Harvard University-Kennedy School of Government

# Investor-State Relations in the Chavez Age

## The Nature of Resource Nationalism in the 21st Century

**Justin Dargin**

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# 1.0 Introduction: Venezuela's History of Resource Nationalism

Venezuela has a long and rich history of being at the forefront of revolutionary politics: after all this was the land from which the great liberator, Simon Bolivar, sprang forth. Venezuela understands well the art of revolutionary politics, being one of the founding members of the Organization of Petroleum Exporting Countries (OPEC) in 1960.

Inflammatory rhetoric encouraging the overthrow of the Washington Consensus and the neoliberal economic order are not unique to Venezuela's current president, Hugo Chavez. The animosity against liberal Western economic policies have emanated before, as epitomized by Venezuelan President Carlos Andres Perez (1974-1979), who announced at the UN General Assembly on November 16, 1976 that, "[A] new economic order is essential for world peace." [1] Indeed, President Perez (nicknamed Simonsito-Little Simon Bolivar), foresaw a Bolivarian mandate to overturn the Bretton Woods economic system that had prevailed since the end of World War Two. [2]

Perez's vision of the New International Economic Order inspired a host of maneuvers during the 1970s, when developing nations sought to promote their economic interests by improving the prevalent terms of trade, urging developed countries to reduce their tariffs for primary products, and demanding increased international aid.[3]

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[1] Markos Mamalakis, *The New International Economic Order: Centerpiece Venezuela,* Journal of Interamerican Studies and World Affairs, Vol. 20, No. 3. (1978) pp. 265-295.

[2] The Bretton Woods Economic system established the rules for financial and commercial relations among the World's advanced states during in aftermath of World War Two. *See* John Williamson, *The End of the Great Boom and the Breakdown of Bretton Woods: Was it a Coincidence? On the System in Bretton Woods*, The American Economic Review, Vol. 75, No. 2, Papers and Proceedings of the Ninety-Seventh Annual Meeting of the American Economic Association (May, 1985), pp. 74-79.

[3] The term, The New International Economic Order (NIEO), was derived from the *Declaration for the Establishment of a New International Economic Order*, adopted by the United Nations General Assembly in 1974. The NIEO referred to a wide range of trade, financial, commodity, and debt-related issues between the industrialized

Much more recently, Venezuela appeared prominently in the global press for its actions concerning, not just Hugo Chavez's publicly stated goal of pursuing his "Bolivarian Revolution," but for the full scale nationalization of equity holdings of foreign international oil companies (IOC).[4] To return the Venezuelan State to the commanding heights of the economy, the Chavez administration advanced strategies against the IOCs that included: 1) An increased royalty/tax regime; 2) Expropriation of equity shares in various ventures; 3) The reverse of the liberalization policies promoted in the 1990s; 4) Utilization of its oil wealth as leverage to support anti-Western politicians in Latin America and abroad.

This paper analyzes the background of the legal strategies that the Chavez administration pursued in the energy sector since his first term in 1999, it also will project the Chavez administration's energy-sector objectives from the mid to long-term, as well as determine the future trade and political matrix that IOCs may plausibly anticipate in that market.

Section One provides an overview of the intellectual contours of resource nationalism and provides examples of methods many resource-rich developing countries employed to overcome economic underdevelopment by utilization of their natural resources to foster industrialization.

Section Two discusses the history of Venezuela's energy sector, and details the origin of the Chavez administration's discontent with the preceding administration's policy of energy sector liberalization and privatization.

Section Three analyzes the legal and administrative steps that the Chavez administration undertook to regain strategic control of the Venezuelan energy sector. In particular, this section focuses on the three pillars of Venezuela's strategy: the implementation of a windfall profit taxation regime; a campaign to regain taxes that the IOCs owed to the central government; and a

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countries and the developing nations. The United Nations, *United Nations Documents*, A/RES/S-6/3201 (May 1, 1974)

[4] The "Bolivarian revolution" reflects President Chavez's efforts to yoke Venezuela's massive oil wealth his economic restricting program. Anabil Romero, a political scientist at Simon Bolivar University in Caracas, contended that, "[C]hávez is dead set on his revolution; there's no turning back, the question is how fast and how far." *Chavez's Oil-Fuelled Revolution*, Business Week, Oct. 10, 2005.

royalty rate increase. All three actions set the stage for the eventual expropriation of IOC investments in Venezuela's Orinoco Belt.

Section Four explains how the Chavez administration implemented its expropriation drive through Presidential Decree No. 5200, which mandated that IOCs operating in the Orinoco Belt reform their equity structures to grant the Venezuelan national oil company, PDVSA, a majority stake.

Section Five analyzes the reaction of the IOCs that had their investments expropriated, and discusses, in particular, the ramifications of the arbitral and legal actions that Exxon Mobil instituted against PDVSA.

Section Six concludes by discussing the nature of resource nationalism as exemplified by the Chavez Administration, and the cyclical nature of resource nationalism in an era of extreme oil price volatility.

## *1.1 Resource Nationalism and Economic Development*

With the exception of Canada, the US, Russia, Australia and a handful of other countries, most resource-producing or potential-resource producing nations, i.e., host countries, are situated in the developing world. Most host countries were formerly administered by the global North, as colonies, semi-colonies, or protectorates. Even Latin America, which obtained its independence from Spain and Portugal in the nineteenth century, (earlier than the rest of the Southern countries, with the notable exception of Haiti) remained dependent on investment from Britain and the United States. Despite political independence, Latin American countries generally retained economic structures that mirrored recently decolonized States.[5]

[5] For Dos Santos, national dependence in all its variants is a concept rooted in economic factors, which is buttressed by technological dependency. Dos Santos argued that if a country or region were dependent on international trade cycles, as opposed to the internal laws of capital accumulation, that country or region was "dependant." Dos Santos distinguished between colonial dependence, which he argued was based upon an alliance of commercial and political interests from the colonial country, exerted on the colonized country, and financial-industrial dependence which he asserted was characterized by expansion abroad through large-scale capital investments in the export sector of an underdeveloped country. Theotonio Dos Santos, "The Structure of Dependence" in (ed) Jorge I. Domínguez, *Latin America's International Relations and their Domestic Consequences: War and Peace, Dependency and Autonomy, Integration and Disintegration* (1994) pp.59-6.

Resource nationalism is an opaque term, and the methods through which developing countries pursue this strategy are difficult to quantify. This difficulty is exacerbated by the fact that economic nationalism has historically been practiced in the parent, or resource consuming, countries that birthed major international oil and gas companies. Traditionally, these companies acquired concessions for hydrocarbon extraction when most oil producing countries were either under the colonial rule or when, as in the case of Latin America, significant underdevelopment induced a state of economic dependence on the developed countries for capital investment and for the purchase of their primary product exports.[6]

Two evolutionary, if not revolutionary, factors prompted the collapse of the traditional global oil market in the 1960s: the rapid decolonization that swept across the world in the post-World War Two epoch, and the collaboration of oil producing countries that collectively challenged the international oil market (i.e., the founding of OPEC in 1960). The move to propel market change included legal - if not extra-legal - tools, such as forced nationalization of the oil assets of the IOCs, increased taxation, and the unilateral contractual change of the concessionary system that then dominated the global energy market.

While the specific manifestations of resource nationalism will be discussed subsequently, the essential premise of this paper is that resource-rich developing regions view the underground resources of a nation as an integral part, *de facto* and *de jure*, of the national territorial lands in which they are found. From their view, the sovereign disposition of such resources is part and parcel of the inalienable right of a people's national self determination. It is, therefore, axiomatic that nations motivated by this form of commercial nationalism would utilize the legal code to exert control over natural resources within their geographical boundaries. A simple, multistage schema can give an overview of the legal precepts forged and constructed to advance the cause of State-directed resource nationalism.

[6] The decolonized states of Latin America were in a process of fragmentation, when by 1850, they experienced increased global demand for their primary products, a revolution in the transportation sector, and an increased availability of credit. This had the net effect of buttressing the process of State formation. State formation in Latin America proceeded quite differently than in Europe, where conquest was wedded to the development of the State. In Latin America, States developed within an international economic architecture, whereby trade and access to credit were of the utmost importance to facilitate economic development. See generally, Stanley J. Stein, *The Colonial Heritage of Latin America: Essays on Economic Dependence in Perspective*, (1970)

The initial drivers in resource nationalism are calls for "autonomy" and "independence," terms that abound with domestic and extra-national significance. Internal and external dynamics compete when the resource-rich nations modify the domestic legal code that governs the oil and gas sector to erect legal or fiscal burdens against perceived domination from without. The change in the State's orientation from passive rent seeking behavior to a more proactive position becomes clear when a new, more stringent taxation regime is introduced, when contracts are unilaterally modified, or when foreign assets are nationalized. The basic sense of autonomy encourages behaviors and policies that appear to assert national control over natural resource development, rather than foreign control.

The second driver in resource nationalism is "formation."[7] The host-nation strives to shape the natural resource sector into a functioning, revenue-rich economic base. Once developed, the natural resource sector drives economic growth and subsequent industrialization into downstream value-added industries, e.g., petrochemicals and refineries. To facilitate this stage, the host-nation promulgates regulations that promote its own national oil companies, indigenization of the labor force, technology transfer, and local content specifications. The ultimate purpose of these legal maneuvers is to escape the constraints that Wallerstein termed the economic "periphery," the status to which developing nations were relegated by virtue of being mere primary product exporters that lacked an industrial base.[8]

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7 Yoichi Itagaki, *Economic Nationalism and the Problem of Natural Resources*, The Developing Economies Journa, Vol.11, No.3, 233 (Sept. 1973).

8 Immanuel Wallerstein divided the world into three main economic zones, the core, the semi-periphery and the periphery. Wallerstein argued that the core countries, basically synonymous with the developed West, are those countries that benefited most from the capitalist world economy. According to Wallerstein, the core States first emerged from the feudalistic Middle Ages to develop the modern nation states based on nascent industrial production. Wallerstein asserted that the growth in geopolitical power of these States later led them to colonize the developing world and enfold them into the capitalist system as subordinates. The periphery was the other side of the continuum. These were historically states that had been dominated by other states or lacked a strong central government. These nations typically were colonized by the developed countries during the 15$^{th}$ -20$^{th}$ centuries. In Wallerstein's hierarchy, the semi-periphery was an area that served as a buffer between the core and the periphery. The semi- peripheral countries were those that are industrializing, and had organizational characteristics of both the core (Northern) and peripheral (Southern) countries. The semi-periphery countries were known under a variety of different names, such as newly industrializing countries (NICs) or in contemporary parlance, they are known as developing countries, e.g., South Korea, the Gulf countries, Mexico and China.

