



SPEYSIDE

CORPORATE RELATIONS

Like a Candle in the Wind? The Brazilian Oil and Gas Sector

25 May 2016

Mid-impeachment edition: President Dilma suspended and Acting President Temer forms administration

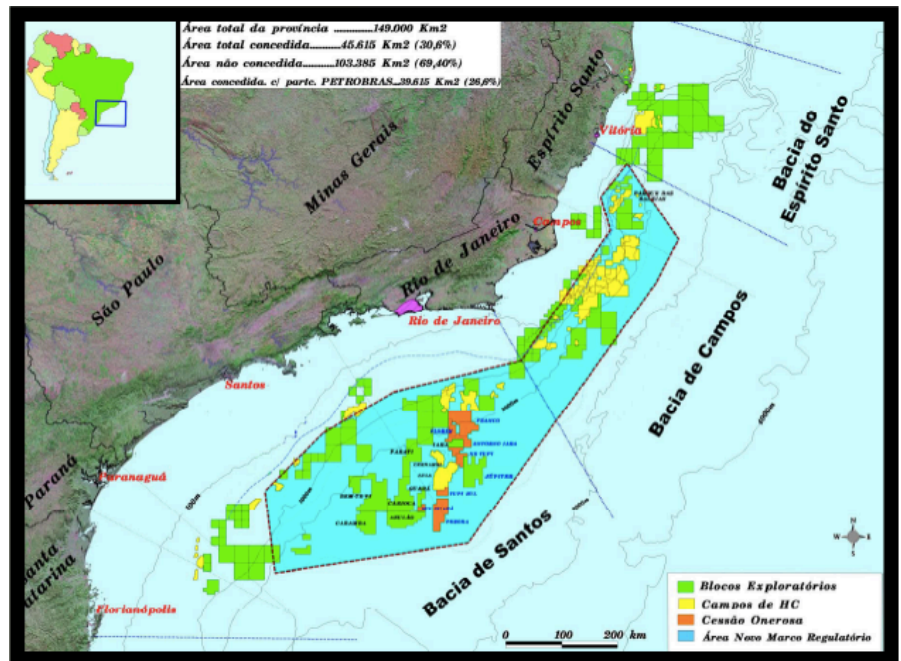


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Executive summary

- *This Insight think piece is dated 25th May, and written after the Brazilian Senate had suspended President Dilma Rousseff (who currently remains in office but without power). At the time of writing, Vice President Temer has assumed power as Acting President and has formed a government that is expected to be very different in policy priorities to that of the suspended president.*
- A perfect storm of factors has worked against the economics of the domestic oil and gas (O&G) sector in Brazil. Global oversupply of oil has cratered prices from the levels at which Brazil's giant state-controlled oil firm, Petrobras, made its business and investment plans. Since the beginning of 2016, Petrobras has chopped USD 32 billion, or 24.5% off from its 2015-2019 investment plans. The international macro-economic background would be challenging for any firm, but Petrobras also sits in the maelstrom of the huge Brazilian corruption scandal, *Lava Jato*, that is seemingly bringing down an entire generation of political and business leaders, and is contributing to the public outrage that has led to the Brazilian president's suspension.
- Brazil's current political, economic and regulatory framework are key elements to monitor before investing in the country, especially as the O&G sector is widely controlled by the government. The new Minister of Mines and Energy (MME), federal representative Fernando Coelho Filho (PSB-PE), stated that he will open dialogue with sector associations with the main goal of enhancing the energy business environment and attracting investment.
- The 'jewel in the crown' of the Brazilian oil and gas sector is the so-called pre-salt reserves located off the coastline of Southeastern Brazil. While the investment math for these massive fields looks very different today than three years ago – devastating the Petrobras balance sheet – many potential international bidders view them as long-term investment opportunities, and there are new bidding rounds to come. Improvements in O&G regulations, given the likely more business-friendly policies of Acting President Temer's government, are likely to improve the investment environment for foreign investors.
- The regulatory environment is susceptible to policy-making changes, inasmuch as the O&G segment is considered strategic by the government. As one of the main drivers, Bill 131/2015 may improve the business environment around the O&G sector, facilitating investment and allowing foreign companies greater participation in the exploration of the pre-salt reserves. The bill will likely end up allowing foreign investment without mandatory Petrobras involvement. It passed in the Senate on February 24th, and thereafter it needs to be approved by the Lower House and the Presidency. Speyside expects the bill, with further amendments, to pass in the House by the end of 2016.
- Lower oil prices, corruption scandals and poor management practices have deeply damaged the Petrobras balance sheet. Groaning with debt, Petrobras is looking to implement a divestment plan worth over USD

