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PDVSA: LEADING COMPANY WITH REGARD TO CORPORATE SOCIAL RESPONSIBILITY

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At the beginning of the year, PDVSA released its end of the year report for 2006 which also included this year's budget, both documents of utmost importance in order to understand oil industry's current situation. Despite the fact that these are preliminary figures since they haven't been audited by independent companies, the report contains a number of interesting elements that are worth commenting, especially those regarding investment and spending. And this year's budget announced in the report holds the key to why we at **Ecoanalítica** think that the possible emission of bonds by PDVSA should be earmarked to finance the migration of the Orinoco Belt associations to mixed companies.

PDVSA's biggest investment last year was in the social sector

According to the Government, PDVSA's financial resources earmarked for social programs and infrastructure projects reached US\$11.84 billion, including that which was allocated to FONDEN (US\$6.86 billion). This figure represents an increase of 62.5% compared to last

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year (2005). However, if it's compared to 2003, when the so-called "social spending" was only US\$ 549 million, the increase is an unbelievable 2,056%. In fact, for the period 2003-2006, PDVSA's social spending totaled US\$23.99 billion.

Given that the aforementioned report only shows the last two years (2005 and 2006), we will confine our analysis to this period: In 2005, so-called social spending reached US\$7.29 billion, representing PDVSA's 112% global earnings (US\$6.48 billion). In 2006, funds earmarked for social spending represented 198% of global earnings (US\$5.97 billion). In other words, so-called social spending represented almost double the company's earnings. It's important to point out that this indicator was at 49.2% in 2004.

After social spending what went up the most were tax contributions

PDVSA's tax contributions through income tax, royalties, and dividends were US\$27.21 billion in 2006, which compared to 2005 represents an increase of 54%. Royalties increased the most reaching 62%, while oil income taxes expanded to 50%. Dividends didn't register any variations.

These figures indicate that PDVSA seems to be following the same path that PEMEX did during the 80s and 90s, by becoming an oil company destined to finance the State at the cost of efficient managing and the expansion of its production capabilities.

A company like PDVSA should be dedicating itself to increasing production and reducing production costs in order to maximize profits, in such a way that it first increases tax contributions (especially through dividends) and then contributions to FONDEN. At **Ecoanalítica**, we don't understand how, after allocating US\$6.86 billion to FONDEN in 2006, PDVSA invested US\$4.98 billion in social programs when these programs are the sole responsibility of the Government.

PDVSA Key Indicators (Billion US\$)			
	2005	2006	Var %
FINANCIAL INFORMATION			
Global Gross Income	85.730	101.990	19,0%
Global Net Income	6.483	5.970	-7,9%
BUDGET EXPENDITURES			
Operation Cost	7.420	9.049	22,0%
Other Costs and expenditures	6.461	5.874	-9,1%
Investments	3.878	5.832	50,4%
SOCIAL PROGRAMS CONTRIBUTIONS			
Social Development	3.762	4.754	26,4%
FONDESPA	2.000	229	-88,6%
FONDEN	1.525	6.855	349,5%
FISCAL CONTRIBUTIONS/ SHAREHOLDER			
Income Tax	5.069	7.594	49,8%
Royalties	11.327	18.302	61,6%
Dividends	1.317	1.317	0,0%

Sources: PDVSA and Econalítica

The saddest thing about this story: PDVSA's productive investments aren't enough

In contrast to social contributions, industry investments that are mainly associated with increasing production, improving processes and increasing added value activities (especially refinery) totaled US\$5.83 billion. This amount represents 49.3% of what PDVSA contributed to the different social programs and funds established by the Government.

In 2005, PDVSA investment increased 50.3%. But, if instead of financing social programs, PDVSA would have earmarked that amount for productive investment, this figure would have reached US\$10.81 billion, quite a significant figure for increasing production and improving refinery capabilities.

You don't have to be an oil expert to figure out that if the industry doesn't make significant investments in order to increase production levels and product mixtures, its financial capabilities could be compromised in the future. During the last few years, despite the drastic changes suffered by PDVSA during the general strike in 2002-2003, financial results have been acceptable due to the high oil prices.

