

**THE PROPOSED FREE TRADE AREA OF THE AMERICAS:**  
**AN OPPORTUNITY FOR ECONOMIC DEVELOPMENT**

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## 1. OBJECTIVE

The proposed Free Trade Area of the Americas (FTAA) will have a significant impact on the Venezuelan petroleum sector. This study will consider how Venezuela may use its FTAA bargaining position to maximize its economic benefit from the petroleum sector. Economic benefit will be defined as steady economic growth that provides equitable benefits and opportunities with positive externalities. Petroleum is the backbone of the Venezuelan economy, accounting for over 80% of export revenue and approximately 25% of GDP.<sup>1</sup> Recently, Venezuelan president Hugo Chavez has expressed strong opposition to the FTAA, declaring that the proposed hemispheric trading bloc “is already dead”.<sup>2</sup> This paper does not attempt to provide an in-depth analysis of the issues confronting the proposed FTAA or the global petroleum industry. It will, however, present an overview of the Venezuelan petroleum sector, identifying current issues facing the industry. The impact of the FTAA on these issues will be examined, and the potential use of regulatory control mechanisms as a strategy for Venezuela to retain a measure of control over the petroleum industry will be assessed. It will be argued that Venezuela should pursue the implementation of the FTAA, while amending domestic legislation and reforming its petroleum industry..

This study will not focus on the petroleum industry as a whole. Rather, the scope will be limited to crude oil, an essential source of global energy. Less data is available on natural gas and petrochemicals, which will be excluded from this analysis. This study will focus exclusively on the ‘upstream’ petroleum processes of exploration, extraction and production. These procedures occur within Venezuela and are often reliant on foreign

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<sup>1</sup> *Venezuela Economy* (2005) retrieved March 1, 2005 from CIA – The World Factbook, <http://www.cia.gov/cia/publications/factbook/geos/ve.html#Econ>.

<sup>2</sup> *Trinidad and Tobago* (2005) retrieved March 23, 2005 from Latin Petroleum Analytics, [http://www.latinpetroleum.com/article\\_3905.shtml](http://www.latinpetroleum.com/article_3905.shtml).

investment that is currently restricted by Venezuelan legislation.<sup>3</sup> The transportation, refining and retail of Venezuelan petroleum will not be included. This study will contribute to existing literature by moving beyond the traditional dichotomy between free trade and protectionism in an attempt to find some middle ground.

## 2. METHODOLOGY

To assess how Venezuela can maximize economic benefit from its petroleum sector, this study integrated literature examining Venezuelan political economy, the global petroleum industry and the proposed FTAA. Information was obtained from primary sources, including the FTAA draft agreement, translated Venezuelan government documents and the Petroleos de Venezuela (PdVSA) website, and secondary sources, including relevant scholarly articles and books.

This study acknowledges a number of limitations. The narrow scope of this paper does not allow consideration of factors outside of the proposed FTAA that may affect the Venezuelan petroleum sector. In addition, there is limited information available regarding the potential impact of the FTAA on the petroleum industry in the Americas. Thus, the nature of similar agreements, such as the role of Mexico and Canada in the North American Free Trade Agreement (NAFTA), were reviewed. Finally, this study does not conduct an in-depth analysis of the tumultuous Venezuelan political scene that heavily influences the Venezuelan economy.

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<sup>3</sup> *Venezuela*. (2004) retrieved February 9, 2005 from EIA Country Analysis Briefs, <http://www.eia.doe.gov/emeu/cabs/venez/html>.