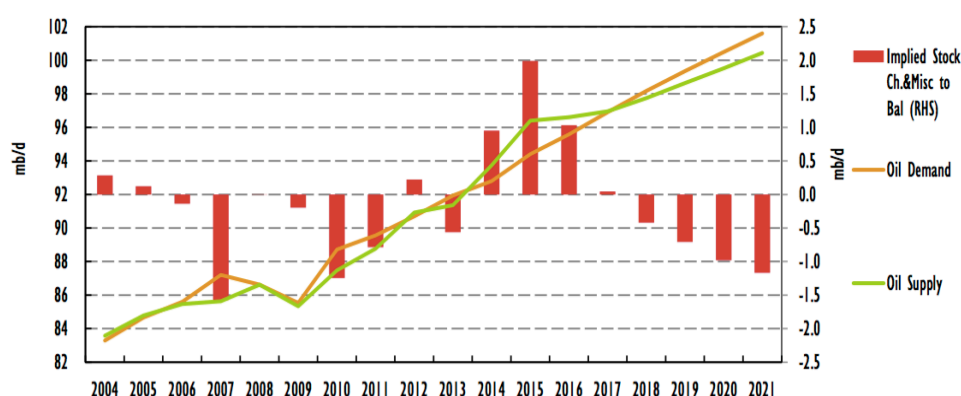


50 billion from 2015-2018, including the sale of valuable assets such as BR Distribuidora; Gaspetro; and Petrobras Argentina. Gaspetro is a huge Petrobras subsidiary for gas distribution and BR Distribuidora is a fuel distribution subsidiary with a network right across Brazil. As Petrobras needs to sell more of its assets, further commercial opportunities will emerge for foreign companies seeking to enter the Brazilian O&G market.

Current global landscape

Slowing emerging markets, uncertainty around the recovery of the developed economies and global oil oversupply have cratered the price of oil in recent years, rendering the sector highly unstable. The fall in the Chinese demand; the advent of shale gas in scale; and the re-entry of Iranian oil into the global market – after the United States lifted many economic and financial sanctions – also contributed to this process. In addition, the urgency of the transition to cleaner and renewable sources of energy, consecrated by the recent UN talks in Paris and New York, have all had a profound impact on the economics of the oil industry and in a remarkably concentrated period of time.

Figure ES 1 Global balance base case



In February 2016, however, the International Energy Agency (IEA) released its annual [Medium-Term Oil Market Report \(MTOMR\)](#) stating that oil supply growth is plunging while US output is also falling sharply. The report points out that the O&G market may begin rebalancing in 2017 (see the IEA's chart, left). The IEA also considers that there is some

uncertainty around those expectations in a "New Era of low prices of oil", but prices are unlikely to increase significantly in the short-term. An adjustment between supply and demand is therefore needed before sustainable price recovery. Amid this recovery, unexpected geopolitical issues can turn tables drastically. Despite the increasing importance of biofuels and renewable energies within the global energy matrix, oil and gas will continue to rank among the primary sources of energy for the next decades to come.

