

the HDP. The PKK too appears unconcerned at the possible demise of the first Kurdish political party to have made a serious mark on Turkish politics, suggesting this may have been its strategy all along. Joining mainstream politics may have improved the lot of Turkey's Kurds, but would spell an uncertain future for the PKK's leaders.

Opinion polls indicate little change in support levels for the four parties in the Turkish parliament, but the continuation or even worsening of hostilities through the more than two months to polling could well have an effect on voting patterns, although what that effect might be is impossible to ascertain with any accuracy.

With the AKP focused almost exclusively on reversing its June poll defeat, key questions are first to what extent it is prepared to sacrifice the existing and potential future revenues from transiting crude oil and natural gas from the KRG-controlled region; and second what impact a lack of money will have on the KRG's relations with Baghdad and its ability to combat IS.

With media reports now claiming that much of the crude being exported from the KRG region is finding its way to Israel, the AKP – and Erdogan in particular – may find it difficult to allow those exports to continue, even at the risk of undermining the KRG's ability to repel incursions by IS, and hence the opprobrium of Turkey's NATO allies.

Turkey and Israel have had no formal diplomatic relations since the Gaza Flotilla incident in 2010. Frequent allegations by Erdogan and his aides of Israeli and Jewish conspiracies having undermined attempts at reconciliation.

Indeed, the most worrying aspect of the entire situation is the extent to which it boils down to the wishes of one man, Erdogan, who claims executive powers that the constitution does not currently convey. Turkey's opposition parties have openly blamed the failure of coalition talks on the AKP's unwillingness to accept anything that undermines him. His response has been to announce that he already enjoys executive power, and it is up to the Turkish parliament to reflect that reality by formalizing the arrangement by changing the constitution.

Venezuela: default risks grow

Venezuela, South America's biggest oil producer, has seen the value of its oil exports fall to its lowest level since 2004. The economy faces hyperinflation and increasing shortages of basic goods. Debt default seems highly likely. State oil company PDVSA has neither the institutional capacity nor the funds to expand oil production. It is a downward spiral that will lead to political change. **Mery Mogollon**

After a decade enjoying a bonanza from high oil prices, Venezuela has in the last year lost about half of its annual oil income, brutally exposing the shaky foundations on which former president Hugo Chavez founded his economic policy. Lines of Venezuelans waiting outside stores to buy basic food and goods sold under strict government price controls are more reminiscent of Soviet Russia than a modern economy.

Free market prices are rocketing and threaten hyperinflation. The black market rate for the Venezuelan Bolivar was put at 630 to the dollar in July, a hundred times less than the official exchange rate of 6.3.

With its foreign reserves precariously low, massive foreign debts and a continued slide in its currency, doubts over Venezuela's ability to avoid a debt default have hit all-time highs. S&P, which like Platts is a unit of McGraw-Hill Financial, downgraded Venezuela's sovereign debt rating to CCC in February, denoting junk bond status and a high risk of default.

Concerns are focused on PDVSA, the country's state-owned oil company, which, as Venezuela's largest company, is also the backbone of its economy. With its coffers having been raided continually to support

government social programs, PDVSA is now loaded with debt and suffering from its own funding problems. It appears incapable of raising crude output to offset falling prices.

"The most influential members of OPEC are expanding their production capacity, ensuring at the same time greater supply, not only to protect their market share, but to improve their ability to respond to demand," said Einstein Millán, a Kuwaiti-based Venezuelan energy economist. "But PDVSA seems focused on projects which, although strategic, raise its per barrel and operating costs. Complex, costly projects are of questionable value when compared to more profitable alternatives and, as time goes by, PDVSA's financial integrity and technological capacity are reduced."

Orinoco riches

Venezuela may hold the world's largest reserves of oil, but the majority of those reserves are difficult to produce. The Orinoco extra heavy oil belt holds massive resources estimated at 230 billion barrels of crude. But their high sulfur and metals content requires processing before being blended with diluents such as naphtha before the crude can be processed in a conventional refinery.

Referred to locally as the 'La Faja' or belt, the region has become a new production frontier for PDVSA, which hopes to lift output from the region to 4 million b/d in 2019, up from 1.3 million b/d currently. This target was ambitious even before crude prices collapsed and many observers question the economics of the Faja's projects at current price levels.

PDVSA currently has seven ongoing projects in the Faja, including the construction of six crude upgraders and a refinery capable of processing the heavy crude. It's partners include Spain's Repsol, US major Chevron, Russian state oil company Rosneft and China's CNPC.

