Venezuela's Debt: Untying the PDVSA Knot

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Venezuela clearly cannot pay its debt yet the government continues to divert scarce cash needed for food and medicine for the Venezuelan people to pay foreign bondholders. This choice is driven by fears that the knot tying the government's $35 billion of foreign bonds to the $30 billion of foreign bonds of national oil company PDVSA creates an insurmountable obstacle to a debt restructuring.

Transferring PDVSA's Venezuelan assets to the government by act of the National Assembly, including its oil concessions, combined with an offer to exchange PDVSA bonds $ for $ for identical bonds of the government will cut the knot. The risk of a transfer of PDVSA's domestic assets was fully disclosed in the offering documents of the PDVSA bonds.

There will be few hold-out PDVSA bondholders because there are no significant PDVSA assets outside Venezuela that can be seized by creditors and creditors have little ability to seize Venezuelan government assets in Venezuela.

The official sector and the courts will view the government's offer to exchange PDVSA bonds $ for $ for identical government bonds as a sincere good-faith effort to resolve a difficult situation in a fair and equitable manner.

The exchange of PDVSA bonds into government bonds will create a uniform pool of sovereign bonds that can be restructured in a classic sovereign debt exchange. The combination of a Venezuelan government acceptable to the international community, a credible program to restore the Venezuelan economy and a debt restructuring offer that recognizes the economy's potential will ensure the success of the restructuring.

The ability of creditors to seize oil related assets and disrupt the flow of oil revenue will be greatly reduced by the PDVSA exchange and by an adjustment to the oil sale settlement mechanism that provides payment in Venezuela.

I. The Venezuelan Foreign Debt

Venezuela's debt under foreign law is divided into six major groups:

1. Government bonds: US$ 35 billion;
2. Petroleos de Venezuela, SA (PDVSA) bonds: US$ 25 billion[1];
3. Petroleos de Venezuela, SA (PDVSA) promissory notes to suppliers: US$ 5 billion (estimate)
4. Bilateral loans from China and Russia: US$ 50 billion (estimate)[2];
5. Supplier credits;
6. Arbitration awards to foreign investors from the nationalization/cancellation of Venezuelan assets.

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[1] $3.4 billion of PDVSA bonds are secured by a 50.1% shareholding in its US subsidiary Citgo. These bonds will be subject to a separate restructuring.

[2] The bilateral loans will be subject to a separate restructuring agreement. In the case of Iraq, commercial creditors and the major bilateral lenders, both Paris Club and non-Paris Club, received virtually identical terms.

Restructuring the foreign bonds of the government and the foreign bonds and promissory notes of PDVSA is a necessary step to debt sustainability and economic recovery.

II. Oil Revenue Flows Must be Ensured

Any disruption of oil revenues would be catastrophic for the Venezuelan government and the Venezuelan people. Oil accounts for 95% of exports and virtually all State revenue. The vast majority of food and medical supplies are imported.

Fear that a default will lead to seizures of oil shipments and sales proceeds by creditors has driven the government to pay foreign bondholders at the cost of a collapse in the living standards of the Venezuelan people.

III. PDVSA's Principal Assets are Governed by Domestic Venezuelan Law

PDVSA's principal assets are located in Venezuela and are subject to Venezuelan law. The Venezuelan National Assembly, just as any national legislature, has the right to change the nation's domestic law under its constitution. A change in national law is a risk that all foreign investors voluntarily and knowingly take when they purchase bonds based upon domestic assets.

The most important asset of PDVSA is its oil concessions granted by the government. The Venezuelan National Assembly can cancel the concessions by legislative act, returning the Company's oil assets to the government. The risks of a transfer of PDVSA's domestic assets and of a cancellation of PDVSA's oil concessions were fully disclosed in the offering documents of the PDVSA bonds.

PDVSA's only significant asset outside Venezuela is its US subsidiary Citgo. However, PDVSA has pledged 100% of Citgo to a group of bondholders (50.1%) and Russian oil company Rosneft (49.9%).

IV. Three-Step Venezuelan Debt Restructuring

The restructuring of the Venezuelan foreign bond debt will be a three-stage process:

1. All of PDVSA's Venezuelan assets will be transferred to the government by act of the National Assembly. The legislation will include a cancellation of PDVSA's oil concessions.

