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VENEZUELAN OIL BASKET PLUNGES ... THE UNPREDICTABILITY OF OIL PRICES

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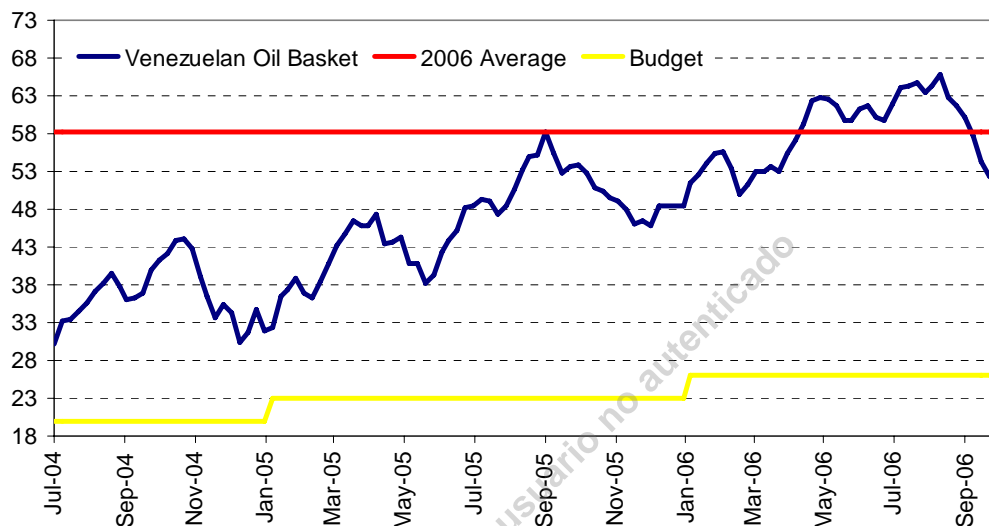
In the last eight weeks oil prices have plummeted much to the surprise of the markets. However, oil prices are difficult to predict because of the nature of the market and their statistical characteristics. In our opinion, this slide is not a great danger for Venezuelans fiscal sustainability – at least for the time being.

The Venezuelan basket has tumbled over 20% in the last two months

In the last two months, benchmark oil prices have fallen on average 18.5%. The Venezuelan basket has not escaped this trend and in the last eight weeks has lost a total of 21.3%. The unexpected fall has surprised most oil analysts and experts, particularly in a context where world conflicts tend to intensify, especially in the Middle East.

Weekly Report

**Oil Price
(Venezuelan Basket US\$/pb)**



Sources: MEP and Ecoanalítica

Forget oil at US\$100 a barrel

The almost 20% drop in oil prices has wiped out the forecasts of the experts who were looking at a barrel at US\$100, a mistake that analysts are now trying to explain away. According to *The Financial Times*, in mid-August, experts were betting on prices of US\$80 in the short term, and some even predicted a barrel at US\$100.

What happened in eight weeks to radically reverse the trends?

First, the risks that pushed prices up have been gradually disappearing. The market realized that the crisis over the Iranian nuclear program would not end with sanctions against that country, the world's fourth oil producer, but would be resolved through long and slow negotiations.

Second, the market also noted that the pre-winter season in the United States and Canada had been developing without any problems of gasoline supplies, and that the hurricane season would be less intense than last year in the Gulf of Mexico where many oil platforms are located.

Weaker demand for oil forecast

The ceasefire in Lebanon, the easing of tensions in Nigeria (foremost African oil producer), and the resumption of part of the crude production in Prudhoe Bay, Alaska, the largest oilfield in the United States, quelled fears and contributed to falling prices.

Weekly Report

According to a Société Générale report, the risk premiums which had accumulated since June disappeared, and oil entered a second bearish phase on signs of a cooling of the world economy in 2007, especially in the United States, where the symptoms are clear in the real estate and industrial sectors.

In this climate, analysts and various organizations revised down their forecasts of increases in world oil demand, and many funds and investment banks changed their strategy in the energy market and began to sell.

