



Two Visions of Energy in the Americas

By Roger F. Noriega

“America is addicted to oil,” President George W. Bush told the nation in his January 31 State of the Union address, “which is often imported from unstable parts of the world.” Spelling out a plan for using technology “to develop cleaner, cheaper, more reliable alternative energy sources,” the president set a worthy goal to “make our dependence on Middle Eastern oil a thing of the past.”¹ Although the president’s long-term vision is of a country less dependent on petroleum, a near-term solution for being less reliant on “unstable” sources of energy can be found in encouraging resource-rich nations in the Western Hemisphere to adopt sound policies for developing their oil and gas industries. Without a concerted effort right now engaging government and industry, however, we may witness some countries with vast potential embrace statist models that squander their natural resources and make them less reliable and less stable partners.

Today, the United States is the largest consumer of global energy resources, making secure access to energy at market terms a strategic imperative. Given the current climate—characterized by the economic maturation of China, India, and other developing nations; rising energy prices affected by short-term shocks including recent hurricanes and refining bottlenecks; and continued insecurity with our energy partners in the Middle East—building constructive, cooperative approaches to energy along with our neighbors in the Americas should be a priority for the United States.

The entire Western Hemisphere stands to gain if countries adopt rational strategies for energy sector development that respect market forces and build public-private collaboration. Governments must strike a delicate balance: on one hand, they must generate vast amounts of foreign capital; on the other hand, they must reassure their people that they are protecting their nation’s sovereignty and precious patrimony. Countries like Bolivia,

Colombia, Ecuador, Peru, the island states of the Caribbean, and others are weighing energy development models that suit them. Some countries have fostered market-driven reforms and have demonstrated that attracting capital and serving the national interest are not mutually exclusive. Other countries, however, appear tempted by statist models, which may actually threaten the economic viability of their markets and stunt the growth of an industry that could be the engine of development. The task at hand is very clear: energy companies and governments can and should work together to foster genuine growth and development in the hemisphere that serves both the bottom line and the moral imperative of helping raise millions out of poverty through the sound stewardship of natural resources.

Increasing Demand in Search of New Suppliers²

Notwithstanding President Bush’s bold new energy initiative, significant domestic conservation efforts are unlikely to yield sufficient results. U.S. energy consumption is expected to grow steadily through 2025 at 1.4 percent per year—equivalent to nearly

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half the rate of total expected U.S. gross domestic product (GDP) growth for that period. Increased net energy imports will have to meet this demand, even if the country is successful in increasing domestic production.

Imports are expected to increase from 27 percent of total U.S. energy consumption to 38 percent in 2025.

Fossil fuels are the leading energy source for the United States, led by oil and natural gas. Two of our top three oil suppliers are on our border, and Venezuela provides approximately 14 percent of total oil imports. Demand for natural gas is expected to rise at an even higher rate—by about 20 percent by 2030—and our largest gas provider, Canada, is expected to steadily reduce its exports due to depletion and growing domestic demand. Because prosperity and access to energy are intrinsically linked, fostering energy partnerships must be a top priority for the United States.

The United States does not have to look far to find an alternative to the “unstable” Middle East: Canada, Latin America, and the Caribbean states are blessed with abundant energy resources. If current investment trends continue, the hemisphere (excluding the United States) can expect to be a net energy exporter through 2025. This situation stands to benefit both the United States and its suppliers: if developed properly, energy production can serve as a viable motor for regional development while contributing to the global competitiveness of the entire hemisphere. In fact, advances in exploration and production technologies will allow the Western Hemisphere’s net oil import/export balance to grow from 5.5 million barrels per day in 2004 to just over 8 million barrels per day by 2025. This promise, however, relies upon the assumption that the hemisphere moves forward with a market-based, public-private approach to energy sector development.

Roadblocks to Energy Sector Partnership

Two important factors shed some light on why energy sector development has lagged in Latin America and the Caribbean. Energy development is a capital-intensive industry, and as such requires massive amounts of investment. The industry is concerned with production, but also

with exploration, transportation, and refining—none of which can stand alone and all of which require a major commitment on the part of energy companies. It is not enough that the reserves exist: countries must have

positive investment climates to reassure investors who have opportunities around the world from which to choose. When investors fear risks caused by uncertainty in regulations, tax regimes, personal security, corruption, or unfair dispute resolution, they tend to look elsewhere.

