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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Economic Implications of Peru's Expropriation of US Oil Properties

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
October 1968

INTELLIGENCE MEMORANDUM

Economic Implications of Peru's Expropriation of US Oil Properties

Summary

Seizure of the principal properties of the US-owned International Petroleum Company (IPC) by Peru's new military regime probably will delay the economy's recovery from its present recession and, if arrangements for adequate compensation are not made promptly, could create new and major economic difficulties for the regime. Refusal to make such arrangements would jeopardize the continuation of aid from the United States and international lending institutions and would discourage direct foreign investment.

The IPC, a subsidiary of Standard Oil of New Jersey, is Peru's largest oil firm, with total assets valued (by the company) at $200 million. The expropriation involves the company's La Brea y Parinas oilfield and its large Talara refinery, but not its half-interest in a second, larger field or its extensive wholesale and retail distribution facilities. So far, the regime has failed to take the initiative in offering compensation for the seizure. It has indicated, however, that government claims for back taxes and penalties in excess of $144 million would be applied against the value of the expropriated properties when compensation is eventually determined by Peruvian courts. The validity of these claims is strongly denied by the company.

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence.

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The expropriation is delaying US aid and current negotiations with the International Monetary Fund for stand-by credits of $75 million and with US and European banks for refinancing some $150 million in debt-servicing obligations, all of which Peru badly needs to alleviate its balance-of-payments difficulties. If prompt and adequate compensation is not forthcoming, the United States could be forced to suspend economic aid and the US sugar quota. If the United States took this step, the stand-by credit and debt refinancing negotiations would be jeopardized, and Peru would face a drying up of direct foreign investment, including pending copper investments that could total more than $600 million over the next several years.

The regime should have no major long-term difficulty in operating the seized oil properties. Lack of cooperation from IPC, which retains control of a large part of the oil supply going to the Talara refinery and a nationwide marketing system for petroleum products, probably would provoke the regime into nationalizing these properties as well. The regime stands to gain some $20 million to $25 million annually in profits formerly retained by the company after payment of Peruvian taxes. These profits, however, will not necessarily provide a net gain in government revenues -- at least for a number of years. If the regime compensates IPC adequately, these profits will have to be used, at least in part, for this purpose. If the regime does not provide compensation, the added profits could be more than offset by losses from suspension of US economic aid and the US sugar quota as well as declines in direct foreign investment.

Introduction

1. One of the first major acts of Peru's new military regime, which ousted the government of President Belaunde Terry on 3 October 1968, was to expropriate the principal facilities of the US-owned International Petroleum Company (IPC), a subsidiary of Standard Oil of New Jersey. The regime has announced that government claims for back taxes, the validity of which is strongly denied by the company, would be applied against the value of the expropriated facilities in determining compensation. The seizure, which climaxes a lengthy dispute between the company and successive Peruvian governments, has had an immense popular appeal that has effectively unified much of the public in support of the regime, at least temporarily.

2. The regime has offered public and private assurances to other foreign firms in Peru that IPC is the only firm to be subjected to expropriation and that their facilities, operations, and existing contracts with the state will be respected. Nevertheless, the seizure -- particularly the indication that adequate compensation may not be offered -- worsens Peru's already strained relations with the United States. It also threatens Peru with adverse economic measures by the United States and international financial institutions that would make recovery from the present economic recession more difficult.

3. The IPC is one of Peru's largest industrial firms and is the largest of the eight US-owned petroleum companies operating in the country. It is also Peru's largest taxpayer, accounting for about 4 percent of the revenues of the central government in 1966. The company dominates all aspects of the country's petroleum industry, including exploration, extraction, refining, and distribution. Among its assets, presently valued by the company at an estimated $200 million, are (a) the La Brea y Parinas (LBP) oilfield, which

in 1967 accounted for 27 percent of Peruvian crude oil production; (b) a half-interest (with the Lobitas Oil Company, owned by British and Peruvian interests) in the Lima oilfield, which is located near the LBP field and accounted for 42 percent of crude oil production in 1967; (c) a large refinery at the port of Talara which has a capacity of 60,000 barrels of crude oil per day, refines nearly all of the crude produced by the LBP and Lima oilfields, and accounted for two-thirds of Peru's production of refined products in 1967; (d) petroleum storage and loading facilities at the ports of Talara and Callao (near Lima); and (e) a countrywide wholesale and retail distribution system for refined products. Peru's supply of and demand for petroleum in recent years are shown in the table.

