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PetroCaribe: More Noose Than Lifeline

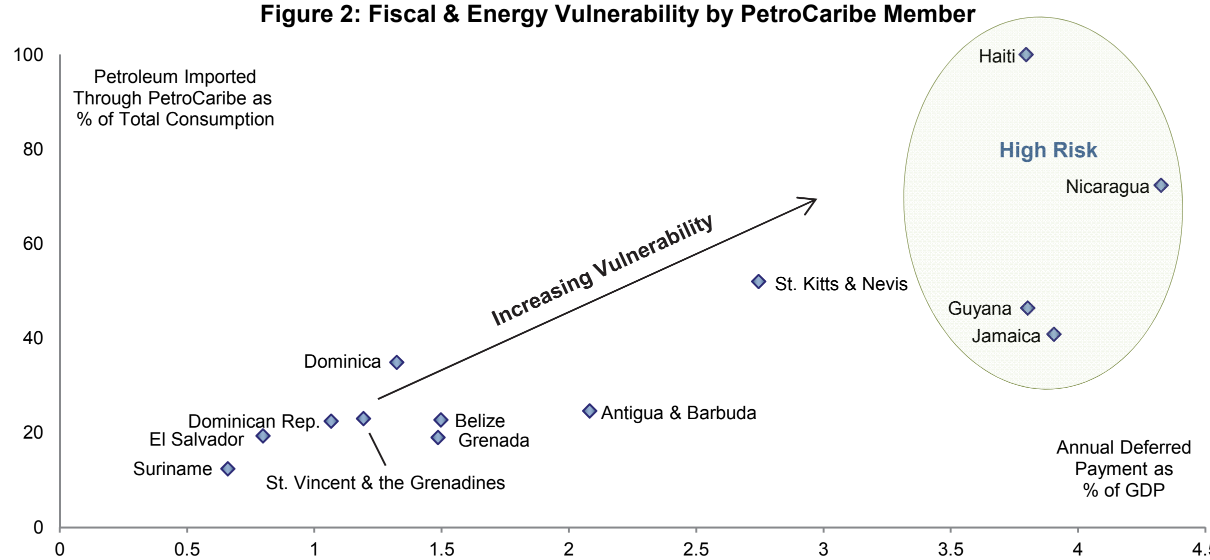
- **There are political and fundamental factors affecting the longevity of PetroCaribe, and both are trending toward an eventual dissolution of the energy union. When, how, or even if the PetroCaribe agreement will collapse is clouded by uncertainty but the outsized impact of such a scenario necessitates concern.**
- **The PetroCaribe energy accord was created in June 2005 to provide preferentially financed Venezuelan petroleum to Central American and Caribbean member states (See Figure 1).**
- **Almost a decade later, the agreement has fostered a fiscal dependence on Venezuela amongst members and perpetuated petroleum consumption patterns that are unsustainable in the current era of high oil prices.**
- **Should the agreement collapse, unsubsidized market prices would amplify public sector and current account deficits in member countries. Meanwhile, rapidly reducing the consumption of petroleum-based fuels would adversely impact the fragile economies of participating states.**
- **The future of PetroCaribe is far from certain but it is essential to understand how it works in order to best assess and manage discontinuity risks. In particular, it is crucial to ascertain which participants are most vulnerable to its unwinding — see Figure 2 for an overview of member vulnerability.**

Figure 1: Active PetroCaribe Members*

1) Antigua & Barbuda
2) Belize
3) Dominica
4) Dominican Republic
5) El Salvador
6) Grenada
7) Guyana
8) Haiti
9) Jamaica
10) Nicaragua
11) St. Kitts & Nevis
12) St. Vincent & the Grenadines
13) Suriname

** Currently importing petroleum through PetroCaribe according to PDVSA annual reports.*

Figure 2: Fiscal & Energy Vulnerability by PetroCaribe Member



Note: Percentages Represent 3-Year Average (2011-13).
Source: PDVSA, PetroCaribe, IMF, EIA, Scotiabank Economics.

Overview

PetroCaribe employs a progressive financing system to provide relief from the volatility of global energy prices to energy importing nations in Central America and the Caribbean. The percentage of payment deferred rises with the price of oil, keeping the up-front cost of petroleum around US$40 per barrel, about half the going market rate (Figure 3). Softening these price swings and allowing the full cost to be amortized over 25 years (at very low interest rates of 1-2%) facilitates a better sense of future expectations, enabling more effective public planning and budget management. With rates so generous and maturities so long, however, it is more useful to think of PetroCaribe as a subsidy rather than simply a loan; 25 years is a very long time for countries that are facing acute financial distress today.

PetroCaribe's generous subsidies benefit recipients in the short term, yet the illusion of affordability has preserved uneconomical energy practices such as petroleum-fueled electricity generation. Most PetroCaribe members depend on outdated fuel oil generators to provide the majority of their electricity, a practice that non-subsidized states have long since dropped — this juxtaposition of member and non-member electricity generation can be seen in Figure 4. These subsidies have distorted price signals that would have exerted downward pressure on petroleum demand as prices rose, eliminating the impetus for timely substitution to less-expensive feedstock such as liquefied natural gas, coal, or non-hydro renewables.