"Extra-heavy oil in the Orinoco Belt is still cheap, but PDVSA is very inefficient," said Thomas O'Donnell, an oil analyst based in Berlin. "In the Orinoco Belt the geology is simple. Although it [the crude] needs upgrading; it can be mixed with lighter oils, avoiding building expensive upgraders – although this forfeits value added from (pre-) refining. And the glut of light fracked oil in North America means there can be a market even there for heavier oil that refineries like to mix in," O'Donnell said.

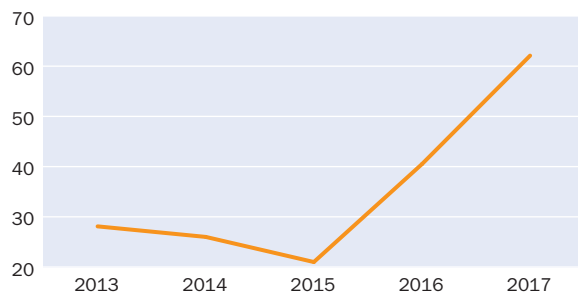
The problem is investment, infrastructure and operational competence, he said. "PDVSA has very little of these, but foreign companies do. Only if more operational control is given to foreign firms will this extra-heavy oil production be expanded. Some changes have occurred; however all 'under the table' due to politics. But, the potential is there, below ground, as it always has been. The strong likelihood of years of low prices and an international oil glut make this all harder, even if everything were suddenly done right by PDVSA – which won't happen until there are political changes." O'Donnell said.

Growth constraints

Despite PDVSA's efforts to progress its heavy oil ventures in the Faja, the country's oil production has stalled. For the second week of August, Venezuelan oil production stood at 2.89 million b/d (1.3 million b/d from the Orinoco Belt), well below the 2015 target of 3.3 million b/d, according to the Production Monitoring Committee, an internal group that reports to the president of PDVSA.

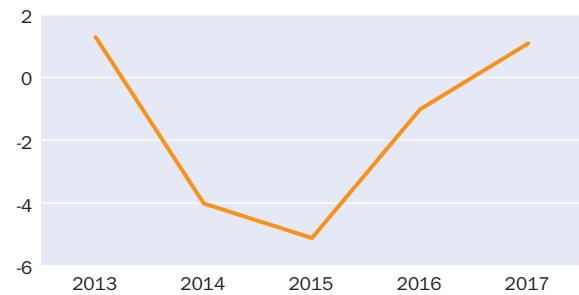
These production figures have been questioned by analysts, who say the real volume is much lower.

Venezuela consumer price inflation (%)



*2014 is an estimate, 2015-2017 are forecasts
Source: World Bank

Venezuela real GDP* (%)



*2014 is an estimate, 2015-2017 are forecasts

Source: World Bank

According to the latest Platts survey, Venezuelan production in July averaged 2.34 million b/d.

The main short-term threat to PDVSA remains a lack of finance to cover its daily operations. However, even if the state defaults and goes to the IMF for a bailout, it will continue to function. "In such a situation, there might be a sale of a portion of the company to raise cash, and much more operational autonomy for foreign firms. But, for now, paralysis is the norm," O'Donnell said.

PDVSA's paralysis is certainly having consequences, the biggest of which is the loss of profitable markets for Venezuela's crude exports. Since 1998, Venezuelan oil exports have fallen by more than one million b/d, or almost 40%, making oil progressively less of a key earner for the country, notes Francisco Monaldi, Baker Institute Fellow in Latin American Energy Policy at Rice University in the US.

"Almost all the fall in exports occurred in the US, which are the most profitable, while a large part of exports towards Latin America and the Caribbean are highly subsidized and those to Asia yield lower margins due to the higher cost of transport," according to Monaldi.

The outlook is a bleak one for PDVSA. Despite efforts to court new Asian customers, Millan believes that Venezuelan crude is losing its attractiveness in key consuming countries such as China and India, particularly as Saudi Arabia and other Gulf producers are targeting these countries as areas where they can grow their share of the market.

Production costs

"With the likely return of Iran to world oil markets, rising production in Iraq, and Saudi Arabia's pursuit of market share, PDVSA's potential to continue and increase its supply to Asian markets is under question unless it's prepared to offer bigger discounts for its crudes," said Millan. As a consequence, PDVSA runs the risk of a major cash flow crunch particularly as the cost of production continues to climb, he said.