4. The properties expropriated were the LBP oilfield, the Talara refinery, and the related storage and loading facilities in the port of Talara. These properties together constitute an integrated extracting, refining, and storage complex. The company's head offices in Lima, its bank accounts, and the remaining facilities listed above have not been expropriated. [redacted]

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Background of the Dispute

5. The expropriation brings to a climax a century-old dispute between owners of the LBP oilfield and the state over the division of the profits from its exploitation. To a considerable extent, the dispute turns on the ownership of subsurface mineral rights in the LBP area. Under Peruvian law, as under the laws of most Latin American countries, subsurface mineral rights are considered to be the property of the state, and their exploitation by private individuals is subject to regulation and special taxation.

6. Nevertheless, the LBP properties, including subsurface mineral rights, were deeded to a private individual in 1826 and were sold to a British firm in 1888. Attempts by Peruvian

Peru: Petroleum Supply and Demand
1963-67

	Million 42 US Gallon Barrels				
	1963	1964	1965	1966	1967
Supply (excluding stocks)					
Production of crude oil	21.5	23.1	23.1	23.0	25.9
Imports of crude oil	0.7	0.5	0.8	0.7	1.2
Imports of refined products	4.2	5.1	5.7	8.1	7.7 a/
Total	*26.4*	*28.7*	*29.6*	*31.8*	*34.8*
Demand					
Domestic demand	22.7	25.5	26.3	29.1	30.4
Exports of crude oil	2.9	2.7	2.4	2.0	3.7
Exports of refined products	0.8	0.5	0.9	0.7	0.7
Total	*26.4*	*28.7*	*29.6*	*31.8*	*34.8*

a. Peru's partial dependence on imports of refined products will be reduced in 1968 as a result of the completion in December 1967 of a new state-owned refinery with an annual capacity of 7.3 million barrels.

governments to impose higher taxes on the property led in 1918 to submission of the dispute by the British and Peruvian governments to a court of international arbitration. The court's ruling, which was handed down in 1922, confirmed the claim of the British firm to ownership of the subsurface mineral rights, granted Peru a $1 million settlement of back taxes, and established a new tax rate on the LBP property that was to hold until 1972. On the basis of this ruling, IPC purchased the LBP property in 1924.

7. The dispute remained relatively dormant until 1959. Although the Peruvian Congress passed a law in 1932 authorizing the President to request a revision of the arbitration award, it was not acted on. In 1957, IPC offered to give up its ownership of the LBP field, requesting that it be permitted to operate the field under the same concession status as its Lima field and all other oilfields in Peru. The request was rejected by the government because IPC would pay smaller taxes as a concessionaire than as a property owner. Following a large government-authorized increase in petroleum prices in 1959, however, the dispute became a major political issue, as nationalist politicians sought expropriation of the LBP oilfield and the Talara refinery as a means of capturing the additional profits.

The Dispute Under Belaunde

8. President Belaunde, who took office in June 1963, sought to negotiate a settlement of the dispute with the company that would satisfy Peruvian nationalists but would not significantly alter the division of its profits. He did not want to jeopardize his program of attracting direct foreign investment and obtaining economic aid from the United States and international lending institutions. Most of the time, Belaunde's position had the support of a majority of the Congress, although Congress unanimously passed a resolution in 1963 that rejected the arbitration award of 1922 and passed a bill in August 1967 that expropriated the LBP properties. These congressional actions were not given practical effect, and the government's negotiations with IPC dragged on fruitlessly

until late 1967. In November 1967, however, the government initiated legal proceedings to recover an unspecified amount of back taxes (estimated by IPC at $1.2 million) and $144 million in "unjust enrichment," which represented the company's total profits (after Peruvian taxes) from the LBP properties over the preceding 15 years.

