

Venezuela and its oil sector is on the brink of collapse

The collapse in oil production has pushed Venezuela into an economic death spiral. The IMF estimates its economy, which relies on oil for 95% of its exports, shrank 12% in 2017 and will contract another 15% this year. If this forecast holds true, by the end of this year Venezuela's economy will be 50% smaller than it was in 2013. To make matters worse, inflation is projected to reach 13,000% this year, up from 1,133% in 2017.

The country has also been hit hard by severe shortages of food, medicine and other necessities owing to economic mismanagement. The imposition of price controls has dissuaded companies from producing goods because they would be forced to sell them at a loss. This, combined with the forced nationalization of thousands of companies, has seriously reduced the capacity of Venezuela's economy to produce anything of value other than oil. Finally, the decline in oil production and the dire state of the economy has severely curtailed the government's ability to import these goods from abroad.

The country's foreign reserves currently stand at about \$9 billion (mostly in gold), down from \$27.6 billion five years ago. Venezuela owes about \$150 billion in foreign debt. It began defaulting on certain bonds (\$2.5 billion so far) last November.¹

A further negative indicator is the fact China, one of its main backers, has grown tired of throwing good money after bad and has decided to not lend anymore funds. Venezuela presently owes China \$20-\$25 billion.

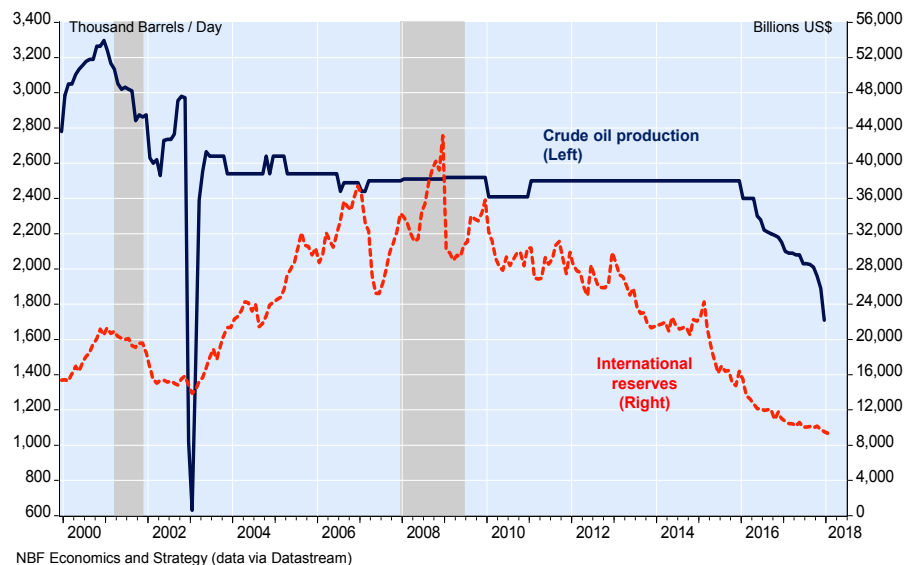
Finally, the human toll of this economic catastrophe cannot be understated. Food shortages caused Venezuelans to lose 11 kilograms (24 pounds) on average in 2017.²

The epic collapse of Venezuela's oil production

Oil production fell from a peak of 3.3 million barrels per day (bpd) in 2001 to 1.55 million bpd last February - an over 30-year low.³ It sank an astounding 600,000 bpd in 2017 alone. **Given that these are government figures, there is good reason to believe that the true extent of the decline has been under-reported.**

Venezuela: Oil production and international reserves decreasing

EIA oil production figures (December 2017) and Banco Central international reserves (February 2018)