Oil will not go through the floor

Ecoanalítica believes that the oil barrel on global markets will not dip below US\$55. Demand for crude is not going to fall, it will simply increase more slowly, and the market will not be flooded with oil.

The Organization of Petroleum Exporting Countries (OPEC), which supplies almost 40% of world crude, is ready to intervene to prevent prices going too far below US\$60 in a bid to preserve its oil revenue. Venezuela and Nigeria announced that they would cut their production by 50,000 and 150,000 b/d respectively, effective from October 1.

However, the impact of this decision is limited, especially in the case of Venezuela, where crude production has been 500,000 b/d below its OPEC quota for some time. The cartel plans to meet in December in Nigeria, but does not rule out calling an urgency meeting earlier to cut quotas if the oil price continues to fall.

Oil prices are difficult to predict

In Venezuela we should be used to sudden changes in oil prices. This has been the trend since from start of our oil industry but has intensified in the last 30 years. The biggest mistakes of Venezuelan economic policy have originated in poor estimates of oil prices.

The inaccuracy of these estimates is due to the characteristics of the stochastic process of oil prices which means that oil revenue has strong volatility (variability and uncertainty), and a high volume of information in the current price for projection of future prices. The great volatility of oil prices would not be harmful if price changes could be forecast with some level of certainty. In an extreme case, if future oil prices were volatile but predictable, it would be feasible to plan despite significant fluctuations.

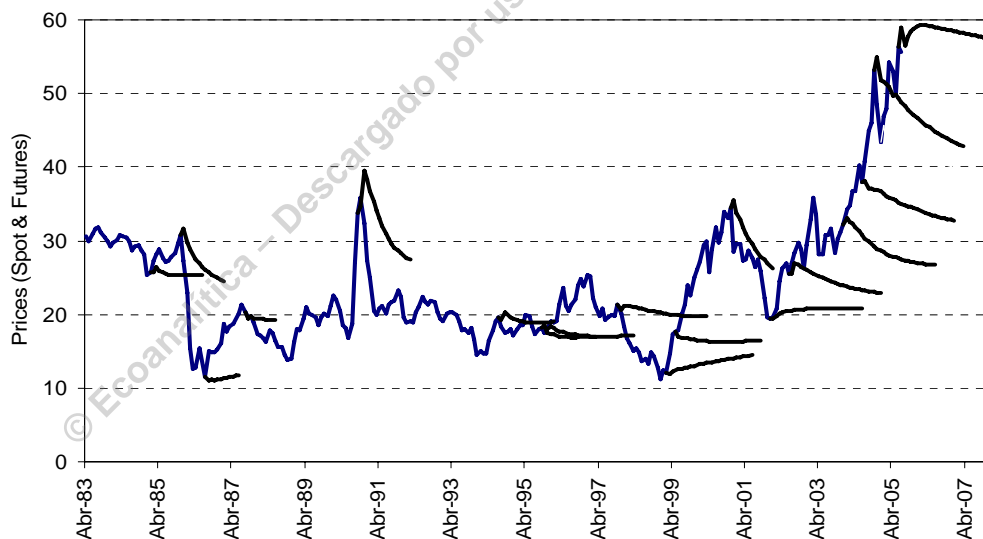
Weekly Report

Another characteristic of oil prices is that they do not seem to follow a steady trend and their reversion to the mean is very slow. The conclusion is that the current price is the best estimate of future prices, which has serious repercussions on the planning and design of economic policy. However, despite being the best estimator, today's price is also a very bad estimator with a high degree of error.

The market makes mistakes

An analysis of the degree of prediction of the market reveals that it is extremely inefficient. The next chart presents real oil prices and oil futures. As we see, despite all the information available, the market is not capable of making estimates that reveal at least some trend. The current drop in oil prices is the best example of this situation. In fact, futures are simply the current price less storage costs.

