

## **BRAZIL - A COUNTRY OF OPPORTUNITIES**

### **INVESTMENTS IN THE EXPLORATION AND PRODUCTION OF PETROLEUM AND NATURAL GAS**

#### **I. Introduction.**

The Brazilian Federal Constitution, enacted on October 5, 1989, established a government monopoly over petroleum exploration and production activities in Brazil. In 1995, by means of Constitutional Amendment No. 9 ("Amendment No. 9 / 95"), this monopoly became more flexible, allowing the Brazilian government to contract with public or private companies with headquarters and administration in Brazil to perform petroleum exploration and production activities.

In 1997, the "Petroleum Law" was approved by the Brazilian Congress. The first regime adopted for exploration and productions activities was the Concession Regime (see *infra* for discussion of the Concession Regime). The Concession Regime lasted for almost 10 years until, in 2008, a major offshore reserve was discovered in the pre-salt layer off the coast of Brazil, near the State of Rio de Janeiro. The discovery of reserves in the "Tupi" field (currently denominated as the "Lula" field), among others, resulted in the implementation of the new Production Sharing Regime for strategic and pre-salt layer exploration and production.

Due to the discovery of new reserves and resulting legal changes, the Brazilian petroleum industry has grown significantly. More recently, from 2000 to 2010, according to the Brazilian Petroleum Agency ("Agência Nacional do Petróleo, Gás Natural e Bio-Combustíveis" or "ANP"), the proven petroleum reserves grew from 1.346 million cubic meters to 2.224 million cubic meters. The proven natural gas reserves grew from 219.692 million cubic meters to 423.021 million cubic meters. The tremendous growth of the Brazilian oil & gas industry is regularly profiled in the media, as demonstrated by the recent announcement of a new production record of 2,108 barrels of oil equivalent per day ("boed") in 2010. According to the Petróleo Brasileiro S.A. ("PETROBRAS") investment plan for 2009-2012, PETROBRAS intends to invest US\$104,6 billion in exploration and production activities. A significant portion of the investment will be made in development of the pre-salt layer areas, which are located in ultra-deep water far from

the Brazilian coast. The logistics for pre-salt exploitation will increase the need for equipment such as floating production storage and offloading (FPSO), flexible line manifolds and supply boats, risers, construction of pipelines, technological support, etc. Further, the construction of drilling rigs in Brazil is now a reality since the demand for this type of vessel has also increased.

Development of the Brazilian oil & gas services industry expects to mirror the rapid growth seen in the exploration sector. It is important to note that companies located in Brazil will have a competitive advantage due to the availability of local financing from the Brazilian social development bank (BNDES) and mandatory requirements of local purchase for equipment and services under the Concession Regimes. PETROBRAS procurement activities and requirements (as a government policy to develop the local Oil & Gas services and equipment manufacturing industries) should be repeated in the Production Sharing Regimes as we observe below.

## **II. The Production Sharing Regime.**

In 2009, the Brazilian government announced a new regulatory framework for exploration and production of crude oil and natural gas located in “strategic” and pre-salt areas. Three new laws were submitted to the Brazilian Congress for: (i) creation of the Production Sharing Contract; (ii) creation of a public company to manage the Production Sharing Contract and to market the crude oil produced under the Production Sharing Contract (a company called Empresa Brasileira de Administração de Petróleo e Gás Natural S/A – “Pré-Sal Petróleo S/A”); (iii) the creation of a social fund designed to raise funds for social and regional development; and (iv) assignment by the Federal Government to PETROBRAS of control of certain exploration and production areas in the pre-salt layer.

The Brazilian government through Pré-Sal Petróleo S/A will be a party to the Production Sharing Contract and PETROBRAS will be the mandatory operator in all blocks. However, other interested parties will be selected for participation through a public bid defined by the Brazilian Ministry of Mines and Energy and the Brazilian Council of Energy policy.

The bid process will be conducted by the ANP and the winning proposal will be the one that grants the Brazilian government the highest exceeding oil (i.e., the highest percentage in the division of the total oil production less costs). The Production Sharing Contract

(which is not yet available), in its essence, should follow the same format and structure as the Concession Contract in relation to the payment of royalties, signature bonus, local content requirement, term, and exploration and development phases as further discussed below.

### **III. Key Elements of the Concession Regime.**

Under the Concession Regime, the Brazilian oil & gas industry was able to attract foreign oil companies to Brazil. These foreign companies were able to successfully bid for concessions during 10 bid rounds sponsored by the ANP. The Concession Regime will remain in-place for non-“strategic” and non-pre-salt exploration. Because it is likely that the Production Sharing Contract will share many similarities with the Concession Contract, a review of the Concession Contract is instructive.

The Concession Contract is a contractual instrument by which the Brazilian government, through the ANP, is the grantor and a company or a consortium (non-incorporated joint-venture) of companies is the concessionaire. The Concession Contract is granted by means of a public bid and gives the concessionaire the right to explore and produce oil and natural gas in a given concession area during a defined period of time (usually 32 years).

The public bid offer should be a balance of a cash offer called signature bonus (i.e. the amount offered by the concessionaire during the bidding process, to be paid in Brazilian currency and before signing the concession contract) and a commitment to acquire local services and products (the so-called “local content requirement”). The local content requirement has been increased, varying in percentage and should be verified before each bid round.

The Concession Contract is divided in two phases: exploration and development/production. The exploration activities are performed at the sole risk of the concessionaire and, in the case of success, the concessionaire will be entitled to the produced crude oil or natural gas. The concessionaire is obliged to pay all the government taxes which will include: signature bonus, royalty, special participation and payment for the retention of the area. The royalty is defined as compensation for the concession and the concessionaire pays monthly, in Brazilian currency, after production begins in a given field. The royalty percentage may vary from 5-10% of production of oil and gas, according to its market price.

A special participation fee is extra compensation payable by the concessionaire to the Brazilian government as the result of large production volume at a field. The special participation fee ranges from 10-40% on net revenue on the quarterly production of each field, after deductions provided for in the applicable legislation.

A retention payment must also be made to continue occupation or retention of the concession area. This payment is assessed for each calendar year from the date of execution of the Concession Contract.

Again, some characteristics of the Concession Contract are likely to be retained in the Production Sharing Contract. We will advise of other or different requirements once the Brazilian government makes this information public.

#### **IV. Upcoming Opportunities In Oil & Gas in Brazil.**

In addition to the ongoing private farm-in and farm-out transactions in Brazil, the Brazilian government has announced its intention to hold a public bid process for the exploration and production of crude oil and natural gas under the Concession Regime (i.e., for non-pre-salt fields). This bid process should be held in September or October 2011 and will include nine sedimentary basins with 174 blocks that have not yet been defined.

Another bid round should be expected soon for the Production Sharing Regime in the pre-salt fields and it should catch the attention of major exploration companies and investors due to the high investment requirements for the pre-salt layer.

Brazil is a country of opportunities for companies of all sizes who are interested in participating in the Concession and Production Sharing Regimes. These regimes will co-exist for the different types of areas to be explored, as well as for service and equipment providers as the result of opportunities to supply the growing oil & gas industry.

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