Petroleum supplied through PetroCaribe has more than doubled since its inception and as of 2013 accounted for 34% of members' total consumption (Figure 5). Substituting physical supply would not be difficult if Venezuela chose to turn off the tap, but the value of PetroCaribe is its preferential financing and members would be hard-pressed to find similar terms in the open market.

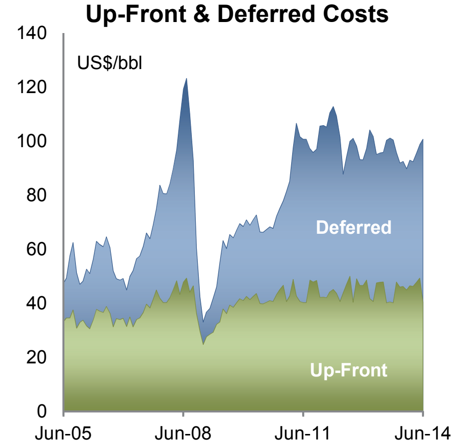
Financial Impact

PetroCaribe financing is a material factor affecting the economies of participating states and would leave a sizable fiscal gap if discontinued. While it is questionable whether or not these loans will ever be repaid, they still weigh on recipient economies, if only symbolically. Over US$11 billion in PetroCaribe debt had been accumulated by the end of 2013, equal to 16% of gross debt and 8% of the group's GDP (see Figure 6 on next page).

The petroleum import costs deferred each year act as cheap long-term deficit financing and reached an annual average of US$2.3 billion between 2011 and 2013, equal to 9% of the group's public sector revenue (see Figure 7 on next page). Without this financing, most participating governments would be pushed into public sector deficits, if they are not there already. The deferral also has a significant impact on the external position of member countries, amounting to an average 7% of member country exports and 13% of foreign currency reserves (see Figure 8 on next page). If the agreement collapsed, members would feel considerable pressure on their current accounts and further downward pressure on local currencies.

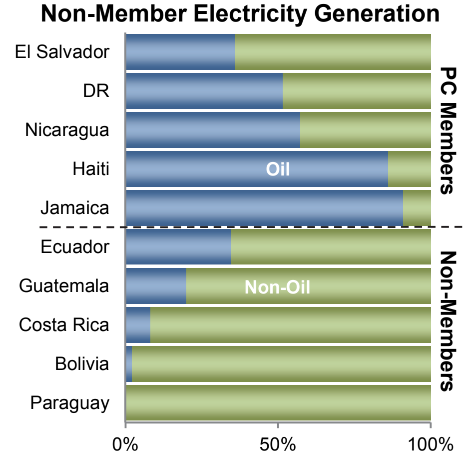
There are wide disparities between participant countries concerning their relative reliance on the PetroCaribe framework and some members have done better than others in diversifying their energy profiles. The Dominican Republic serves as an excellent example of how diversification can lower reliance on the agreement. When PetroCaribe was signed in 2005, oil accounted for over three-quarters of Dominican electricity feedstock. That figure decreased to one-half by 2013 as policymakers prioritized structural energy sector reform by building liquefied natural gas import terminals and increasing coal deliveries. Decoupling subsidized petroleum from core economic performance would benefit every member country in the long run and resources saved on current consumption could be used for these purposes.

Figure 3: PetroCaribe Up-Front & Deferred Costs



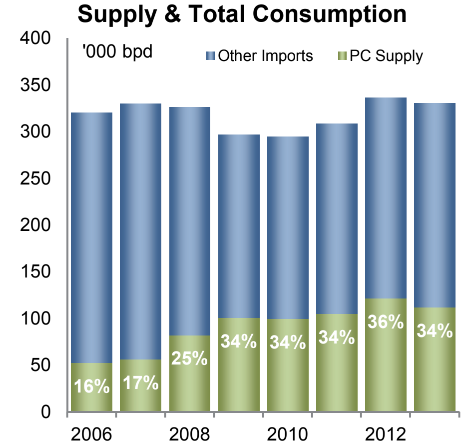
Note: According to PetroCaribe discount schedule.
Source: PetroCaribe, OPEC, Scotiabank Economics.

Figure 4: Selected Member & Non-Member Electricity Generation



Note: Shares Of 2012 Generation.
Source: IEA, Scotiabank Economics.

Figure 5: PetroCaribe Petroleum Supply & Total Consumption



Source: PDVSA, EIA, Scotiabank Economics.

PetroCaribe Unwinding?

The PetroCaribe agreement's continued existence should not be taken for granted and the deteriorating political, economic, and petroleum sector environment in Venezuela calls into question the longevity of the accord.