According to "[Will we ever stop using fossil fuels?](#)", a paper published this year by the Journal of Economic Perspectives and re-published by the World Economic Forum, new drilling and exploration techniques have enabled the exploration of oil and gas reserves that beforehand were impossible, and made them cheaper, even since the 2000s. The study also points out that the consumption of oil and gas may last for decades, maybe centuries ahead, as renewable sources of energy remain costlier than traditional sources of energy. The cost of solar energy, for instance, is still twice the cost of natural gas. Considering the United States alone, the paper explains that oil reserves expanded 59% between the years of 2000 and 2014, while natural gas reserves expanded 94% in the same period. Brazil's giant state oil company, Petrobras, has also invested in techniques to improve cost-effectiveness in the exploration of the pre-salt reserves. With regards to emerging markets, particularly Brazil, there is room for expansion too, as we will see in the section ahead.

The oil and gas industry is under great strain in the current low-price and oversupply scenario, but in the long-term, market prices should adjust to demand. The problem is especially acute for firms such as Petrobras whose balance sheets and financial outgoings, over all, assumed permanently high oil prices. The so-called 'super-majors' (the giant Anglo-Saxon oil firms that have gone through many price cycles) however, have been radically cutting costs and adjusting to the new pricing and investment environment.

The resulting business environment, though challenging for firms like Petrobras, may favor M&A in the sector, as firms such as Petrobras need to cut costs, including capex, and 'shrink-to-fit' to their more constrained balance sheets. The sale of key assets will likely see more foreign direct investors into the Brazil, not least Russian and Chinese.

Brazilian Policy Background

Brazil has a historic debate around the O&G exploration and production regimen that divides opinions. On the one hand, there are those who stand for the state monopoly, and support policies in favor of the state ruling the sector. This is a surprisingly trenchantly-held view, even amongst otherwise capitalistic middle class elites, reflecting a latent South American suspicion of foreign O&G investment, especially if coming from the USA.

On the other hand, there are those who defend private participation through concession models. Since the beginning of the 20th century, the regulatory environment has been influenced by this debate, in which economic and ideological drivers balance government decisions. In 1946, for instance, the Federal Constitution established the state monopoly of the O&G sector that eight years later led to the creation of Petrobras. In 1975, in the opposite direction after two years of the first Oil Shock, the Brazilian government allowed more flexible regulations, allowing private companies to take part in O&G exploration.

Since the creation of Petrobras in the 1950s, however, the much-dreamed of self-sufficiency in oil was never achieved *de facto*. A new regulatory framework resulted after long discussions on the concessions model for the sector in the 1990s. A new model of concessions, allied to state control, helped to double Brazilian oil production between 1997 and 2008, passing from 850,000 BPD to 1,8 million BPD. Brazil finally became self-sufficient in 2006, a feat proudly and widely announced by former president Lula and his government. The discovery of Southeastern Brazil's pre-salt layer, also in 2006, led again to discussions about the exploration and production model, which, from 2008 to 2013, stalled concessions and auctions related to the sector. Brazil lost momentum – and its oil self-sufficiency – and then economic recession hit the country from 2014.

Also in 2006, President Lula was reelected. Unable to run for a third consecutive election, he maneuvered Dilma Rousseff as the 2010 presidential candidate for his left-leaning Workers' Party (PT). Twice a minister during Lula's mandates – Mines and Energy (and, in this post, president of Petrobras board) and later Chief Minister ("Casa Civil") – Rousseff was then an unknown bureaucratic figure to most of the Brazilian electorate. She nevertheless benefited from Lula's impressive popularity of over 80%, as well as of the majority he enjoyed in Congress, and was elected president, taking office in January 2011. Dilma could have enjoyed about one year of "honeymoon" as the first female president of a country that had witnessed unprecedented social inclusion during Lula's years. But Dilma's increasingly evident inability for political compromise and decision-making (in particular on the economic front) led the country to the worst economic recession in Brazilian history although she managed, perhaps by promising to do the very opposite of her actual initial actions in her second term, to be reelected in 2014. In fact, her very campaign is under the assessment of the Supreme Electoral Court (TSE) in 2015 on suspicion that it may have received illegal funds from Petrobras.

