With the emergence of petroleum as a major global industry, there also enters the historical stage a new form of ground rent: a ground rent that is international in character, as opposed to national as had been the case until then. The *national* property over the natural resource would now have effects and consequences from the international petroleum market and towards the *territorial* nation states. Venezuela, historically, will henceforth be a case of exceptional significance.

Venezuelan society in the early days of the 20th century was a very backward country. Its population was almost entirely rural, its agriculture was very primitive, and its productive infrastructure was sparse at best. This situation was to be radically transformed in a matter of decades. All of this was possible, of course, on account of oil, both the activities dedicated to its extraction and as a source of an international ground rent.

VI.1. OIL: BASES OF THE VENEZUELAN NATIONAL PROJECT

The principle that the financial resources arising from oil and its property were to be the foundation for national development was established early on. The beginnings would witness the flow into the country of immense resources to set up the industry; in comparison to the nationally generated income at the time, the investment was enormous. Then followed the rising and incessant claim of the State, as the natural resource owner, of an international ground rent. Together, both entailed decisive social facts for national development, such as the constitution of a nationwide labor market, the physical integration of the country and the establishment of a sole political authority over the national territory, as well as the institutionalization of both private and public management and administrative practice.

From an economic viewpoint, the fact that international ground rent, derived from the export of the natural resource, is by itself a license for importing goods and services from the international market and given its sheer magnitude, the economic growth of commerce, finance and public services would lead the modernization of the economy. Obviously, industrial development would lag behind. But over six decades, Venezuela exhibited continuous and sustained rates of per capita growth well in excess of those of its neighbors. This was the result of the oil being sown.

From another angle, half of Venezuela's population was already urban by 1960, and a sizable proportion of the population were immigrants, which translated into significant skills and capabilities Venezuela received from the international market.

The economic development of the six previous decades, towards the end of the 1970s, would undergo an historically novel experience: first the halting of per capita growth and then its fall. At the same time, the historically extraordinary stability of the Bolívar came abruptly to an end. So the economic progression underwent then a historical rupture of sorts. The subsequent decades, leaving aside short-lived expansions and booms, would be characterized by contractions and busts. The astonishing continuity of the sowing of oil had ended up in a new state of affairs.

VI.2. SOCIAL DEVELOPMENT

Both the exceptional conditions of an economy in which the continuous presence of an international ground rent, as well as the exceptional value of Venezuela's already centenary experience, allow and demand the assessment of certain elements of judgment with a view to what will have to be the stimulus and promotion of national development in the years to come.

First. It is imperative to have in place an accounting system by means of which the amounts of international oil ground rent will be made manifest. Venezuela requires a bespoke national accounting in which the explicit presence of an international ground rent is at the center of the stage. The current and official National Accounts simply ignore the fact that Venezuela is an oil country; that is to say, a country where an international ground rent in oil is of extraordinary economic importance.

Second. The trove of experience that the historical course of the Venezuelan economy offers allows us to say that the harnessing of an international ground rent in oil, for future national development requires these revenues be put to uses which primarily involve public sector consumption; that is to say, the creation and upkeep of an infrastructure underpinning the welfare and quality of life of all Venezuelans.

Third. Consequently, the use of the international ground rent in oil must have as its purpose social development rather than economic growth. This latter objective should be left to other forces in the country which propel the expansion of material economic life.

VII. POLITICAL CONCLUSIONS

The Chávez government began when the prices of petroleum were at their minimum. It immediately grappled with the corresponding international challenge, with notable success. It also encountered, of course, the resistance of PDVSA and its affiliates. President Chávez, however, was determined to confront them and subordinate them to his governments' policies, as well as to assume his role as main representative of the shareholder State. The clashes from December 2002 to February 2003 ended with the definitive exclusion of about 40% of the oil industry's work force which had participated in the intent to topple President Chávez. This included the overwhelming majority of the upper management, but also a large proportion of white collar workers. The workers in the fields, in contrast, did not participate. Without doubt, this put an end to the 'old PDVSA', but at the price of a very significant loss of human capital.

That was but the beginning of a confrontation with the political opposition that spread to a national level. The Chávez government responded to the blows and counterattacked of its own accord. It dislodged the opposition forces from their traditional power strongholds, both in public administration and in the national economy. Later on, with the oil bonanza beginning in 2004, Venezuela went headfirst into a nationalization program involving a diversity of economic activities. At the same time, though, it dedicated the majority of this bonanza to consumption, with emphasis on the least advantaged sectors of society. However, the Chávez government also indebted the country once again when oil prices were reaching a new historical maximum, well above – in real terms – of the levels reached around the year 1980; even on a per capita basis, international ground rent was somewhat higher than in those earlier years despite the increase in population and lower levels of export.