In order to guarantee that these results can be maintained through time, it's important that production be increased in order to be prepared in case oil prices fall. However, for the last two years oil production seems stagnant, and investment levels are below previous years. In 2006, the volume of crude and products exports was at 2.44 million barrels a day, which represents a 16.8% drop compared to 1997. For 2007, the Government is assuming an export volume of 2.61 million barrels a day, which represents an increase of only 4.8% in two years and 13% below what was produced 9 years ago.

Not only domestic but foreign contributions

An important part of the almost US\$12.0 billion spent on the social sector was not spent domestically but given in the form of donations and financial aid to other countries, some of them richer than ours. The report shows that US\$1.35 billion were earmarked for the Cuba-Venezuela Agreement in 2006; for the Bolivia-Venezuela Agreement (Mercal Mission) the amount was US\$3.3 million. It's important to point out that the first Agreement included the purchase of specialized medical equipment from Cuba. However, it would be important to clarify if this isn't being done within the framework of the current oil exchange between Venezuela and Cuba.

Additionally, PDVSA gave US\$40.2 million to the so-called ALBA Caribbean Fund. The report only includes three agreements that together total US\$1.4 billion, which is equivalent to 12% of total social spending, 24% of productive investment, and 23% of PDVSA's global earnings.

FONDESPA is explained

A point that is often debated between analysts is how much FONDESPA, which could be considered the "father" of FONDEN, has. According to PDVSA, between 2004 and 2006, it gave FONDESPA a total of US\$4.23 billion (US\$2.0 billion in 2004 and 2005, and US\$229 million in 2006). Between 2004 and 2005, US\$3.41 billion was used, which at last year's close, would have left FONDESPA with a balance of US\$823 million.

Most of FONDESPA's resources have been earmarked to finance public transportation projects, electric power, agro-industry,

endogenous development, small and medium-sized businesses, and highways and infrastructure.

What can we expect from PDVSA in 2007?

At **Ecoanalítica** we think it's interesting to analyze the current year's budget figures concerning the oil industry. First, let's establish the fact that, just like the national budget, PDVSA's budget was made based on an average Venezuelan oil basket price of US\$29.00 per barrel, and the assumed volume of crude and products for export to be at 2.61 million barrels a day. On the other hand, total production is assumed to be at 3.25 million barrels a day, and the year's final production to reach 3.81 million barrels a day, a fact that we at **Ecoanalítica** don't think is very probable.

PDVSA estimates a slight surplus

Taking these parameters into account, we find that the total income figures (current and capital) for PDVSA to be around VEB69.2 trillion (US\$32.19 billion), while total spending is being budgeted at VEB64.7 trillion (US\$30.09 billion) which indicates that PDVSA will have a slight financial surplus of VEB 4.5 trillion (US\$ 2.09 billion).

Many analysts believe that this slight surplus explains why PDVSA is about to issue debt in order to guarantee the necessary investments, social spending, and especially the migration process of operative agreements and strategic associations to mixed company status. However, this surplus is greater as we'll demonstrate below.

Calculating the budget with a more realistic oil price we find that the surplus is enormous

To date, the Venezuelan oil basket has been averaging a price of US\$48.68, or in other words, US\$19.68 above the budgeted value. At **Ecoanalítica** we take a conservative stance and predict that the Venezuelan oil basket price will be around US\$41.3 per barrel. Additionally, we assume that the export volume will be a little less than what the Government figures indicate and place it at 2.4 million barrels a day.

Based on these figures, budget recalculations reflect that total revenues will reach VEB93.1 trillion (US\$43.30 billion) while spending will remain almost as it is, stemming from the principle that a change in price doesn't generate significant changes in the structure of industry

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spending. Consequently, PDVSA will have a surplus of VEB28.4 trillion (US\$13.21 billion).

