

Venezuela adding Risk to Crude Oil Prices: *A Crisis in Danger of being Overlooked*

Introduction by Shawn Reynolds, Portfolio Manager



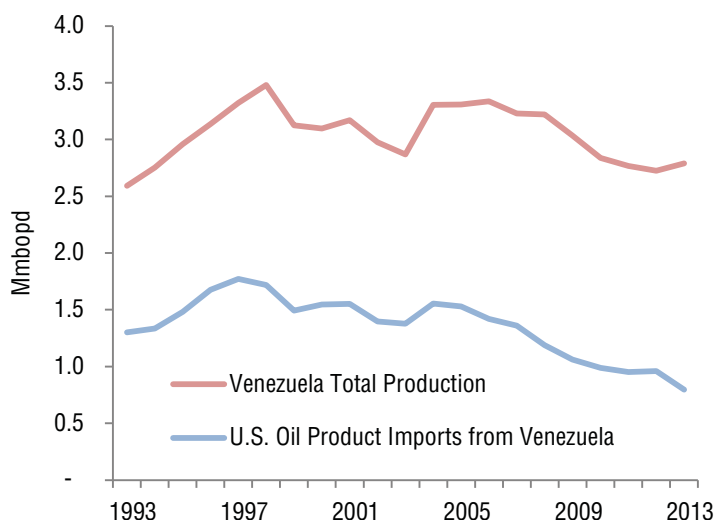
VENEZUELA MATTERS - As global media focus in recent weeks has swung from the crisis in Syria to the standoff in Ukraine, social unrest and street protests in Venezuela, and the government's violent response, are at risk of being overlooked.

Venezuela has among the largest recoverable oil reserves on the planet and is a founding member of the Organization of Petroleum Exporting Countries (OPEC). With crude oil production of some 2.79 million barrels per day through last November, it probably maintained its spot as eleventh largest producer in 2013. It is also a major crude exporter, accounting for approximately 9% of U.S. oil imports and sending over one million barrels per day to Asia.

As the political crisis unfolds in Venezuela, concern over the security of crude exports is growing. After the failed coup in 2002, oil exports were interrupted for some time, an interregnum that could, arguably, be partially blamed as the catalyst for the relentless climb in oil prices over the following six years. Any new disruptions to its long-deteriorating supply capabilities could potentially exacerbate pressure on current global crude oil pricing and is a situation the Van Eck investment team is monitoring closely.

Two members of the Van Eck Global investment team are Venezuelan nationals. Imaru Casanova, Senior Gold Analyst, and Patricia Gonzalez, Senior Analyst and Latin American specialist, were both born and raised in the country. They both have studied and worked there. Most members of their families still live in Venezuela. From their unique standpoint, Imaru and Patricia shared with me their personal views of the unfolding crisis and the potential likelihood of an implosion of the Hugo Chávez/Nicolas Maduro socialist experiment.

VENEZUELA PRODUCTION / U.S. IMPORTS



Shawn Reynolds (SR): *Imaru, even here in New York, it's difficult to find out what's going on in Caracas. What do you understand to be the current situation?*

Imaru Casanova (IC): Over the past few months, the streets of Venezuela have become the center stage of the country's deteriorating political situation, reflecting a level of unrest not experienced since 2002, when the government of Hugo Chávez was overthrown for a brief 48 hours.

This year's protests were originally called by university students and later joined by those opposing the government of President Nicolas Maduro, Chávez's successor. The protests, which started peacefully, have turned very violent. This has resulted in (unofficial estimates) dozens of people killed, mostly young students, hundreds injured and many more jailed. Videos and pictures disseminated via social media, which are, effectively, the only reliable news outlets available in the country at present, show government armed forces and pro-government armed groups, shooting, tear gassing, and brutally assaulting unarmed protesters. The images are very disturbing.

Source: U.S. Energy Information Administration; Simmons Research

Source: Bloomberg. Data as of December 31, 2013.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

SR: *Patricia, how come we're seeing so little about this?*

Patricia Gonzalez (PG): This is primarily due to the government taking control of the television and newspapers in the country and recently cutting the signals of several foreign channels that had been reporting on the situation. Currently, the country is on a media blackout, limiting the flow of information from traditional sources to both the Venezuelan population and the outside world. As a result, the opposition has been forced to rely on social media and on Venezuelans around the globe to get information and demonstrate to the world the current situation.

SR: *But why the protests?*

PG: The reasons behind these protests are many. Venezuela has seen a significant increase in violence over the last few years, making it one of the more dangerous countries in the world. The economic situation has only worsened throughout the years, despite Venezuela having massive oil reserves. The government of Venezuela has taken control of the private sector, nationalizing many areas of the economy. This has resulted in the closure of both businesses and industries, and a significant decline in private investment. In addition, the government has also sought to control prices and the profits of businesses, making it difficult for companies not just to produce, but to even remain in business. This has created shortages of food, medicines and basic needs. Now the country has to import most of what it consumes. The government also has established exchange controls, with the official exchange rate (depending on different factors) ranging from six to 11 Bolivars to one U.S. Dollar. At the same time, in the black market, the going rate has fluctuated from 60 to 90 Bolivars to one U.S. Dollar. Annual inflation has been around 55%.