Many of these countries were viewed as declining core countries that came under the economic domination of other powerful developed countries. Specific regions in the core can also decline. For a concise reprisal of

German economist, Friedrich List, credited as the intellectual father of economic nationalism, explained that the main problem for the "late industrializers," i.e., countries that attempted to industrialize after Great Britain in the nineteenth century, was to have embarked upon global economic competition severely hampered. According to List, late industrializers were severely hampered because their technology deficiency required them to develop their infant industrial base by strong protective tariffs and by the imposition of a legal-regulatory regime that discouraged foreign imports from flooding the domestic market.[9] List was a fierce detractor from Adam Smith's free trade principles, with the contention that Smith's scheme benefited the wealthy and advanced nations, but impoverished the weaker ones.[10] List urged that a country build its infant industrial base by channeling its natural resources to the domestic sector, rather than to the international market, and by instituting high import barriers and forming a legal shield against a flood of inexpensive foreign products.[11]

List's detailed study considered the US, Germany, Italy and France, each of which was initially disadvantaged in the international trading system by Great Britain's relative trade and military hegemony during the nineteenth century. The U.S., Germany and the other underdeveloped nations of Western Europe constructed an integrated national economy that relied on protective tariff systems to develop the respective domestic industries. Each of these Western European countries and the US achieved economic self-sufficiency along the framework of List's theory, and eventually formed the core of the developed world.

After emerging from the shadow of colonialism, many developing nations attempted to institute the classic Listian prescription, or some derivation thereof, to spur industrial

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Wallerstein's main thesis, see Immanuel Wallerstein, *The Modern World System: Capitalist Agriculture and the Origins of the European World-Economy in the Sixteenth Century*, 229-33 (1976)

9 See generally, Friedrich List, et al, *National system of political economy* (trans. George-Auguste Matile, Henri Richelot) (1856)

10 When List came arrived in the U.S. as a political exile in 1824, he plunged himself into the raging debates of how American industrialization could best be fostered. List gained national fame as an ardent defender of the "American System," which called for high tariffs to protect the nascent American industry from British manufactured imports. Leonard Gomes, *The Economics and Ideology of Free Trade: a Historical Review*, 73-89 (2003)

11 Bolivia, under the Morales administration, is attempting to foster internal consumption to drive economic growth, instead of depending upon commodity dependence from the international market. However, there are serious doubts as to whether Bolivia, the poorest country in South America, will be successful in this policy. Naomi Mapstone, et al, *Bolivia Rejects 'Savage Capitalism'*, Financial Times, Dec. 5, 2009.

development and utilize their often prodigious natural resources without foreign assistance. In accordance with List's teachings, the legal regimes that sprouted up in developing nations during the 1960s decolonization movements either severely restricted or limited foreign involvement in "strategic sectors," especially with regard to natural resources. Another approach involved import-substitution industrialization, with the stated aims to ostensibly reduce foreign dependency and favor local production of manufactured goods.[12]

However, the Listian approach, which was successful for the advancement of Western European economies, failed to yield similar rewards in today's developing nations.[13] As former colonies of Western Europe, these nations struggle under entirely different burdens than the Western European late industrializers. The handicap of being a former colony permeates all facets of the developing nation's economic framework. However, that handicap relates primarily to the "dual economy" that endured as part of the colonial legacy. The dual economy concept was first recognized by Dutch Economist J.H. Boeke, who concluded that the internal commerce of the developing countries consisted of bifurcated economies, in which one sector is oriented toward local demands, and the other, toward the demands of the international export market. [14]

During the colonial stage, development resulted from technology, capital, and skills transferred from the mother country, which bolstered those economic sectors that were intimately bound the colonial nation to Europe's metropolitan countries, but, simultaneously, segregated them from the local economy.[15] Burdened with this commercial heritage, the former

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[12] Import-substitution industrialization was conceptually promoted by such structural economists as Raul Prebisch, Hans Singer and Celso Furtado. At its most basic formulation, import-substitution was influenced by Keynesian philosophy, which called for increased governmental spending to induce industrialization and job creation. The United Nations Economic Commission for Latin America and the Caribbean and other multilateral organizations connected with the UN served as the global platform for these ideas.

[13] In the U.S., Alexander Hamilton was one of the primary creators of the "national economy," whereby the American economy was structured to build up its industrial base by the institution of high tariffs against British manufactured goods. See generally, Curtis Putnam Nettels, The Emergence of a National Economy, 1775-1815 (1989)

14 J.H. Boeke, *Three Forms of Disintegration in Dual Societies*, Indonesie Journal Vol. 7, no. 4, 294 (Apr. 1954)

[15] This may be observed even in the early twenty-first century, when international oil companies that are active in Equatorial Guinea import everything from labor, food and construction material. In enclave-investment environments such as this, there tends not to be the development of an organic connection with the local economy. Thus, even though the *per capita* oil wealth of Equatorial Guinea is higher than Saudi Arabia, little benefit trickles down to the population. Peter Maass, *Crude World: The Violent Twilight of Oil*, 26-52 (2009) pp. 26-52; For an intriguing study of economic enclaves in the Latin American context, see ,Catherine LeGrand," Living in

colonial countries attempted to find ways to overcome this dichotomy by reforms in the legal and regulatory sector. The developing countries perceived the dual economic structure as essentially a foreign economic sector implanted in their domestic economy.

This economic segmentation prevented benefits derived from the natural resource sector from percolating throughout the host country's whole economy, and stifled trade reciprocity from linking the internal and external economic systems. Yet, foreign direct investment (FDI) in the natural resource sector of developing nations has perhaps been unfairly accused by developing nations of having a deleterious impact. Because it assisted in the creation of a drastically unbalanced production structure, FDI is frequently credited with forming the archetypal rentier State. as the oil curse. Under this scenario, foreign capital gravitated to the host country's natural resources for export, but neglected to nourish the domestic economic sectors. Thus, foreign investment flowed into the natural resource sector and transformed it into the most advanced sector of the economy. The objective, however, was to retain it as an economic enclave. Beneficial effects would not be recycled into the economic lifelines of the host-country.

Even when certain enclaves, such as the mining or the plantation sector expanded, the benefits remained bound to the economic interests and fiscal demand cycles of the industrialized countries. In these dual economies, the export sector, as the only advanced portion of the economy, was surrounded by a preindustrial domestic sector.[16]

The colonial structures, therefore, left a bifurcated economic structure that prevented backward and forward linkages throughout the economy. The Listian approach to protecting and enhancing the prowess of the natural resource sector did not resolve the inherent contradiction of the classic colonial economic structure built to serve external interests and facilitate colonial expansion, or the economic and legal edifices surrounding that economic structure.

Raul Prebisch recognized the inequalities inherent in the relations between the natural resource producing countries and the developed consumer countries. With his colleague, Hans

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Macondo: Economy and Culture in a United Fruit Company Banana Enclave in Colombia" in (ed) Gilbert Michael Joseph, *Close encounters of Empire: Writing the Cultural History of U.S.-Latin American Relations*, 333-57 *(1998)*

16 Gerald Meier, "External Trade and Internal Development" in (ed) Peter Duignan, et al, *Colonialism in Africa, 1870-1960 (*1975*)*

Singer, Prebisch developed the theory known as the Singer-Prebisch thesis to argue that the terms of trade for commodities tend to decline versus manufactured products.[17] Prebisch reasoned that primary product exporting countries face an additional threat that was not considered by previous economists, namely that of long-term price degradation of primary products on the international market. According to Prebisch, the international economic order is composed of industrialized countries that form the center of the global economy and of developing nations that are arrayed on the economic periphery.

The colonial system entangled both industrialized and underdeveloped nations in an asymmetrical symbiotic paradigm. The industrialized countries depended upon raw material exports from the periphery to fuel their own advanced economies, while the periphery was dependent on the industrialized economies for the sparse economic opportunities it enjoyed. The vulnerability of the periphery was due, not only to the lack of a diversified industrial base, but also the singular dependence on a primary product export.

Prebisch explored the disparity in growth between the industrialized "core" economies and the underdeveloped economies; he formulated his theory, which has as many non-economic factors, as economic ones, to provide a theoretical basis for the long-term deterioration of primary product pricing relative to manufactured goods' pricing.[18] He stressed that primary product producing nations must relieve the "external bottlenecks" caused by a persistent pattern of economic disequilibrium that inevitably destabilizes the prices of primary products.[19] He attributed this disparity to the fact that the primary product exporting countries lack the ability to coordinate production with external demand fluctuation.

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[17] The conventional explanation for this theory was that the income elasticity for manufactured products is greater than that for primary products.

18 Raúl Prebisch, *Towards a Dynamic Development Policy for Latin* America (1963)

[19] President Kennedy echoed Prebisch's assessment when he stated in June, 1963 that, "…. We can't help but to be concerned by the fact that the price of raw materials of the underdeveloped world steadily declines relative to the price of manufactured goods, and, therefore, its economic position in some ways is worse off in spite of all the aid we have given; and, therefore-unless we work hard- we may find ourselves a rich area in a poor world which is subject to all the influences that poverty brings with it and ultimately we would be affected." John Fitzgerald Kennedy, et al, *Kennedy and the Press: The News Conferences* , 455 (1965)

Prebisch, astutely, suggested the formation of primary product cartels to coordinate production and influence world commodity prices. OPEC is one of the most enduring exemplars of his theories. Prebisch argued that without coordination on the global level, impoverished developing nations would be trapped into exporting their primary products and mineral raw materials, while continuing to import the manufactured goods formed from those raw materials by the wealthy "core" countries.

An example of this phenomenon occurs when an oil producing country, such as Mexico, exports oil for a relatively low price and then imports petrochemical products-made from those very oil exports-at a significantly higher price. Prebisch concluded that this trap could be overcome by an alternative regulatory and legal structure that would change world patterns of trade and support local industry in developing nations. [20]

The Prebisch model fomented the numerous commodity cartels (bauxite, tin, phosphates copper, tin, coco, etc.) that sprouted up in the 1960s and 1970s. These primary product cartels sought to influence the price of primary products on the international market in the aftermath of decolonization. Many early decisions undertaken by the United Nations Conference on Trade and Development (UNCTAD) were also based on the Prebisch thesis. However, Prebisch's theory failed decisively, to the extent that it did not account for the residual economic affects that colonialism left in the developing world. The demands that the developing nations placed upon the developed world would encourage international cooperation and improve the price of primary exports, organize commodity markets, develop preferential loans, and provide local content standards. Yet, even these innovations did not address the essence of the dual economy structure that typified the developing world. Merely forming a commodity cartel to protect the international price of a particular commodity in the global market did not reform the basic global economic architecture, in which commodity exporting countries persistently relied upon the international market demand, while lacking the necessary industrial capacity to process and sell the commodity as a manufactured product.

The Prebisch approach required laws and price formulations that would grant developing resource rich nations a greater input into their destiny. However, that approach idealistically

20 Raymond C. Miller, *International Political Economy: Contrasting World Views*, 196 (2008)

merged modern day developing nations into a single genre with the classic, Listian backward nations, and concluded that the same policy and legal prescriptions, including protective tariff frameworks, would initiate economic development. Because today's developing nations are completely different from late modernizers of the nineteenth and twentieth century, due primarily to the bifurcated economy, List's approach obscures the ability to understand either resource nationalism, or the economic and legal inequalities that developing nations seek to overcome. Nor can the Listian approach account for the highly intense psychological reaction that feeds the underdeveloped world's economic nationalism.