### 3. LITERATURE REVIEW

#### a) Overview of the Venezuelan Petroleum Sector

Venezuela is the largest exporter of oil in the western hemisphere (see Table 1), and generates massive revenues from its petroleum sector. However, a significant portion

Table 1<sup>4</sup> - Highest Global Oil Producing States



of the Venezuelan population continues to languish in poverty, as 47% of Venezuelans live under the poverty line, unable to reap the benefits of Venezuela's significant oil reserves.<sup>5</sup>

President Chavez, elected in 1998, has overhauled the petroleum sector and the state oil company PdVSA in order to support his social policies and programs. Venezuela is familiar with oil protectionism, as the petroleum sector was nationalized in 1975, resulting in the creation of PdVSA. Upon taking power, Chavez set out to impose government control over PdVSA by reinforcing the ability of the Venezuelan Ministry of Energy and Mines (MEM) to control the oil conglomerate. . The Bolivarian Constitution of 1999 outlawed the

<sup>4</sup> *Venezuela Profile*. (2005) retrieved March 3, 2005 from Nationmaster.com, <http://www.nationmaster.com/country/ve/Energy>.

<sup>5</sup> *Venezuela Economy* (2005) retrieved March 1, 2005 from CIA – The World Factbook, <http://www.cia.gov/cia/publications/factbook/geos/ve.html#Econ>

<sup>11</sup> Millard, P. "Venezuela Oil Tax Raises Obstacles". *Wall Street Journal*. October 12, 2004, A.20.

privatization of PdVSA, and the Hydrocarbons Law of 2001 significantly raised petroleum royalties on ‘upstream processes’, discouraging private investment and guaranteeing PdVSA involvement in future Venezuelan oil exploration and production. Observers feared that foreign companies would be discouraged from investing in the Venezuelan petroleum sector.<sup>11</sup> The discontent with government policy resulted in a nationwide strike, in which numerous PdVSA employees took part, lasting from December 2002 until January 2003.

The strike failed to unseat Chavez, but managed to devastate the Venezuelan petroleum sector and cause a large decline in GDP (see Graph 1 and Table 3).

Graph 1<sup>12</sup>

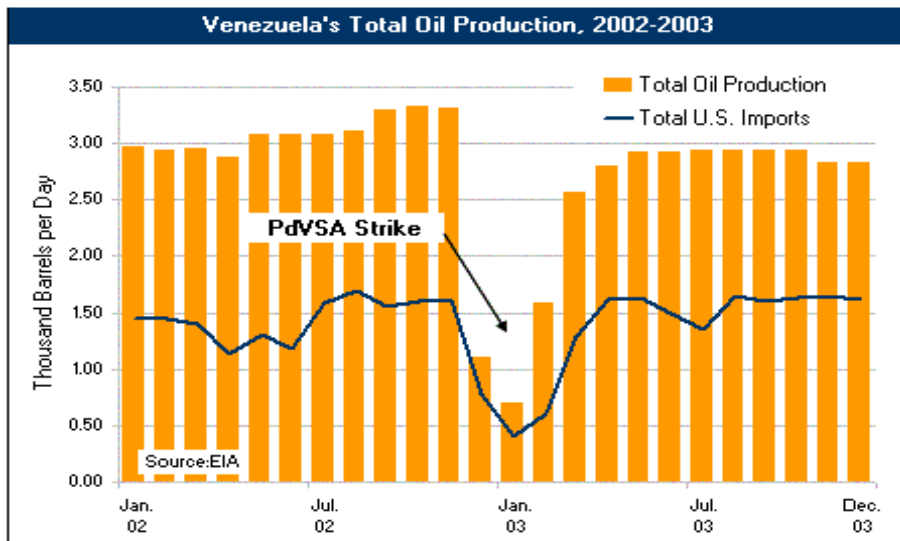


Table 3 – Venezuelan Economic Indicators<sup>13</sup>

2000 2001 2002 2003

<sup>12</sup> *Venezuela*. (2004) retrieved February 9, 2005 from EIA Country Analysis Briefs, <http://www.eia.doe.gov/emeu/cabs/venez/html>.

<sup>13</sup> *Venezuela*. (2004) retrieved March 3, 2005 from Economist Country Briefings: Venezuela, <http://www.economist.com/countries/Venezuela/profile.cfm?folder=Profile-Economic%20Data>.