IC: I think, too, that for the average Venezuelan, the evidence is now becoming very clear of the consequences of more than a decade of government policies and controls designed to advance Chávez's populist agenda. When almost every member of one's family has been victim of a robbery at gunpoint, and at times kidnapping, and news of homicides is not just read about in the papers, but comes from close friends, then we can only imagine that any and every Venezuelan must understand that things are not well. The same is true when one is required to stand in line for hours and show one's ID every time there is the chance to buy a chicken, a liter of milk or a roll of toilet paper. And, when buying that chicken, it now costs over 50% more than it did last year.

SR: *But Venezuela is one of the world's main oil producers and has the second largest oil reserves in the world.*

IC: To understand how a country so rich in natural resources can end up in what is clearly a very difficult economic position at present, I think it helps to look into what has been happening inside Petroleos de Venezuela SA (PDVSA), Venezuela's state owned oil company and what is viewed as the country's economic engine.

A country wide, massive strike by PDVSA employees and leadership in 2002-2003 failed to remove Hugo Chávez from power, but it did lead to the firing of thousands of key PDVSA personnel. These included experienced operators, engineers, and scientists, as well as most of the technical and corporate leadership teams running the company at the time. Their positions were quickly filled (sometimes "double-filled") by what were unavoidably less-qualified individuals, many of whom lacked any experience whatsoever in the sector and were simply handpicked by the government to help advance its political objectives.

Having worked in the oil sector in Venezuela, with many friends and family working in the pre- and post-2003 PDVSA, we were close to the situation. In the years that followed, we saw our friends, together with their education and experience, leave the country to the benefit of other oil producing nations; we heard of the arbitrary appointments;

we witnessed the change in operating agreements with the multinational companies. We watched our brothers and sisters put on red shirts while on the job in order to meet a mandatory requirement to campaign for the government party, while those who were blacklisted for publically supporting the opposition remain unemployable by the economic apparatus now largely controlled by the government.

PDVSA became not just the country's economic engine, but the ruling government's party political machine. To get some idea of the multitude of functions PDVSA serves, think of the fact that PDVSA is (or at least was until recently) in charge of running one of the government's main social programs, its subsidized, popular food markets. So it comes as no surprise to us that following years of mismanagement and under investment, and a redefinition of its role, the great PDVSA is where it is today.

SR: *So, what next?*

PG: While it is not clear what the outcome of these events will be, the current political, financial and social environment in Venezuela has grown very difficult and the country could be close to a crisis. For more than 60 years, Venezuela has depended on its vast oil reserves not only to support the economy, but also to finance virtually all the social programs and more recently fund its "revolution". However, while the country commitments have increased, its oil production has decreased. Based on the latest numbers provided from the Ministry of Energy and Oil, the country is producing 2.8 million barrels per day, down from as high as 3.5 million. Of those 2.8 million barrels, about 800 thousand barrels per day are for domestic use, and thus generate no real economic profit for PDVSA, as oil consumption in Venezuela is highly subsidized. This leaves about 2 million barrels for exports. However, about 400 thousand barrels per day are sent to China as payment for a \$40 billion loan to the Venezuelan government. In addition, in an effort to create alliances in the Latin American region, Venezuela entered PetroCaribe, a pact to provide somewhere around 300 thousand barrels per day to countries including Nicaragua, Jamaica, Dominican Republic and Cuba at concessionary prices on deferred terms. Thus, roughly, only 1.3 million barrels per day of PDVSA's oil production are available for exports, of which the U.S. is the main buyer, and generate real income, required by the Venezuelan government to meet all its obligations and to pay for all of its imports.

SR: *That doesn't appear to provide much reason for optimism.*

IC: No, it doesn't. Venezuela's oil production is likely to continue in a declining path. It takes expertise, technology, and intensive capital investment to offset the natural decline rates of mature fields, and to access undeveloped and unconventional sources of reserves. Venezuela has historically relied on foreign companies to develop its large oil reserves, but the multinationals are cautious now about investing in a country where previous agreements have been disregarded and assets have been nationalized. In many cases, companies have yet to be compensated. In addition, under the current administration, its double role as the country's main economic and political organization could continue to compromise its productivity. Even a reversal to its old ways, driven by a change of power, could take many years to bear fruit and bring PDVSA back to the place it once held as one of the best run oil companies in the world.

PG: I'm afraid I have to agree with Ima. The situation will likely get worse before it gets better. The students and the people of Venezuela are experiencing lack of security, general staples and opportunities for their future. The situation is unsustainable and requires a change. Economic policies need to be implemented and changes in the oil industry are necessary.

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