Political considerations have historically played a fundamental role in energy sector decisions in Latin America and the Caribbean. National sovereignty concerns figure prominently in governmental decisions involving the exploitation of natural resources by foreign interests. History has taught many countries a bitter lesson when foreign governments have exploited their resources, leaving many with the sentiment that mineral wealth is part of the national patrimony that must be jealously guarded. However valid these political and cultural sensitivities may be, they frequently undermine confidence on all

sides of a potential deal and complicate commercial transactions. Also, most governments and state-owned enterprises have made political decisions to limit private participation in energy production and to direct the bulk of profits into domestic spending. Although such social spending can produce immediate, tangible, and positive results, it also bleeds essential capital away from the energy sector and undermines the ability to maximize recovery rates, as countries such as Mexico have come to recognize.³

Of course, concerns about protecting the environment and respecting indigenous communities and cultural values are among the other variables that must be considered by those looking to do business in Latin America today. These political and social considerations have a place in government and private company discussions, but they can be addressed without entangling energy development.⁴ Various energy projects in the hemisphere have served up “best practices” for managing all of these interests.

Oil Does Not Have to Be a Curse

“Oil is a curse” is a truism often contemplated by those concerned with the stable, equitable growth of developing

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countries rich with natural resources. Although estimates vary, underdeveloped countries with petroleum resources historically grow a half to a full percentage point below those without them.⁵ Although much of this failure has been attributed to foreign exploitation, homegrown corruption and mismanagement are to blame as well.

It does not have to be that way. Governments and oil companies alike can choose how they do business in a Western Hemisphere that understands the challenge of being more competitive for global capital. Some countries are quite comfortable with a free-market model, while others are tempted by a statist vision that promises more control over development. A string of events in the hemisphere just last month made abundantly clear these very different approaches.

- On January 11, a report by CIBC World Markets forecast that the Canadian oil sands will become the single biggest contributor to incremental global supply by 2010, outstripping Saudi Arabia.⁶
- On January 12, Peruvian president Alejandro Toledo joined Hunt Oil Company president Ray L. Hunt and dozens of community and political leaders to inaugurate phase II of the Camisea Natural Gas Project. In public comments at the event, Toledo projected that the project, which attracted US\$1.6 billion in external financing and is hailed by the Inter-American Development Bank as a model energy deal, will generate 35,000 jobs for Peruvians as it lowers energy costs and generates long-term growth.
- On January 13, Prime Minister Patrick Manning, of oil-rich Trinidad and Tobago, bluntly warned his Caribbean neighbors that the Venezuela-sponsored PetroCaribe initiative is a statist approach that could leave island states high and dry if private companies abandoned the region.⁷
- On January 24, Bolivian president Evo Morales and Venezuelan president Hugo Chávez signed a series of economic accords, including a plan to swap Venezuelan petroleum products for Bolivian farm goods and an agreement to provide Venezuelan advice to Bolivia's state-run oil firm Yacimientos Petrolíferos y Fiscales Bolivianos (YPFB).⁸
- On January 26, the Spanish energy firm Repsol YPF announced a significant reduction in its proven gas

reserves, due mostly to political uncertainty in Bolivia.⁹

Two Visions

These news briefs present two very different visions of energy production: a model that balances free-market principles with national considerations versus a statist approach championed by Venezuela's Chávez. As the news items suggest, Canada and Peru—among other countries—stand out as model countries in the region for their commitment to free-market principles and for creating a positive investment climate for the energy sector. Venezuela still respects an arrangement at home where foreign companies do business side-by-side with the government-owned Petroleos de Venezuela, S.A. (PDVSA); under Chávez, however, the state has stepped up controls on foreign operators incrementally and has steered energy sector profits to foreign as well as domestic priorities.

It is important to note that foreign energy companies are doing very well in Venezuela, and they regard any ideological judgments about their Venezuelan partner as a potential threat to their bottom line. They are right to continue to do business with Venezuela: it is their money—their capital—at stake, and they are, after all, American companies bringing home a valuable commodity. U.S. companies are claiming the lion's share of an extraordinarily profitable trade because Venezuela's state-owned oil company is in such disrepair. And, compared with the rogue states (and worse) they are accustomed to dealing with in the Middle East, Russia, and other countries of the former Soviet Union, Chávez's Venezuela is downright hospitable.