Spot Prices and Futures in the NY Market



Source : Ecoanalítica

Oil prices tend to move to their average historical values

If we are in a period of rising prices (which are not going to Drop next year) it is because of the way the oil market works. During periods of high prices, world oil production does not adequately meet growing demand. The high prices stimulate investment in energy production, whether oil or a substitute, and in using gasoline and other fuels more efficiently. But this investment takes several years to reach production

levels that meet and later overtake demand. This leads to a period of moderate falls, after which prices begin to decline more steeply.

In the previous cycle, the last few years of increases were from 1978 to 1980. The theoretical curve peaked in 1981. Then a slow fall began, which speeded up mostly in the last months of 1985 and the first half of 1986. Extrapolating this to the current cycle, which may not follow the same track but does have the same underlying causes, prices would peak in 2009, there would then be a slow decline for some five years followed by the fall.

Already some processes are in sight which could cause, together with related developments, this new trend. On the demand side, hybrid cars, which consume up to half the gasoline of conventional cars, have doubled their annual sales in the United States. However some years are needed before they really affect the market and bring about a significant cut in demand for gasoline.

With respect to supply, in Alberta, Canada, bituminous rock is being processed to obtain synthetic oil. Expensive oil means that this process is now commercial. The raw material exists in abundance but current production is too low to affect the market.

Venezuela is part of this reality

Something similar is happening in Venezuela with extra-heavy crude. A few years ago its extraction was not commercial, now PDVSA is working for the certification of the "new" reserves as proven to then start production.

But there are differences

There is an important difference in relation to the cycle of the 1990s and 1980s. The production costs of the new sources of energy are much higher than, for example, the Persian Gulf crudes which dominate the market. This means that prices cannot go as low as they have in the past.

In this situation, Venezuela should be more cautious although the spell of high prices looks set to continue, at least in the medium term.

For the time being, we do not see a substantial and permanent fall in the Venezuelan crude price at least in the medium term. This year's average is around US\$58 per barrel and could end the year at around US\$55 per barrel, which is still US\$29 above the budget estimate, providing the central government with extraordinary revenue of approximately US\$26.45 billion.

Weekly Report

The administration could be considering a very conservative oil price scenario for next year even in a range of US\$28-US\$35 per barrel. However, the most probable scenario is that the Venezuelan basket will stay above these levels, so the administration is not likely to encounter serious fiscal problems, especially as the windfall oil surpluses are managed discretionally.

But in periods of high oil prices, governments not only spend all the extraordinary revenue they receive in the bonanza, but they also get into debt. So when prices fall, they have to put through a strong fiscal adjustment not only to adapt to the lower level of revenue but also to pay the obligations contracted. We all know what that adjustment is: on the revenue side, devaluation, higher taxes and new taxes; on the expenditure side, cuts and delayed payments to suppliers; and on the side of the people, more poverty and falling living standards.

Economic Tips

Inflation is here to stay. The Central Bank reported an inflation rate of 1.9% for September, higher than September 2005 (1.5%) and slightly below August (2.2%). Inflation in the first nine months totaled 12.5%, higher than the same period last year (11.6%). The year-on-year change to September is 15.3%.

Inflation looks set to end the year around 16%. An interesting fact is that inflation from May to September was 8.6%. If this spurt were to continue, annual inflation would be 28.1%. Currently, the country is halfway through a process of speeding inflation much stronger than in 2005. On these results **Ecoanalítica** forecasts that inflation will end the year at 15.7%.

Labor costs and education. The Central Bank, in its report, attributes the spurt in the CPI to the application of the authorized price adjustments for education services, and the decree raising the minimum wage. These are seasonal factors which push prices up in this period of the year. Prices of controlled goods rose 2.5% and free-market goods 1.4%.

S&P upgrades debt rating. The Standard & Poor's agency upgraded Venezuela's credit panorama to positive from stable, due to the strong improvement in the country's public and foreign debt indicators. S&P confirmed its "BB-" rating for Venezuelan long-term debt and "B" for short-term debt.