Gunnar Myrdal, who dismissed Prebish's theorems as inadequate, explained that "market forces will tend to cumulatively accentuate international inequalities," and that a "quite normal result of unhampered trade between two countries, one of which is industrial and the other is underdeveloped, is the initiation of a cumulative process towards the overall impoverishment and stagnation of the latter."[21]

Nationalization of the energy sector by developing countries in the early to mid twentieth century was merely a means, not an end, which sought to facilitate wide-ranging economic changes. The developing country's ultimate goal behind the expropriations and nationalizations was to facilitate what Itagaki termed, "system transformation." System transformation is the effort to radically restructure the residuals from a colonial economy, which was bifurcated because of a focus on primary product export to the major Western metropolises, into a unified national economy focused on directing national revenue inward for domestic industrialization.[22] Developing nations wanted to eliminate any remaining structural dissonance and to enable the various economic sectors to merge into a cohesive economic unit that would become a seedbed to incubate a self generating national economic system. Developing nations understood from

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21 Gunnar Mrydal, *An International Economy* , 55;95 (1956)

[22] With the rise of the so-called BRIC economies (Brazil, Russia, India and China) through export- led growth, i.e., staged increases in value-added manufacturing of primary products, leading to simple manufactures, culminating with advanced goods, it appears that the model of export –led growth advocated by the World Bank has been successful if a country prudently manages its resources. Some studies, however, cited research that illustrated that export-led growth amongst developing nations is essentially a zero-sum contest, as all countries are not able to simultaneously supply the global demand, while reaping the same economic benefits. The crux of the hypothesis is that the world can only absorb so many primary product exports or simple manufactures before a "crowding out" effect occurs. See generally, Thomas Palley, *Export-Led Growth: Evidence of Developing World Crowding Out*, Open Society Institute, (April 2000)

their vantage point that this evolution could occur in the international and domestic arenas, only if the host countries generated laws and regulations that encouraged economic nationalism.

"Integration." is the overarching goal of resource nationalism. The host country attempts to construct a legal code that facilitates national economic unification and integration by restricting foreign participation in the economy and perhaps by mandating technology transfer, local content requirements and labor indigenization strategies. The goal of a host nation's economic integration efforts is to construct a unified, modern and planned economy that would enable the resource-rich developing nation a measure of autonomy from the demand cycles of the industrialized regions.

The presumptions that augment these goals are not without legal basis. The argument that States have immutable sovereignty over their resources was reflected most topically in the first Declaration of Permanent Sovereignty over Natural Resources (DPSNR), which the United Nations General Assembly adopted as a fundamental principle at its seventeenth session in 1962.[23] The DPSNR signaled a decisive change in the relations of developed nations *vis-a-vis* the developing world, since it took a political concept and intertwined it with international relations and domestic law. Even though the DPSNR appeared to state a relatively novel concept, resource nationalism actually pitted the Anglo-Saxon concept of absolute private ownership, i.e., protection of property rights, against the older Spanish concept that ownership of subsurface wealth is vested in the crown.

Consistent with medieval Spanish legal principles on natural resource sovereignty, Venezuela – one of the World's largest oil producers - struggled for much of its oil exporting history to integrate its national economy and foster development. Throughout the twentieth century, it switched quite notably between liberalization and a more Statist policy, dependent on the administration that governed the country at that moment.

Venezuela's case could be considered essentially a "throwback" to the more jingoistic nationalism of the 1960s decolonization struggles, but at the same time, Venezuela does

23 For a concise history on the political implications of the passage of this declaration and the contentious UN debate that preceded it, see generally, Nico Schrijver, *Sovereignty Over Natural Resources: Balancing Rights and Duties,* 70-81 (2008).

represent the more extreme case of resource rich countries seeking to control energy production on their territory. Venezuela's actions, while highly aggressive, do not vary in content from the energy policies promoted by the quite amiable Gulf countries.

Furthermore, the "Venezuelan model" spread throughout Latin America, where it was copied to a certain extent by Ecuador and Bolivia. Venezuela's goal of twenty-first century socialism is predicated on funneling revenue from domestic natural resource production domestically, and building such technical competence as to develop its own resources without recourse to international energy companies. While the socialist aspect of this model is unattractive to most energy producing nations outside of Latin America, the strong Statist element of control over natural resources proved attractive worldwide, especially during the sustained increase in the international price of oil from 2002-2008.

# 2.0 Energy Sector Liberalization

In the 1990s Venezuela sought foreign investment through an economic liberalization program known as the *apertura* (the opening). During the “opening” Venezuela entered into thirty-two operating service agreements (OSA) with twenty- different IOCs, and allowed the IOCs to produce and manage the fields. *Petroleus de Venezuela* (PDVSA), the Venezuelan national oil company, paid these IOCs a fee to operate the oil fields, and purchased the produced crude at rates pegged to the market value.

Venezuela also developed an innovative risk/share contractual arrangement that included an options clause to purchase a thirty-five percent equity stake in the project if the IOC discovered commercially viable crude during exploration.[24] Consistent with this arrangement, Venezuela created four "strategic associations" in the Orinoco Belt, located in Northern Venezuela (see Map One) for the production of heavy crude and its eventual upgrade to synthetic crude "syncrude," in which PDVSA held an equity stake.[25]

**Map One: Map of Orinoco Belt Tar Sands**

**Source: United States Geological Survey (USGS)**

The Orinoco Belt is among the largest oil fields in the world with estimated reserves of 235 billion barrels of crude.[26] Yet, the US Geological Service, which has a more optimistic estimation of Venezuelan oil reserves, announced in 2010 that Venezuela contains 513 billion barrels of recoverable oil, placing it ahead of such energy behemoths as Canada and Saudi Arabia.[27]

As one of the first steps undertaken to reverse these relatively liberal energy provisions, the Chavez administration promulgated a 2001 hydrocarbon law, designed to supersede the 1943 Hydrocarbons Law and 1975 Nationalization Law. This new enactment granted PDVSA a majority equity stake in all new hydrocarbon projects, and, simultaneously increased the royalty framework schedule for IOCs. The new law also abolished all previous equity formations, such as OSAs, and the Risk Sharing Profit Agreements (RPSA) and strategic. It required that all subsequent contracts reflect a joint venture with PDVSA. The Venezuela Ministry of Energy and Mines (MEM) mandated that PDVSA's thirty-two OSAs, the four strategic associations, and the

[24] *Question and Answer with Venezuela's Energy Minister*, The Washington Post, May 11, 2007. [25] *Id.*

[26] U.S. Energy Information Administration, *Country Analysis Briefs*: *Venezuela, available at* http://www.eia.doe.gov/emeu/cabs/Venezuela/Background.html (last visited May 17, 2010.).

[27] Angel Gonzalez, *Orinoco Oil Reserves Total 513 B Barrels*, Dow Jones News Wire, Jan. 22, 2010.

RPSAs be handled by a government subsidiary known as *Corporacion Venezolana de Petroleo* (CVP). [28]

Calendar year 2005 marked the government's efforts to decisively implement the legal changes governing energy exploration and production contracts. As required by the directives of the new Hydrocarbon law. In April 2005, the MEM directed that all foreign operators must convert existing OSA projects into a new JV structure. By the following year, MEM modified existing OSA projects into joint ventures (JV), in which the CVP possessed a sixty-percent equity stake. [29] The contract changed the status of booked oil reserves held by the IOCs. The Minister of Venezuela's MEM, Rafael Ramirez, informed the IOCs that they would no longer be able to book for their accounting purposes the oil reserves held under the new JV structure.[30]

# 3.0 The Modified Fiscal Regime

The 2001 Hydrocarbons Law required that the primary activities associated with hydrocarbon production be undertaken either by the government in the form of PDVSA, or by a JV company where the government owned a controlling share.[31] The amended law, which left few opportunities for foreign participation, limited IOCs to operational duties such as oil field exploration or refining ventures under a permit and license regime. Emboldened by the sharp rise in oil and gas prices near the end of 2001, Chavez exercised the power granted to him by the new Hydrocarbon law on October 2004 in a series of highly publicized tax/royalty rate increases, and seizures of back taxes purportedly owed by IOCs.

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[28] *Update: The Venezuelan Economy in the Chávez Years*, The Center for Economic and Policy Research (Feb. 2008) [29] For example, in August 2006, CVP concluded two agreements with British Petroleum, thus creating the Boqueron and Petroperija joint ventures to operate the Boqueron (7,500 bbl/d) and DZO (12,000 bbl/d) fields, respectively, in Zulia state. U.S. Energy Information Administration, *Country Analysis Briefs*: *Venezuela, available at* http://www.eia.doe.gov/emeu/cabs/Venezuela/Background.html (last visited May 17, 2010.).

[30] Steve Levine, *the Oil and the Glory*. (Mar. 4, 2008). Oil and gas reserves are the principle assets of an IOC. Booking is the process by which the oil and gas reserves of a particular reservoir are added to the company's balance sheet. Booking is important to IOCs because that is how their success is gauged by the financial sector to analyze, compare and contrast their past and probable future financial success. See generally, Rob Arnott, *Oil and Gas Reserves: Communication with the Financial Sector*, Chatham House, October 2004.

[31] U.S. Department of State, *2007 Investment Climate: Venezuela, available at* http://www.state.gov/e/eeb/ifd/2007/80762.htm (last visited May 17, 2010)

### *3.1 Royalty Rate Increase*

Because much of the oil in the Orinoco Belt is so-called heavy oil, i.e., oil of higher viscosity and density, Venezuela requires advanced technology to process this resource before it can be profitably exported. The projects to transform the heavy tar-like oil into synthetic oil began in the mid-1990s. However, many IOCs were reluctant to invest because of the technological issues associated with drilling for heavy oil and the challenges in heavy oil refinement. There were also concerns about return on investment, because during the low oil price environment of the 1990s, there was very little profitability in producing large quantities of heavy crude oil.[32] During the mid 1990s, the average price of the Venezuelan oil basket was approximately $10 per barrel.[33] This resulted in the government making substantial concessions in the income tax and royalty rate to encourage foreign investment because most IOCs would not invest significant capital in such a low price environment without significant financial inducements from the State.

Nonetheless, in the new higher-priced energy environment since 2001, Chavez felt emboldened to exercise his new powers to modify the status quo. On October 10, 2004, Venezuela increased the IOC tax/ royalty rate for work in Orinoco's heavy oil fields from 1% of the oil export price to 16.6%.[34] On national television, Chavez announced that the increased tax represented the "second and true phase of the nationalization of the country's oil."[35] While Venezuelan Energy Minister Rafael Ramirez admitted that IOCs had received no warnings, he proclaimed the move was nevertheless in accordance with Venezuelan law, and, therefore, not subject to dispute.[36]

Venezuela's legal regimen was, in a word, complicated. The 1943 constitution recognized the government's sovereign rights to unilaterally increase royalties, but the extra-heavy crude contracts the IOCs signed with Venezuela in the mid-1990s took advantage of a

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[32] *Royalty Rise Raises Risk Perception*, Oxford Analytica. (Oct. 18, 2004) The extra heavy crude projects specifically targeted were: Petrozuata, Cerro Negro, Sincor and Hamaca, which are produced jointly with Total, Statoil, BP, ConocoPhillips and ExxonMobil.

[33] OECD Observer, *Oil Price Conundrum*, The International Trade Centre, No. 245, Nov. 2004.

[34] Iain Bruce, *Venezuela Raises Oil Drilling Tax*, BBC News, Oct. 11, 2004.