Regardless of their choice to do business with Venezuela, U.S. energy companies have every reason to try to bolster the free-market energy model that is taking hold in other countries in the Americas. Rather than have to accommodate roguish characters, they can have partners in the Americas who are democratic, accountable to the law, respond to reason, run stable countries because they govern justly, and do not change the rules of the game for political purposes—in short, partners who respect the market.

Canada's Oil Sands: A Model from the North

The sheer size of Canada's vast oil sands (currently providing 1 million barrels of oil per day, with nearly 180

billion barrels in proven reserves) is not its only significance. Canada has led the way in creating a positive investment climate, and domestic and international investors have responded. Our northern neighbor serves as a model because it has been able to balance private exploration and national sovereignty over natural resources.

Canada is not unlike many of our southern neighbors in that its constitution establishes energy as national patrimony and places restrictions on its development. Energy policy responsibility is divided between the provincial and federal governments. The provincial governments own the natural resources, and as owners they are responsible for regulation and development within their territories. The federal government has other responsibilities, including harmonizing energy policy at the national level; promoting regional economic development; and establishing policies concerning frontier lands, offshore development, interprovincial facilities, and international and interprovincial trade.¹⁰

Although Canada has the advantage of an unquestioned commitment to democracy and the rule of law, it has enacted several reforms and policies to further promote its energy sector. Federal energy policy underwent a major reform in the mid-1980s with the goal of making the sector more market-oriented. As a country, Canada has further demonstrated its commitment to a market-based energy sector through ratification of the North American Free Trade Agreement (remember that the United States is its largest energy partner) and through eliminating foreign ownership restrictions for production licenses on frontier lands.

Alberta's example proves that national sovereignty and market-oriented policies are compatible. Recognizing the high technological and capital costs involved in developing its oil sands, the province has applied a competitive royalty regime to make investment attractive to private investors. In the last five years alone, the private sector has plowed 25 billion Canadian dollars into technology and infrastructure to exploit this resource, which was recently valued at 1.4 trillion Canadian dollars.¹¹ Private companies bid in a transparent (Internet-based) auction to obtain the temporary rights to explore and develop particular tracts of crown land; they pay rent and market-based royalties to the government.

As a result of this privately financed development, exploitation of this resource from the years 2000 to 2020 is expected to generate 123 billion Canadian dollars in government revenue, with 41 percent going to Canada's

federal government.¹² About 240,000 new jobs will be created in Canada by the oil sands development by 2008.¹³ As for the "nationalization" debate that has caused such a furor in Bolivia recently, the oil sands and all the rest of Canada's mineral wealth is understood unquestionably to be the property of the crown and the Canadian state.

Camisea: Peru's Success Story

The Camisea Natural Gas Project is the most ambitious energy project in Peru's history and offers many positive lessons for its South American neighbors. These fields (about 500 miles due east of Lima) are thought to contain 13 trillion cubic feet of natural gas. Just over US\$1.6 billion in private capital will fund the three-phase project to explore and develop the fields and build a fractionation plant and marine terminal, and to build a 460-mile natural gas pipeline from the fields to a site near Lima, as well as a distribution network in Lima and nearby Callao.

Camisea also provides interesting challenges to exploration in that the project is located in an area of unique biodiversity and indigenous communities. As such, multilateral organizations such as the Inter-American Development Bank (IDB) and the Andean Corporation for Investment are key contributors to the pipeline project and monitor the environmental and other conditions for the financing. From its early stages in development, the project has combined erosion control and re-vegetation initiatives with measures to prevent migration and colonization so as to balance regional and national interests with free-market considerations.

The Camisea Project will make Peru an important exporter of natural gas and makes clear that ample private financing and advanced technology are readily available to help a country exploit its natural resources for the social development of all its people. U.S. oil entrepreneur Ray L. Hunt noted the importance of political stability and rational energy policies in attracting private capital, saying at the January 12, 2006, Camisea ceremony, "Peru has been blessed in terms of having a political system which is very much aware of its responsibilities to the people of Peru both today and for many generations to come."¹⁴ President Toledo noted that the Camisea Project will generate about 35,000 direct and indirect jobs and US\$200 million per year in royalties and taxes for his successor's government. The project is also expected to account for a full 1 percent in additional GDP growth in Peru. Peruvians will save over

US\$4 billion in energy costs over a thirty-year period, noting that the marginal costs of power generation will be reduced by about 30 percent.

