

No Business as Usual for Russia in Venezuela

By [Chris Weafer](#)

March 10, 2013



Despite assurances from government officials in Caracas that it will be business as usual after the death of Venezuelan President Hugo Chavez last week, his passing will almost certainly lead to the start of political and social changes in that country. The only question is the time frame. Chavez's death and the emergence of a new presidential administration will surely have a significant impact on the global oil industry and price of oil, although perhaps on an even longer timeline. According to the BP Energy Review, Venezuela sits on the world's largest exploitable reserves of oil. Chavez's policies have led not only to no significant exploitation of those reserves but have actually directly led to a cut in the country's average daily oil output by one-third in the 14 years he served as president.

In 1999, the country produced an average of 3.5 million barrels per day, while the current average output has dropped to 2.5 million barrels. With the right investments, the country may easily support average daily oil output of 5 million barrels and probably higher, according to industry estimates. There can be little doubt that as of last week, Venezuela has become the most important target location for foreign oil majors, especially U.S. companies.

Russian oil majors still have a small advantage, and senior executives from state-owned Rosneft and Gazprom will be eager to ensure good relations with the next administration. But they must know that there is now a limited window to convert promised cooperation with the Venezuelan state-owned oil company, PDVSA, into actual projects. Oil executives from Houston will soon be descending on Venezuela with lucrative alternatives, and PDVSA, in dire need of capital investment, will surely be listening to their offers. For Russia, that means three risks. First, Gazprom and Rosneft will have more competition for joint-venture deals in that country. Second, Venezuela is an easier alternative to the hostile and unpredictable Russian Arctic for U.S. oil companies, which may make it harder for Moscow to attract joint-venture deals. Finally, the prospect of more oil coming out of Venezuela adds to the growth projections for shale oil as a significant longer-term threat to the price of oil, and therefore, to the Russian economy.

None of this will be lost on the Kremlin. It means that there will have to be greater urgency to convert promised deals into real projects in Venezuela. At the same time, the Kremlin will want to conclude more joint ventures to exploit the Arctic. It also means that the clock counting down to lower oil revenues is now ticking, increasing the need for more urgent progress in economic reforms.

The Venezuelan constitution mandates that a new election must take place within 30 days. As it stands today, the current vice president, Nicolas Maduro, is expected to be elected to replace Chavez. Maduro said he intends to stick with the economic and political policies and ideologies of his former boss, but since Maduro is no Chavez, this will be virtually impossible to achieve. Chavez was a hugely charismatic, larger-than-life leader who managed to maintain unity of purpose among the many vested interests in the country. At the same time, he stayed popular with the people even as the economy slid further into trouble. With oil averaging over \$110 per barrel last year, the Venezuelan state budget ran a deficit of close to 20 percent of gross domestic product.

Now that Chavez is gone, the soon-to-be-elected president Maduro will come under increasing pressure to take actions to start improving the economy. No different from President Vladimir Putin's situation when he took over an ailing economy in Russia in 2000, the only place that the new Venezuelan president can get revenue is from the oil sector. But after Chavez practically destroyed PDVSA when he fired 20,000 skilled engineers and other workers in 2002, PDVSA will need a huge boost to capital spending and joint-venture partnerships. Although politically risky, Maduro may have no other choice than to ask ExxonMobil and Chevron, two of the U.S. majors that had their local projects nationalized by Chavez, to come back.

Venezuela is certainly an attractive option for the world's big oil majors. Recoverable reserves are now put at just under 300 billion barrels, compared to about 265 billion in Saudi Arabia and less than 100 billion in Russia. Most of Venezuelan oil is heavy and more expensive to refine, but it lies only a few hundred meters below the Orinoco Belt. That makes it a lot more attractive than, for example, speculatively drilling in the hostile Russian Arctic while dodging icebergs. The Orinoco Belt is an extremely important natural environment, and the inevitable objections from domestic, regional and international environmentalists will slow any development. But as has happened in similar situations elsewhere, the quest for the prize will almost certainly prevail. Venezuela needs the money.

Venezuela has also very likely moved to near the top of the U.S. government's list of geopolitical priorities. The U.S. is set on a course to become energy independent, and the International Energy Agency calculates this may take two to three decades based on current trends and with optimistic assumptions for U.S. shale oil production. Such assumptions have always been speculative when it comes to the oil industry. But a more achievable target for the U.S. is to become regionally oil independent — that is, to only source its oil requirements domestically and from Canada, Mexico and now perhaps from Venezuela. That would allow the U.S. to become completely independent of Middle East oil within 10 years or so. A change in Venezuela's political and economic priorities would also weaken the Cuban economy since Chavez supplied Cuba with almost free oil. That would hasten the inevitable regime change there as well, an extra bonus for Washington.

But while such an outcome would be very favorable for the U.S. economy, it would accelerate the game change already started in the global oil industry with the rapid growth in shale oil volumes. No matter how you work the assumptions, the world is heading for a lot more oil supply over the balance of this decade. New major oil production will come from North America, Iraq and the Caspian Sea, where Kazakhstan's giant Kashagan field starts to produce from this year, almost certainly from Venezuela if a new administration takes concrete steps to increase foreign investment and production in the oil sector. This may be the real reason Russian officials shed a few tears at Chavez's funeral on Friday.

Chris Weafer is chief strategist at Sberbank Investment Research.

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