GDP per head (\$ at PPP)	5,948	6,161	5,610	5,100
GDP (% real change pa)	3.24	2.79	-8.88	-9.20
Government consumption (% of GDP)	7.23	8.59	8.06	8.90
Budget balance (% of GDP)	-1.65	-4.41	-4.80	-5.80
Consumer prices (% change pa; av)	16.21	12.53	22.43	31.10
Public debt (% of GDP)*	27.01	30.41	38.35	38.60
Labour costs per hour (USD)	3.22	3.44	2.45	2.11
Recorded unemployment (%)**	13.90	13.30	15.90	21.00
Current-account balance/GDP	9.98	1.63	7.80	11.30
Foreign-exchange reserves (mUS\$)	13,089	9,239	8,487	16,035

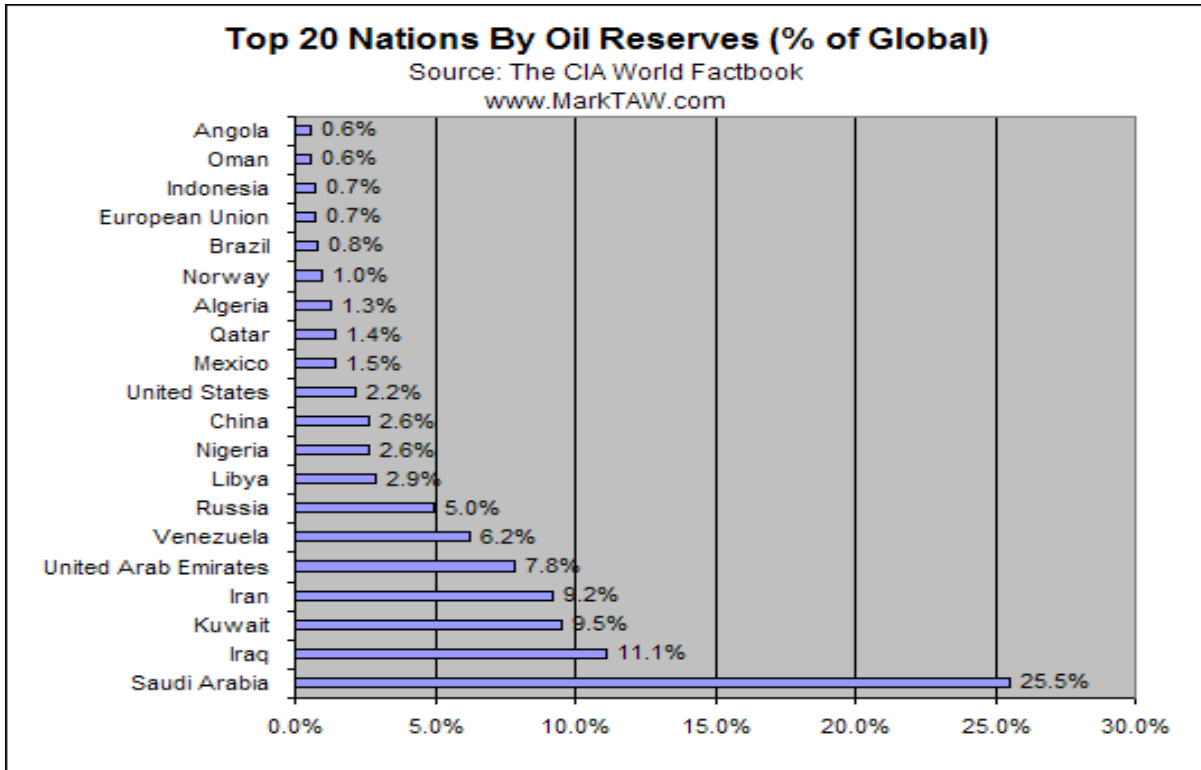
Revenues declined sharply, equipment was damaged, and experienced workers were ousted from PdVSA for their part in the strike. The result has been that Venezuela is in even greater need of increased foreign investment to stimulate a petroleum industry that has been unable to fully regain its pre-strike production levels. Venezuelan petroleum reserves, roughly 60-80 billion barrels (see Graph 2), consist mainly of medium, heavy and extra-heavy crude oil. PdVSA currently controls all exploration and production activity in Venezuela. Approximately 8 billion dollars is invested annually into the Venezuelan petroleum sector.