[35] Grant Hanessian, et al, *Investment-State Disputes in the Oil and Gas Sector in Bolivia, Ecuador and Venezuela*, The Global Oil and Gas Report, Baker and McKenzie, (Feb. 2009).

[36] *Id.*

special clause for reduced royalties. Yet, even the mid-1990s contracts contained an optional clause that allowed the State to impose royalty rate increases after the IOC's recovered their original investment.

Although the royalty rate increase may have been constitutionally valid under national law, it certainly abused the premise under which the government secured IOC investment, by providing them attractive investment terms to undertake massive capital investments in the then (1990s) nominally profitable heavy oil reserves.[37] Not only the IOCs, but industry analysts were also stunned by the assertiveness with which Venezuela implemented the royalty modifications, which ultimately increased Venezuela's share of syncrude production to $3.33 a barrel from $.20, and brought in an additional $7.66 million annually, under the then current (2004) oil prices.[38] Chavez argued that the IOCs were unjustifiably granted preferential treatment by the previous administration. However, the IOCs generally argued that, while the royalty rate increase may comport with the letter of the law, increased royalty rates violate the spirit of partnership on which investment was predicated.

Exxon-Mobil, which was the most resistant of the IOCs, considered the possibility of international arbitration to challenge the royalty increases, even though the other IOCs more or less passively indicated that they would not dispute it.[39] Rather than an abundance of boldness, Exxon-Mobil's resistance may have reflected that its Venezuelan holdings represent only a small proportion of its total portfolio. Because Exxon-Mobil was not too overextended in this market, she can afford to walk away.[40]

## *3.2 Windfall Profit Taxes*

Venezuela has one of the most aggressive tax regimes in the world, with an overall fiscal take at approximately eighty-five percent (including windfall profit, extraction taxes, etc.),

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[37] *Oil Firms Study Legal Options after Royalty Increase in Venezuela*, Alexander Gas and Oil Connections, Vol. #9 Issue 22 (Nov. 11, 2004)

[38] *Id.*

[39] Gregory Wilpert, *Exxon Mobil to Challenge Venezuela's Oil Tax Increase*, Venezuela Analysis. (Feb. 25, 2005) [40] Exxon Mobil announced that it was interested in meeting with PDVSA President and Ministry of Energy and Mines Minister, Rafael Ramirez, but Ramirez turned down the request, stating that the decision to raise royalties was immutable. *Id.*

similar to Norway's extraction industries taxation structure, but much higher than other regional producers, such as Mexico, which levies a seventy-percent rate, and Brazil, which utilizes a sliding scale.[41] In 2006, Chavez initiated a round of new tax measures. One measure, which he termed an "extraction tax," increased the tax rate from seventeen-percent to thirty-three percent. His administration estimated that these increases would bring in an additional billion dollars to the government's coffers.[42]

In consideration that light, sweet crude surpassed $110 per barrel for the first time on March 12, 2008, and Venezuela's heavy, sulfur crude reached a record price of $94 per barrel in tandem, Venezuelan legislators drafted a new windfall profit's law to take advantage of "sudden revenue gains" by IOCs.[43] The tax is based on the monthly average price of benchmark Brent crude oil, and not Venezuelan light and heavy crude, because it is a globally recognized barometer. The tax automatically comes into effect when the price of benchmark Brent crude rises above $70 per barrel.

If oil prices remain above that threshold for one month, the State would take fifty-percent of the difference between this average and the final sale price of each barrel.[44] When Brent crude exceeds the $100-a-barrel average, the rate would automatically rise to sixty-percent. Critics of this windfall profit law contended that it would discourage foreign direct investment in Venezuela and "chill" development in Venezuela's energy sector. But, according to Chavez and his supporters, this tax, which was formulated to support ambitious social programs, was expected to raise more than $9 billion annually.[45] Predictably, many IOCs complained the imposition of this new tax, with Total claiming that Venezuela's 2010 auction of oilfields containing approximately 15 billion barrels in the Orinoco Belt lost its attractiveness because of the burdensome taxation.[46]

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[41] Peter Wilson, *Chavez Sees a Gusher in a Windfall Tax*, Business Week, Feb. 21, 2008.
[42] *Chavez Doubles Tax for Oil Firms*, BBC News, May 08, 2006.
[43] *Venezuela Drafting New Oil Tax*, Business Week, Mar. 13, 2008.
[44] Christopher Toothaker, *Venezuela Starts Collecting New Oil Tax*, Associated Press, Apr. 16, 2008.
[45] *Venezuela Approves $9 bln Oil Windfall Profit Law*, Reuters, Apr. 15, 2008.
[46] Tara Patel, et al, *Total Says Venezuela Taxes Make Orinoco Oil Auction 'Difficult'*, Business Week. Jan. 28, 2010.

### *3.3 The Campaign against Back Taxes*

In addition to the royalty/tax increase, Venezuela began a campaign to collect what it alleged were egregious failures to pay "back taxes" by the IOCs. The Venezuela tax ministry, Seniat, alleged that IOCS operating in Venezuela owed $4 billion in back taxes dating from 2001.[47] It also contended that the OSA operators owed $3 billion in back taxes, and that the IOCs participating in the strategic associations owed approximately $1 billion.[48]

The tax collection efforts targeted at IOCs were only a portion of a much wider economy-wide campaign to increase government revenue under the auspices of back taxes claw back.[49] SENIAT argued that the IOCs that operated under the OSA legal framework were previously classified incorrectly by the Venezuelan authorities in the 1990s. The Chavez administration alleged that the previous Caldera administration classified the OSA operators as 'contracted help," which folded them into the thirty-four percent income tax rate, as opposed to the fifty-percent income tax rate that is applicable to standard oil operations.[50] The IOCs disputed the legality of the claim, but nearly all of them eventually paid the taxes, albeit, at a lower negotiated rate.[51]

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[47] 2001 was the earliest date for which Venezuela allowed its tax authorities to collect taxes in arrears under national law. However, the taxing authorities indicated that they are exploring whether they can extend the audit to the early 1990s for tax arrearages. Tax-News Website, Mike Godfrey, *Venezuela May Expand Oil Industry Tax Audit Back to the 1990s*, *Available at* < http://www.taxnews.com/news/Venezuela_May_Expand_Oil_Industry_Tax_Audit_Back_To_1990s____22304.htm l > (last visited April 15, 2010)

[48] *Update 1, Venezuela hits Conoco, Chevron, with Back Tax Claim*, Reuters, Nov. 14, 2006.

[49] The Venezuelan tax authority, SENIAT, also audited four foreign mining companies, including US-based Hecla Mining Co., along with the other firms headquartered in Canada, Israel, and India.

[50] Natalie Obiko Pearson, *For Some Oil Companies, Venezuela is Hardly the Worst Option*, International Herald Tribune, June 28, 2007.

[51] *Id.*

### *3.4 Steps toward Expropriation: Enabling Legislation*

After Chavez's December 3, 2006 landslide re-election, he vowed to unleash an increased tempo for taxation on energy operators, as he needed massive funds to implement his massive economic redistribution scheme.[52] In contrast to the steps taken from 2001-2006, which were concerned with enlarging the government revenue, from 2007 onward, the Chavez administration inaugurated its strategy to expropriate the majority equity shares of IOCs operating in the Orinoco Belt.

The authority for these expropriations was grounded in legislation that the Venezuelan National Assembly passed January 31, 2007, entitled the "Enabling Law," and that Chavez signed into law the following week.[53] This law provided Chavez with the legal authority he needed to proceed with the nationalization plans that he repeatedly alluded to since he began his first term the in 1999. This enabling act allowed the executive to rule by decree for a period of eighteen months in eleven different economic and industrial sectors.[54] Chavez had long argued for this authority in order to end foreign ownership of crude oil refineries in the Orinoco Belt, and to reverse prior Venezuela legislation that granted IOCs majority equity holdings in national energy assets.

# 4. The Expropriation Campaign

As one of the first demonstrations of his newly granted power, Chavez issued Presidential

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[52] Juan Forero, *Chavez Restyles Venezuela with 21st Century Socialism*, The New York Times, Oct. 30, 2005.

[53] Christopher F. Dugan and Joseph R. Profaizer, *Venezuela Launches Next Stage of Expropriation,* Stay Current, March 2007.

[54] *Rule by Decree Passed for Chavez*, BBC News, Jan. 19, 2007. Rule by decree is not a modern practice, its lineage dates from ancient Rome, whereby the first recorded example occurred in the wake of Julius Caesar's assassination. The Roman senate granted Caesar's successor, Gaius Octavian, nearly unlimited decree power under the Lex Titia legislation. Josiah Osgood, *Caesar's Legacy: Civil War and the Emergence of the Roman Empire*, 59-60 (2006).

Decree No. 5200 on May 1, 2007, and declared that the IOCs operating in the Orinoco Belt had to reform their equity structures to conform to the new joint venture regime in which PDVSA would have majority equity interest.[55] Decree No. 5200, which mirrored the Calvo Doctrine to a certain degree, mandated that Venezuelan law would govern all disputes, under the explicit jurisdiction of Venezuelan courts. Venezuelan authorities gave the companies until June 26, 2007 to construct the final details of the handover. In response to the anticipated IOC antipathy, Chavez retorted that, "[I]'m sure they [the IOCs] will accept because we will continue to be partners, but if they do not agree, they are free to leave."[56]

America's Chevron, Norway's Statoil, Britain's BP and France's Total agreed to the partial takeover, while Conoco-Philips and Exxon Mobil refused on grounds that the lack of agreement between asset valuation, compensation for lost value, and decision-making rules in the future JVs, made the disagreement insurmountable.[57] In Venezuela's calculation of the value of the assets, the MEM stated that it will only recognize the initial investment capital cost (generally much lower), as opposed to current net value (often higher), or a company's future estimated income stream.[58]

Exxon Mobil had expressed its discontent from the very beginning, stating that it would leave the Cerro Negro Orinoco venture if profitability were too low under the new regime. In contrast, Total expressed a strong desire to continue under the new mandated partnership structure.[59] Although Exxon Mobil had more booked reserves than the other IOCs in the region, overall it represented a small slice of their worldwide holdings, and it took a much harder line with the Venezuelan government. Chevron and Statoil seemed to be willing to bear a period of nearly flat profitability, just in order to maintain a foothold in this oil-rich country.[60]

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[55] *Chavez Gives Foreign Companies in Orinoco Projects May 1st, Ultimatum*, Business News America, Feb. 2, 2007. [56] *Id.*

[57] *Oil Firms Reject Venezuela Deal*, Al Jazeera News, Jun. 26, 2007.

[58] *Venezuela Says it Will Only Recognize Orinoco Book Value*, Reuters News, Mar. 30, 2007.

[59] Peter Milliard, *PDVSA, Conoco-Phillips, Chevron, Set Transition Team for Orinoco*, Dow Jones Newswire, Mar. 8, 2007.

[60] IOC executives expressed regret for not negotiating with the government as a bloc, which they think could have increased their leverage in current talks. The overriding opinion is that their various strategies weakened them as a group, and that divergent positions made it difficult to form a unified front. Peter Milliard, *Big Oil Faces Tough Talks in their Stakes in Orinoco Patch*, Dow Jones Newswire, Mar. 15, 2007.

