Venezuelan Debt *Conundrum*

By Steven T. Kargman

Continued deterioration of the oil industry will make restructuring even more difficult.

In the Fall 2018 issue of *TIE,* we discussed the myriad obstacles to a Venezuelan debt restructuring existing at that time, and also reviewed various scenarios in which such obstacles might be overcome. In this issue, we will review how a delay in restructuring Venezuela's debt—especially in light of the deteriorating state of Venezuela's economy in general and its oil industry in particular—will only make any eventual restructuring even more difficult to accomplish, and the longer the delay, the greater the difficulty.

Since last fall, there have obviously been major political developments in Venezuela, most notably the declaration by Juan Guaidó, president of the Venezuelan National Assembly, on January 23, 2019, of his intention to begin serving as the interim president of Venezuela. That declaration was followed shortly thereafter by the recognition of Guaidó by dozens of foreign governments, including the United States, as the legitimate leader of Venezuela. However, recognition was not granted by Russia, Cuba, China, and Turkey, which reaffirmed their support for the Maduro regime.

In addition, since recognizing Guaidó as the interim president, the U.S. government has imposed additional sanctions affecting the Republic of Venezuela, its state-owned oil company PDVSA, and additional individuals in the Venezuelan government. The purpose of the U.S. sanctions imposed by the Trump administration is to sharply increase the economic and

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financial pressure on the Maduro regime with the fairly express aim of ultimately forcing the regime from power.

Among other things, the sanctions have effectively cut off Venezuela's exports of oil to the United States—the key source of Venezuela's foreign exchange—and U.S. sales of light oil to Venezuela (which in the past was used for blending with Venezuela's heavy oil, thereby making it suitable for export). Most recently, in mid-April, new U.S. sanctions targeted Venezuela's central bank with the apparent aim of making it more difficult for Venezuela to conduct international financial transactions and access international financing, thereby attempting to put additional financial pressure on the Maduro regime.

GDP has shrunk by approximately 50 percent in the last several years.

The grave humanitarian crisis in Venezuela persists and appears to have grown increasingly dire by the day, and matters were not helped at all in late February when the Maduro regime used military force to block caravans of urgently needed humanitarian aid from entering into Venezuela. The nationwide blackouts which beset Venezuela in March only made the situation even more fraught and, indeed, even more desperate for many citizens, and such blackouts apparently represent a continuing threat in light of the vulnerabilities and fragility of Venezuela's electricity grid infrastructure.

Some observers have argued that U.S. sanctions have exacerbated an already precarious situation for Venezuela's citizens since Venezuela has a reduced ability to import necessities such as food and medicine, given the diminished oil revenues available to the Venezuelan government resulting from the sanctions. As stated in a *New York Times* headline in February, "U.S. Sanctions Are Aimed at Venezuela's Oil. Its Citizens May Suffer First."

Yet, as of late May, the Maduro regime remains in power. Most recently, in late April/early May, the Maduro regime thwarted an attempted uprising that had been announced by the Guaidó-led opposition forces. Only time will tell whether the Maduro regime will continue to hold on, or whether Guaidó and/or any other opposition-led group will eventually be able to ascend to power. Another possibility, in light of recent reports regarding the resumption of talks in Oslo between representatives of the Maduro regime and the opposition forces, would be some political settlement between the opposition and the Maduro regime.

As explained previously, it is difficult to envisage a Venezuelan debt restructuring taking place as long as the Maduro regime remains in power. The recent events described above perhaps only reinforce this point. Specifically, the distance between the Maduro regime and much of the international community (apart from Russia, China, Cuba, and Turkey in particular) has only grown wider since last fall.

Thus, the possibility of the Maduro regime being able to work with the international community on, for example, arranging a package of financial assistance to assist Venezuela on an economic reform and recovery effort would seem to be even more remote than it was last

Venezuela's **Nicolás Maduro** *visited Russian President* **Vladimir Putin** *near Moscow in December 2018 to seek financial assistance for Venezuela. Maduro announced on his Twitter account that contracts were signed during the trip to guarantee more than $5 billion in oil investment.*

fall, assuming that China and/or Russia do not otherwise step into such a role.

On the other hand, a change from the Maduro regime to a more democratic, reform-minded government might be one of the scenarios in which one could more readily envisage a debt restructuring taking place, and that presumably would be the case if a Guaidó-led opposition came to power.

Nevertheless, whether the Maduro regime remains or is replaced by an opposition-led government or some type of transitional government, a delay in initiating a restructuring of the outstanding debt of the Republic and PDVSA is only likely to make such an eventual restructuring even more difficult and challenging than it would otherwise be. And the longer the delay, the more difficult and challenging any eventual restructuring is likely to be.