### **b) Issues Facing The Venezuelan Petroleum Sector**

The question of whether the Venezuelan government should continue to pursue protectionist policies or gradually liberalize the petroleum industry is crucially important to the Venezuelan economy. Critics of the Chavez regime cite the need to attract increased levels of foreign investment to the petroleum sector. Current regulatory mechanisms on 'upstream processes' have deterred potential investment capital, without which production

Graph 2<sup>15</sup>

<sup>15</sup> *Global Oil Production and Consumption*. (2004) retrieved March 2, 2005 from MarkTAW.com, [http://www.marktaw.com/culture\\_and\\_media/politics/GlobalOil.html](http://www.marktaw.com/culture_and_media/politics/GlobalOil.html).



levels will stagnate<sup>18</sup>. Detractors also claim that Chavez continues to misspend petroleum revenues by focusing on short-term projects rather than long-term development. It has been argued that prudent government expenditure combined with increased foreign investment directed towards exploitation technology and repairing damages caused by the recent strike could double current petroleum output levels.<sup>19</sup> In addition, inadequately equipped, trained and staffed Venezuelan regulatory bodies have come under fire for making politically influenced decisions. Oil consuming states, foreign oil companies, foreign investors and some factions within PdVSA take the logical position that Venezuela must open its

<sup>18</sup> *Venezuela*. (2004) retrieved February 9, 2005 from EIA Country Analysis Briefs, <http://www.eia.doe.gov/emeu/cabs/venez/html>.

<sup>19</sup> Flakus, G. (2004) "Americas Management of Venezuelan Oil Revenue Stirs Controversy". *BizVantage*. retrieved March 23, 2005 from <http://quickstart.clari.net/voa/art/cv/A6FB9039-C4A5-4112-B5273B5F78EC0EA6.html>.

petroleum sector to foreign investment in order to address these concerns and reduce the impact of fluctuating oil prices on the Venezuelan economy.

On the other hand, the Venezuelan government has been optimistic about the financial status of PdVSA, claiming that petroleum production has reached an optimum level of approximately 3.1 million barrels per day (bbl/d)<sup>20</sup>. However, industry observers dispute that figure, and criticize the PdVSA's sluggish production that may have contributed to higher oil prices. The Chavez regime denies the charge that a global shortage of investment capital has led to lower Venezuelan oil revenues, and increased dependence on sources of capital such as the United States (US).<sup>21</sup> Rather, the government claims that oil prices will remain high (see graph 3), providing the Venezuelan government with a reliable source of revenue to invest in redistributive social programs and heavy infrastructure projects.<sup>22</sup> In addition, recent deals with ConocoPhillips and TotalSA of France indicate that Venezuela is still willing to develop ties with private oil companies.<sup>23</sup> In fact, many foreign oil companies currently doing business in Venezuela have commented favorably about the Chavez regime.<sup>24</sup> Regardless, the Venezuelan government, and the now dependent PdVSA, continue to pursue state control over the petroleum sector by means of legislation, regulations and presidential decrees. The current regime has been reluctant to liberalize the petroleum sector, arguing that the result would be exploitation and eroded government sovereignty.

Graph 3 – World Oil Price Chronology<sup>25</sup>

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<sup>20</sup> *Petroleos de Venezuela*. retrieved March 2, 2005 from PdVSA, <http://www.pdvsa.com/en/index.html>.