Venezuela and PetroCaribe: Debt and Dependence

Venezuela has made several political decisions concerning its oil production also stemming from the concept of oil as national patrimony as well as a foreign policy tool, an interesting example of which is its PetroCaribe initiative. Launched in June 2005, PetroCaribe represents an offer by Venezuela to its Caribbean neighbors of substantial savings in oil costs. The terms and conditions are important: PetroCaribe partners would purchase oil from Venezuela at a temporary discount of 30 to 40 percent (depending on the prevailing cost of oil), but the difference between the market price and the discounted price would be financed by Venezuela at 1 to 2 percent interest over fifteen to twenty-five years. Also, the Caribbean countries would be expected to replace privately run storage and distribution facilities with a state-run counterpart for the Venezuelan-owned PDVSA. Because most of the oil consumed in the Caribbean today is supplied by U.S. companies, Chávez's apparent aim is to replace the U.S. commercial ties with dependence on a single Venezuelan supplier.

In his statement last month, Prime Minister Manning of Trinidad and Tobago (a country that remains out of the deal) was clear in his understanding of the obvious effects of the initiative: far from being a boon for the Caribbean, the approach inherent in the PetroCaribe scheme represents a retreat from the market principles that are central to Caribbean economic integration. Moreover, much of the oil consumed by Caribbean states today comes from Trinidad and Tobago. Those opting for the Venezuelan model may lose access to alternative sources of oil, Manning notes, leaving them vulnerable if PetroCaribe were to fail. "It is a question of cutting your own throat, if you are not careful," Manning told reporters gathered in the CARICOM headquarters in Georgetown, Guyana.¹⁵

Another concern is the impact on indebtedness. All fourteen of the CARICOM member states rank among the thirty most indebted emerging market countries in the world, comprising seven of the top ten.¹⁶ Just as the Caribbean states appeal to the international community for debt relief, the PetroCaribe arrangement requires these small economies to incur millions of dollars in additional debt to finance consumption.

It is clear that the PetroCaribe initiative was conceived in Caracas to buy influence with needy neighbors. It is ironic that, as one of OPEC's chief price hawks, Chávez has advocated historically high oil prices since taking power in 1999. So the largesse he is using as political leverage comes in part from the poorest countries that are more susceptible than ever to this "charitable" scheme. While desperate Caribbean governments might be forgiven for grasping at almost any opportunity to deal with soaring energy costs, the long-term consequences of this decision may come at a much higher price than these fiercely independent leaders have calculated. And, as Prime Minister Manning makes clear, it is a serious setback for market principles.

Bolivia: When the Partner Becomes the Master

While Bolivia's new president Evo Morales aimed his comment that Bolivia "needs partners, not masters" at the United States, he could well have been referring to his domineering friend in Caracas. After being sworn in, Morales signed agreements with Chávez that appear to put Bolivia firmly in Venezuela's economic and political orbit.

One of the January 24 accords swaps 200,000 barrels of Venezuelan crude, diesel, and liquefied petroleum gas per month in exchange for 200,000 tons of Bolivian soy and 20,000 tons of poultry. Bolivia also accepted an offer from Venezuela's PDVSA to provide technical assistance to exploit its vast natural gas reserves and to renovate its virtually moribund energy firm YPF.

The barter deal smacks of the oil-for-sugar swaps between the Soviet Union and Cuba. One wonders why Bolivia could not find a ready market and a fair price for its agricultural goods among its traditional trade partners and instead must turn to an artificial arrangement. And, the only reason Bolivia would come to depend on Venezuela for energy is if Morales takes too much advice from the inexperienced political loyalists running PDVSA today.

Chávez clearly hopes that Bolivia will come to depend on Venezuela for more than advice. Bolivia is in need of billions of dollars in technology and infrastructure to tap its natural gas and carry it to markets. Even before Morales took power, the Bolivian Congress rewrote a hydrocarbons law in May 2005, declaring gas a strategic resource, making hydrocarbons state property held by YPF, imposing new taxes on production, and ordering the renegotiation of previous shared-risk contacts.