CADIVI pulls out the stops. According to Cadivi President Manuel Barroso, the Central Bank has increased the foreign currency budget for monthly delivery to US\$2.6 billion. The maximum average amount to be liquidated per day will now be US\$118 million. This record amount shows the administration's intention to rely on the import subsidy to contain inflation.

CADIVI announces its results to August. According to CADIVI, from January to August, authorizations totaled US\$16.0 billion, of which the Central Bank liquidated US\$15.5 billion. Goods imports were US\$9.8 billion and capital goods US\$2.7 billion. Imports under the ALADI Convention received US\$3.1 billion, while US\$920 million was for foreign investment, US\$890 million for foreign private debt, and US\$751 million for overseas credit card use.

Regulations for the Foreign Currency Offenses Law on standby. Barroso also said that the regulations for the Foreign Currency Offenses Law, in force for a year, are being drafted by the Finance Ministry, although they are applied by a division of CADIVI.

Oil Tips

New tax regime published. The income tax changes for oil companies have been published. Starting January 2007, the income tax rate for the Orinoco Belt associations will be 50%, bringing them into line with the joint ventures. In other changes, the 8% rebate and the additional 4% for investments in hydrocarbons recovery, gas exploitation and conservation, and hydrocarbon valorization were repealed, along with the 10% rebate for investments in assets and programs related to environmental conservation and improvements in oil exploration and production areas.

Joint venture production down. According to data from the operating companies, production from 18 fields operated by the former joint ventures, now in a transition regime, dropped from 224,354 b/d in October 2005 to 211,889 b/d in March. This is in addition to a fall last August of over 13,500 b/d which sent the average below 200,000 b/d (198,300 b/d). The downturn is mainly due to the fact that the transition regime does not permit the operators to make large investments and postpones key decisions. These figures exclude the seven fields that were transferred to PDVSA and some others for which no specific figures are available.

Slow negotiations. The private oil companies say that the negotiations for the final setting up of the joint ventures are moving slowly. A 60-day extension was granted on

the migration documents that most of the companies signed with CVP, following disagreements on basic points which have held up the negotiations. Another controversial point relates to the migration of workers from the old operating agreements to the new joint ventures. According to the oil authorities, this year the labor accounts should be settled and the workers who will migrate defined.

ENI awaits compensation. In its 1H06 financial report, the Italian oil company ENI estimates the compensation that it expects to receive from PDVSA for termination of the business relationship under which the company operated the Dación field at EUR654 million (US\$831 million). This amount is based on its own calculations and those of independent contractors.

Sectoral Tips

New president at CADAPE. The administration named María González the new president of CADAPE to replace Nervis Villalobos. González had been general manager of the Interconnected Systems Planning Office (OP SIS).

Increase in power generation. Electricity generation in Venezuela grew 5.96% to August from the same period last year, according to the Venezuelan Electricity Industry Chamber (Caveinel).

BOD buys Corp Banca. Corpgroup announced the signing of the sale commitment with Banco Occidental de Descuento (BOD). The parties have not specified the amount of the sale, which is subject to compliance with the legal regime. Corpgroup, which has been in the country for 10 years, said that it would concentrate its operations in Chile. After the merger, BOD will continue in fifth place in the bank ranking.

CANTV threatened again. President Chávez repeated that CANTV would be nationalized if it does not comply with the adjustment to the payments to the pensioners. According to Chávez, "the company is continuing to resist recognizing the debt ... if they don't pay, I'm not going to say when, I have a waiting period open, but I've told the Solicitor General to work on the expropriation decree." *Ecoanalítica* does not understand these remarks because CANTV has shown willingness to honor its commitments. The president's comments could be an election ploy related to the upcoming presidential election.

Not only the president. PPT secretary general José Albornoz joined in the threats against CANTV. He said that the company was behind a "provocation" plan to alter social peace and affect the technological development of the December elections.