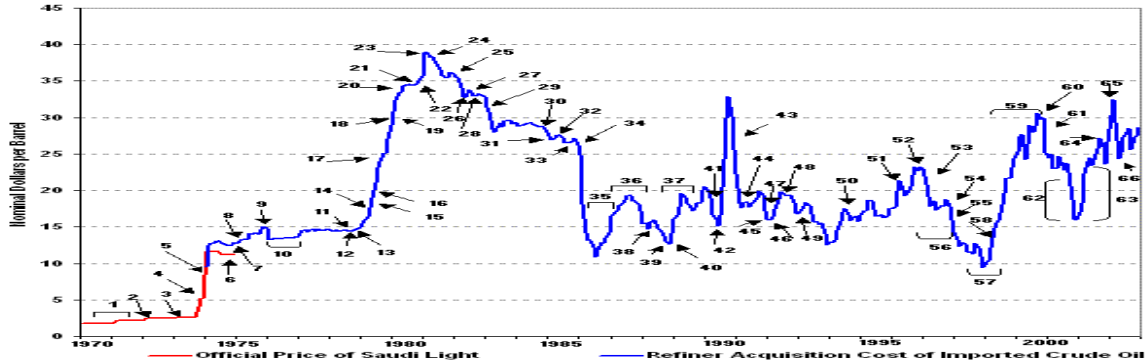
<sup>21</sup> Kanovsky, E. (2003) "Oil: Who's Really Over a Barrel?". *Middle East Quarterly*. Spring 2003.

<sup>22</sup> Edited (2004) "Oil Prices". *Petroleum Economist*. September 2004. 35.

<sup>23</sup> Luhnow, D. and Millard, P. "Venezuelan Oil Deals Ease Tensions: Conoco, Total Pacts Advance, Softening Foreign Concern Over the Role of State Firms". *Wall Street Journal*. February 14, 2005. A.2.

<sup>24</sup> McCaughan, M. (2004) *The Battle of Venezuela*. London, England: Latin American Bureau.

<sup>25</sup> *World Oil Market and Oil Price Chronologies: 1970-2003*. (2004) retrieved February 9, 2005 from EIA Energy Information Administration, <http://www.eia.doe.gov/emeu/cabs/chron.html>.



However, these are the very problems that arose when the Venezuelan government last implemented protectionist policies.

#### 4. ANALYSIS

##### **a) Benefits of the Proposed FTAA for the Venezuelan Petroleum Industry**

The Venezuelan government has expressed strong doubts regarding the feasibility of the currently proposed FTAA draft agreement. Instead, the Chavez regime has advocated regional alliances, and even offered an alternative to the FTAA called the Bolivarian Alternative for Latin America (ALBA). In order to analyze Venezuelan bargaining strategy vis-à-vis the FTAA, it is necessary to examine the actual effects the proposed FTAA would have on the Venezuelan petroleum sector.

##### ***FTAA Draft Agreement***

Objectives of the FTAA include “trade liberalization with a view to generate economic growth and prosperity, (the generation) of increasing levels of trade...and investment, (the elimination) of barriers to the movement of capital and (the establishment) of mechanisms that guarantee greater access to technology”.<sup>26</sup> These goals would address the important areas in which the Venezuelan petroleum industry is currently deficient.

<sup>26</sup> FTAA – Free Trade Area of the Americas Draft Agreement (2003) Chapter 2, Article 2.1.

According to the FTAA document, “nothing in this agreement shall be construed to prevent a Party from maintaining or establishing a state enterprise, according to its national...legislation”.<sup>27</sup> However, “each Party shall ensure...that any state enterprise maintains or establishes non-discriminatory treatment to investments in the Party’s territory of investors of another Party in the sale of its goods or services”<sup>28</sup>, and “each Party shall (endeavor to) adopt or maintain competition laws or regulations, at a national or subregional level, to proscribe anticompetitive (business) conduct”.<sup>29</sup> Thus, under the proposed FTAA, PdVSA would be able to continue its operations. However, the Venezuelan government would be required to ensure that the state oil company does not have a competitive advantage in principle against foreign companies. Furthermore, Article 11 of the FTAA – Transitional Measures - allows for some flexibility in the deadline for implementing the required reforms.