2. PDVSA and the government will launch an exchange offer for PDVSA foreign bonds and promissory notes. Under the offer, PDVSA's foreign unsecured bonds and promissory notes will be exchanged $ for $ for new foreign unsecured bonds of the government with identical terms. [3]

3. The government will launch a classic debt restructuring offer for both its old bonds and its new bonds issued in the PDVSA exchange.

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[3] The transfer of the PDVSA debt liabilities to the government could also be effected by act of the Venezuelan National Assembly. However, a PDVSA debtholder may challenge this transfer in a New York court.

Under the exchange of PDVSA bonds and promissory notes for government bonds, the government becomes the successor obligor of the PDVSA bonds and notes. All liabilities of PDVSA will be assumed by the government.

The official sector and the courts will view the government's offer to exchange PDVSA bonds and notes $ for $ for identical government bonds as a sincere good-faith effort to resolve a difficult situation in a fair and equitable manner.

V. Few Hold-Outs in PDVSA Exchange to Government Bonds

There will be few hold-outs in the exchange of PDVSA bonds and promissory notes for government bonds because nothing can be gained from holding out.

PDVSA bondholders will receive a wind-fall profit from the exchange because government bonds have a higher market value than PDVSA bonds.

PDVSA bondholders and promissory noteholders that refuse the exchange will retain their original claim on PDVSA. However, all of PDVSA's assets in Venezuela have been legally transferred to the government and its oil concessions have been cancelled by act of the National Assembly. There are no significant PDVSA assets outside Venezuela that can be seized by creditors. PDVSA's main non-Venezuelan asset, US subsidiary Citgo, has already been pledged as collateral to secured bondholders and to Russian oil company Rosneft. The hold-out PDVSA debtholder has a claim on an empty box.

The PDVSA assets transferred to the government are all governed by Venezuelan law and are all located on Venezuelan soil. It is very unlikely that a Venezuelan court will seize Venezuelan government assets in Venezuela and deliver them to a foreign creditor.

The adjustment to the oil sale settlement mechanism that provides payment in Venezuela, detailed in Section VII below, will protect oil related assets and the flow of oil revenue from attachment by creditors.

A PDVSA hold-out debtholder may claim that if the vast majority of PDVSA assets has been transferred to the government, the government has become the successor obligor of its PDVSA debt. If this claim is upheld by the courts, the hold-out will be in the exact same position as if it had accepted the offer to exchange its PDVSA debt $ for $ for government bonds with identical terms.

VI. PDVSA Exchange Creates a Uniform Pool of Sovereign Bonds

After the exchange of PDVSA bonds and promissory notes for new government bonds, the Venezuelan foreign bond debt is a standard pool of sovereign bonds that can be restructured under a traditional exchange offer.

The combination of a Venezuelan government acceptable to the international community, a credible program to restore the Venezuelan economy and a debt restructuring offer that recognizes the economy's potential will ensure the success of the restructuring.

VII. Risk of Oil Revenue Disruption is Greatly Reduced

The exchange of PDVSA bonds and promissory notes for bonds of the government and an adjustment to the oil sale settlement mechanism that provides payment in Venezuela will greatly reduce the ability of debtholders to seize oil-related assets and disrupt the flow of oil revenues.

Venezuelan oil is sold Free On Board (FOB) Venezuela. There is therefore little ability for creditors to seize the oil shipments once they leave Venezuela. Seizing the oil or the proceeds of oil sales in Venezuela is very unlikely because the foreign creditor must convince a Venezuelan court to seize assets owned by the Venezuelan government and to deliver these assets to the foreign creditor.

Oil purchasers normally pay 30-60 days after delivery. To eliminate the ability of hold-out debtholders to attach the "payments due from oil purchasers" outside Venezuela, the government should move to a "cash versus loaded shipment" oil settlement mechanism.

Purchasers will pay for the oil in Caracas once the oil is loaded on the ships in Venezuela. Buyers will demand a price discount to compensate for the 45-75 day financing period between payment for the oil upon loading and the normal post-delivery payment terms. However, the cost to Venezuela will be less than the price discount because the government will earn interest on the cash or pay down debt and reduce borrowing costs during the 45-75 day period. The effective price discount will be negligible if a Venezuelan government acceptable to the international community is in place and the sanctions imposed by the United States are lifted.