

Analysts**Grace Fan**Senior Analyst
gf@trustedsources.co.ukFor more information please
contact Sales:sales1@trustedsources.co.uk
+44 (0) 20 3170 7254Important information: Please
see last page of this report for
all disclaimer/disclosure
information**04 Sep 2009****UPDATE: BRAZIL: Petrobras' subsalt
role becomes clearer*****The new regulatory model makes subsalt central to the 2010
presidential race***

The Brazilian government this week unveiled its long-awaited regulatory model for the country's promising subsalt reserves in four bills that are awaiting congressional approval. We delved into many of the issues surrounding the government's plans in our [August report](#) "Petrobras and subsalt in the political spotlight"; but the bills include additional points related to the capitalisation of Petrobras and the company's role as the sole operator of all new subsalt blocks, which we examine more closely here.

Key judgements

- ❑ The Lula administration's plan to capitalise Petrobras has already garnered tacit support from the opposition PSDB party and has a chance of being passed by Congress by 2010. Details about valuation will not be hammered out for several months. However, on its face the proposal strengthens Petrobras' position as a major global player, its ability to obtain financing and its role in the country's future subsalt development, as we previously forecast.
- ❑ Although we believe that the rights of minority shareholders will be respected, the details of the plan are highly speculative, and there is a risk of greater state intervention in Petrobras' activities if minority shareholders do not fully subscribe and the government steps into the breach.
- ❑ The plan to make Petrobras the sole operator of all new subsalt blocks is extremely negative both for the company and for Brazil's oil sector, but this measure will possibly face legal challenges and is likely to be modified.
- ❑ Our baseline scenario is that the centrepiece of the Lula administration's bill – its proposal for a production-sharing model – is unlikely to gain approval before the 2010 elections owing to a sharply divided Senate. In the improbable event that it does pass before Lula leaves office, we believe that any post-Lula administration will still be forced to be less ideological and more pragmatic in negotiating future subsalt E&P agreements with international oil majors, because of the colossal financing needed for subsalt development.

Please feel free to contact the author of this report directly or to schedule a call please contact Justine Moxham on +44 (0) 203 008 6094.

Context

The Lula administration began to consider a possible change to the 1997 Petroleum Law from the current concessions-based model for E&P blocks to a production-sharing model only a few months after Petrobras' announcement of its discovery of the Tupi subsalt oil field in late 2007. After more than a year of deliberation and delays, President Lula finally unveiled his proposed new regulatory model on 31 August by formally signing four bills to be sent to Congress. In brief, these bills propose:

- ❑ Changing the current concession-based model for unauctioned subsalt acreage to a production-sharing model under which Petrobras would be the sole operator of all subsalt concessions and would hold a minimum 30 per cent stake in them.
- ❑ Creation of a new state company (dubbed "Petrosal" by the local media) to administer these subsalt reserves.
- ❑ The ceding of rights to up to 5 billion barrels of subsalt oil equivalent to Petrobras (the firm's proven reserves are currently estimated at roughly 14 billion barrels). In exchange, Petrobras will issue new shares to existing shareholders only, at a to-be-determined price for subsalt reserves yet to be defined and valued. Preliminary estimates for the capital-raising exercise range from US\$20 billion (Credit Suisse) to US\$50 billion (government sources). If Congress approves this bill, the offering would likely occur in H1/10.
- ❑ Creation of a social investment fund with some of the subsalt oil revenues, to be invested primarily in education, health, technology and poverty alleviation.

We examined many of the proposed details of these bills in our August report, but two developments in particular bear further scrutiny here.

1. Capital increase for Petrobras

The all-important details of the valuation of Petrobras' new share offering will be hammered out only in the next few months. Nevertheless, the proposed bill is clearly a boon to the company by greatly enhancing its ability to obtain financing. In a crucial move for Petrobras, the opposition PSDB party has signalled that it is not averse to a capital increase. This implies that the bill has a fair chance of passing Congress by H1/10, independently of what happens to the other three bills. As we mentioned in our earlier report, Lula won the 2006 presidential election by falsely but successfully painting the PSDB challenger Geraldo Alckmin as a champion of privatisation. Therefore the PSDB will try to avoid falling into the same trap in 2010.

Although minority shareholders still need answers to several big questions, the proposals so far contain some reasonable legal assurances. First, the government has affirmed that the rights of minority shareholders will be respected in the new share offering and that the price of the oil will be determined by an independent third-party evaluator who will conduct a technical assessment of Brazil's subsalt geography. In addition, the bill has a clause that provides for the reevaluation of the price of oil within 24 months, upon which Petrobras would pay the government the difference if the price is higher or the government would pay the company back if the price has fallen.