### ***Venezuelan Objections***

An important factor in the Venezuelan government’s opposition to the proposed FTAA is the desire to circumvent American influence. The current regime fears that US investors and politicians would be able to control Venezuelan oil revenues under the proposed FTAA. However, Americans currently receive over half of Venezuelan exports, and account for nearly 30% of Venezuelan imports.<sup>30</sup> The Venezuelan economy is already highly dependent on the US, despite protectionist policies. As a result, it seems sensible for the Venezuelan government to pursue the FTAA in order to avoid alienating their most important trade partner.

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<sup>27</sup> *Ibid* Chapter 19, Article 9.6.

<sup>28</sup> *Ibid* Chapter 19, Article 9.8.

<sup>29</sup> *Ibid* Chapter 19, Article 6.1.

<sup>30</sup> Venezuela Economy (2005) retrieved March 1, 2005 from CIA – The World Factbook, <http://www.cia.gov/cia/publications/factbook/geos/ve.html#Econ>.

The current Venezuelan regime is wary of the apparent threat posed by the FTAA to oil revenue. The redistribution of petroleum revenues within Venezuelan society has contributed to Chavez's political success.<sup>31</sup> The government fears that petroleum revenue would be diverted to foreign companies under the FTAA, undermining the social programs that are crucial to the current regime. However, the additional foreign investment and technology available under the FTAA would lead to increased levels of petroleum extraction and production, offsetting any decreased revenue. Furthermore, the economic prudence of Chavez's recent economic policies has been called into question. It has been argued that his social spending and large infrastructure projects could compromise future oil production and prevent sustainable economic growth.<sup>32</sup>

Given that upstream oil processes are more risky than others, liberalization under the FTAA may be sensible to reduce the risk assumed by the Venezuelan economy. In addition, Venezuelan oil production figures in recent decades indicate that the petroleum sector has been most productive when opened to foreign investment – from the mid-1980's until the election of Chavez (see graph 4). Consequently, liberalization under the proposed FTAA would likely promote stable economic growth in Venezuela.

Graph 4<sup>33</sup>

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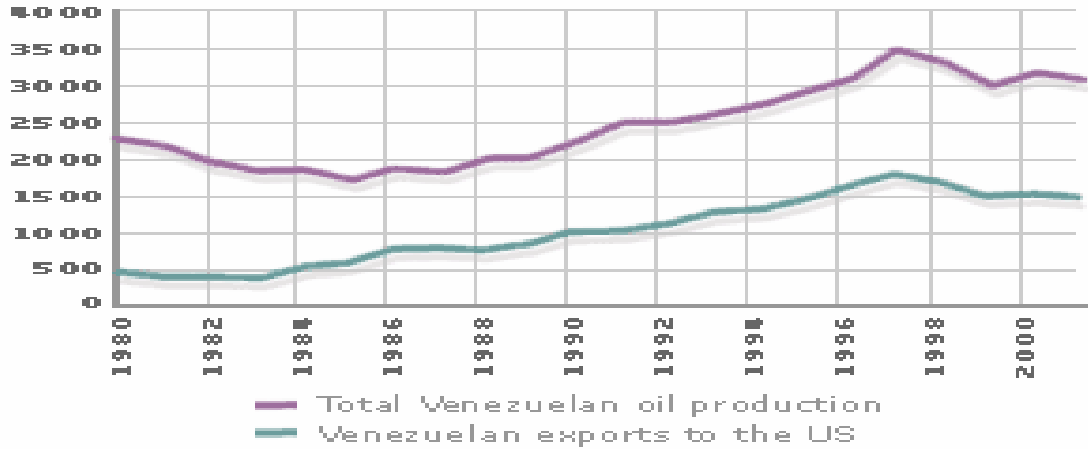
<sup>31</sup> Leight, J. (2005) *Oil-flush Chavez begins to strut his stuff*. Retrieved March 1, 2005 from PetroleumWorld, <http://www.petroleumworld.com/SF022705.htm>.

<sup>32</sup> Flakus, G. (2004) "Americas Management of Venezuelan Oil Revenue Stirs Controversy". *BizVantage*. retrieved March 23, 2005 from <http://quickstart.clari.net/voa/art/cv/A6FB9039-C4A5-4112-B5273B5F78EC0EA6.html>.