The Council of Americas' Recommendations for Fostering a Hemispheric Energy Partnership

The Council of the Americas released a report titled *Energy in the Americas: Building a Lasting Partnership for Security and Prosperity* that served in many ways as the inspiration for this *Outlook*. The report highlighted several recommendations for the development of lasting energy partnerships in the Americas that are replicated with permission here.

To join the Partnership, governments take the following steps:

- Energy is a strategic matter for the United States, and support for increasing partnership in hemispheric energy must be a priority. For energy producing nations of Latin America and the Caribbean, energy offers a significant potential engine of growth and development. Such long-term, mutual interests should form the basis of regional partnership.
- Increasing energy production in Latin America and the Caribbean requires massive new investment, drawing from a limited pool of global capital. As a result, increased attention must be paid to overall investment climate matters generally, and energy investment specifically. Conditions must be proactively created to draw the amounts of investment required. Among them: improved education rates, regulatory certainty, non-discriminatory and stable tax regimes, effective personal security, anti-corruption [regulations], and effective dispute resolution.
- Long-term investors in all sectors are reassured when laws are respected and regulations are clear and fair. In a competitive global environment, nations that seek healthy investment inflows in their respective energy sectors must abide by contractual obligations as mutually agreed. When disputes arise, they must also be willing to implement the rulings of international arbiters in good faith.
- Energy in the Americas is traditionally viewed as part of the national patrimony, but it is also a commodity. Governments must do a better job of communicating the long-term benefits of energy projects to the broad spectrum of their citizens, while ensuring that such benefits are widely and visibly distributed. Beyond such benefits, reducing the cost of energy generally will also improve consumer well-being and improve competitiveness across the entire production chain. Both countries and companies should ensure a robust consultative process with environmental and indigenous communities during the development of new projects and be willing to listen to legitimate concerns.
- In the North American context, trilateral energy coordination focused on regulatory and harmonization standards, improved infrastructure, and increased Mexican energy production is fundamental to strengthen regional security and competitiveness.
- Greater integration requires the standardization of regional and sub-regional laws, taxes, royalties, and transmission rates. Nations should consider linking their energy sectors more closely together based on a high-standards, best practices approach in order to enhance market efficiencies and economic development.
- Energy diversification would lessen the impact of supply shocks, while increasingly utilizing alternative resources of significance in the Americas. Creative means should be found in trade policy and elsewhere whereby the use of such alternative fuels is encouraged or, at a minimum, not discouraged, understanding that alternative fuels will not represent a large percentage of the regional energy profile for many years. More generally, the sustained application of new technologies can deliver solutions to supply, efficiency, and environmental challenges that currently vex regional markets.
- Finally, multilateral organizations should continue to prioritize support for infrastructure development projects in the Americas, particularly those focused on energy. Enhanced project support and guarantees would encourage the rapid development of the energy sector in the Americas. Regional partnership should be encouraged.

Needless to say, the law sent capital fleeing. Only those companies with a stake in the US\$3.5 billion invested in Bolivia today have no choice but to roll with the punches, but few of them are eager to throw good money after bad. A dose of President Chávez's advice on energy markets should frighten off the remaining intrepid investors still tempted by Bolivia's potential. That may render Bolivia totally dependent for capital on Venezuela—its chief natural gas competitor in Latin America. The “partner” becomes the “master.”

The final bit of news from January shows the consequences of bad policy, as the Spanish energy giant Repsol YPF was forced to cut its proven reserve estimates by 25 percent. Fully half of the forfeited reserves are attributable to the political uncertainty and shifting commercial ground in Bolivia. According to Repsol's statement, the May 2005 Bolivian hydrocarbons law that intends to vitiate binding contracts and raise combined tax and royalty rates to 50 percent renders future production in some Bolivian fields “no longer commercially viable.”¹⁷

The latest signals from Bolivia point to a challenging environment for countries seeking to do business there. President Morales' new energy minister, Andrés Soliz Rada, recently said that foreign firms could not count Bolivian oil and gas reserves as theirs because they actually belong to YPF. New YPF chief Jorge Alvarado has said that Bolivia would begin to acquire refineries now belonging to the Brazilian firm Petrobras. Several foreign oil companies, which have invested US\$3.5 billion in the last decade, have declared their willingness to renegotiate the terms of their existing contracts with the new Morales team.¹⁸

Conclusions and Recommendations

The Canada and Camisea experiences have served up fresh, compelling evidence that market-driven decisions in the energy sector pay dividends in every sense of the word. The statist model being foisted by Chávez on his neighbors is fraught with political and economic risks. Nevertheless, some governments may be tempted to seek facile answers, so the private companies with a stake in market-based approaches have every reason to make their case in this debate.