All together, Venezuela compensated Statoil and Total with $1.1 billion for their equity holdings, less than half of the estimated market value of the holdings.[61] In contrast to the statement made by the MEM Minister Rafael Ramirez, that the IOCs would receive compensation solely in crude, Venezuela ultimately paid the companies a combination of crude oil and cash.[62] After the equity reconfiguration, Statoil subsequently held a 9.7 percent equity stake in the Sincor bloc, Total held a 30.3% stake, while PDVSA held a controlling stake of 60%. Originally, Total held a 47% stake; Statoil owned 15% and PDVSA 38%.[63] Conoco-Phillips, which suffered heavily for its exit, was resigned to write off billions of dollars. It is estimated that Conoco-Phillips lost five-percent of its global crude oil production, and ten-percent- more than a billion barrels-of its booked oil and gas reserves.[64] After a period of much publicized discord, Exxon Mobil pulled out of the Orinoco Belt and requested international arbitration by the International Centre for Settlement of Investment Disputes (ICSID) in September, 2007.[65]

Even though Exxon Mobil had a decidedly frosty relationship with Caracas, in contrast, Conoco-Phillips CEO, Jim Mulva, announced that it had a "normal business relationship with Venezuela," in spite of the mutual recriminations.[66] At the company's annual analyst meeting in March, 2008, Mulva expressed hope for an eventual amicable settlement.[67] Despite the Orinoco equity shake-up, Conoco-Phillips and PDVSA are still cooperating in the JV refinery they share in Texas. PDVSA, meanwhile, continues to provide feedstock to Conoco-Phillips' refineries on

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[61] Raul Gallegos, *Venezuela to Pay Total , Statoil Hydro $1.1B for Sincor*, Dow Jones Newswire, Jan. 31, 2008.

[62] As part of the settlement Total and Statoil must invest $130 million as a bonus to fund the new Sincor joint venture company. Furthermore, the $1.1 billion given as compensation by PDVSA to the Sincor partners for its 22% only represents less than half of its estimated value of $5 billion. However, while PDVSA assessed the project value at $5 billion, a UBS AG assessment of the Sincor investment valued the project at an estimated net present value of $10.8 billion, and estimated that all four ventures had an estimated value of $28 billion. *Id.*

[63] *Id.*

[64] Steven Mufson, *Conoco, Exxon Exit Venezuela Oil Deals*, Washington Post, June 27, 2007. Conoco-Phillips position appeared to become quite untenable, since in 2005 it received approximately $20 per barrel from its Petrozuata holdings. This was further whittled down to $3 per barrel during the first quarter of 2007. Gabriel DeSanctis, *Venezuela: Ratings Agency Could Withdraw Heavy Crude Project Ratings; PDVSA to Face Technological Challenges to Operate Projects*, Financial Times, July 6, 2007.

[65] The tax increase by Venezuelan authorities could have been an attempt to bolster Venezuela's position before a comprehensive valuation of assets, since an increased tax rate could possibly skew the value of the holding.

[66] Gregory Meyer and Isabel Ordonez, *Conoco Could Reach Deal With Venezuela This Year*, Dow Jones Newswire. Mar. 12, 2007.

[67] *Id.*

the U.S. Gulf coast. However, there is uncertainty as to how long the collaborative relationship will last.

In early 2008, after Conoco-Phillips announced that it would buy out PDVSA's fifty-percent equity stake in the refinery, PDVSA announced that it would sue Conoco-Philips in international arbitration. On March 6, 2010 PDVSA announced that it was officially filed arbitration proceedings with the International Chamber of Commerce (ICC) against Conoco-Philips' attempted forced buy-out.[68] At the time of writing, it is not certain how this issue will proceed; but nonetheless, it is likely to be a protracted fight.

### *4.1 Fate of Intellectual Property*

However, one little acknowledged issue of the Orinoco expropriations is the issue of who owns the departed intellectual property. When Conoco-Phillips and Exxon Mobil departed Venezuela, they abandoned more than their valuable equity holdings. They abandoned valuable technology and intellectual property that rivals may exploit to maximize heavy oil production.[69] Because of their long history in Orinoco, these companies achieved expertise in sophisticated drilling techniques, refining technology, and best practices in avoiding accidents, each of which PDVSA would find useful in its drive to obtain technology.[70]

Since most national oil companies often find it challenging to refine nontraditional oil deposits, e.g., bitumen and heavy oil, they depend upon IOC technological expertise. However, any company that utilizes it could be subject to a suit from the departed IOCs, in addition to the legal actions associated with the equity holdings.[71] More specifically, an oil company that used

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[68] Conoco-Philips announced that it was contractually allowed to buy out PDVSA's share, and that PDVSA failed to uphold its contractual obligations. *Conoco Says it Received Notice of PDVSA International Lawsuit*, MarketWatch, Mar. 6, 2010.

[69] Historically, heavy oil was not economically feasible to produce. However, in the era of declining production of easier to process "sweet" (low sulphur) oil, technological advances, and elevated crude prices, heavier oil deposits were in high demand for much of 2002-2008.

[70] Isabella Ordonez, *Technology Left in Venezuela by Exxon, Conoco May Aid Rivals*, Rigzone, Oct. 9, 2007.

[71] One of the most valuable pieces of equipment left in Venezuela was, at least temporarily, abandoned by Conoco-Phillips. This was the delayed process mechanism that refines heavy crude into lighter crude. Once the heavy oil is produced, it is refined further in a chemical plant that applies high temperature and intense pressure to separate the carbon molecules. The Orinoco Belt also makes extensive use of multilateral, horizontal wells built by Exxon Mobil and ConocoPhillips. It is the only region of the world where these wells have been drilled by the hundreds. Learning how to operate them in a harmonious and safe manner would be a valuable skill for any oil company. *Id.*

this technology could be legally obligated to pay compensation to either Exxon Mobil or Conoco-Phillips. This is all the more so because these IOCs used the Orinoco Belt as a proving ground to develop new techniques in heavy oil refinement and to enhance best practices to minimize safety issues in an environmentally challenging region.[72]

### *4.2 Venezuela Moves Cautiously with Creditors*

Even while Venezuela seemingly took a defiant approach towards the IOCs, it scrupulously avoided upsetting its creditors. Chavez, despite the anti-imperialist rhetoric, moved gingerly with Venezuela's creditors. The obvious reason is that PDVSA still requires approximately $2 billion dollars annually in debt financing.[73] Furthermore, negotiated settlements with creditors should guarantee access to sovereign credit markets. In 2007, PDVSA hired an international law firm to assist with the financial and legal issues that occurred in its negotiations with the Sincor and Hamaca bank creditors, and with the banks and bondholders in the Cerro Negro and Petrozuata oil projects.[74]

Venezuela had to act fairly quickly after the promulgation of the expropriations to reassure international credit markets, since rating agencies were considering withdrawing their credit ratings. Fitch, Moody's and S&P, which rated the oil fields left by Exxon Mobil and Conoco-Phillips, were uncomfortable about continuing to rate these projects, given the lack of government guarantees about debt service. The principal issue for the rating agencies was whether Venezuela was in technical default on oil field- related debts following the transfer of ownership. According to the contractual provisions that undergird Fitch's, Moody's and S&P's rating agreements, any unauthorized transfer of ownership without the creditors' consent

[72] Horizontal wells have to be precisely drilled and the extra heavy crude upgraders are quite sophisticated pieces of equipment. Being located at the front end of the refinery, they are quite dangerous to operate.

[73] Ana Isabel Martinez, *Venezuela PDVSA Planning $2.5 bln Bond Issue*, Reuters, Apr. 28, 2009.

[74] The negotiations were handled by Curtis, Mallet-Prevost, Colt & Mosle and Lazard L.L.P. Gabriel DeSanctis, *Venezuela Avoids Missteps with Orinoco Heavy Crude Creditors; Should Guarantee the Sovereign's Access to Credit Markets,* Financial Times, Aug. 27, 2007.

constitutes a default.[75] In late April 2007, the bond holders of Cerro Negro cautioned PDVSA of a potential technical default.

With the exit of Exxon Mobil and Conoco-Phillips, and PDVSA's inability to operate the extra heavy upgraders, bond holders and debt holders were anxious to have PDVSA purchase their interests. [76] For the creditors, an unresolved issue was if PDVSA, Total and Statoil could increase PDVSA's equity participation without violating the equity pledged as collateral to the bank debt. [77] In fact, the creditors had much better leverage than the IOCs *vis-à-vis* the Chavez administration because of PDVSA's immediate financing needs, and especially because the threat of a potential default compelled the administration to adhere to the existing heavy crude financing contracts.

Even the government's high profile feting of Iranian and Russian NOCs to take over the position of the departed IOCs did not reassure the financial and energy markets, because it was widely presumed that their respective NOCs also lacked the technical expertise to produce and process these heavy reserves. Although the equity conveyance occurred on May 1, 2007, the change was in many ways superficial: expatriate senior managers, who were previously in charge under the IOCs, now simply had to report to an additional layer of PDVSA management.

However, PDVSA had a difficult time retaining the private-sector rank and file oil field workers, who were reticent at accepting the lower wages at PDSVA if they transitioned. Without specialized personnel, PDVSA experienced numerous difficulties in maintaining the latest safety and operating standards.[78] These issues could have a compounding effect that may cause Orinoco production rates to decline over the medium term.

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[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] Peter Milliard, *ConocoPhillips Draws Attention is Defying Venezuela over Oil Fields*, April 27, 2007.

# 5. Exxon-Mobil's Court and Arbitral Proceedings

As part of its resistance strategy, Exxon Mobil initiated two international arbitral actions under the original contracts: one was initiated in ICSID in September 2007 and the other before the ICC in January 2008. As a precautionary measure to ensure that PDVSA would not liquidate its holdings in the face of an unfavorable holding in the arbitral tribunals, Exxon Mobil filed lawsuits in New York, the United Kingdom, the Netherlands and the Dutch Antilles for a temporary injunction to bar PDVSA from liquidating holdings in these territories.[79]

On February 7, 2008, the courts in the United Kingdom, the Netherlands and the Netherlands Antilles awarded an order preventing any sale of PDVSA's $12 billion in assets under their jurisdiction.[80] Exxon Mobil had argued that the U.K. had jurisdiction because PDVSA held a minority interest in two refiners on British territory.[81] Venezuela argued that Britain did not have jurisdiction since PDVSA was neither a British company, nor incorporated under British law, and had no assets, businesses or bank accounts in British territory.

Venezuela also argued that its subsidiary, Pdv UK, was liquidated in December of 2006 and that the UK assets owned by its JV with the Finnish energy company, Neste Oil - Nynas Petroleum – were too tangential for the court to issue jurisdiction.[82] The High Court in London initially ruled for Exxon Mobil and issued a temporary injunction prohibiting PDVSA from selling its British assets. In New York, Exxon Mobil secured a temporary injunction against $300

[79] Exxon Mobil's case in the Dutch Antilles was grounded on the fact that PDVSA has refinery assets in the Dutch Antilles, located off the coast of eastern Venezuela.

[80] The announcement of the judgment against Venezuela precipitated a large drop in Venezuela's dollar denominated bonds from concern that Venezuela could face an extended legal battle, and cause difficulty if Venezuela wanted to sell its overseas assets at anytime in the future. See Simon Romero, *Court Bars Sales of Billions in Oil Assets by Venezuela*, The New York Times, Feb. 8, 2008. PDVSA owns refineries in Texas and has joint venture refining interests in Germany with BP, and in Scandinavia with the Finnish oil company, Neste.

