

Venezuela Crises: Potential Impact on the Oil Markets

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Overview

Prices of crude oil have been recovering since the beginning of the New Year ever since the OPEC+ production cuts have come into play. Crude oil had entered the bear market during the month of December and had fallen sharply from the prices prevailing during October 2018.

Prices of oil had fallen due to the rise in US tight oil production, grant of temporary waivers by the US on Iranian sanctions and sentiment hovering towards the slowdown in the global economy due to the ongoing trade wars between US and China.

Recovery in crude oil has been muted due to the increase in production in the U.S. and weaker economic growth around the globe in CY19 forecasts. The US recorded 11.9 mb/d of production as per latest numbers.

Crisis in Venezuela

Venezuela has been facing turmoil with the nation being subjected to growing political discontent further fuelled by hyperinflation, power cuts and shortages of food and medicine.

Ever since, Nicolás Maduro was re-elected and sworn in to a second six-year term in office after a controversial election, Venezuela's political crisis has reaching a boiling point.

On 23rd January, leader of the opposition Juan Guaidó, declared himself the interim President though Maduro did not step down and contest a fair election.

Guaidó stance has been backed by US president Donald Trump, Canada, UK and by several Latin American nations like Brazil, Argentina, Peru and Chile as well. Maduro has gathered supported from Russia, China and Turkey.

Maduro had previously cut all diplomatic ties with the US and demanded for the evacuation of US diplomats from Venezuela immediately, but is now open to negotiation with a 30-day window period.

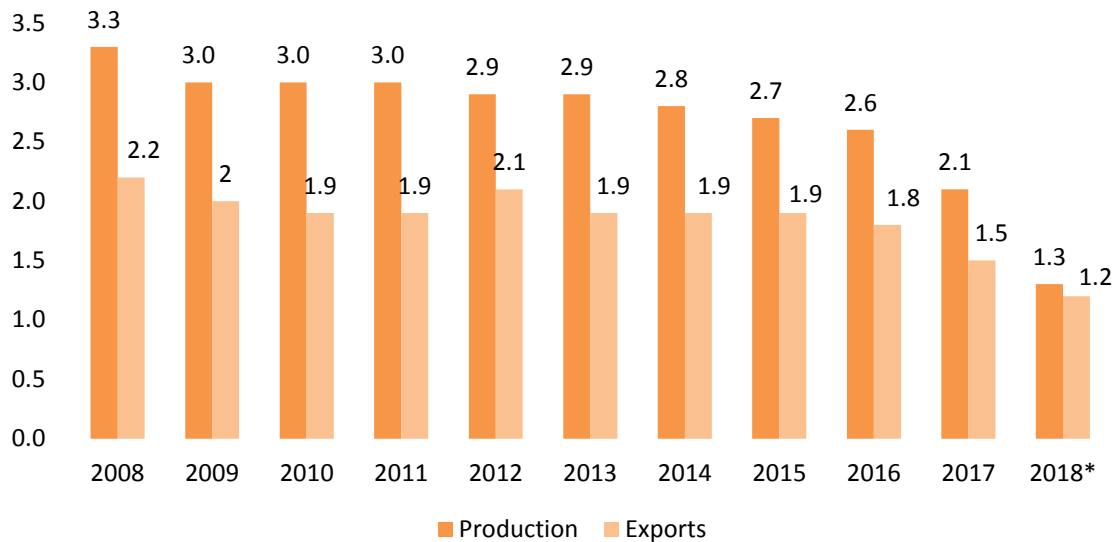
The US government had already imposed financial sanctions on Venezuela but did not extend it to its oil trade on humanitarian grounds as the Venezuelan economy is already in a low growth phase with 90% of the nation's income depending on oil exports. Given the latest developments in the past few days the US is planning to impose

sanctions on the oil trade as well unless Venezuela contests fair elections.

Inter-dependence of the Venezuelan and US Oil Markets

Venezuela has the world’s largest crude oil reserves (303.2 billion barrels of proven crude oil reserves) but hasn’t been able to capitalize on increasing its production due to lack of investments and the political situation in the country.

Chart 1: Production and Export levels of Venezuela (mb/d)



Source: Bloomberg

2018* January-November

In the past 10 years crude oil production has fallen by 2/5th from it being 3.3 million barrels per day (mb/d) to a daily average of 1.3 mb/d during CY18 (January-November) and exports have nearly halved.

The US is Venezuela's biggest and most important oil customer and as per EIA, Venezuela was the 4th biggest source of imported oil that flowed into the US last October. Several U.S. refineries on the Gulf Coast still import heavy sour crude from Venezuela, and those volumes are not easily replaced by oil from Texas, which is light and sweet. Venezuela's state company PDVSA even owns refineries in Texas through a subsidiary called CITGO.

The US government has already imposed sanctions on Venezuela but has so far declined to block imports of its crude. It has also held off on blocking exports of U.S.-origin diluents (like naphta and light crude), which Venezuela needs to dilute its heavy oil.

The US government has cautioned U.S. refiners which rely on Venezuelan crude to produce gasoline, jet fuel and other products that it “could impose Venezuela oil sanctions if the political situation in Venezuela is not resolved and further deteriorates.

Impact on the Oil Markets

Sanctions against Venezuelan crude would mean the U.S. is restricting flows from two OPEC countries, leading to a sharp supply outage and trade disruption in the global markets. Already the supply from Libya and Nigeria has curtailed and the OPEC+ production cuts have come into effect since the beginning of the year.

The loss of heavy crude oil will be a setback for the American refineries as sourcing heavy crude from other sources could be a hindrance given the OPEC+ production cuts are taking heavier oils off of the market, further complicating the global supply mix.