PDVSA BUDGET (VEB Trillion)		
	Budget 2007 US\$ 29,0 per barrel	Ecoanalítica US\$ 41,3 per barrel
I. Current Account		
Current Income	67,5	91,0
- Income of Operation	66,6	90,1
- Other Income	0,9	0,9
Current Expenditures	43,1	43,1
- Expenditures of Operation	17,1	17,1
- Other Expenditures	26,0	26,0
Economic Result: Safe	24,4	47,9
II. Capital Account		
Capital Resources	26,1	50,0
Capital Expenditures	21,6	21,6
Financial Result: Surplus	4,5	28,4
III. Financial Account		
Financial Resources	(1,4)	(25,3)
Financial Applications	(1,4)	(25,3)

Sources: PDVSA and Ecoanalítica

PDVSA could institute an aggressive investment program

Based on the aforementioned calculations, it's clear that PDVSA has enough resources to satisfy three of the Government's priority at the same time: First, to commit to an investment plan over the mid term that would allow for the increase of the levels of oil production in order to be able to fulfill the 2007-2012 Investment Plan which aims to increase production to a little over 5 million barrels a day. Second, commit surplus resources to the Government's fiscal management (remember that this surplus has already been subtracted from the industry's tax contributions), and third, satisfy ¿the? so-called social spending.

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The bad news is that it might not turn out this way

However, given the Executive's voracious fiscal appetite and the unorthodox way of managing industry accounts, the most probable scenario is that the PDVSA surplus be used to primarily finance public spending, in any of its variations, and that investing in the oil industry not be considered so important. Let's hope that PDVSA will at least invest the US\$10.07 billion that's allocated in the budget for this purpose which would represent a 72.7% increase compared to what was invested in 2006.

According to PDVSA's budget, estimated spending for social development is at US\$2.8 billion, and we assume that this doesn't include FONDEN contributions. Nevertheless, we think this figure is quite low.

With such favorable predictions, any debt incurred by PDVSA should be earmarked for the migration process to mixed company

Taking these results into consideration, it doesn't make any sense for PDVSA to go in debt, even though financial conditions are favorable. However, possible debt emission for a not to shabby amount of US\$3.5 billion, within the context of a high financial surplus situation, should be earmarked for the financing of the migration process of the operative agreements and strategic associations to mixed company status, since expert calculations have estimated that this process could require expenses of over US\$10.0 billion

Despite the fact that PDVSA is a company with a very low current debt (approximately US\$4.0 billion), new debt should be earmarked to avoid having to sacrifice adequate productive investment levels. It would be counterproductive to enter our main company into debt at an accelerated rate in order to confront cash flow problems produced by the Governments voracious fiscal appetite, thereby killing the goose that lays the golden eggs.

Economic Tips

Monetary Reform Law approved. According to President Chávez, the Government approved the Decree-Law that will regulate the monetary conversion process that will eliminate three zeros from the bolivar. Said Law established in its 1st article that starting from January 1st, 2008, the present currency will be re-expressed in the equivalent to the present day one thousand bolivars, and the currency resulting from this re-conversion will be divisible in 100 cents .

The *Bono del Sur* was successfully placed and the market waits for more. The Ministry of Finance awarded the total amount issued (US\$1.5 billion). US\$750 million of it was Bonden 15 (Argentinean papers) and US\$750 million was TICC (Venezuelan interest and capital covered securities). According to the amounts awarded by the Ministry of Finance, those investors that requested up to US\$5,000 were awarded the total amount they asked for, those that requested between US\$5,000 and US\$20,000, were awarded between US\$5,000 and US\$8,000.

The market is eager for more. Though the Ministry of Finance didn't release any details concerning the total amount of the demand or the proportion of investors, at **Ecoanalítica** we estimate that the demand on the combined offer ranged between US\$12.0 billion and US\$13.5 billion, and with regard to the awards, we estimate that 60% of the bonds awarded went to small investors and 40% to large investors. In the first issue of *Bono del Sur* in November 2006, 30% of those participating were small investors, which duplicated this time around. Finance Minister Cabezas declared that the Government will continue to issue papers, and he added that in the short term, PDVSA would be issuing bonds. It's estimated that the oil company will place US\$3.5 billion on the domestic market, though it may happen in two stages.

