

# **IMI: Challenges for U.S. Companies in the Brazilian Oil and Gas Sector**

**September 27, 2013**

## **Summary**

In 2007 huge reserves of oil under a pre-salt layer were discovered approximately 200-300 kilometers off the coasts of the States of Espírito Santo, Rio de Janeiro, São Paulo, and Santa Catarina. The pre-salt oil finds are estimated to contain at least 50 billion barrels of oil. In an effort to develop these oil fields responsibly, the Brazilian government has been trying to follow the Norwegian model of oil development which gives priority to the national oil company and other domestic firms seeking to participate in the extraction of oil in Brazil. Local content requirements (LCR) and giving priority to the state-owned oil company, Petróleo Brasileiro S.A. (Petrobras), make it a challenge for U.S. companies to participate in this potentially lucrative sector. This IMI describes barriers to entry such as LCR and logistical bottlenecks. This IMI also summarizes the October 21<sup>st</sup> Libra Pre-Salt Oil Field auction and provides resources and strategy insights for U.S. companies seeking to operate in the Brazilian oil sector.

## **Barriers to Entry: Regulations and Requirements in the Brazilian Petroleum Sector**

The main impediments for U.S. companies wanting to operate in the Brazilian petroleum sector are regulations concerning domestic content and priority given to Petrobras. To begin, the Brazilian government has reserved a 30% equity share for Petrobras in all future pre-salt drilling and development concessions, according to a 2010 Brazilian law created specifically to address upcoming pre-salt auctions. This law also requires Petrobras to lead operations in both exploration and development on all pre-sal operations. Aside from these regulations aimed to exclusively promote Brazilian interests, the Brazilian government is also looking to promote domestic industry clusters, or, groups of companies in related subsectors, such as valves, pipes, vessels, etc. that support oil drilling.

Concession auctions are regularly held to sell development rights to the highest bidder. The next auction will be held on October 21st, 2013 for the Libra pre-salt oil field. This auction will follow a new model (e.g. Production Sharing Agreement – PSA).

## **The Libra Pre-Salt PSA Auction**

**The main points related to the Libra field auction are as follows:**

- The bid winner will be the consortium that offers the State the highest profit oil rate, which cannot be less than 41.65% or revenue after expenses.
- The company is allowed to use the money from produced oil to recover capital and operational expenditures, known as "cost oil". The remaining money is known as "profit oil", and is split between the government and the company.
- The winner consortium will be able to retain 50% of the bulk revenues generated out of the oil production until the expenses incurred by the oil companies are recovered.
- This percentage limit will be applied by oil production platform, not by oil field, which is seen as a positive change by industry contacts. However, the oil regulator (ANP) will not allow monetary correction on these costs.
- The winner of each concession will pay the State a R\$15 billion (reais) bonus.
- A new entity (Pré-Sal Petróleo S.A. – PPSA) will manage the PSA contracts. (Note: On October 11, 2013, President Dilma designated Mr. Oswaldo Pedrosa, former Petrobras executive and, most recently, a Director at private oil company HRT, to be the General Director of PPSA.)
- The PPSA will receive R\$ 50 million (reais) out of the total bonus.
- Petrobras will have to come up with 4.5 billion reais no matter which of the 11 pre-qualified companies win the auction.
- The payment is Petrobras' minimum share of the 15 billion real up-front fee winners will pay Brazil for the rights to Libra.
- The bid winner must enter a consortium with PPSA and with Petrobras, if the latter is not already in the consortium. Petrobras will be the sole operator and will have a minimum participation of 30%.
- Petrobras must also supply at least 30 percent of the estimated 400 billion reais (\$180 billion) that will be needed to develop the area.
- The PSA contract will have a 35-year duration, with a requirement to begin exploration within 4 years.
- **LCR for Libra:**

- Exploratory phase: 37%
- Development phase up to 2021: 55%
- Development phase after 2021: 59%

### **Logistical Challenges for U.S. Companies**

Infrastructure issues and unfavorable policies present challenges for U.S. firms seeking to operate in the region. With the oil being located roughly 7,000 meters below the surface under a layer of salt approximately 2,000 meters thick, intense deep water pressure and salt-induced corrosion become major issues. New technology is required to ensure drilling equipment can withstand highly corrosive conditions that can seriously harm operations and cost millions of dollars if not properly handled. As previously mentioned, LCR presents another logistical challenge as oil companies are required to fulfill the LC percentages that they commit to the National Oil Regulator when they sign contracts to explore and produce oil in Brazil. In many cases, there are bottlenecks in the local supply chain that can delay a project or make it more costly. Adding to logistical challenges are high taxes, high cost of capital, and rigid labor laws that can greatly augment the cost of doing business in Brazil. The SELIC rate (interest rate) has risen since April 2013 from 7.25% to 9% in September 2013. Brazil's burgeoning bureaucracy also makes operating in the country ever more cumbersome.

### **Resources to U.S. Companies**

Penetrating the Brazilian oil sector is difficult yet achievable. It is crucial that U.S. companies establish partnerships with Brazilian companies and contract a reputable law firm with connections to the industry. It is important to note that the Brazilian government is not looking for foreign companies to export products, but rather, looking for foreign firms to establish operations in Brazil and create a lasting relationship with Brazilian firms. The U.S. Commercial Service (USCS) in Rio de Janeiro is a valuable asset for any company looking to penetrate this market. The USCS Oil and Gas Team has specialists who are extremely knowledgeable about and have many contacts in the Brazilian oil and gas sector. The USCS' Gold Key service can provide market insight and strategy for entering the market.

**For additional market research reports and information on USCS services, please visit:**  
[http://export.gov/brazil/industryhighlights/energy/eg\\_br\\_051813.asp](http://export.gov/brazil/industryhighlights/energy/eg_br_051813.asp)

**For more information about export opportunities in this sector, please contact  
US Commercial Service Industry Specialist:**

**Regina Cunha ([regina.cunha@trade.gov](mailto:regina.cunha@trade.gov))**  
**Senior Commercial Specialist**  
**U.S. Commercial Service**