[81] Jeremy Morgan, *Venezuela Petrochemicals Industry to be Expropriated*, Latin American Herald Tribune, May 12, 2010.

[82] Nynas Petroleum owns a number of refineries in Europe, including two in the UK. See *Exxon Mobil Hits Out at PDVSA Claims*, Upstreamonline, Mar. 4, 2008.

million of PDVSA's assets (primarily CITGO-related); because the judge found it likely that Exxon Mobil would prevail in its arbitral action.[83]

The injunction attempted to prevent PDVSA from avoiding enforcement of any arbitral award against Venezuela. Obviously, Exxon Mobil was determined that it would get remunerated for the loss of the Orinoco project and compensated for future revenues if international arbitration resolved the issue in its favor. In an effort to elude the injunction, PDVSA told clients that their payments should be made to the UBS bank in Switzerland, where the banking laws are generally believed to be more protective of depositors' funds.[84]

Even though Exxon Mobil had initially claimed $5 billion in damages, it subsequently increased its claim to $12 billion. Venezuela disputed Exxon Mobil's figures and contended that Exxon Mobil's Cerro Negro holding was only worth $750 million.[85] Exxon Mobil sought and received political support from the White House. The State Department announced in February 2008 that, "[We] fully support the efforts of Exxon Mobil to get a just and fair compensation package for their assets according to the standards of the international law."[86]

To counterbalance Exxon Mobil's political support from the U.S. State Department, Venezuela attempted to increase its political leverage by securing the visible backing of OPEC.[87] Chavez also sought to broaden the row with the "imperial" Exxon Mobil by threatening to embargo oil shipments to the U.S., of which Venezuela is its fourth largest exporter. However, the hollowness of the threat appeared almost immediately as observers pointed out that such a move would not only cripple PDVSA, but also undercut Chavez's extensive social programs just as much-or more so- as it could potentially harm the U.S.[88]

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[83] As Citgo Petroleum Co. is a US incorporated subsidiary of PDVSA, it would only be subject to the jurisdiction of American courts. *Exxon Mobil Makes its Case,* Upstreamonline, Mar. 4, 2008.
[84] Brian Ellsworth, *Venezuela Moves Bank Accounts After Exxon Freeze*, Reuters, Feb. 11, 2008.
[85] *Venezuela May Sue Exxon-Mobil*, Upstreamonline, Feb, 18, 2008.
[86] *Exxon Mobil's Hard line on Expropriation*, MarketWatch, Feb. 14, 2008.
[87] *OPEC May Back Venezuela*, Upstreamonline, Feb. 15, 2008.
[88] Frank Jack Daniel, *Chavez Fight with "Imperial" Exxon May Lift Support*, Feb. 11, 2008.

While the embargo threat eventually petered out, Chavez did implement a freeze on oil shipments to Exxon Mobil. Nevertheless, as specified its contract with Exxon Mobil, PDVSA still continued to supply the Chalmette, Louisiana JV refinery. [89] [90]

In a significant reversal of Exxon Mobil's initial legal victory, British Judge Paul Walker, on February 18, 2008, dismissed the temporary injunction. Justice Walker embraced Venezuela's position that Britain was not a proper jurisdiction for this action, and held that there was no imminent risk of PDVSA liquidating its assets to avoid paying compensation.[91] Justice Walker ruled that injunction orders, as Exxon Mobil demanded, "are rare and [only] occur in cases where there is "usually compelling evidence of serious international fraud."[92] Exxon Mobil indicated that it would not appeal the decision and argued that the judge based his decision on jurisdictional issues without determining-or undermining- the underlying merits of the claim.[93]

ExxonMobil explained that, regardless of this temporary legal setback, the courts' rulings in New York and the Netherlands remained valid.[94] However, the PDVSA legal team disputed Exxon Mobil's interpretation, and responded that since the other European injunctions were based on the preliminary U.K ruling, they should be subject to review as well.[95] The Chavez administration considered the British ruling its first major success in the expropriation struggle. MEM Minister, Rafael Ramirez, jubilantly declared, "Our People won, our country won, our homeland won." He continued describing the ruling as a "hundred percent" victory for Venezuela, and contended that the judge's decision was a "lesson to Exxon Mobil."[96]

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[89] Simon Romero, *Chavez Threatens to End Oil Exports to U.S. in Exxon Feud*, The New York Times, Feb. 11, 2008. However, Chavez later reversed himself and publicly stated that he had no plans to embargo oil shipments to the US. Chavez pledged that U.S. bound shipments would only stop if the U.S. launched a military attack. *Chavez says Venezuela does not Plan to Halt Oil Shipments*, Stockhouse News, Feb. 17 2008.

[90] The markets barely reacted to this news, as the action was largely symbolic, and accounted for a small part of the crude oil imports in the U.S. Morning Zhou, *Energy Markets Moved Little as Venezuela Partially Halts Exports*, Market Watch, Feb. 13, 2008.

[91] John Poretto, *British Judge Rules Against ExxonMobil*, Associated Press, Mar. 18, 2008.

[92] *ExxonMobil Loses Venezuela Case*, Al-Jazeera, Mar. 19, 2008.

[93] *Id.*

[94] *Id.*

[95] *Id.*

[96] Tom Bergin, *Court Reverses Freeze on Venezuelan Assets*, Reuters News, Mar. 19, 2008.

Justice Walker, ordered Exxon Mobil to make an interim payment of $765,300 to cover Venezuela's legal costs, with payment mandated twenty one days after the ruling's announcement.[97] He also ordered Exxon Mobil to compensate Venezuela for any damage that occurred out of the injunction order. Still, this ruling may have foreclosed any possibility for Venezuela to gain compensation on its allegation that the dispute increased it sovereign borrowing costs, and that such costs should be integral to any consideration of damages. If the court had considered increased sovereign borrowing costs, Exxon Mobil could potentially have been saddled with an astronomical financial burden.

After the U.K. ruling, Venezuela announced that it was seriously considering separate litigation to sue Exxon Mobil for damage caused to PDVSA and Venezuela in the international markets.[98] Chavez argued that PDVSA had the requisite grounds to sue, due to Exxon-Mobil's alleged failure to pay taxes on the alleged 500,000 barrels of oil that it produced before the beginning phase of its Orinoco operations. It was not apparent at the time whether Venezuela intended to pursue an actual claim, or merely sought to strategically increase its leverage over Exxon Mobil.

It is telling that, while Venezuela consistently promoted a hard-line on the international stage against arbitration clauses in energy investments contracts, it generally respected the contractual right for arbitration, and defended what it viewed as its national interests in international arbitration forums.

## *5.1 The New York Action*

With the other legal disputes against PDVSA marred by opacity, there is no certainty as to how the New York suit initiated by Exxon Mobil will conclude. Exxon Mobil's temporary injunction in New York was later affirmed, and thereby froze $315 million of revenue that would have been transferred to PDVSA in a February 13, 2008 bond buyback.[99]

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[97] *Id.*
[98] *Id.*
[99] *Exxon Mobil Makes its Case*, Upstreamonline, Mar. 4, 2008.

PDVSA pled sovereign immunity because it contended that as a national oil company, acting under the direction of the Venezuelan government, it is immune from lawsuits.[100] However, under the Foreign Sovereign Immunity Act of 1976, if a government acts as a corporation in a commercial manner, it may lose its sovereign status, and become liable to suit. Because PDVSA undoubtedly acts in a commercial matter, U.S. courts may find that sovereign immunity does not apply in this instance. Because relations between Venezuela and the U.S. are at an all time low, there is minimal possibility that U.S. federal authorities, i.e., the State Department, would oppose an adverse ruling against PDVSA on political grounds.

The legal fight will likely persist for years, since both Venezuela and Exxon Mobil have aggressively approached this dispute as a zero-sum contest. Exxon Mobil has taken this issue to heart and appears to be prepared to use its substantial financial reserves to continue the legal struggle within its home judicial system. Meanwhile, PDVSA, perhaps emboldened by the U.K. ruling, claimed to have taken one-hundred percent operational control of the fields departed by Exxon Mobil.

The Exxon Mobil dispute is not confined to the relatively narrow issue of the legal validity of Venezuela's expropriation; both parties view this conflict through a global lens. During the sustained rise in international oil prices from 2001-2008, restrictive investment laws, unilateral modification of contractual terms and expropriation swept much of the world. At least three States (Ecuador, Bolivia and Russia) have nationalized property belonging to IOCs (de facto or de jure), while a host of other States have implemented or announced pending implementation (e.g., Nigeria, Australia, Canada, the U.S., Algeria, etc.) of windfall profit laws to claw back what they perceive as inordinate profiteering by IOCs.

The Exxon Mobil-Venezuela clash is being watched closely by many resource-rich States and capital exporting nations A triumph by Exxon Mobil would likely be viewed as an encouragement for more robust resistance by other IOCs in the face of nationalization drives,

[100] Phillipa Charles, *Section 44, Freezing Injunctions and Foreign Arbitrations: Limitations on Jurisdiction*, Mayer Brown (2009)

while a victory by PDVSA would likely embolden other petro-states to expropriate foreign investments during cyclical upswings in the international price of oil.[101]

## *5.2 Venezuela Opens Up Again*

Although Venezuela nationalized the fields in Orinoco Belt, she continues to represent a very attractive investment opportunity in a world in which IOCs not only have decreasing investment opportunities, but confront the peaking of higher quality light, sweet crude and easily extractable oil.[102] Indeed, foreign oil executives resumed seeking business with the Chavez administration after the highly controversial 2007 expropriations. Italian oil firm, ENI, signed a lucrative deal in January 2010 with PDVSA, to form a JV that would add $8.3 billion to develop the Junin 5 block in the Orinoco Belt.[103] In fact, ENI's general global business strategy appears to take advantage of opportunity in politically unstable countries that otherwise have enormous energy assets.

ENI concluded the Orinoco Belt deal after an agreement with Venezuela over the Dacion oil field, nationalized in 2006. Venezuela compelled ENI to accept $700 million for the Dacion field, much less than the book value, before it would agree to the new investment deal.[104] These new agreements are ostensibly an integral part of Venezuela's aggressive strategy to demonstrate on the global stage that Exxon Mobil and Conoco-Phillips are the "losers," not Venezuela. ENI's intended to initially produce at a rate of 30,000 barrels per day (b/d) by 2010, and increase production to 300,000 b/d by 2014.[105] However, the ENI contract adheres to the new contract formula that Chavez imposed, in which PDVSA must hold a controlling interest. In the latest ENI-PDVSA agreement, PDVSA holds a sixty-percent stake as opposed to ENI's forty-

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[101] Venezuela apparently considered offering Exxon Mobil PDVSA's share in the Chalmette refinery as compensation for the Cerro Negro expropriation. Exxon Mobil, *PDVSA in Chalmette Row*, Upstream online, Mar 3, 2008.

[102] Shell predicted that by 2015, supplies of easy-to-access oil and gas will not keep up with demand. Carl Mortished, *The Times: Shell Chief Fears Oil Shortage in Seven Years*, The Times, Jan. 25, 2008.