VEB12 trillion in surplus. According to a Ministry of Finance report, the 2006 surplus reached VEB12.2 trillion (US\$5.7 billion). These funds were distributed through two organisms: the Ministry of Finance trust and the National Treasury Office (ONT), and the Miranda Fund. Surplus resources may increase as the National Assembly reviews supplementary appropriations operations authorized in 2006 amounting to VEB46 trillion.

Argentina to contribute to *Banco del Sur*. The Argentinean government plans to earmark 10% of its reserves (around US\$3.5 billion) in order to launch the *Banco del Sur*, which will also be backed by Venezuela that is putting up the same amount, reported the Argentinean newspaper *Página 12*.

Personal income tax changes. The Constitutional Chamber of the Supreme Court modified the personal income tax return scheme. In a decision published on February 27th, the TSJ reformed article 31 of the Income Tax Law. Now in order to pay taxes, net earnings (declared estimated income) will only include your regularly earned salary. Net earnings won't continue to include resources that a person may have due to benefits or other income other than salary.

SENIAT answers. SENIAT superintendent, José Vielma Mora, petitioned for an explanation of the aforementioned tax reform before the Constitutional Chamber of the TSJ yesterday, and additionally he petitioned an interpretation of how the reform should be applied. From the SENIAT's point of view, the decision can't be retroactive, which is to say, it can't be applied to taxes filed for the 2006 fiscal year, which have to be submitted before March 31st, 2007.

OIL TIPS

Slight drop. Last week, the Venezuelan oil basket registered a slight drop (US\$0.36) and closed at US\$52.79 per barrel. For the year, the Venezuelan oil basket average is at US\$48.68 per barrel.

CVP speaks. The director of PDVSA and president of the Venezuelan Oil Corporation (CVP), Eulogio Del Pino, pointed out that the delays in migration process of the operative agreements to mixed company status is just as much PDVSA's responsibility as it is the responsibility of the companies involved. The main delay is due to a legal procedure: after the new legal framework is approved, the companies had to register with VEB1.0 billion in initial capital, but some of the partners haven't made the necessary increases adjustments in terms of capital. This process is pending in 10 of the 21 cases.

Most of the workers have migrated. According to Del Pino, 85% of the workers (2,400 in all) have migrated to the PDVSA package, leaving just the small companies pending.

Production drop is recognized. Del Pino recognizes that the mixed companies' biggest drop in production happened last year because of reduced investments in 2005. PDVSA's plan is to close this year with 360,000 barrels per day, which is to say that the average for 2007 would be around 350,000 barrels per day, because investments have been made since last year, allocating US\$1.0 billion for investments for 2007.

Jusepín ready. PDVSA signed the Jusepín camp settlement with Total and BP, both companies worked the camp. The agreed to payments reach US\$250 million and won't be paid in cash but through an agreement which involves an amount of crude not made public.

ExxonMobil is ready. ExxonMobil will turn over to the Government operations of the *Cerro Negro* heavy crude upgrader before May 1st, the deadline set by President Chávez for the State to take control of the projects, according to an unidentified source within the industry. Exxon has a 41.7% stake in *Cerro Negro*, and operates the upgrader on behalf of its partners, PDVSA which also has a 41.7% stake, and BP which has 16.6%.