The legacy of the Chavismo era is the steady weakening of political and economic institutions. Soaring crime rates, inflation of almost 60% y/y, and an inability to import basic consumer goods have served as traction for the opposition. For many, it is hard to justify billion-dollar handouts when Venezuelan citizens are in need of assistance and opposition parties have already signaled their intent to dismantle the agreement should they come to power. It is difficult to forecast exactly when or if this public discontent will result in regime change, but the likelihood increases as the situation continues to deteriorate in Caracas. If PetroCaribe survives it will likely be due to the current government's deference to past Chávez policies and trouble for president Nicolás Maduro translates to trouble for PetroCaribe.

Add to this that Petróleos de Venezuela S.A. (PDVSA), Venezuela's national oil company, is run more like a government ministry than a typical oil company and petroleum proceeds are used to support general government finances rather than being reinvested in production infrastructure. PDVSA is perceived to be governed by those loyal to the government and investment decisions are often made on the basis of political rather than technical gain. Hugo Chávez fired thousands of PDVSA employees — including roughly 80% of the company's research division — during political purges that occurred in 2003, draining the country of some of its top technical minds. Since then, the country has struggled to increase production despite sitting on the world's largest deposits of crude oil. Venezuela was pumping over 3.5 million barrels of oil per day in the year before Chávez took office but current production stands at only 2.5 million barrels per day, almost 30% lower.

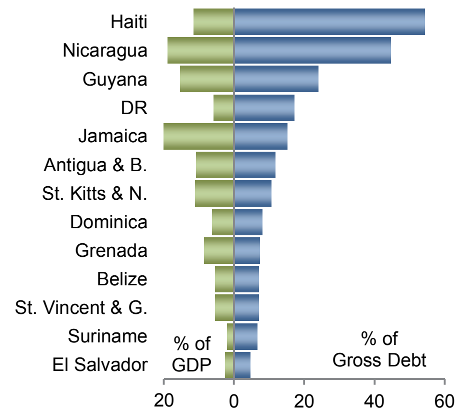
Heavy financial demands placed on PDVSA by the government serve to exacerbate this operational strain by starving the company of its cash flow. The most onerous of these burdens is the program of deeply subsidized domestic petroleum prices. Venezuelans enjoy the cheapest gasoline in the world with an official posted price of US$0.05/gallon and a street price reaching as low as half a U.S. cent due to the demand for foreign currency. In addition, the government is diverting a growing share of production to pay back Chinese loans, on which the Venezuelan government is increasingly reliant due to falling export earnings. Less cash is flowing into PDVSA coffers as more production is diverted into these non-cash-generating avenues, and this share is growing at the very time when domestic production infrastructure desperately needs heavy capital injections.

Conclusion

PetroCaribe members have grown accustomed to the status quo but it is important for both governments and global investors to consider the implications of a policy shift in Venezuela given current domestic trends. Mitigating the importance of the agreement would require an expensive reworking of national energy systems, but preventative action would cost far less in the long run than an unexpected and disorderly unwinding of PetroCaribe.

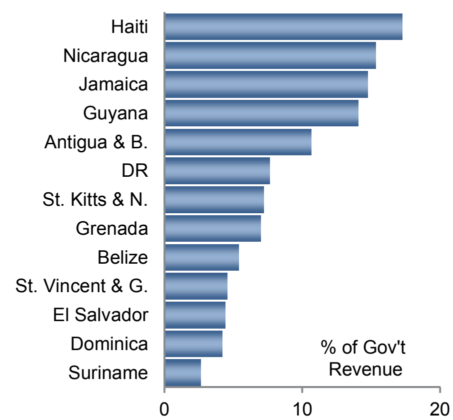
Dwindling Venezuelan petroleum production is being spread ever-thinner across a complicated web of regional alliances, oil-for-loan deals, and a domestic fuel subsidy program that costs the government tens of billions of dollars every year. As the government in Caracas moves to rationalize energy policies, many beneficiaries of Chavismo largess may lose that status.

Figure 6: Accumulated PetroCaribe Debt Stock



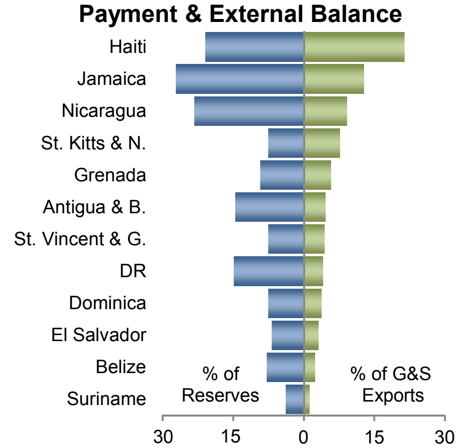
Note: Accumulated Debt Stock, 2006-2013.
Source: PDVSA, IMF, Scotiabank Economics.

Figure 7: Annual Deferred Payment & Gov't Finances



Note: 3-Year Average (2011-13).
Source: PDVSA, IMF, Scotiabank Economics.

Figure 8: Annual Deferred Payment & External Balance



Note: 3-Year Average (2011-13); Guyana Excluded.
Source: PDVSA, IMF, Scotiabank Economics.

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