Despite a slip in service industry costs elsewhere, Millan estimates that production costs in Venezuela will rise to average over \$24/b in 2016, up from around \$18/b

currently, as the volumes from the higher-cost Orinoco Belt rise. According to Millan, PDVSA will lose \$400 million of operating income for every dollar increase in costs.

Another market where PDVSA is losing its traditional foothold is the Caribbean, where US refiners have been able to make inroads. PDVSA's oil exports to PetroCaribe countries averaged 154,700 b/d in 2014, down 12% from 176,100 b/d in 2013, according to the company's latest annual report. PetroCaribe is a trade group of 17 countries in the Caribbean region that was created in 2005 to foster economic and energy security among members. Part of the energy supply agreement includes favorable financing.

This year, PetroCaribe members Dominican Republic and Jamaica paid off their discounted oil deals with Venezuela, giving Caracas valuable breathing room for its foreign currency reserves. Cuba, Nicaragua and Haiti, which make up about 70% of oil supplies under PetroCaribe, have yet to agree any payment deals. The reduction in crude supply to PetroCaribe is positive for PDVSA because it reduces the amount of subsidized crude sales that it has to make, but the extended financing it involves remains a drain on its resources.

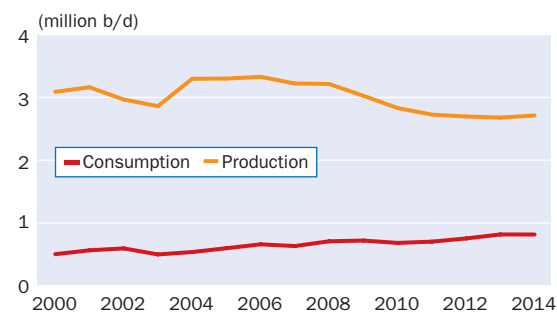
Slow change

The country's economic crisis, precipitated by the falling oil price, has sparked some changes at PDVSA. But they are slow and modest. "Since Eulogio Del Pino took over as its head, PDVSA has assumed a more pragmatic political role," said Monaldi. "Production in the Orinoco Belt has risen, making up for some of the falls in conventional crude output. Subsidized oil exports are falling and the relationships with foreign oil partners have improved. But we are still a long way from seeing a clear path to recovery," he said.

Although the number of drilled wells rose to 70 in July, up from 54 in April, analysts believe these levels are insufficient to boost overall output. According to OPEC, there were 108 active oil rigs in Venezuela in July, but the required rig count for sustaining production should be around 150-170 active rigs, Millan believes.

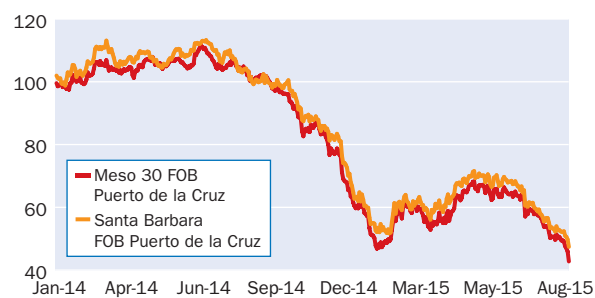
This total covers both conventional and unconventional oil activities in the Orinoco Belt. Owing to the high

Venezuelan oil production and consumption



Source: BP Statistical Review of World Energy

Venezuelan crude prices (\$/barrel)



Source: Platts Latin American Wire

decline rate in the region, at least one new well per day is need just to maintain output.

"Due to the intensive drilling activity required to keep production alive in the Orinoco Belt, some 200 active rigs are actually needed only for this asset to achieve the required acceleration to reach the expected 4 million b/d target," Millan said. "So, in the event these figures are right, it implies an imminent collapse in PDVSA's oil production", he warns.

Since 2008, and after more than 3,300 new wells drilled, only 270,000 b/d has been added to production, making it "practically impossible to reach the 2019 goal, as the net increase per well is negligible", he said.

For O'Donnell, "the managerial and technical capacity of PDVSA is likely the lowest of any OPEC state; however, there is no movement towards reform ... That is not to say that there are not professionals inside PDVSA who know more or less what needs to be done technically, and even somewhat managerially. However, to empower them and other competent people who could return to PDVSA from inside and outside the country, there has to be a top-down reform program with clear political support from the Assembly and president's office. PDVSA's operational capacity, and the Oil and Mining Ministry's oversight capacity, can only be slowly rebuilt," O'Donnell said.