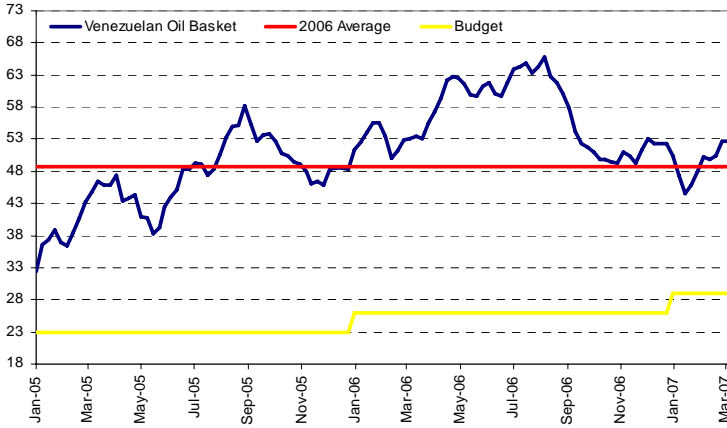
BUSINESS SECTOR TIPS

The Government means to control profits. According to the Minister of Planning and Development, Jorge Giordani, the change in the economic regimen that Venezuela is going through is also going to be reflected in the way domestic companies do business. They can't expect to aim for 100% earnings because that would be speculation. "In a capitalist system (...) profits of up to 7% and 8% is considered reasonable, but some private sectors immediately want 100% in a year. That's speculation, that's not even rational capitalism," said the Minister of Planning and Development.

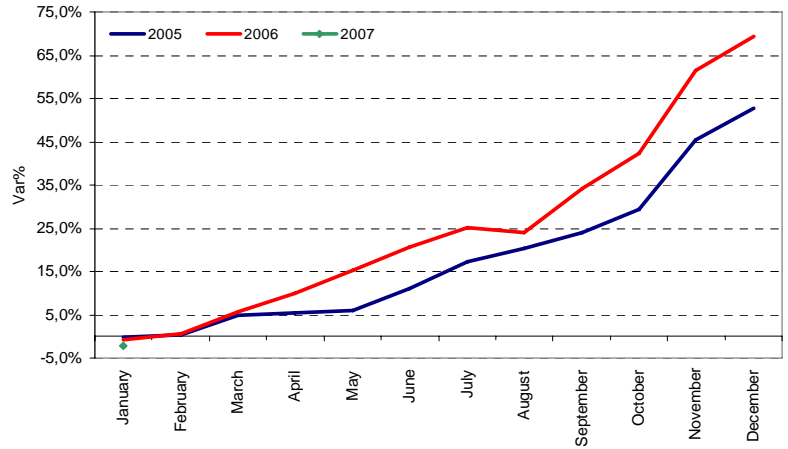
Banking under the gun. Finance Minister, Rodrigo Cabezas, pointed out that according to Banking Law reform, the Government will coordinate the whole public financing system, and it will also more clearly state the article that forces the BCV to set interest rates and it will introduce changes to stimulate loans. He also discarded the idea of nationalizing the private banking system but stated that the bank will need to increase its financial intermediation index from 48% to 78%.

ECONOMIC OVERVIEW

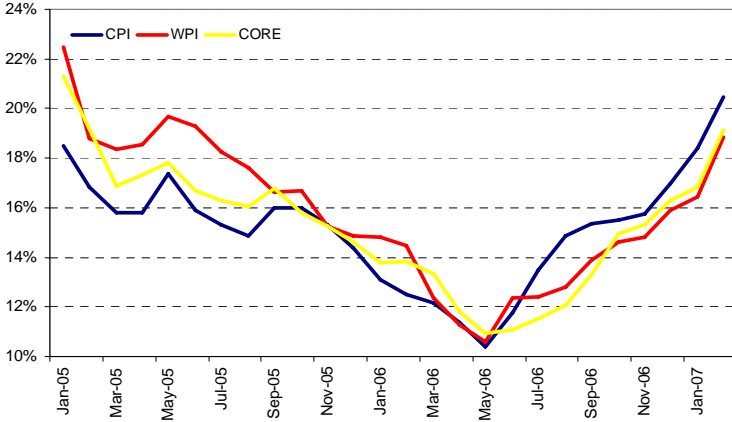
Oil Price
(Venezuelan Basket US\$/pb)



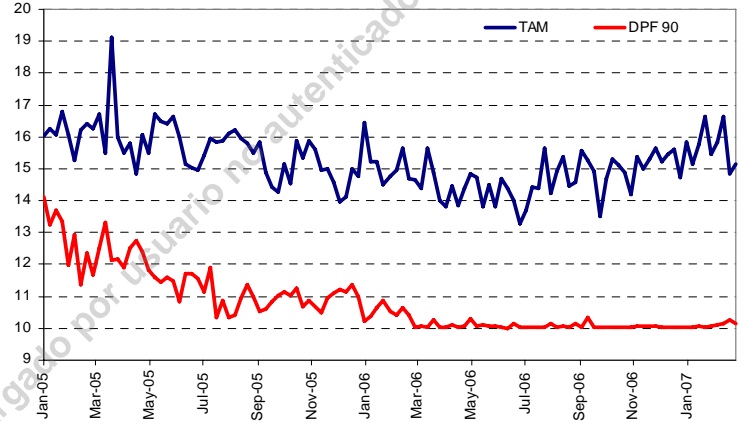
Real Expansion (M2)