The Act of Talara

9. In August 1968 the Belaunde government and IPC reached a settlement that became known as the Act of Talara. Its terms closely resemble those of a compromise offer made by the company in mid-July. IPC exchanged its claims to the LBP oilfields (including both surface facilities and subsurface mineral rights) for a quit-claim for back taxes and "unjust enrichment" and a 40-year concession to (a) operate its refinery, (b) continue wholesale and retail distribution of petroleum products, and (c) seek and develop petroleum deposits in the Amazon region previously reserved for the State Petroleum Company (EPF). These concessions, which resemble those extended to other foreign oil companies in Peru, authorized IPC to enlarge and improve its refinery, expand its drilling operations, and import duty-free any necessary equipment and materials, including any crude petroleum required to use the refinery's full capacity.

10. The settlement also provided that the EPF, which was to take over operations of the LBP properties by December 1968 at the latest, would sell at least 80 percent of the LBP output to the Talara refinery for a period of 6 years at $1.97 per barrel, less a maximum of $0.89 per barrel to be paid by EPF to IPC for services rendered. The price of $1.97 seems to have been a fair price, since it approximates that paid during 1967-68 by buyers of oil produced in neighboring Colombia. Although it is not clear whether the service charge to be paid to IPC was reasonable, this feature was not criticized by the opponents of the settlement.

11. A few hours after the signing of the agreement on 13 August, the government accepted the formal transfer of the LBP properties to the state at a public ceremony. As the benefits received by IPC gradually became known, a storm of protest arose from nationalist politicians. Their main criticisms were that IPC should have been forced to give up the Talara refinery or at least make a large payment to settle the government's claims for back taxes and "unjust enrichment."

12. Irregularities in the handling of the original document were deftly exploited by nationalist politicians to cast suspicion on the propriety of the agreement. The president of EPF, who was a signer of the agreement, charged that one page containing an amplification of the terms at which EPF would sell crude petroleum to IPC was never published. Public mistrust of the settlement continued to grow in spite of the government's offer to rewrite the contract to clarify the terms of sale of oil to IPC and to specify that IPC would pay EPF for oil extracted from the LBP fields beginning 13 August rather than when EPF took over operations. Military dissatisfaction with the settlement also became apparent. Although a majority of Congress supported the settlement and voted down a motion of censure of the government, the cabinet resigned on 1 October in an unsuccessful attempt to forestall a coup. The Act of Talara was nullified by the military regime when it seized power two days later. The regime also indicated that the three principal cabinet members involved in the settlement would be prosecuted.

Peru's Economic Relations with the United States

13. Expropriation of the IPC properties may prove to be a blow to economic progress in Peru, which has a substantial stake in maintaining good relations with the United States. The United States is Peru's most important trading partner, purchasing 42 percent of Peru's exports and supplying 37 percent of its imports in 1967. Almost all of Peru's sugar exports and important shares of other leading exports such as copper, cotton, and coffee go to the United States.

14. Peru relies to a considerable extent on foreign private and official capital, nearly all of which comes from the United States or from public and private international lending institutions in which the United States has strong influence. Net inflows of private long-term capital, which have come predominantly from the United States, averaged $33 million annually during 1965-67. The total book value of US direct investments amounted to $518 million (net of accumulated depreciation) at the end of 1966. US firms dominate many of the country's export industries -- including copper, other non-ferrous metals, and sugar -- and are becoming increasingly important in fishmeal production, manufacturing, domestic trade, and banking.

15. Inflows of official capital also have been significant. During US fiscal years 1963-67, Peru was authorized a total of $247 million in US economic aid and military assistance -- $137 million in loans and $110 million in grants. Authorized loans from public international lending institutions such as the International Bank for Reconstruction and Development and the Inter-American Development Bank amounted to $211 million during the same period. In addition, the government of Peru received large loans from private US banks.