Suspended by the Senate and now facing trial for impeachment to end her term of office, President Rousseff's Vice President, Michel Temer (PMDB-SP), has obtained power as Acting President and has formed his own government. Rousseff's trial may take up to six months, during which time she remains in office but suspended from power. Temer's government, which we see developing at the time of writing, relies upon a promise of bringing economic recovery to survive the next two and a half years.

The Brazilian political environment is likely to remain fragile with Temer so long as economic recession, unemployment and new findings in ongoing corruption investigations come up. This context will keep challenging an eventual new government on its attempts to anchor expectations (instability in the markets) but nonetheless Speyside's believes that the Senate will be prevailed upon to convict President Dilma Rousseff and thus eject her from office, effecting her impeachment and permanent removal, and confirming Temer as President.

If it can achieve a strong and stable political coalition, the government of Michel Temer will seek to promote reforms; achieve economic recovery; attract investment; and resume GDP and employment growth. With regards to the O&G sector, experts close to Temer expect him to be more aligned to the previous, pre-PT model of concessions used in Brazil, in which the concessionaries are not obliged to share the production with Petrobras, or have the company as the operator of the exploration in the pre-salt layer.

The Brazilian Oil & Gas Sector

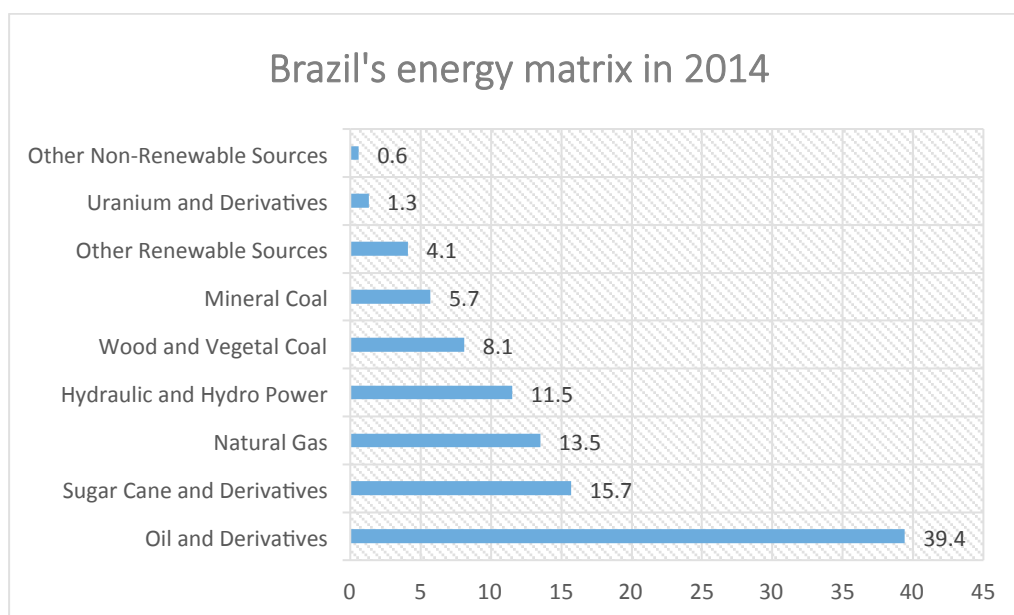
The involvement of Petrobras in major mismanagement and corruption scandals, coupled with lower oil prices, have severely compromised the state-owned company's financial health and viability. Petrobras total debt is around BRL 500 billion (USD 131 billion), and the company is now capitalized at just 28% of what it used to be back in 2008, with market capitalization falling from USD 145 billion to USD 42 billion. Worsening Petrobras' debts, which are fixed in US dollars, the Brazilian currency (Real) devalued sharply against the dollar throughout 2015 and early 2016. On the latest Business and Management Plan (PNG 2015-2019), the state oil company has cut 24,5% of investment in relation to the previous investment plan published in June 2015; reducing it further from USD 130 billion to USD 98 billion. Furthermore, Petrobras announced in January 2016 a disinvestment plan of assets to be sold which it hopes will raise over USD 50 billion; including putting up for sale BR Distribuidora and Gaspetro, in addition to its other subsidiaries and valuable assets.