[103] Benedict Mander, *Venezuela's Belt Opens to Private Groups*, The Financial Times, Mar. 10, 2008.

[104] *Id.*

[105] *Id.*

percent.[106] The total cost of the investment, which includes the upgrade of a crude oil refinery, is estimated to be $10 billion.[107]

Venezuela requires access to the technology to produce and refine the heavy oil of the Orinoco Belt, while the IOCs require access to Venezuela's prodigious oil fields. Statoil, which remained in the Orinoco Belt after agreeing to the new equity makeup, undertook a much more conciliatory approach than Exxon Mobil after the Chavez administration forced upon Statoil the new contractual terms. On January 23, 2008, Statoil signed a new oilfield reservoir assessment agreement to increase PDVSA's technical understanding of the Orinoco Belt reserviour.[108] The contract requires Statoil to quantify the reserves of the Junin 10 block in the Orinoco Belt, possibly the largest deposit of extra-heavy crude oil in the world. The Chavez administration wants to certify Venezuela as the world's number one reserve oil holder, which would boost its international standing significantly.[109]

Venezuela depends upon PDVSA's revenue to fund Chavez's vision of 21st Century Socialism, and to buttress his strategic plan to double PDVSA's oil production by 2012, from its current production of a little over three million b/d to approximately six million b/d.[110] Venezuela's massive investment plan calls for $77 billion to be funneled into the oil field infrastructure - a third of that investment sum is slated to come from foreign partners.[111] This may signal that PDSVA now wants to work in a constructive relationship with the international market, albeit largely on its own terms.

For several years after the Orinoco nationalizations, IOCs shied away from large scale investments in Venezuela. Potential new entrants constrained themselves to merely certifying reserves, rather than exploring or developing them. But by 2010, in a seeming vote of confidence by the international business community, Venezuela signed three new agreements with IOCs worth up to $80 billion, which could potentially increase Venezuela's declining oil production. In February, 2010, Chinese and Russian national oil companies and Italy's ENI obtained

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[106] *Id.*
[107] Benedict Mander, *Venezuela's Belt Opens to Private Groups*, The Financial Times, Mar. 10, 2008.
[108] Benedict Mander, *Statoil Signs Deal to Survey Venezuela Reserves*, Financial Times, Jan. 23, 2008.
[109] *Id.*
[110] *Id.*
[111] Peter Wilson, *Venezuela Bites Back at Exxon-Mobil*, Business Week, Feb. 08. 2008.

preliminary stakes in the Orinoco's Junin block equivalent to approximately $50 billion dollars worth of investment. Consortia led by the U.S., Chevron and Spain's Repsol won minority stakes in two $15 billion projects in the Orinoco's Carabobo block in February of 2010.[112] Although new investment were quite unexpected after the international fracas over the 2007 nationalizations, there is no clear indication as to when these investments would come to fruition and restore robust oil production in the Orinoco Belt.

Venezuela showed new flexibility in the oil field assignments, softened contractual terms, lowered royalties and eliminated some taxes. However, even though the field assignments represent the largest investments since Chavez's 1999 ascent to power, many IOCs that initially indicated interest, declined to participate in the subsequent bidding stages. [113] Venezuela's relative flexibility may indicate the cyclical nature of resource nationalism in the face of lower oil prices since the onset of the global financial crisis in third quarter 2008.

### *5.3 PDVSA's Mounting Problems*

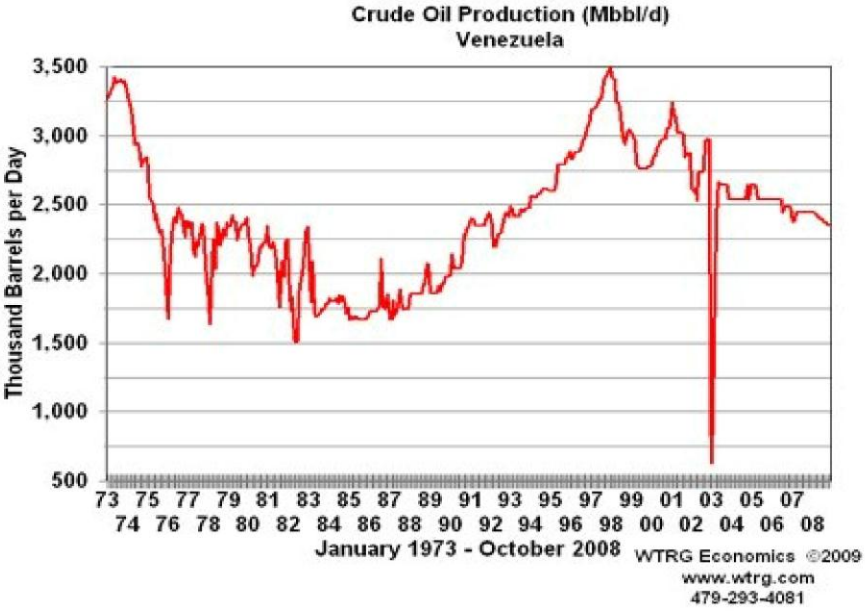


**Figure One: Venezuelan Oil production**

PDVSA is a clear beneficiary of the JVs with the Western IOCs. As much as Chavez wishes to extricate himself from dependence on Western firms, he is hampered by the fact that PDVSA lacks the necessary technical expertise and technology to optimally develop Venezuela's oil and gas resources.

Furthermore, PDVSA is still crippled from the politically motivated 2002 oil strike, which resulted in the government

112 Benedict Mander, *Venezuela Secures $80bn Oil Investment*, Financial Times, Feb. 16, 2010. 113 IOCs such as BP, Shell, Total and Statoil all participated initially.

firing 18,000 trained workers at once (see the drop in oil production in Figure One below for the years 2002-2003).[114] A protracted series of obstacles and a shift away from PDVSA's core competencies to more social objectives (e.g., housing construction, low-price food markets, etc.) also caused Venezuela's oil production to steadily decline.

As a possible illustration of a growing rift between her domestic production and her international obligations, Venezuela purchased 100,000 barrels a day of crude from Russia in May 2006 at a cost of $2 billion, to avoid defaulting on international contracts.[115] The Venezuela –Russia agreement, which lasted until December 2006, was nearly unprecedented in the history of the oil market. Venezuela's objective was to avoid default (and thereby incurring hefty financial penalties) on its supply contracts with third parties.

Under Chavez's social and economic restructuring, PDVSA now assumes a much more public role in society, which caused it to sacrifice capital investment spending.[116] During 2008-2009, PDVSA also established seven new subsidiaries that spanned the gamut from the agriculture sector, the service industry, the industrial sector, naval construction, communal gas development, engineering and construction, to urban development.[117] Chavez utilized PDVSA to absorb massive numbers of political loyalists and the oil behemoth's employee rolls increased dramatically, from 48,000 to approximately 75,000 employees in a space of a few. The massive hiring spree was also to partially implemented to remedy the significant institutional damage done when PDVSA lost most of its expert employees during the 2002 mass firing of striking workers.[118]

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[114] The strike, which was instigated by Chavez's political opponents, lasted for approximately two months and caused production to slow down to a trickle. Mr. Chavez reacted to the strike by firing thousands of employees and calling in retirees to replace them. David Buchbinder, *Venezuela's Oil Strike is Over, But Industry Faces High Hurdles*, Christian Science Monitor, Feb. 19, 2003. Furthermore, approximately 10,000 wells in the west of the country have been rendered useless due to neglect and the administration's failure to repair them. Joe Duarte, *Venezuela Buys Oil to Meet Contracts*, Rigzone, May 02, 2006.

[115] It could also be that PDVSA is stretched so thin by Mr. Chavez's commitment to provide inexpensive oil to prop up regional allies that it simply does not have enough to go around. Andy Webb-Vidal, *Venezuela Buys Russia Oil to Avoid Defaulting on Deals*, Financial Times, Apr. 28, 2006.s

[116] *Id.*

[117] *Id.*

[118] *Id.*

Yet, there are truly ominous signs. In spite of unprecedented oil price escalations during 2006, PDSVA's debt increased from $4 billion to more than $16 billion.[119] This significant increase may suggest profound structural weaknesses that even elevated oil prices cannot cosmetically mask. While the 2010 Orinoco tender brought more investors into Venezuela's energy sector, PDSVA faces the daunting task of coordinating these massive projects and attempting to understand highly complex technical and capital requirements. Another major obstacle to PDVSA efficiently developing its fields is that it tends to stifle the minority partners efforts to gain broader operational control, a weakness compounded by its own bleak management record. Furthermore, Chavez's ever-present threat of expropriation hangs as a damoclean sword over interested investors and further constrains what could otherwise become a major investment focus of IOCs.

# 6. Conclusion

Global political risks for IOCs are not confined to expropriation, war, or coups. [120] Even greater risks may inhere in factors that contribute to legal instability, such as curency repatriation restrictions, modified legislation against IOCs interests, and abrupt contractual changes (renegotiation).[121]

The ideas espoused by neo-liberal economic thought clashed continuously with the Southern view of national sovereignty. Southern nations promoted the view that it is the inherent right for sovereign nations to restructure their economies as they see fit in the wake of decolonization, primarily through nationalization of the property of foreign investors. [122] The

[119] Benedict Mander, *PDVSA Results Allay Venezuela Bond Worries*, Financial Times, Apr. 21, 2010.

[120] Expropriation first occurred in the non-communist world with the nationalization of foreign investments in Mexico in 1938. This set the stage for later expropriations in Latin America and the Middle East. Justin Dargin *Pemex: Challenges and Opportunities, Time for Reform*? USAEE Dialogue Vol. 4 No. 3, Nov. 2006.

[121] It should be kept in mind that renegotiation differs from expropriation. For renegotiation, the dispute is considered settled after the successful conclusion of the negotiation. In regards to expropriation, the investor whose assets were expropriated generally expects compensation that weighs the current market value of the investment. On the history of petroleum agreements, Ernest E. Smith and John Dzienkowski, *A Fifty-Year perspective on World Petroleum Arrangement*, University of Texas School of Law (1989)

[122] The North-South Divide is the socio-economic and political demarcation between the wealthy developed countries known collectively as the "North," and the poorer developing countries known as the "South." Historically, the term originated due to the fact that most countries north of the Equator were industrialized and

leaders of the host-States generally perceived themselves as hampered by international law that emphasized sanctity of contracts and "prompt, adequate and effective" compensation for nationalizations. Generally, in response to nationalization, IOCs insisted on restitution equal to the full market value of the nationalized property, a nearly impossible condition for the developing nations.

The clash between the resource-rich developing countries and foreign investors lies in two central questions: Are property rights absolute, even in the international context of foreign investment in strategic sectors? Does the State have the authority to waive critical aspects of its jurisdiction by selling rights to investors?

## *6.1 The Chavez Phenomenon*

As discussed in the introduction, resource nationalism is a nebulous phrase that lacks concrete parameters. The essential question is whether Chavez's brand of resource nationalism represents a unique, Venezuelan method of State control or is it more universal?