<sup>33</sup> Analysis: Venezuela's Oil Industry (2002) retrieved March 23, 2005 from BBC News, [news.bbc.co.uk/media/images/38558000/gif/\\_385](http://news.bbc.co.uk/media/images/38558000/gif/_385).

## Venezuelan Oil Production and Exports

(1000 barrels per day)



SOURCE : EIA

### *The Impact of NAFTA on the Canadian Energy Sector*

In order to gain a better understanding of the potential effects of the proposed FTAA on the Venezuelan petroleum sector, this study will briefly review the effects of NAFTA on the Canadian sector. NAFTA is a highly comprehensive trade deal, in that it deeply restricts member state's government power over the energy sector. Canadian control was limited by: the right of foreign companies to invest, the reduction in powers of the Canadian National Energy Board, a system of 'proportional sharing', supplies to the US in perpetuity, banned export taxes and banned preferential pricing for domestic customers.

"As a result, Canada's exports to the US more than quadrupled in a decade while oil exports doubled".<sup>34</sup> The Americans were unable to secure such extensive access to the Mexican energy sector, but hope to utilize FTAA negotiations to do so. Although Venezuela and Canada have notable differences in economic development and energy resources, the Canadian example exhibits the potential for sector expansion in Venezuela via increased

<sup>34</sup> *The WTO and Oil*. retrieved March 23, 2005 from the International Forum on Globalization, <http://www.ifg.org/analysis/wto/cancun/usoilvm.htm>.

foreign investment under a free trade agreement. The proposed FTAA is unlikely to restrict Venezuelan government control to the same extent as NAFTA limited Canadian government action. However, the FTAA would likely encourage foreign companies to invest much needed capital into the Venezuelan petroleum sector.

**b) The Advantages of Regulatory Control Mechanisms**

Although the FTAA proposes a hemispheric free trade agreement, Venezuela need not completely abandon its protectionist petroleum policies.<sup>35</sup> There is no clear dichotomy between privatization and nationalization. The Venezuelan government may choose to partially liberalize the petroleum industry, while maintain a certain degree of control and protecting national interests. A means to achieve this goal could be the implementation of sectoral regulatory control mechanisms under the FTAA.

The Venezuelan government could control the petroleum sector by creating an effective regulatory framework. The FTAA draft agreement recognizes the importance of “market regulatory policies and measures” in promoting “pro-competitive principles”.<sup>36</sup> Common types of control mechanisms include antitrust laws, a consumer ombudsman, watchdog agencies, financial, constitutional, and tariff regulations and a number of other legislative and institutional control mechanisms. For example, privatization under the FTAA may result in the monopolization of promising fields by a foreign company and the diversion of oil revenues from the Venezuelan government. It may well be in Venezuela’s interest to implement antitrust laws in order to promote competitive access to oilfields. Regulatory control mechanisms could protect market competition and the interests of consumers, monitor the performance and responsiveness of the petroleum sector, and promote the

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<sup>35</sup> Ellner, S. (2004) *Leftist Goals and the Debate over Anti-Neoliberal Strategy in Latin America*. Science and Society. 68(1). 10-32.

<sup>36</sup> FTAA – *Free Trade Area of the Americas Draft Agreement* (2003) Chapter 19, Article 9.1.

concerns of Venezuelan stakeholders.<sup>37</sup> The government could create favorable conditions for PdVSA and attract increased foreign investment. In addition, regulatory mechanisms could make the petroleum industry more environmentally and socially friendly. Indeed, replacing the current legislation that limits foreign investment with effective regulations under the FTAA could successfully preserve national priorities and facilitate the distribution of benefits throughout society.<sup>38</sup>

### **c) The Possibility for Successful Reform Without an FTAA Agreement**

It is possible that the Chavez regime could continue to reject the need for a hemispheric free trade area, while implementing domestic reforms that increase foreign investment and technology flow into the Venezuelan petroleum sector. However, without an agreement such as the FTAA to institutionalize and reinforce such reforms, the changes would be highly vulnerable to the political and economic climate within Venezuela. As a result, the petroleum industry would remain unstable and likely unattractive to foreign investors. Furthermore, the Venezuelan government may alienate itself from the United States, the primary consumer of Venezuelan petroleum, by totally rejecting the FTAA. This would negatively affect Venezuelan-American relations, and may cause a decrease in American investment that domestic reforms could not compensate for. Thus, the achievement of successful FTAA negotiations is critical to the development of the Venezuelan petroleum sector.