Delays in initiation are often viewed as being detrimental to the restructuring process as well as to the sovereign debtor country itself. In the Venezuelan context, the general risks of delay are amplified by at least two major risks specific to Venezuela. The first such risk is the continued deterioration of the Venezuelan economy, and the second is the threat of creditor litigation in advance of the commencement of any restructuring process (to be discussed in a future issue of *TIE.*)

CONTINUED ECONOMIC DETERIORATION

One major risk to any future debt restructuring is the continued steady deterioration of the Venezuelan economy, an economy that many observers consider to be already in a state of virtual collapse. Indeed, the severity of the crisis was captured by a *New York Times* article in mid-May with the headline, "Venezuela's Collapse Is the Worst Outside of War in Recent Decades, Economists Say."

The Venezuelan economy has contracted quite dramatically in recent years, with estimates that Venezuela's GDP has shrunk by approximately 50 percent in the last several years alone, a huge contraction that some observers have noted is even larger than the contraction experienced by the U.S. economy during the Great Depression. As has been widely reported, Venezuela is suffering from a wide array of very serious economic woes including hyperinflation (some estimates say inflation is running at a rate of one million percent per year or greater), a very large budget deficit (sustained only by having the government print money on a massive basis), a deeply devalued currency, rising unemployment, and dwindling foreign exchange reserves.

These serious economic woes have contributed to a dramatic unraveling of the social fabric of Venezuela. That in turn has led in the last few years to a mass exodus of Venezuelans to other countries in the region, such as Colombia, Peru, Chile, Ecuador, Argentina, and Brazil. This exodus has involved approximately 3,000,000–3,500,000 or more, creating serious refugee-related humanitarian and social issues in those countries.

Any efforts in the future to fix the Venezuelan economy will have to address a range of daunting and complex macroeconomic challenges, including bringing Venezuela's ruinous hyperinflation under control. Until the broad range of macroeconomic challenges facing Venezuela are successfully addressed, it will be difficult to steer the economy in a more positive direction.

The Venezuelan oil industry is—and has been for some time—in a state of serious decline and dysfunction.

CENTRAL ROLE OF OIL

Looking at Venezuela's economic prospects, one also needs to consider the central and indispensable role of the country's oil industry in Venezuela's economy. Certain aspects of the Venezuelan oil industry—a complex subject—are particularly relevant to debt restructuring-related issues.

The Venezuelan oil industry is the engine that has traditionally powered the Venezuelan economy, and revenues from the oil industry have played an outsized role in the economic fortunes of Venezuela generally. It has been estimated by many observers that oil revenues in the past have constituted, in approximate amounts, 25 percent of Venezuela's GDP, 50 percent of Venezuelan government revenues, and 90 percent or more of Venezuela's export revenues.

However, the Venezuelan oil industry, centered on PDVSA (including PDVSA's joint ventures with foreign partners), is—and has been for some time—in a state of serious decline and dysfunction. Just in the last few years, production has dropped very sharply and has continued on a negative trajectory or has been in a "free fall," to use the words of the executive director of the International Energy Agency from late last year.

The Venezuelan oil industry was producing approximately 2.5 million barrels per day in 2015, but by December 2018 was producing only roughly half of that amount (an estimate from OPEC's monthly market reports puts the figure for Venezuelan oil production at 1.148 million barrels per day for December 2018). At the end of 2018, observers predicted that Venezuela's decline in oil production would continue throughout 2019, with the possibility that daily production of oil might even drop to less than one million barrels per day during 2019.

Sanctions have effectively cut off Venezuela's exports of oil to the United States.

In fact, although it was reported that Venezuelan oil production in February 2019 was approximately 1.2 million barrels a day, oil production dropped sharply in March 2019, with some estimates indicating that Venezuela was only producing approximately 750,000–850,000 barrels per day. Observers have noted that the March figures represent the lowest level of Venezuelan oil production since 2003 during a nationwide strike. However, this steep drop in March has been attributed, among other factors, to the disruptive and negative impact of the nationwide blackouts occurring at that time on production capabilities.

To put Venezuela's current depressed levels of oil production in perspective, it should be noted that around the time Hugo Chavez was first elected president in late 1998, oil production was at a level of approximately 3.5 million barrels per day.

It should be noted that in light of Venezuela's so-called oil-for-loan transactions with China and Russia, hundreds of thousands of barrels of Venezuela's daily oil production have already been effectively earmarked for China and Russia. This oil is thus unavailable for the purpose of generating fresh revenues for PDVSA by sale to customers in countries other than Russian and China. Customers in these other countries would presumably pay Venezuela in cash, which Venezuela urgently needs, as opposed to having such oil shipments simply applied by Venezuela to the repayment of loans as is the case of Russia and China under the oil-for-loan transactions with those countries.

DEGRADATION OF OIL PRODUCTION CAPABILITIES

In recent years in particular, PDVSA has not made the capital expenditures necessary to properly maintain its operations, and its production capabilities have been further eroded by, among other things, its failure to keep up with payments to many of its oil field service providers. As a result of such non-payments, a number of oil field service providers have simply stopped providing services that are considered essential for proper functioning.