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However, Albornoaz offered no concrete evidence. The PPT is a minor partner in the government coalition.

Movilnet increases investment. CANTV's mobile phone subsidiary Movilnet announced that this year it would invest US\$750 million in acquisition of new equipment. The operator added that it has not plans for the time being to migrate to GSM and would continue operating under CDMA standards.

Capital market in expansion. Venezuelan Stockbrokers Association (AVCB) President Gabriel Osío predicted that the capital market would grow 70% by the end of the year. He said that the best indicator to demonstrate the growth trend is the Caracas Stock Exchange Index (IBC), whose return has fluctuated between 60% and 70%.

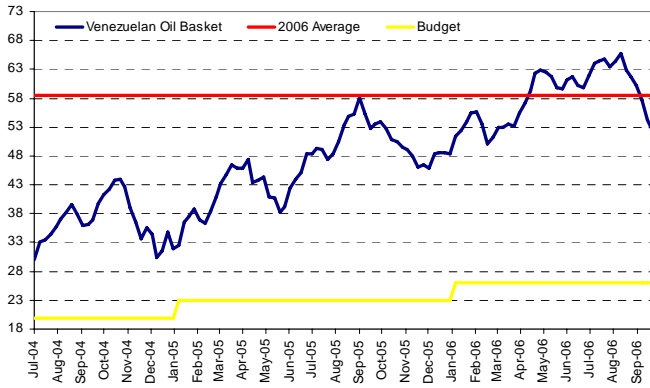
Another company copies Electricidad de Caracas. Domínguez & Cía is offering 459.18 million of its shares owned by its majority shareholders, which hold 76.92% of its capital. The largest manufacturer of tin, aluminum and plastic containers in Venezuela, the company launched a public offering for 19.08% of its capital with the objective of expanding its shareholder base. The offering closes on October 13. The shares are priced at VEB58. The company hopes to raise VEB26.63 billion (US\$12.4 million) from the operation.

Banco Canarias joins the club. Banco Canarias will enter the stock market with an equity issue of between 30% and 40% of its capital. Bank employees will be the first to benefit from the operation, acquiring 10% of the block. A tentative date for the issue is 1Q07, which will be preceded by a capital increase of VEB60.00 billion (US\$27.9 million).

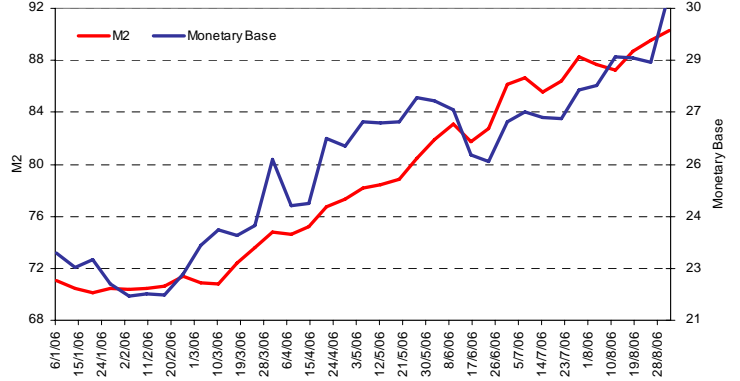
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ECONOMIC OVERVIEW

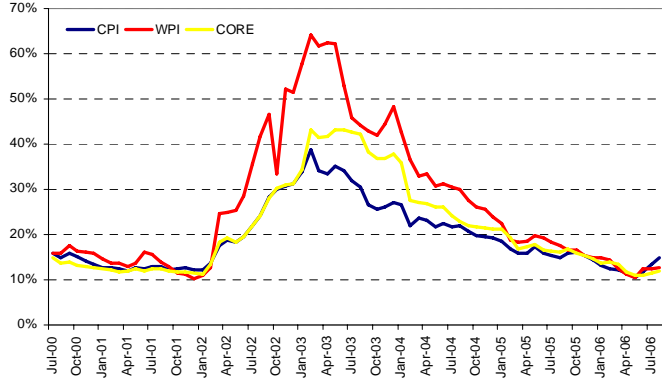
Oil Price
(Venezuelan Basket US\$/pb)