16. Another benefit that Peru obtains from the United States is the subsidy deriving from its sugar quota in the US market. In 1967, Peru exported 338,000 metric tons of sugar to the United States, for which it received $46 million, or 6 percent of its total export earnings. Of this total, $33 million represented payments in excess of those that Peru would have received if the sugar had been sold at world market prices.

17. Nevertheless, Peru's relations with the United States have been strained in the last two years. In 1967, when the LBP oilfield was nominally expropriated, US economic aid was suspended temporarily

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under the provisions of the Hickenlooper amendments.* Again, last apring, US aid was temporarily suspended when Peru ran afoul of the Symington and Conte-Long amendments** for purchasing French Mirage jet aircraft and other military equipment.

18. Relations between the two countries also have been irritated by Peruvian seizure of US fishing vessels off Peru's coast. Along with Chile and Ecuador, Peru claims a 200-mile offshore territorial limit that is not recognized by the United States. Recent Peruvian seizures of US fishing vessels were a factor in the passage last August of the Pelley amendment to the US Fishermen's Protective Act. The amendment provides that fines and other expenses incurred by ship owners as the result of the seizure of US fishing vessels by a country receiving US economic aid may under some circumstances be deducted from that aid.

<u>Recent Peruvian Economic Performance</u>

19. Peru has made its nationalistic move against IPC at a time of recession, following a long period of rapid economic growth. During 1961-66, gross domestic product grew an average of 6.3 percent annually -- the highest rate in South America. As this advance continued, however, strains began to develop. Balance-of-payments difficulties emerged as imports increased faster than exports, and sluggish government revenues led to rising budgetary deficits and mounting inflationary pressures. In

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* *The Hickenlooper amendments provide that US economic aid is to be suspended if a recipient country that expropriates the assets of a US-owned firm fails within six months to take steps (including arbitration) to provide equitable and speedy compensation in convertible foreign exchange.*

** *The Symington amendments provide that US economic aid is to be suspended if a country is diverting this aid to finance military purchases or if military expenditures are interfering materially with its economic development. The Conte-Long amendments provide that US economic aid is to be reduced by the amount expended by the recipient country for the purchase of "sophisticated" military equipment such as supersonic jet aircraft.*

1967 the rate of growth dropped to 4.0 percent, partly because bad weather cut agricultural production. In addition, declining export earnings and a capital flight worsened the balance-of-payments difficulties and led to a 31-percent devaluation of the sol in September. Public and private investment dropped, and the expansion of construction and manufacturing slowed.

20. The slowdown has been accentuated in 1968. Agricultural production has continued to decline because of serious drought. Political obstacles to the balancing of the government budget have led to repeated cabinet shuffles and an erosion of business confidence. Although the devaluation stimulated exports and sharply curbed imports, continued capital flight restricted recovery of the balance of payments. Private investment outlays continued to be depressed by a clampdown on private credit. Production was restrained by shortages of imports, the cost of which was raised by the devaluation and the subsequent imposition of a substantial surcharge on customs duties. Consumer prices have risen an average of more than 1 percent a month since the first of the year.

21. Last June the Belaunde government began a strong attempt to stabilize the economy with the aid of special powers granted by the congress. Under these powers, which allowed rule by decree for 60 days, the government imposed sizable tax increases and cut expenditures. It also initiated a request to the International Monetary Fund for a new, expanded stand-by credit of $75 million and began negotiations with a number of private US and European banks to refinance some $150 million in debt service payments that fall due during the next year and a half. In addition, it requested $10 million worth of rice from the United States under Public Law 480. Finally, it increased the pressure on three large US-owned copper companies to proceed with planned investments totaling more than $600 million over the next several years. All of these negotiations were pending at the time of the coup, and the new regime has taken steps to continue them.