Brazil led the global production of deep water hydrocarbons and considerably expanded the Brazilian O&G sector, from 2007, investing in technology and developing expertise for this type of exploration. This resulted in significant discoveries of light oil in the pre-salt layer, positioning the country amongst the ten major countries in oil reserves.

The proven reserves in Brazil amount to nearly 14 billion barrels of oil equivalent (BOE), and there are expectations that the country could expand its reserves at 55 billion BOE per year as it begins to explore the pre-salt reserves. Despite current low oil prices, the economic viability of the pre-salt layer is still cost-effective and, in the long-term, offers extremely attractive returns.

The participation of natural gas in Brazil's energy matrix increased from 1% in 1980 to approximately 13.5% in 2014. In comparison with 2013, the use of natural gas increased 9.5% in 2014 due to its use in energy generation. The use of natural gas in the country is concentrated in vehicles, and thermal plants for energy generation, as well as domestic and industrial use.

While renewable/ sustainable sources of energy amount to 39.4%, non-renewable sources still respond to 60.6% of Brazil's energy matrix - as can be seen in Graph 1:



Source: Brazilian Ministry of Mines and Energy

This distribution shows that even though renewable sources of energy have been increasing their role in the local energy matrix, the infrastructure already installed favors the use of fossil fuels. Indeed, the discovery of the pre-salt layer plays a significant role in the continuity of the exploration and use of O&G in Brazil.

This critical domestic and international environment will lead Brazil towards local regulatory reforms to avoid staying behind competitors and losing the momentum to explore the pre-salt reserves. The much hoped-for stabilization of the political scenario, in the medium-term, coupled with oil prices having likely bottomed out in the second half of 2016, is likely to trigger the pre-salt bidding rounds that have been stalled due to Brazil's political paralysis and tanking oil prices.

This context strengthens the chances for approval of Bill 131/2015, which would create several commercial and investment opportunities in the Brazilian O&G sector, speeding up bidding rounds in the pre-salt layer and opening opportunities for foreign companies to make local investments. Speyside expects the bill to be approved, albeit with amendments, in the House by the end of November, when the political landscape might be more stable, and regulatory guidelines for bids and concessions clearer.

Regulatory Environment

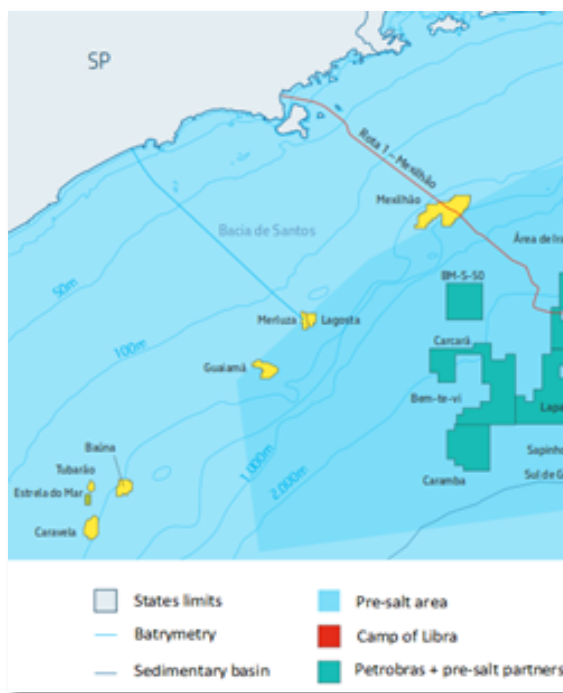
The Brazilian O&G sector, considered highly strategic by the government, is extensively regulated by federal and state regulations. To take part into the O&G sector through public concessions, private or state-owned foreign companies must comply with the "Oil Law" (Law 9478/1997); the "Gas Law" (Law 11909/2009); and the latest "Pre-Salt Law" (Law 12351/2010). Thus, according to the Brazilian Federal Constitution, all oil and gas reserves located within Brazilian territory (onshore and offshore) are national assets.