## **5. VENEZUELA SHOULD PURSUE THE IMPLEMENTATION OF THE FTAA, WHILE AMENDING DOMESTIC LEGISLATION AND REFORMING ITS PETROLEUM INDUSTRY**

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<sup>37</sup> BC Oil and Gas Commission (2005) retrieved from BC Oil and Gas Commission, <http://www.ogc.gov.bc.ca/>.

<sup>38</sup> Hira, A. (2003) *Political Economy of Energy in the Southern Cone*. Westport, Connecticut: Praeger Publishers.

Although the current Venezuelan government has dismissed the proposed FTAA, it would be prudent to reassess the potential advantages associated with a hemispheric trading bloc. Recent political and economic instability in Venezuela has emphasized the need for increased foreign investment and technology to stimulate growth in the vital petroleum sector. Presently, it may be difficult to convince the Chavez regime that the petroleum sector is at risk of stagnation, given record-high oil prices that have produced an economic boom in Venezuela. However, oil prices fluctuate, undermining the long-term sustainability of economic growth. Recent decades have demonstrated that gradual liberalization of the Venezuelan petroleum sector can deliver increased petroleum production, while protectionist policies result in uneven growth and undermine long-term development.

This study has established that much of Chavez's concern regarding the FTAA is unsubstantiated. The FTAA would not inevitably lead to the complete privatization of the Venezuelan petroleum sector. Rather, the government could gradually liberalize the economy, while utilizing regulatory control mechanisms to preserve national interests and protect Venezuelan stakeholders. In order to achieve these objectives, the Venezuelan government should adopt the following recommendations:

1. Amend the Bolivarian Constitution of 1999 and repeal the Hydrocarbons Law of 2001 in order to attract much needed foreign investment.
2. Divert some petroleum revenue from redistributive social programs to the development and maintenance of the petroleum sector to promote long-term productivity.
3. Pursue the implementation of the proposed FTAA agreement as a means to liberalize the petroleum sector and attract foreign investment and technology.
4. Implement effective regulatory control mechanisms to protect national interests and ensure the distribution of oil revenue throughout society.

Amending the Bolivarian Constitution would reduce current restrictions that prevent foreign petroleum companies from operating in Venezuela. Repealing the Hydrocarbons Law would decrease the royalties and income taxes paid by such foreign investors. Both measures would facilitate the vital flow of foreign capital into the Venezuelan petroleum sector. Diverting petroleum revenue towards the development and maintenance of equipment and technology would de-politicize the expenditure of Venezuelan oil money, while promoting sectoral long-term sustainability. Successful FTAA negotiations are crucial, as they would reinforce the legislative reform discussed above. Furthermore, the FTAA would allow Venezuela to build closer, more productive relations with its key trading partners, particularly the United States. Finally, the implementation of regulatory control mechanisms would allow the Venezuelan government to maintain a measure of control over the petroleum industry and the revenues that it generates.

By pursuing such a strategy, the Venezuelan government could promote sustainable economic growth, while continuing to redistribute oil revenue within Venezuelan society. This would allow Venezuela to become more economically competitive and to develop a wealthier more egalitarian society.

## **6. FUTURE RESEARCH**

There are a number of closely related issues beyond the scope of this paper; hence additional research would compliment this study. Areas for further research:

- The affect of Venezuelan politics on the petroleum sector.
- Potential regulatory mechanisms and their affect on the Venezuelan petroleum sector.
- The role of the energy sector in FTAA negotiations.

- The role of PdVSA affiliates in foreign states

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