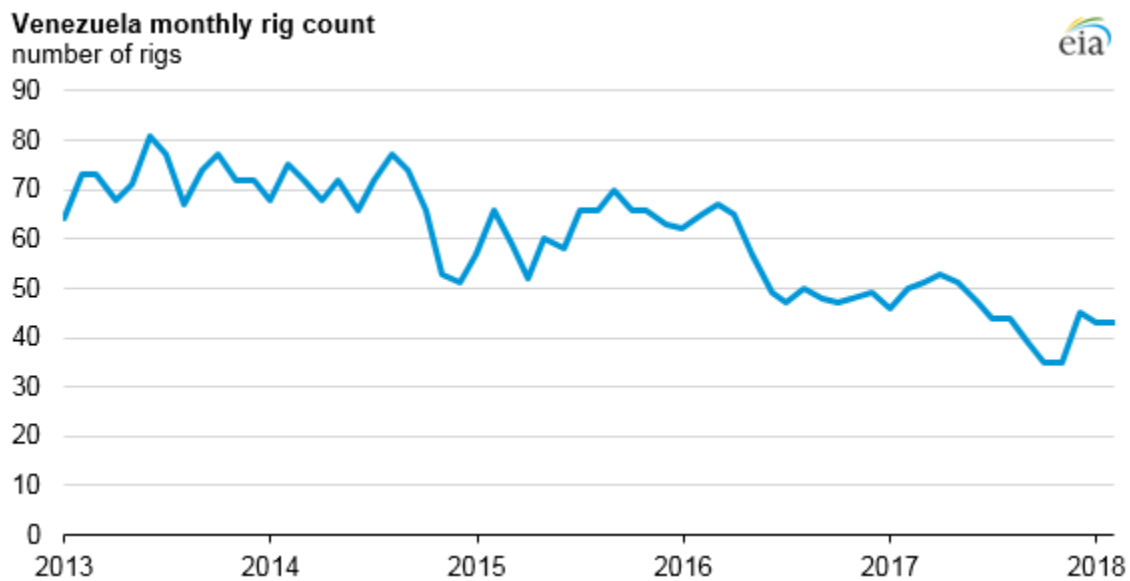


¹ "Venezuela Is in Default, but Goldman Sachs Just Got Paid," Wall Street Journal, April 8, 2018

² "Under military rule, Venezuela oil workers quit in a stampede," Reuters, April 17, 2018

³ "Elections a new rupture point in Venezuela crisis," Petroleum Economist, April 16, 2018

Another ominous sign: The number of active rigs dropped from nearly 70 in the first quarter of 2016 to an average of 43 in the last quarter of 2017.



The sharp decline in oil production is due to the following factors:

- The nationalization of the oil industry in the past decade has scared off most foreign investors.
- Petroleos de Venezuela SA (PDVSA), the state-owned oil company, has replaced tens of thousands of qualified workers with political loyalists. The most recent prominent example being President Maduro's nomination of Manuel Quevedo, a military general with no industry experience, to run PDVSA.
- With the national currency nearly worthless thanks to hyperinflation and its foreign currency reserves nearly depleted, Venezuela is increasingly unable to import needed machinery and spare parts. It is estimated the country owes \$60 billion to energy contractors and suppliers.⁴
- The oil sector's inability to pay its labour force a living wage under hyper-inflationary conditions has left many workers too weak and hungry to perform heavy labour. This has resulted in mass resignations and absenteeism. While official statistics are not available, one union leader recently said that about 25,000 workers resigned between January 2017 and January 2018. PDVSA reported 146,000 people on its payroll in 2016.⁵
- The decrepit state of its refining infrastructure is forcing Venezuela to significantly increase its imports of lighter oil (currently 200,000 bpd) to be used as a diluent for its heavy oil.⁶

On top of all of the above-mentioned difficulties, about 40% of Venezuela's production in 2017 went to China and Russia to repay loans and to its ally Cuba at way below the market price.⁷ Just under 20% of production was consumed in the domestic market at a huge loss (the cost of low-grade oil is about 10 cents per litre or 38 cents per gallon). Ironically, this has made the United States, Venezuela's main geopolitical adversary, its largest cash buyer by far. However, declining oil production caused exports to the United States to plunge from an average of 810,000 bpd in 2016 to 555,000 bpd in November 2017.⁸

⁴ "Corporate America's nightmare in Venezuela is getting worse," CNN Money, January 19, 2018

⁵ "Under military rule, Venezuela oil workers quit in a stampede," Reuters, April 17, 2018

⁶ "How Venezuela has resorted to importing oil as its core industry faces collapse," The Independent, April 16, 2018

⁷ "The Venezuelan oil industry is on a cliff's edge. Trump could tip it over," Washington Post, February 25, 2018

⁸ "The collapse of the Venezuelan oil industry and its consequences," Atlantic Council, March 2018

The looming menace of further U.S. sanctions

Venezuela's problems have been exacerbated by U.S. sanctions. These include restrictions on American banks with respect to issuing or restructuring debt for the Venezuelan government or PDVSA. Other potential sanctions include:

- Prohibiting U.S. exports of diluents such as naphtha, which are needed to reduce the thickness of Venezuela's heavy oil to allow it to flow through pipelines.
- Targeting the insurance coverage of oil tankers carrying Venezuelan oil, a tactic that had a devastating impact on Iranian exports several years ago. Without insurance, tankers cannot legally sail in international waters.
- Banning the importing of Venezuelan oil to the United States. The country could reroute shipments to India or China, but such sales would probably occur at a significant discount.