But as political divisions in the country were deepening, there was a continuous loss of both human capital and managerial capacity in both the public sector and in the economy at large. Oil prices in 2013, when President Chávez passed away, were still at historically high levels. Since 2013, however, those prices began to fall, albeit not to the disastrous lows of 1998.

Currently, oil prices in real terms maintain levels well above the threshold price which both ExxonMobil and Lagoven had been considering, in 1997, as very high.

Nevertheless, the country finds itself, in these final years of its first centenary as an oil exporter, in a most profound crisis affecting every dimension of its existence as a Nation and, perhaps more importantly, amidst a profound political division. Those who promoted the Oil Opening, from within but also from outside the petroleum industry, with the dismantling of our legal, political and economic structures, are today openly calling for armed foreign intervention.

FOR NATIONAL UNITY

Modern Venezuela, throughout the duration of the concessionary regime, structured itself around petroleum as a natural resource and stood united confronting the international oil companies, claiming an international ground rent. After the nationalization of Venezuela's oil industry this unity became the object of systematic attacks by the international oil interests. They would not attack the claim for an international ground rent at its origin, the national ownership of the natural resource. Rather, the international oil companies and the governments of the consuming countries would attack indirectly, questioning its use. Neoliberal concepts imposed themselves ideologically with the customary point of view of the country's 'Right'; namely, that it is only through its productive investment that an international ground rent can be legitimized, even if *ex post*, and even in full knowledge that this was objectively impossible. But its failure would then be explained subjectively, citing the multiple defects of the prevailing political regime, ranging from 'the incompetence of the public administration' to 'populism' and 'corruption', all the way to what is supposedly inherent to any state intervention. Then, petroleum policy itself would come under attack with the Oil Opening, which was to progress in the same measure that the sowing of the oil failed.

From 1999 onwards, President Hugo Chávez tackled the dismantling of national petroleum policy and unmasked the Oil Opening as a 'policy of the Right'. However, it was something more than merely a 'policy of the Right'. Indeed, PDVSA and its affiliates were committed to an anti-national policy. The actions of the new political regime were limited in essence to rescuing the international ground rent in oil. Moreover, this occurred amidst favorable circumstances, as the price crash of 1998 turned out to be a temporary market fluctuation, and in no way changed the fundamental truth of an historically rising scarcity of hydrocarbons worldwide. However, no new petroleum regime emerged, as demonstrated by the evolution of pertinent legislation and, in particular, the continuity as regards new bilateral investment treaties. The structure of the old regime of reserved activities is still standing.

The division of the country continued to deepen, supposedly in accordance with a dividing line between 'Right' and 'Left'. But petroleum policy is essentially *national* in character, as it arises from the *national* public ownership of hydrocarbons. The division between 'Right' and 'Left', in contrast, applies to the sowing of the oil: a distribution of the international ground rent in a way that is more, or less, favorable to the interests of one, or another, social class. During the period of the concessionary regime, these two forces faced off against one another and generated a sufficiently balanced equilibrium so as to make possible the extraordinary success of the sowing of the oil. From 1999 onwards, the promoter of the oil opening wanted to demonstrate that, after the ‘Right’, the ‘Left’ would fail too, and this was *prima facie* evidence of the alleged impossibility of sowing the oil. Therefore, this would be the best moment to impose the Oil Opening once and for all, with all of its practical and ideological extensions.

So the fundamental conclusion that follows from our experience throughout our first century as an oil exporting country is that, above everything else, we must defend national unity. The forces that actively promoted the Oil Opening, both within and outside PDVSA, divided the country, but they only represent a very small – albeit still powerful – proportion of the political spectrum. These dividing forces must be isolated. The vast majority of the people are located within that space between ‘Left’ and ‘Right’, quite apart from the situations of confusion that we have experienced. This overwhelming majority, above all, wants a political leadership, allowing them to continue to work and prosper in Venezuela, with Venezuela, and for Venezuela. The starting point for national reunification must be our petroleum policy, because it is that policy that has unified us historically, and which must continue to unify us. Far from being the apple of discord, as it is sometimes portrayed, petroleum is economically the most important component of the national territory that unites us all.

The creation of an institutional platform which incorporates such reflections has to be the outcome of a national debate because it involves something which touches upon all sectors of our society. It is only by having such a platform on hand that we will be able to tackle the very grave problems that face us in the short term. This platform will have to define the policy guidelines that need to be followed, and thus to guarantee the possibility of continuing, strengthening and institutionalizing the transformation started by President Hugo Chávez.

26 November 2017

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