Western energy companies would be wise to use their capital and technical expertise as levers to encourage countries in Latin America and the Caribbean to adopt clear and fair policies that make investments safe and sound. Quite contrary to the rhetoric on the other side, rational energy policy grounded firmly in the marketplace is the only thing that will save the poorest countries from those who know a lot more about spending energy wealth than they do about generating it.

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Notes

1. President George W. Bush, "State of the Union Address," Office of the White House Press Secretary (Washington, D.C.: January 31, 2006), available at <http://www.whitehouse.gov/stateoftheunion/2006/>.

2. Unless otherwise cited, most of the information in this section is taken from Council of the Americas' Energy Action Group, *Energy in the Americas: Building a Lasting Partnership for Security and Prosperity* (Washington, D.C.: Council of the Americas, October 2005), 6–8.

3. David Luhnow, "Mexico's Oil Output May Decline Sharply," *Wall Street Journal*, February 9, 2006.

4. For example, the U.S. Department of Energy recently coordinated a private-public dialogue to identify for the Colombian government measures—which it has since taken—to make it more attractive to foreign capital.

5. For a summary of studies quantifying growth trends, see Martin E. Sandbu, "Taxable Resource Revenue Distributions: A Proposal for Alleviating the Natural Resource Curse," (working paper, Center on Globalization and Sustainable Development, Earth Institute, Columbia University, New York, August 2004), available at http://www.earthinstitute.columbia.edu/cgsd/documents/sandbu_distribution_000.pdf.

6. "Canada's Oil Supply Could Top Saudi Arabia: Report," Canadian Broadcasting Company News, January 11, 2006, available at <http://www.cbc.ca/story/canada/national/2006/01/11/canadian-oil060111.html>.

7. "Manning Warns Caribbean against PetroCaribe," *Jamaica Observer*, January 13, 2006, available at http://www.jamaicaobserver.com/magazines/Business/html/20060112T210000-0500_96451_OBS_MANNING_WARNES_CARIBBEAN_AGAINST_PETROCARIBE.asp.

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9. "Repsol YPF to Cut Reserves 25%," *Business News Americas*, January 26, 2006, available at <http://www.bnamericas.com/story.jsp?sector=9&idioma=I¬icia=342524>.

10. Council of the Americas' Energy Action Group, *Energy in the Americas*, 11.

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12. Report cited in Canada Association of Petroleum Producers, "Oil Sands Economic Impacts across Canada—CERI Report," (CAPP backgrounder, September 2005), available at <http://www.capp.ca/raw.asp?x=1&dt=NTV&e=PDF&dn=92079>.

13. Athabasca Regional Issues Working Group, "Canada's Oil Sands," fact sheet, June 2005, available at <http://www.oilsands.cc/pdfs/June%202005%20Oil%20Sands%20Fact%20Sheet.pdf>.

14. "Peru LNG Holds Official Signing and Site Dedication with President Toledo," *Rigzone.com*, January 12, 2006, available at http://www.rigzone.com/news/article.asp?a_id=28504.

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16. Ratna Sahay, "Stabilization, Debt, and Fiscal Policy in the Caribbean," (IMF working paper, June 8, 2004), available

at <http://www.imf.org/external/np/seminars/eng/2004/carib/pdf/sahay.pdf>.

17. "Repsol YPF to Cut Reserves 25%."

18. Santiago Perez and Bernd Radowitz, "Petrobras Begins Talks With Bolivian Government," LatinPetroleum.com,

January 27, 2006, available at http://www.latinpetroleum.com/article_5201.shtml; and Alan Clendenning, "Repsol YPF Said Willing to Re-Negotiate," LatinPetroleum.com, January 27, 2006, available at http://www.latinpetroleum.com/article_5202.shtml.