Moreover, PDVSA's capabilities have been further undermined by the deprofessionalization and hollowing out of the staff of PDVSA and the replacement of professionals with politically connected employees apparently without much regard to background and experience—or lack thereof. PDVSA was once known for employing top-notch professionals, but the process of deprofessionalization and politicization which began over a decade ago—most notably when the Chavez regime fired thousands of PDVSA workers during a general strike in Venezuela in 2003—and which has continued under the Maduro regime has deprived PDVSA of crucial talent.

It is believed that many rank-and-file workers in the Venezuelan oil industry are, like their fellow citizens, suffering from the immiserating effects of the current economic crisis, including widespread malnutrition and hunger resulting from the current severe food shortages. Many oil workers are simply not showing up for work.

It does not help that, if the workers do show up for work, they are being paid wages in Venezuelan bolivars, and in Venezuela's hyperinflationary environment, Venezuelan bolivars have dramatically less purchasing power than in the past. In fact, the monthly wages received by the workers—which by some estimates are less than the equivalent of twenty U.S. dollars per month—may not even be adequate to provide for anything resembling a regular schedule of meals, much less adequate nutrition, for the workers and their families. Like their compatriots in other sectors of Venezuelan economy, many of these workers may have also left Venezuela and sought refuge (and employment) in other neighboring countries.

In short, the impact of the Venezuelan economic crisis on workers in Venezuela's oil industry obviously has major deleterious consequences for Venezuela's overall oil production capabilities.

NEED TO DIVERSIFY

Even though reviving Venezuela's oil sector may constitute a crucial element of any economic recovery plan at least in the shorter term, over the longer term Venezuela may wish to consider whether it makes sense to attempt

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to further diversify its economy so it is not so heavily dependent on oil—a commodity that, as history has shown, is subject to fairly regular cycles of boom and bust. Yet diversifying a national economy, particularly a commodity-dependent economy such as that of Venezuela, is not a quick or easy task.

Over the longer term, Venezuela, like other oil-producing countries, will almost certainly need to be mindful of how worldwide concerns over global climate change might dampen the demand for fossil fuels. To the extent that Venezuela takes serious heed of these concerns, this could provide Venezuela with the impetus to further diversify its economy

PROSPECTS FOR A DEBT RESTRUCTURING

The key point for our analysis of the prospects for a Venezuelan debt restructuring is that to the extent that Venezuela's oil production capabilities are further degraded with the passage of time, it will become more challenging for any restructuring to succeed due to diminished oil revenues flowing into the coffers of PDVSA and therefore ultimately into the coffers of the Republic. As a result, there would be fewer domestic resources available to support any eventual debt restructuring. Specifically, PDVSA and the Republic would have less liquidity at their disposal to repay debt, even on any restructured terms ultimately agreed upon by PDVSA and/or the Republic with their creditors.

Depending upon the availability and size of any external financing package from the official sector (such as the International Monetary Fund or other organizations), creditors might be expected to make larger sacrifices on their outstanding debt exposure than would otherwise be the case. Specifically, creditors might be asked to take deeper "haircuts" on their outstanding principal or accept longer extensions on the maturities of their debt.

These steps are usually considered to be a bitter pill under the best of circumstances and are thus often strongly resisted by creditors to the extent possible in the context of any type of debt restructuring negotiation. Creditors involved in any Venezuelan restructuring will certainly point out that Venezuela is widely considered to be sitting atop the largest oil reserves in the world, larger even than those of Saudi Arabia and other major oil countries. In this same vein, even today, some observers argue that Venezuela is not currently facing a solvency crisis (in light of the existence of its abundant oil reserves), but rather is only facing a liquidity crisis. Whether that is true is, of course, subject to debate.

In short, if Venezuela's oil industry continues on its downward trajectory of producing less oil and therefore less revenue for both PDVSA and the Republic, this could make any eventual restructuring, whether for the debt of the Republic or PDVSA, even more contentious and/or challenging to resolve than usual. For various reasons, including the large and diverse range of creditor constituencies and the likelihood of major inter-creditor conflicts, any future restructurings promise to be difficult enough even without this additional challenge of declining Venezuelan oil production.

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Moreover, if Venezuela's oil production capabilities remain severely stressed when a restructuring ultimately takes place, that means the participating creditors as well as any parties that might potentially provide new financing for Venezuela would need to take into account the prospects for any type of eventual economic recovery in Venezuela.

Creditors and the providers of new financing in a sovereign debt restructuring situation generally take a certain level of comfort if they can see an economic recovery for the sovereign debtor somewhere on the not-too-distant horizon. Yet that level of comfort may be wanting in the Venezuelan context if the degraded state of Venezuela's oil industry pushes any such eventual economic recovery further into the future.

Such parties may wish to assess how much new financing or new capital would be required as part of any overall restructuring package—and who would be willing to provide such financing or capital—to turn the Venezuelan oil industry around and to put the economy as a whole back on a positive trajectory. Given the capital-intensive nature of the oil industry generally and the current state of the Venezuelan oil industry in particular, it is widely expected that huge investments of capital—potentially billions and billions of dollars—will be necessary to restore Venezuela's oil production capabilities to a satisfactory level. ◆