Venezuela's other leading oil customers are China and India. But Venezuela doesn't get any cash for those oil shipments. The deliveries are made in exchange for payments towards its massive debt.

Venezuela's oil minister and PDVSA President Manuel Quevedo is OPEC's sitting president for 2019. This could further complicate the relations of OPEC and Non OPEC members possibly leading to heightened tension during the OPEC+ meetings where the production cuts are reviewed and the future course of action is decided.

So far it is not known if the potential sanctions imposed by the US on Venezuelan crude will be extended towards other nations (like the Iranian sanctions) or it will only be restrictive towards US trade.

Concluding Remarks

The oil markets have had a muted reaction so far to the chaos in Venezuela given the global oil markets are well supplied due to the increase in US production (which rose by more than 2 million barrels per day (bpd) last year to a record 11.9 million bpd). The output is estimated to rise further as the number of rigs looking for new oil has increased for the first time in 2019 as per Baker Hughes rig count data to 862.

We believe the price of Brent crude oil will not exceed USD 65 bbl in the short term given the rise in US fuel stocks and global economic woes which has weighed the demand outlook for oil. Going forward if the crises in Venezuela is not resolved by the time the waiver period of the Iranian sanctions is lifted it could prove as double whammy on the oil prices raising it **to USD 70 bbl levels by May 2019**. The OPEC+ is also slated to meet in April 2019 to review the oil market situation.

Impact on India

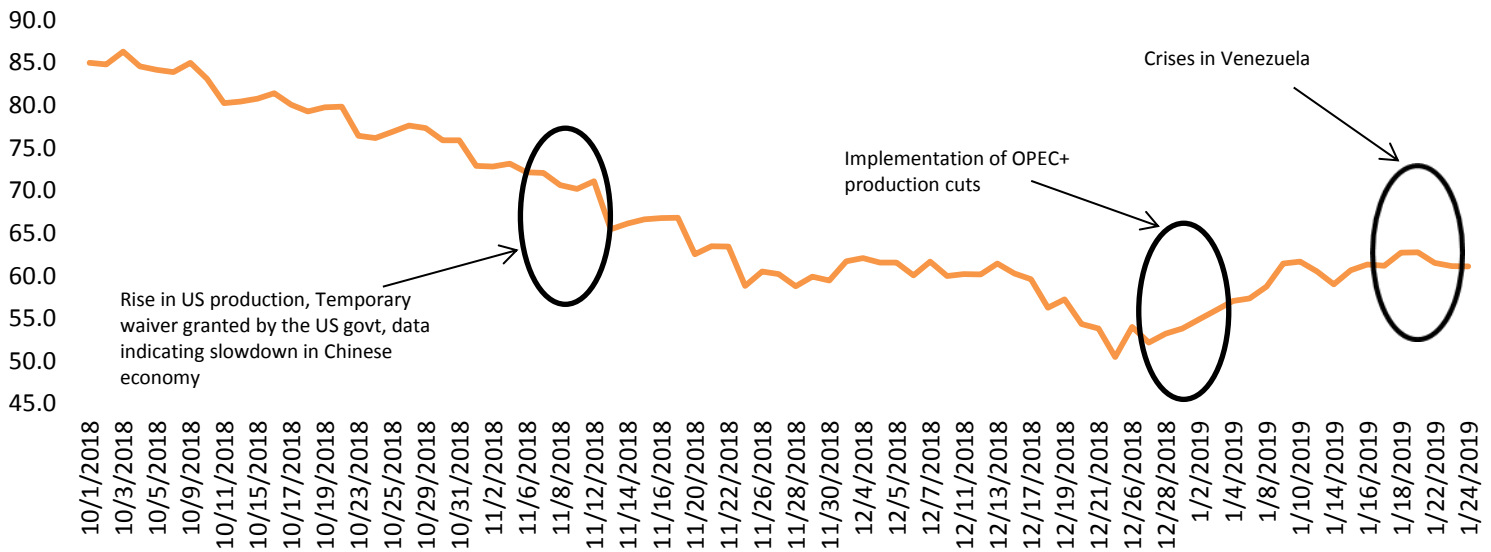
Venezuela has been the 4th biggest crude supplier to India after Iraq, Saudi Arabia and Iran during FY19 (April-November). The supplies accounted for about 12% of total imports. India has imported 4.5 mb/d during the current financial year (April-December).

- Any increase in oil prices is always going to be a cause of concern for India considering we import more than 80% of our oil requirements.
- Impact is to be felt in terms of trade deficit, on the markets, Indian basket of crude oil prices and exchange rate.
- We assume at the macro level with imports of 1643 million barrels of crude oil in FY19 a dollar increase in prices on a permanent basis would increase the bill by roughly USD 1.6 billion per annum
- Crude oil and its products have a weight of 10.4% in the WPI. Of this crude oil and natural gas have a weight of 2.4% and mineral oils around 8%. With the exception of LPG and kerosene (with combined weight of 0.83%), the rest would be driven by market forces. Therefore, any increase in the price of crude oil would tend to impact the

WPI inflation number commensurately. In terms of the CPI, fuel related items have a weight of nearly 2.7-2.8% directly.

- Prices in India change every fortnight based on the changes in the price of petrol and diesel in the international market which are based on crude oil prices. Rise in crude oil prices will commensurate in an increase in petrol and diesel in the depending on how the oil markets react in the reduction in supply.
- Rise in crude oil prices is also to affect the fiscal breakeven oil price which the government keeps in mind while framing the budget.

Chart 2: Daily price movements in Brent Oil (USD/bbl)



Source: Bloomberg, CARE Ratings

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