Oil

Law 12351, enacted in 2010, allowed the so-called Production Sharing Regime (*Regime de Partilha de Produção* in Portuguese) to enter into force. In practice, this legislation stated that Petrobras would take participation in every consortium for the exploration of the offshore blocks found in the pre-salt layer. This resulted in a complete paralysis of the auctions for exploration and production of oil in Brazil between 2008 and 2013. In view of the pre-salt layer, only the Libra oil field was auctioned in 2013, and commercial production is forecasted to start around 2020. Located in the Santos Bay, the Libra field is a premium portion of the pre-salt area and was acquired by a consortium established between Petrobras, Shell, France's Total, and China's CNOOC and CNPC.

Granting the exploration of pre-salt reserves would significantly increase Brazil's O&G market size to over 2.5 million BPD (currently around 2 million BPD). According to a report released by the Industries Federation of the State of Rio de Janeiro (FIRJAN), every year without auctions for oil exploration causes the Brazilian industry to lose approximately USD 11.5 billion in future earnings. The same report also points out that each bidding round attracts an average of USD 27 billion in investment, and there are still one hundred thousand square kilometers (100,000 km²) available to be auctioned in the pre-salt layer.

Representatives from the Brazilian National Agency of Oil, Natural Gas and Biofuels (ANP) frequently highlight business opportunities in the pre-salt areas denominated Pau-Brasil, Peroba, Saturno and Cabo Frio High. As *Map 1* (overleaf) shows below, Peroba's estimated production capacity, for instance, ranges from 810 million barrels to 3.37 billion barrels.



Source: Presalt.com / Speyside editions

Gas

The Gas Law was enacted to regulate gas activities in Brazil, particularly projects related to gas transportation, gas storage and liquid natural gas (LNG) facilities. Nevertheless, because of the Brazilian Federal Constitution¹, natural gas distribution is a prerogative of the states of the federation, not the federal government. Since the opening of the oil market, Brazil's Oil, Natural Gas and Biofuels Agency (ANP) has conducted 12 bidding rounds to grant onshore and offshore blocks to private concessionaries. In early 2013, the National Council for Energy Policy (CNPE) issued Resolution nº 01/2013, concerning incentives for the participation of small and medium players in oil and gas exploration, development and production. The Gas Law has given the ANP additional duties, turning it more independent and facilitating exploration in the sector. Some of the duties include:

- Promoting auctions for construction and operation of transport pipelines
- Elaborating auctions and concession contracts for natural gas transport
- Setting (for concessions) or approving (for authorizations) transport tariffs
- Approving standard transport contracts to be signed between concessionaries or authorized transporters and carriers
- Establishing criteria for calculating the capacity of natural gas pipelines
- Authorizing trading within federal jurisdictional responsibility
- Regulating natural gas storage, including third party access
- Overseeing of natural gas transmission over transport network, assuming its coordination in case of shortage²

After practically five years without bidding rounds, ANP opened an offering of 289 blocks among which 142 were granted in May 2013. Also in 2013, ANP promoted the 12th bidding round, offering 240 onshore gas blocks, from which 72 were awarded.

If approved, Bill 131/2015 would make new auctions possible as early as 2017, with room for foreign companies to contract with the Brazilian government for oil and gas exploration. According to the President of the Pre-Salt

¹ Constitution of the Federative Republic of Brazil, Article 25, section 2

² National Oil, Gas and Biofuels Agency (ANP) – Folder: Natural Gas in Brazil

Petroleum S.A. (PPSA)³, Oswaldo Pedrosa, the approval of Bill 131/2015 is not a mandatory condition for the auctions to happen, but it would “significantly increase the attractiveness of future biddings in the pre-salt layer”.

Commercial Opportunities

Petrobras’ Executive Board for Asset Sales is responsible for the company’s disinvestment plan, which aims to raise USD 15.1 billion between 2015 and 2016 (being 30% in Exploration and Production, 30% in supply and 40% in the Gas and Energy segment). The plan also provides business-restructuring efforts, including asset sales and additional divestments totaling USD 42.6 billion between 2017 and 2018. The review of the investment plan gives room for valuable investment opportunities in the O&G sector in Brazil, as Petrobras will put up for sale many assets while foreign investors may be allowed to take part in the exploration of the pre-salt area if Bill 131/2015 is indeed approved.