These safeguards are reassuring, but the devil will be in the details. For

example, Petrobras has played up the point that the government plans to cede the rights to a fixed amount of oil equivalent (rather than the estimated acreage required to produce the oil), in a move designed to reassure shareholders that much of the future exploration risk for the company will be eliminated. However, the fine print of the bill as it stands states that the law will delineate the exact physical boundaries from where the promised 5 billion barrels or less are to be extracted.

In addition, Petrobras CEO Jose Sergio Gabrielli suggested this week in an investor conference call that the new subsalt acreage that will be granted to Petrobras will come from an area that will not require unitisation. At least one Brazilian congressman claims, contrarily (but plausibly), that the government's proposal primarily involves subsalt acreage that is contiguous to the Tupi and Iara fields, since this could allow the government to sidestep the complex question of unitising contiguous blocks altogether.

If unitisation is not required, however, it will prolong the timeline for commercial production by an additional 5-10 years because subsalt strata in blocks that are not contiguous to the Tupi and Iara fields have seen less exploration thus far. Another negative is that the independent evaluator is likely to base the reserve price assessment for the capitalisation on Tupi/Iara geography rather than on the less-explored subsalt acreage farther afield.

Considerable excitement (and also uncertainty) has been generated by the government's proposals – particularly as they alleviate Petrobras' immediate financing concerns and therefore improve the chances that it will be able to achieve its medium-term subsalt output target. We believe investors must bear in mind that in the best-case scenario it will take 10-15 years for Petrobras to fully develop the fields that will yield the up to 5 billion barrels of oil upon which the capital increase is based.

To the extent that existing shareholders do not fully exercise their right to purchase shares in the new offering, the risk of greater state interference in Petrobras' day-to-day activities rises because they will take up any unpurchased shares. Predictably, both the governing Workers' Party and opposition party PSDB are in favour of this idea, as they play to the Brazilian electorate ahead of the presidential elections.

2. Petrobras to be the sole operator of new subsalt blocks

As we explained in our August report, if Petrobras were to become the sole operator of new subsalt blocks it would be highly negative for both the company and the sector because it puts the bulk of subsalt financing and risk squarely on one firm's shoulders. According to the latest federal government estimates unveiled this week, of Brazil's total subsalt acreage of 149,000 km², only 28 per cent (41,772 km²) has been auctioned off, while Petrobras currently has stakes in 24 per cent (35,739 km²) of the entire subsalt region. Despite Petrobras' undisputed technical expertise in deepwater drilling, it is difficult to figure out how the firm will pull off the development of the region and turn a profit, given its capital-raising requirements, the certain prospect of far higher oil taxes and royalties on future subsalt output and other constraints such as labour and local content issues.

Furthermore, the government could face legal challenges to its proposal to guarantee Petrobras a minimum 30 per cent stake in each new subsalt block. Legal experts warned this week that this may violate the country's laws for

market competition. Brazil's Petroleum Institute – through which the private sector oil industry does its lobbying – has also protested strongly against this proposal.

The bottom line

The presentation of the Lula administration's four bills is driven by politics, with the result that the issue of subsalt is now at the heart of the 2010 presidential election. The PSDB and its allies will fight to modify these bills as the new regulatory model is debated. However, their main focus will be to derail only two of the four bills: the production-sharing model (with the Petrobras sole operator clause) and, by extension, the bill that creates Petrosal. According to PSDB congressman Luiz Paulo Velloso Lucas, the problem with these bills is that they create a "Frankenstein of a regulatory model" for the oil sector – a sentiment shared by many in the oil industry – while the other two bills are not seen as very controversial.

Important technical issues remain unresolved in the new regulatory model, such as the hot-button issue of royalties to be divided between municipalities, states and the federal government, and if and when unitisation of contiguous subsalt blocks will occur. There are months of political carnival ahead of us, but our judgement is that the Lula administration will find it all but impossible to pass its production-sharing model through the Senate, leaving the issue to be dealt with by the post-Lula government. In the unlikely event that it does pass before Lula leaves office, we still expect that the enormous financing needs of subsalt development will force the next Brazilian government to stay level-headed rather than ideological in its negotiations with the private sector.

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Contact us



TRUSTED
SOURCES

Trusted Sources UK Limited

Europe +44 (0) 20 7183 5280

The Americas +1 (646) 496 9856

Asia +852 2973 6093 (Enzard Ltd)

info@trustedsources.co.uk

www.trustedsources.co.uk