If that weren't enough Venezuela's financial balancing act means PDVSA is effectively hand-tied when it comes to digging itself out of its current malaise. The petrodollars which the state giant generates are going to service foreign debt and import food, medicines and other goods. Imports of some finished oil products to feed the country's 350,000 b/d gasoline and diesel market – often sold at subsidized prices – is also absorbing revenues from crude exports. This is money that PDVSA needs if it is to make the investment necessary to raise production.

Debt woes

"Under the current oil price outlook Venezuela cannot meet its commitments to service its foreign debt without incurring a massive economic and social cost," the independent economist José Guerra told a recent

conference. Guerra estimates that, between August and December this year, debt payments totaling \$6.3 billion will fall due and another \$12.5 billion will need to be paid in 2016, excluding oil payments to China.

China has lent more than \$51 billion to Venezuela since 2007 which the producer is paying for in oil exports. "Evidently, the debt is unpayable with the price of the Venezuela's oil exports below \$55/b," Guerra said.

As for PDVSA itself, according to Monaldi, the company's foreign debts have spiraled to an eye-watering \$45 billion from some \$3 billion in 2006. The total excludes debts to suppliers and partners, settlements for expropriated assets and its bolivar debts with the Central Bank. These spiraling debts were built up at a time of record oil prices when oil income was diverted to the government's social programs leaving too little for reinvestment in the oil industry.

According to the Center for Energy Guidance (Coener), a Caracas-based think tank, every dollar from crude exports is effectively going to the government, leaving PDVSA without funds for upstream spending or much-needed refining investments. PDVSA is losing about \$5/b for each processed barrel, according to Coener.

Under official targets given earlier this year, PDVSA hopes to invest some \$25 billion in 2015 just to maintain its current production capacity. The company has not updated the figure nor said how much it has spent for far.

A Chinese upset?

Tackling the country's urgent economic problems will now require more than just a recovery in the global oil price,

according to some observers. President Nicolas Maduro will need to foster a turnaround in the culture of PDVSA and its relationship with the government. "The most serious problem PDVSA has is politics. The company has not even a facade of independence from the office of the president of the republic," O'Donnell said.

Many of PDVSA's problems are longstanding, predating the oil price rout and largely ignored due to the oil boom from 2005. But the country can rely, it appears, on an important ally in China, which has continued to develop its trade and financial ties with Venezuela, despite the country's setbacks. "China represents an ally with a socialist tendency prepared to continue extending credit at more favorable terms than the big multilateral banks such as the IMF," noted economists Asdrúbal Oliveros and Carlos Álvarez in a recent article.

But there is no certainty that China will continue to bankroll Venezuela. GDP growth in China has slowed from the above 10% annual rates of the previous decade to below an estimated 7% this year, according to the IMF. In August, China devalued its currency and suffered a major loss on its stock markets. A slowdown in the Chinese economy could have major repercussions for the Venezuelan economy and consequently for the Maduro government.

Maduro himself – at least in public — appears characteristically unbowed by the woes his country's oil-based economy is facing. "There will be no catastrophe or collapse," Maduro predicted August 20 in a televised speech. "We are following with heart and soul our mission that can't be stopped," he said, announcing at the same time that the value of Venezuela's oil exports had hit \$38/b, the lowest since 2004.

Re-evaluating the role of LNG

The conditions for a profitable global expansion of LNG production have deteriorated substantially in the last two years. The industry appears to have miscalculated the role natural gas would assume in the transition to low carbon energy systems, the impact of renewables, and, more fundamentally, that the role of LNG is most ambiguous in gas-import dependent countries. **Ross McCracken**

The LNG market is undergoing a boom in new production capacity, the like of which has not been seen since the great Qatari expansion of the 2000s. By 2020, Australia is expected to have overtaken Qatar as the world's largest LNG producer. Hot on its heels is the US, which will bring shale gas to the shores of LNG consumers worldwide. This expansion is based on projects already under construction, it is not reliant on the nebulous universe of LNG projects at the proposal stage.

However, in the time it has taken to get these long lead time projects to the point of production, both the price of

oil and spot LNG has crashed. As of August 24, Dated Brent had fallen to \$41.855 a barrel, less than half its average price over the course of 2014 of \$98.95/b. Although US producers have introduced new pricing terms – such as tolling agreements or linking prices to the US Henry Hub price rather than oil – the vast majority of long-term LNG offtake agreements remain indexed to oil.

The spot price of LNG has also tumbled, falling from about \$20/MMBtu in February 2014 to \$7.65/MMBtu August 24 for Asia and from \$16/MMBtu to \$6.06/