- **Nova Transportadora do Sudeste (NTS):** NTS is a company that resulted from the division of the Transportadora Associada de Gás (TAG), and is responsible for the complete Southeastern gas pipelines network – equivalent to 2,500 km of pipelines. Petrobras is expected to sell 81% of its participations in the company.
 - The Argentinian Pampa Energia has signed an exclusive agreement to buy several business operations from Petrobras in Argentina in April, including NTS. The sale is about to be announced for USD 1.2 bn.
- **Transportadora Associada de Gás:** Transportadora Associada de Gas is a subsidiary responsible for the Northern and the Northeastern infrastructure of the pipelines network.
 - Petrobras plans to sell this subsidiary in the second half of 2016.
- **Gaspetro:** Gaspetro is a Petrobras subsidiary for gas distribution. The Japanese group Mitsui bought 49% of the company in October 2015 for BRL 1.9 billion (USD 520 million).
 - The Public Prosecutor’s Office of the state of Bahia has frozen the transaction between Petrobras and Mitsui, on the grounds that it is illegal. Petrobras keeps evaluating legal measures as to complete the transaction. Currently, Mitsui owns the 49% of the company, but cannot benefit from this purchase until the legal battle is finished.
 - The remaining assets are still for sale.
- **BR Distribuidora:** Petrobras plans to sell at least 25% of the fuel distributor subsidiary.
 - The debt of the subsidiaries of Eletrobras Amazonas and Gas Company (Cigás) is seen as an obstacle to the sale of BR Distribuidora. Until September 2015, the debt was about BRL 10.4 billion (USD 3 bn) – owned by Eletrobras’ subsidiaries – plus BRL 788 million (USD 207 million) owned by the Amapá Electricity Company (CEA), which is controlled by the state government.
 - Investors are pressuring Petrobras to sell control of the company.
 - The Cosan Group is interested in the purchase.
- **Braskem:** Petrobras plans to sell 36% - the entire Petrobras participation in the company.
 - Petrobras recognized that the contract with Braskem in 2009 represented a loss because of the necessity of naphtha imports; also, according to calculation of the Brazilian Infrastructure Centre (CBIE), Petrobras failed to gain BRL 55 billion (USD 14 billion) between 2011 and 2014 because of the government’s policy to freeze the price of fuel.

³ The Pre-Salt Petroleum S.A. is a public company created in 2013 by the Decree number 8.063 under the Ministry of Mines and Energy (MME) responsible for the administration (production and commercialization) of the pre-salt reserves.

- **Transpetro:** Petrobras plans to sell part of its participation in the logistics subsidiary.
 - Transpetro is responsible for 54 vessels and the management of 49 logistics terminals.
 - The sale announcement was held before the approval of the Council of Administration of the company, causing controversy around the issue.
 - The Ultra Group seems to be interested.
- **Liquigás:** Liquigas is the second major LNG distributor in the country, with 22.6% of the market. Petrobras plans to sell control of the company, and the negotiation may reach BRL 1.5 billion (USD 420 million).
 - The Ultra Group is interested in the acquisition.
 - Copagaz is interested in the purchase together with Ultragaz, Supergasbras (controlled by the Dutch SHV) and the National Gas, making a consortium.

Conclusions

Following the 2008 economic crisis, developed markets have shown tepid economic recovery while emerging markets have not proven to have resilient capacity to keep growing as expected.

More recently, Brazil has been hit by a political crisis that has engulfed the country in an economic recession that has led Vice President Michel Temer to take office, replacing President Dilma Rousseff. This might give the federal government major support in the Congress to approve fiscal and sectoral reforms, opening the regulatory environment to attract investors. Acting President Temer sees regulatory reforms as the best way out to tackle lack of confidence and increase investments. There are fourteen projects in the federal government related to the pre-salt layer that are stalled from lack of investment. The government must make a decision on the model of concessions to allow investment to speed up the approval process of these projects and others.