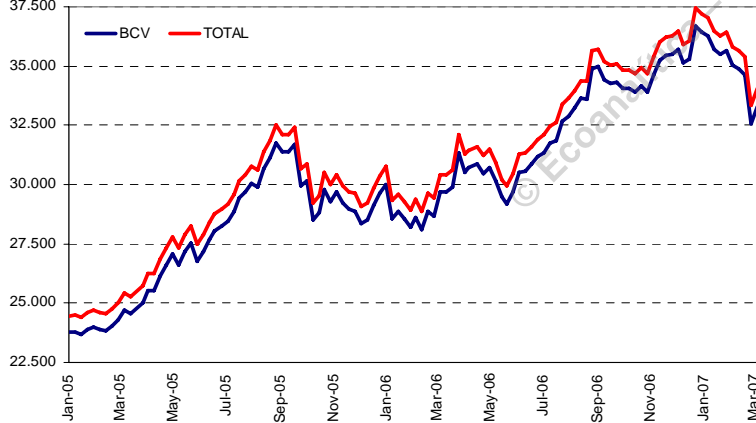
Inflation
(Last 12 Months)



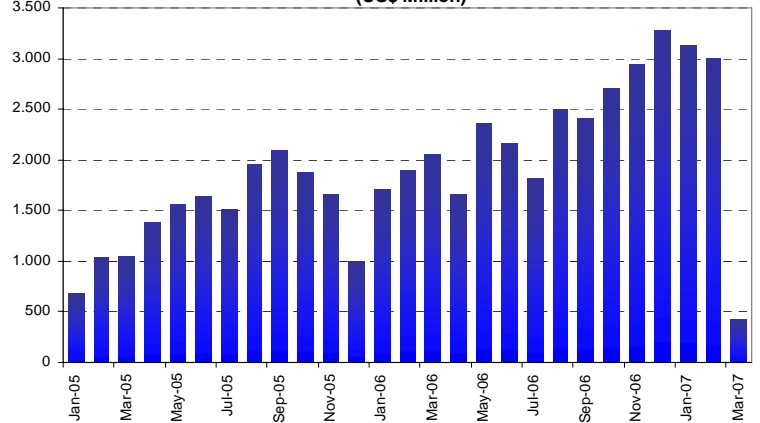
Interest Rate
(Six Principal Banks)



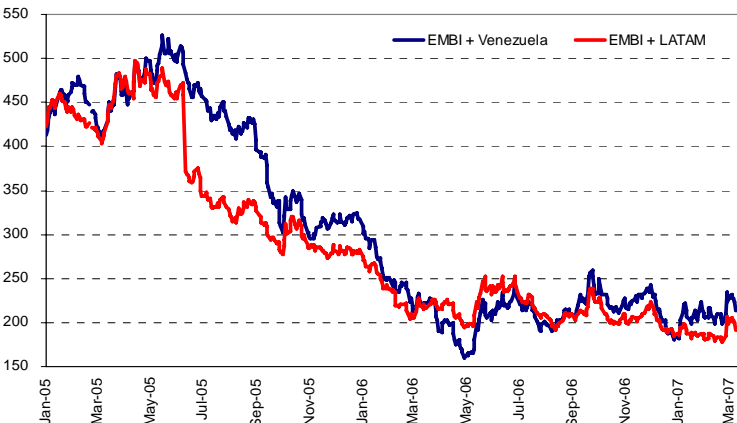
Fx Reserves
(US\$ Million)



Disbursement
(US\$ Million)



EMBI



Central Government
(VEB Billion)