Oil's elevated international price between the years 2001-2008 prompted the global community to weigh the implications of this phenomenon. Many energy analysts conclude that the resource nationalism of today simply resurrects premises that provoked the collective nationalization of the Middle Eastern energy sector in the 1960s and 1970s. However, that reasoning, while derived from many apt historical analogies, does not adequately reflect the policies that make the current manifestation of resource nationalism more enduring, and less outwardly aggressive (on a global scale) than in years past.

The resource nationalism of the 1960s was infused with the ethos of the decolonization struggle in the developing world. Today, resource nationalism is just as likely to precipitate obscure environmental statutes or stir the land rights of indigenous tribes in remote South American or African oil producing regions, as to stir talk of the ostensible "neocolonial" policy of Western nations.

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the countries located south of the equator, were less so. Currently, "North," refers to any developed country regardless of location.

In most developing nations, no longer will observers witness dramatic rhetoric with an "anti-Colonialism" flair. Today's resource nationalism may be developed in policies that promote windfall taxes, tariffs, quotas, "voluntary" production restraint agreements, expropriation of foreign assets, and overly strict (or selective) environmental standards levied against foreign energy corporations. Resource nationalism is also connected to the contractual issue of changed material circumstances. If there has been a major, unexpected change (usually an increase) in oil prices, producing countries frequently mount a call for contractual revisions, even though IOCs generally oppose any contractual modification, based on the 'sanctity of contract' principle, *pacta sunt servanda*.

Western political analysts compare Chavez's conduct in the energy sector to the actions of former Russian president Vladimir Putin and Iran's Ahmadinejad. However, Putin's conception of "sovereign democracy," a Russia no longer subservient to the West for loans or approval, contrasts sharply with Chavez's "Twenty-First Century Socialism," which is much more international in scope, and more willing to sacrifice Venezuela's immediate benefits for a broad future goal. While Mahmoud Ahmadinejad is often in the news for his country's nuclear enrichment program, Iranian oil production tends to be strictly a domestic issue, with economic redistribution occurring through below-market rate gasoline prices, and job creation through a bloated oil sector.

The international press has taken frequent notice of Putin's budding friendship with Hugo Chavez; to the extent of implying that the two share more than friendship, and perhaps consciously rival one another's effort to reassert State control in their respective oil and gas industries. However, Caracas's nationalistic rhetoric does not disguise the fact that Venezuela is more dependent on hydrocarbon revenue than ever before. Chavez represents populism in one of its purest Latin American forms, using Venezuelan oil wealth for redistribution on sometimes-lauded, sometimes-criticized social programs. For Chavez, energy assets a means to an end.

Chavez seeks to reverse the humiliating energy policies of an earlier era (the *Apertura*) which he viewed as a "give-away" to Western IOCs. In a clear rendition of his ultimate goal, he announced publicly that, "[T]he nation should recover its ownership of strategic sectors, all of

that which was privatized, let it be nationalized" and included "all of those sectors in an area as important and strategic for all of us as is electricity."

The ultimate foreign policy goal for Chavez is to reduce reliance on Western IOCs and the IMF and World Bank, and to actively disengage US influence from the region.[123] Working in parallel with his expropriation campaign against IOCs, Chavez has also begun to move against domestic national investors, many of whom were his once most loyal supporters.[124] Chavez has demonstrated a unique ability to consolidate his power, while the crises that swirl around him seem, from an outside view, as if they could topple him.[125]

Chavez successfully exported his particular brand of anti-IOC policies elsewhere in Latin America, most notably to Bolivia and Ecuador. In Bolivia, President Evo Morales, a former coco farmer and union leader, yoked his form of IOC expropriation to the mantle of indigenous rights. Bolivia, preceding Venezuela by about a year, nationalized its hydrocarbon sector in May 2006. Bolivia instituted its nationalization campaign as a broader strategy against what it decried as "savage Capitalism."[126] Ecuador, under President Rafael Correa, seized oil fields located in the Amazon, alleging that nationalization was required to halt the systematic environmental degradation by Occidental.[127]

However, Chavez's aggressive expropriation polices have garnered little sympathy is other Latin American countries. Nationwide polls in Peru found most Peruvians are against incorporating any form of energy sector nationalization based on the Bolivian and Venezuelan

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[123] Venezuela is one of the most active proponents in OPEC to switch from selling oil in Dollars to Euros. However, the Greek economic crisis of 2010 caused a precipitous decline of the Euro. At the time of writing, it is not certain what long term impact this would have on global confidence in the Euro as a potential reserve currency, but the volatility associated with the Greek economic crisis, would certainly damped renewed interest to denominate oil sales in Euros. See generally, *Oil Falls Below $72 on Euro Crisis*, RTE Business, May 14, 2010; Nelson D. Schwartz, *Fears Intensify That Euro Crisis Could Snowball*, May 16, 2010.

[124] Simon Romero, Purging Loyalists, Chavez Tightens His Inner Circle, New York Times, Feb. 16, 2010.

[125] *Id.*

[126] Naomi Mapstone, et al, *Bolivia Rejects 'Savage Capitalism'*, Financial Times, Dec. 5, 2009.

[127] Darcy Crowe, *Ecuador President: Nationalized Oil Firms Would Be Compensated*, Fox News, April 20, 2010.

model. [128] Colombians, on the whole, appear to be particularly antagonistic to Chavez and his policies, especially since the flare-up of border hostilities in 2009 led to Venezuelan troops being sent to the Venezuela-Colombia border.[129]

The energy nationalizations across Latin America led IOCs to transfer operations to other regions and to pursue claims in ICSID, making Latin America the region with the largest share of claims (56%) since 2000.[130] While foreign national oil companies from generally friendly nations have had their oil assets nationalized as well, e.g., Sinopec (China) and Petrobras (Brazil), causing Sinopec to file for arbitration.Typically, Latin American nationalization is directed exclusively against Western IOCs, as Bolivia and Venezuela utilize their energy assets to build more robust linkages with allies such as Iran, China and Russia.

A certain degree of contemporary resource nationalism is organically tied to the cyclical structure of the energy market. A structural shift in the global energy sector has been ongoing since the 1960s, whereby greater control over a nation's natural resource production has been placed in the hands of the government and domestic national oil company. Latin American resource nationalists, as exemplified by Chavez, Correa and Morales, are unique in that they principally view energy assets as a means to an end, namely, to reconfigure the national economy along more socialistic lines. For these Latin American States, political goals tend to trump the purely financial considerations that motivate other resource-rich States to increase taxation on IOCs.

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[128] *Peruvians Unsympathetic to Chavez , Morales*, World Public Opinion, May 26, 2006.
[129] Ian James, *Chavez Warns of War with Colombia*, Associated Press, Mar. 2, 2009.
[130] Johanna Mendelson Forman, et al, "Latin America: America's Forgotten Energy Barn" in (ed) Gal Luft, et al, *Energy Security Challenges for the 21st Century: A Reference Handbook*, 139 (2009).

However, at the same time, these three Latin American leaders are in the ultimate calculus influenced by the volatility in the global oil market, i.e., tightening governmental control when oil prices are relatively high, and relaxing control and encouraging foreign investment when prices are low. But because of the overt political orientation of their overall energy and economic strategies, their overall energy policies tend to be much more inelastic than other resource-rich States that are only concerned with increasing their budgetary revenue.

Nonetheless, resource nationalism is clearly not limited to the developing world. In 2005, when the Chinese National Offshore Oil Company, CNOOC, attempted to acquire Unocal, the resultant political uproar in the U.S. eventually induced CNOOC to withdraw its bid. In Canada, allegations of resource nationalism also surfaced. In 2008, Alberta revised its oil sands royalty regime to boost revenue.

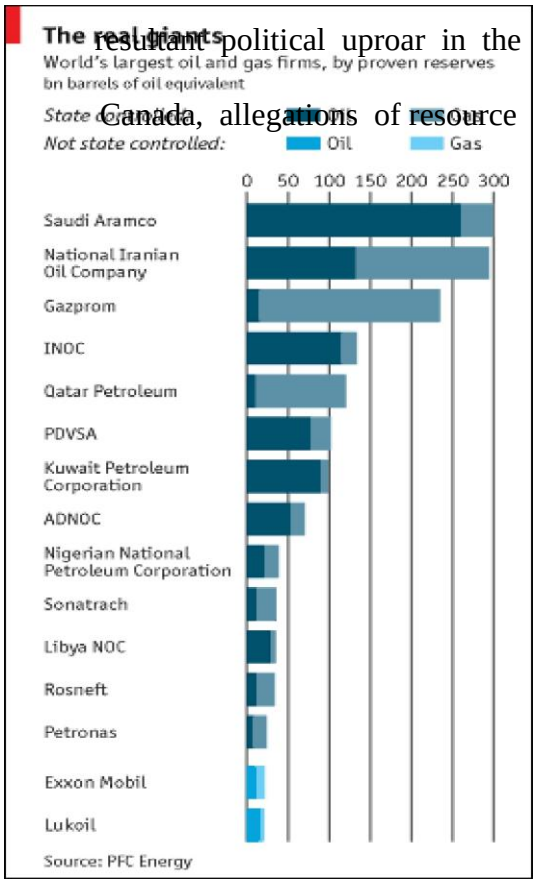


**Figure Two**

Meanwhile in 2010, Australia announced that it would introduce a Resources Super Profit Tax that would tax approximately 40% of corporate profits after projects have achieved a rate of return in excess of the prevailing government bond rate (at the time of writing, about 6%).[131]

Undoubtedly, the Latin American cases of resource nationalism are relative outliers due to their overt political goals. The alleged resource nationalism in the Western

[131] The Commonwealth of Australia , *A Resource Super Profits Tax: A Fair Return to the Nation* (2010) Available at http://www.futuretax.gov.au/documents/attachments/announcement_document.pdf (Last visited May 17, 2010)

jurisdictions depends much more on the upswing of the international price of oil and therefore is quite elastic. However, the general global trend has been for increased State control in the energy sector of developing nations. Most developing states have constitutional mandates that explicitly place the country's natural resources under the sole authority of the State. The developing countries that follow this middle path-neither wholly dependent on the global price structure, but not entirely motivated by ideological reasons- still stay within a general framework of State control.

The advent of the national oil company (see Figure Two) since the late twentieth century has effectively turned the once great IOCs into veritable oil field operating companies, e.g., Halliburton. Since the demise of the concession agreements in the 1960s and 1970s, their primary source of influence is in technology development. The creation of the national oil company, and the resultant increased competence of developing countries to not only produce and refine their own hydrocarbons, but to expand and invest in other energy-rich States, has had a much more profound and lasting influence on the ability of IOCs to secure investment opportunities than the occasional demagoguery associated with Chavez's policies.

While Chavez may be considered a "throwback" to the era when junior officers, with perhaps more enthusiasm than experience, would storm the presidential palace and proclaim a "people's revolution," he is merely the more extreme end of the continuum that sees the IOC gradually pushed out of more jurisdictions. The likely future of these trends is that while resource-rich States will always need investment, more of that investment will come either from other national oil companies, or the State will attempt (a la Friedrich List) to direct the nation's oil and gas resources to the domestic market to satisfy domestic demand and to develop

downstream value-added industries, e.g., petrochemicals, fertilizers, etc. Chavez, while bombastic, does not represent the true nature of resource nationalism, rather, it is the slow and steady growth of the expertise and confidence of resource-rich developing countries that will set the stage for future oil and gas investment policies.