Political turmoil

Venezuelans will be casting their ballots May 20 to elect a president. Despite polls showing challenger Henri Falcón as the clear favourite, most analysts believe President Maduro will prevail through widespread cheating and voter intimidation (i.e., threatening to cut off food benefits to people that vote against the incumbent government).

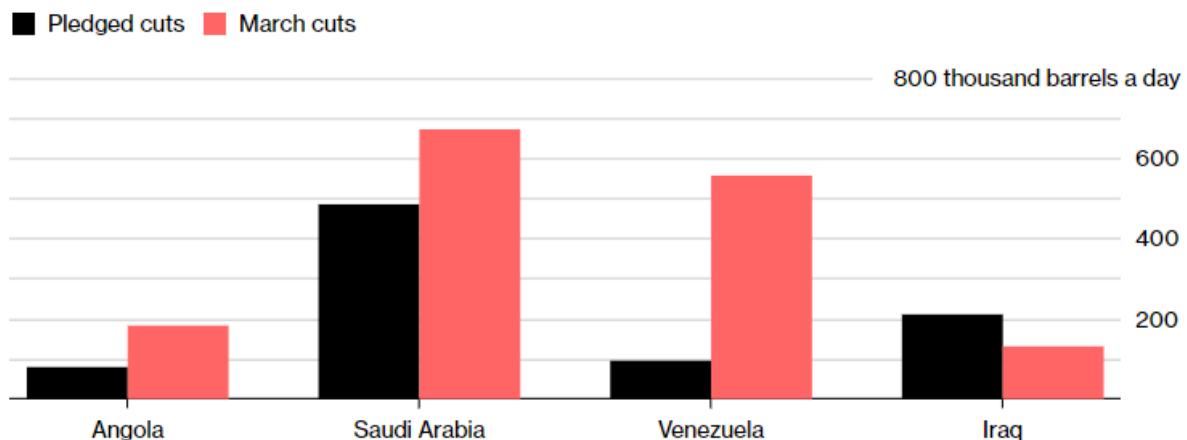
In a further effort to cling to power, President Maduro has increasingly relied on the army. Active and retired officers hold 14 of 32 cabinet posts, oversee much of the oil sector, and control the hungry nation's food supply.⁹

OPEC and other producers succeed in reducing target

Venezuela's oil troubles come at a time when OPEC and several non-OPEC countries have successfully overshoot their goal of cutting oil production by at least 1.8 million barrels per day. Its non-deliberate decline in production has made Venezuela one of the biggest contributors to this success. **As the chart below illustrates, it has significantly exceeded its target of cutting production by 95,000 bpd.** Taken together, these cuts have helped shrink global oil stockpiles from 400 million barrels above their five-year average two years ago to just 43 million barrels above it today.

The Odd Man Out

Iraq has yet to comply with its pledged cuts while Venezuela and Saudi Arabia have over-delivered



Sources: OPEC survey and OPEC agreement communique

Source: OPEC Output Falls to Lowest in a Year Amid Venezuela Woes, Bloomberg, April 3, 2018

⁹ "The Bloody Grab for Gold in Venezuela's Most Dangerous Town," BusinessWeek, April 9, 2018

Conclusion

Continued depressionary economic conditions, dangerously low foreign currency reserves, China's refusal to lend more money, reports of oil workers increasingly abandoning their jobs, the inability to import much needed machinery/spare parts for the oil sector, and the likely imposition of more sanctions by the United States all point to a further significant decline in oil production by the end of this year.

The tipping point for the Maduro regime and its oil sector could be reports of widespread cheating and/or violence in the lead-up to the May 20 election followed by the imposition of even tougher U.S. sanctions. It is also important to note that even if Maduro was ousted from power by the army it would take a considerable amount of time to undo the damage caused to the oil sector.

The oil market would be tightened further still if the United States pulls out of the nuclear accord with Iran (the decision will be made around May 12). Even if the United States was the only country to reinstate sanctions, its leverage would still be considerable thanks to global dominance of the U.S. dollar banking system. Energy analysts estimate that the re-imposition of U.S. sanctions could remove 300,000 to 500,000 bpd of Iranian oil from the global market.

Bottom line: Given the shrinkage of global oil stockpiles, the ongoing collapse of oil production in Venezuela and Iran-U.S. tensions, we see very limited downside potential to oil prices from current levels in 2018.

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