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Chavez's Billion-Dollar Snub of the U.S.

Venezuela President Chavez is cutting a deal to ship oil to China, which will lessen profits—and dependence on the U.S.

by Peter Wilson

Venezuelan President Hugo Chavez can't be accused of letting economic realities derail his energy policies, especially if it helps him snub the U.S.

Venezuela's and China's state oil companies will invest up to $10 billion to develop a heavy oil patch in the South American country, Venezuela's Oil Minister Rafael Ramirez said last month. Production of up to one million barrels a day would be destined for the Chinese market, where the two companies may also build three refineries to process the crude.

No matter that Chinese markets are 30 days away from Venezuela by tanker, compared with five to six days for U.S. Gulf ports. The cost of transporting crude to China will shave several dollars per barrel from Venezuela's take, analysts say.

"Chavez would clearly have to lower the price of the crude," says Lucian Pugliaresi, who heads the Washington-based Energy Policy Research Foundation. "He would have to offer a discount of between $5 and $10 a barrel."

If that's the case, the cost to Venezuela could hit $5 million to $10 million a day in lost profits, or as much as $3.7 billion a year. Still, that may be a price Chavez is willing to pay since a long-term supply and refining agreement would boost Venezuela's toehold in the world's fastest growing energy market. China is now the world's second-largest oil importer, trailing only the U.S. Any long-term pact would also allow Chavez to lessen his dependence on the U.S. market.

"From the Chinese perspective, they see a man in Venezuela who hates the U.S. and is willing to do things that don't make economic sense," says Jim Williams, who heads the London, Arkansas-based WTRG oil consultancy firm. "So, they think, why not take advantage of this situation."

MAJOR SUPPLIER

Chavez has made no secret of his desire to lessen his country's dependence on the U.S., which he has repeatedly accused of seeking to overthrow his regime, including allegedly backing an abortive 2002 coup attempt. Despite the rhetoric, the U.S. still takes about two-thirds of Venezuela's daily oil exports of about two million barrels. Venezuela supplies about 10% of U.S. oil imports and ranks among Washington's five largest suppliers.

But that is changing. Deliveries to the U.S. have fallen in the face of rising domestic consumption and as Chavez has sought to open new markets, especially in Asia, and to a lesser degree the Caribbean and South America. Venezuelan oil shipments to the U.S. fell 9% from 2004 to 2006 to about 1.42 million barrels a day, and are down an additional 8% for the first six months of this year, according to statistics from the U.S. Department of Energy.

During the same period, Venezuelan oil exports to China have soared tenfold from 14,900 barrels a day in 2004 to more than 150,000 barrels today. And if Chavez has his way, that number could more than triple by 2010.

REFINERY COSTS

Given falling Venezuelan oil production, any increase in exports to China, India or other Asian markets would come at the expense of the U.S., analysts say. Although Chavez says that his country's oil output will rise to 5.8 million barrels a day by 2012, few believe him given problems at the state oil company Petroleos de Venezuela, which has seen its investment funds diverted to the President's social programs.

Closer energy ties with China come with a cost, analysts say. To make any agreement more feasible, Venezuela would need to find a Pacific outlet for its crude, either by using an existing pipeline in Panama, or building a new one in Colombia, to avoid shipping its oil around the tip of South America, analysts say. And secondly, China's existing refineries can't process Venezuelan heavy crude, which is high in sulfur and metals. That has forced Chavez to send China fuel oil or other finished products so far.

"Building new refineries in China is essential if Venezuela hopes to boost exports there," says Williams.

OIL COMPANIES LEAVING

A Petroleos de Venezuela (PDVSA) spokesman said talks about the refineries continue but gave no details. PDVSA President Rafael Ramirez, who is also the country's Oil Minister, declined repeated interview requests. Calls to China National Petroleum Corp.'s Venezuelan offices weren't returned.

The growing energy axis between China and Venezuela came about as a result of Chavez seeking to limit the influence of international oil companies in his country. Since 2004 Chavez has repeatedly raised taxes and royalties on foreign oil companies operating in his country, while mandating that Petroleos de Venezuela be given a majority stake in all oil operations.

His steps have led both Exxon Mobil Corp. (XOM) and ConocoPhillips (COP) to exit the South American country (BusinessWeek.com, 6/26/07), and analysts expect others to follow, drying up important funding and technology.

CHINA'S CHALLENGES

Unlike their publicly traded brethren, the Chinese have stayed. China National Petroleum Corp. (CNPC) operates several oil fields in a joint venture with PDVSA, and is also involved in certifying reserves in one heavy oil block. PDVSA is also buying drilling rigs and oil tankers from China, in addition to creating a joint venture shipping company.

However CNPC has also had its share of problems with PDVSA, including a project to produce a boiler fuel that was unilaterally terminated by Venezuela.

"Chinese national oil companies have faced the same challenges operating in joint ventures with PDVSA as private international companies," says one Western oil executive. "The advantage given to the Chinese has been access to new opportunities."

'HIGH EXPECTATIONS'

It remains to be seen whether CNPC and other Chinese companies will be able to find sufficient capital for the Venezuelan joint ventures. The Chinese have scant experience in heavy oil ventures, an obstacle they are trying to remedy by investing in Canadian oil sands.

Venezuela's four existing heavy oil ventures, which were taken over by the government earlier this year, were put together by international oil majors.

"The Chinese are on a learning curve for heavy oil technologies and at this moment do not have the expertise of private international companies," says the executive. "The Venezuelan government has high expectations for the technologies to to be applied in new heavy oil developments, aiming for significantly improved recovery efficiencies. I do not think that Venezuela will allow the Chinese or other [national oil companies] to use outdated technology in developing heavy oil blocks."

Nonetheless, long-term political goals may trump existing obstacles and current economic considerations, says Julian Lee, an analyst at the London-based Center for Global Strategy. "There is an element on both sides seeing this as a strategic guarantee," he says. "The Chinese are scouring the globe, seeking to lock up energy resources, and the Venezuelans, under their present leadership, are seeking to diversify from the North American market."

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