Prospects

22. The direction of the new regime's economic policies has not yet clearly emerged. So far, the regime has stated that it will recognize Peru's international obligations and will continue the Belaunde government's policy of encouraging direct foreign investment. Nevertheless, the highly nationalistic tone of some of its public statements condemning "government subservience to foreign and domestic monopolists" has not been reassuring.

23. Expropriation of the IPC properties probably will increase Peru's economic problems and delay its recovery from the recession. Even if the regime quickly arranges adequate compensation for the company, the reaction in the United States and international financial circles to the expropriation probably will delay pending US aid, the IMF stand-by credit, and the debt refinancing negotiations and will slow the inflow of direct private investment. Moreover, agreement to compensate IPC will increase Peru's outstanding external debt, which now exceeds $900 million, and will add to the already heavy burden of debt servicing obligations on the country's balance of payments. In view of the bleak outlook for Peru's export earnings over the next year or two, particularly if world copper prices decline as expected, the prospects for the economy's performance are dim at best.

24. If the regime fails to offer prompt and adequate compensation to IPC and/or expropriates other US firms, the country faces suspension of all US economic aid and cancellation of its US sugar quota.* If the United States takes such action, the negotiations for the International Monetary Fund stand-by credit and for debt refinancing also would be jeopardized, and Peru would face a drying up of

* *The US Sugar Act of 1948 (as amended) provides for cancellation of a country's US sugar quota in circumstances similar to those penalized by the Hickenlooper amendment.*

the inflow of direct private investment and a probable cut-off of new loans from international financial institutions such as the International Bank for Reconstruction and Development. Such drastic measures would impose major hardships on the economy that might cause the regime to seek economic aid from the Communist world. Aid from Communist countries, however, would not include hard currencies and thus would not help Peru to meet its international financial obligations. Moreover, Peru -- like other Latin American countries -- would find that serious political and economic difficulties stand in the way of large-scale trade with Communist countries and the utilization of economic development credits that they might offer.

25. Peru's action could have repercussions on US investments in extractive industries elsewhere in Latin America, although much depends on what the United States and Peru do next and how the Peruvian economy fares under the new regime. The strong current of nationalism that contributed to Peru's action also is flowing in most other South American countries. And aside from the heated questions of nationalism and anti-Americanism, people in less developed countries the world over have the practical aim of getting a much larger share of the benefits accruing from exploitation of their mineral resources. This trend has been reflected in the postwar period by substantial increases in the share of oil revenues going to some producing countries in the Middle East. The same motive lies behind Venezuela's decision in 1968 to use service contracts rather than the customary concession arrangements for future petroleum development. Although the Peruvian expropriation does not immediately imperil US investments in most countries of Latin America, it does constitute a fresh inspiration for nationalists long intent on taking over US copper investments in Chile as well as in Peru. Apart from its didactic value, the action probably has strengthened popular support for nationalization of those investments.

26. Peru should have no great long-term difficulty in operating the oil properties taken over from IPC. Only 40 of IPC's 4,000 employees are non-Peruvians, and the State Petroleum Company has some experienced personnel upon which it can draw. Any remaining lack of technical personnel probably could be filled readily from private oil companies in Peru or in other Latin American countries. A failure of IPC to cooperate in supplying crude oil to the refinery or in distributing the refinery's products could cause temporary disruptions to oil supplies, but this failure probably would provoke the regime into expropriating the remainder of the company's properties. Beyond a possible short transitional period, therefore, the seizure should not require a significant enlargement of the country's present small net imports of petroleum in order to maintain the supply of petroleum or the economic activities dependent on it.

27. The Peruvian government will not necessarily realize any net gain in revenues as a result of expropriating the LBP properties -- at least for a number of years. Government revenues from these properties could rise as much as $20 million to $25 million annually, assuming that the profits of IPC had been divided about equally between the company and the government. But much or all of this gain might be offset by payments to IPC if it is compensated for the LBP properties. And if it is not compensated adequately, the Peruvian government may lose more from the suspension of US aid and the US sugar quota than it gains in petroleum revenues.