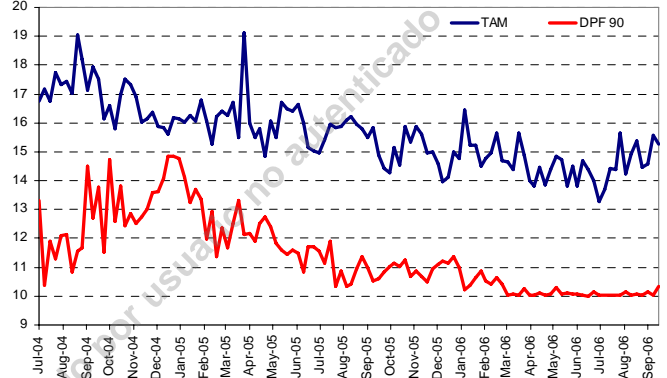
Monetary Base & M2
(VEB Billions)



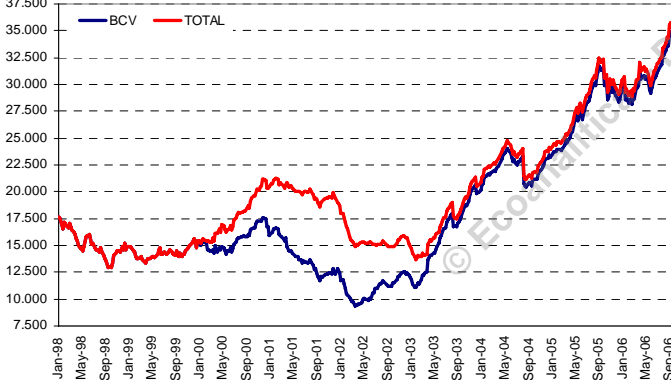
Inflation
(Last 12 Months)



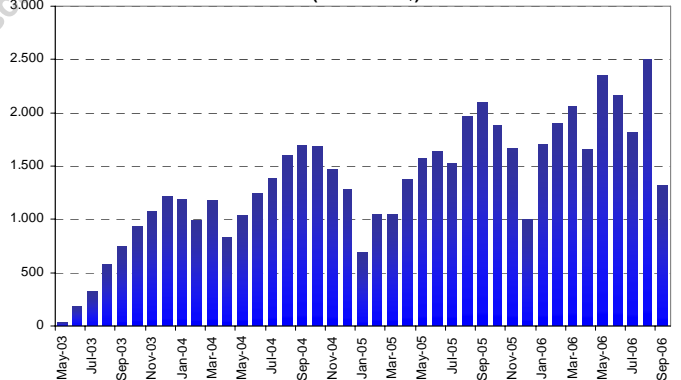
Interest Rate
(Six Principal Banks)



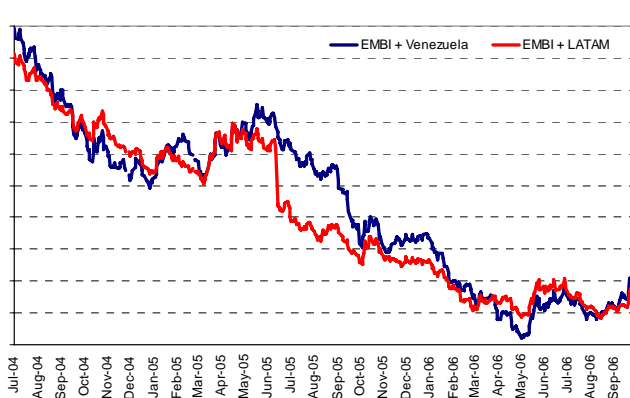
Fx Reserves
(Millions US\$)



Disbursement
(Millions US\$)



EMBI



Central Government
(VEB Billions)