Currently, state-controlled Petrobras has no capacity to invest in the exploration of the pre-salt reserves, and the government may promote regulatory reforms to allow private participation into the business. The demand for reforms will certainly affect state-owned or controlled businesses, and will certainly benefit private sector O&G businesses, particularly those interested in greater participation in the pre-salt layer. The need for investment to resume economic growth is clearly understood by the Temer government and it is likely to pave the way for the approval of Bill 131/2015 and related matters, directly affecting the regulatory environment so as to foster more (and especially foreign) investment in the sector.

In a world particularly worried about carbon emissions and sustainable development, renewable sources of energy are gaining ground, especially in Brazil (most notably wind power⁴). Nevertheless, current major infrastructure is predominantly dedicated to fossil fuels and there are many opportunities for investment. Brazil is still starting to explore the pre-salt layer reserves, and the country aims to explore and secure these resources to finance development in the next decades. This may incite pressure for flexibility in the O&G regulatory environment and facilitate concessions before the 2018 major elections. One of the main priorities for the PMDB-led government of Michel Temer is to promote the privatization of concessions within several sectors to restore the economy, including the energy sector.

⁴ The subject of a future Speyside Brazil Insight

On Speyside Corporate Relations

Speyside is a global consultancy that dovetails deep public policy analysis and government relations with impactful public relations (PR). We have a 25-year track record of helping to lead global companies with market entry (or extraction), growth or turmoil management. We specialise in complex and developing markets with operations across Latin America; Central and Eastern Europe; sub-Saharan Africa; and Central and Southeast Asia.

About the Authors

STEPHEN LOCK, Senior Vice President & Brazil Country Manager



A graduate in law from Cambridge University, who began his career in investment banking with Lazard, Stephen has since had over twenty-five years' consulting experience, initially in financial PR and then in public affairs and crisis work. After a sabbatical in Syria in 2000 he got the travel bug and has since lived in emerging markets for over 15 years.

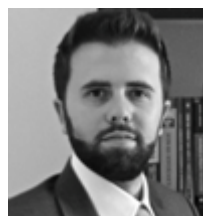
Before joining Speyside in Brazil in 2015, Stephen was CEO, Indonesia and Head of Public Affairs, Southeast Asia for Edelman, the world's largest PR firm. While at Edelman, he launched a digital team whose products and services were focused on corporate and crisis issues. Prior to Edelman, Stephen ran the Eurasia region, and was EMEA head of public affairs, for another PR group, Grayling, living in Russia and then Turkey. Brazil is the seventh country he has lived in. Stephen has worked extensively with oil and gas clients on issues ranging from minority shareholder disputes; IPOs; offshore field development; crisis issues; and environmental and investor communications.



EDUARDO VALLE, Senior Consultant

Eduardo specializes in government relations and public-private partnerships, having worked in Brazilian government organizations at the local, state and federal levels, such as the Brazilian Agency for Industrial Development (ABDI) in Brasília and the State of São Paulo Technological Research Institute (IPT). He also conducted policy analysis with international organizations such as the United Nations in New York City, the Organization of American States and research organizations in Washington D.C. (U.S. National Academies) and Finland (VTT Technology Center) before joining Speyside in 2014. At Speyside, Eduardo works with clients on government relations, stakeholder engagement strategy and political and policy intelligence.

LUIZ RENATO NAIS, Government Relations Analyst



Luiz has excellent communications skills developed through close client contact and involvement in multi-layered projects including both pure government relations and integrated with PR and NGO stakeholder engagement. Luiz is a regular columnist for a leading São Paulo newspaper, writing on Brazilian and LATAM politics. He specializes in the monitoring of political development and making detailed public policy analysis and 'roadmaps'. This involves the analysis of investment opportunities, crisis and risk management, governmental relations, political, economic and regulatory analysis in agribusiness, O&G, infrastructure, defense and healthcare.