

PRE-SALT CONTRACTS

Brazil's massive pre-salt reserves and the need for development open up opportunities for service providers. Here are the steps to entry.

ARTICLE BY
AARON BALL AND
PAULA GALHARDO

ILLUSTRATION BY
RENEE PETERSON

Brazil's massive pre-salt finds made by state-controlled oil company Petrobras signal that its energy sector's time has come. Experts estimate there are more than 50 billion barrels of recoverable light crude in the pre-salt's Santos Basin alone.

Adding to optimism surrounding Brazil's prospects is the fact that it has been shielded from the worst of the global credit crunch. In an ironic twist, some of the unreformed aspects of Brazil's economy, such as state influence over the financial sector (a legacy of the country's past as an inflation-ridden debtor), have helped limit the damage. The government controls key banks, including the country's largest mortgage lender, as well as a large development bank that provides easy credit to favored companies. Hefty reserve requirements and taxes on funding loans increased the price of credit, discouraging the type of high-risk lending that has brought down other countries' economies.

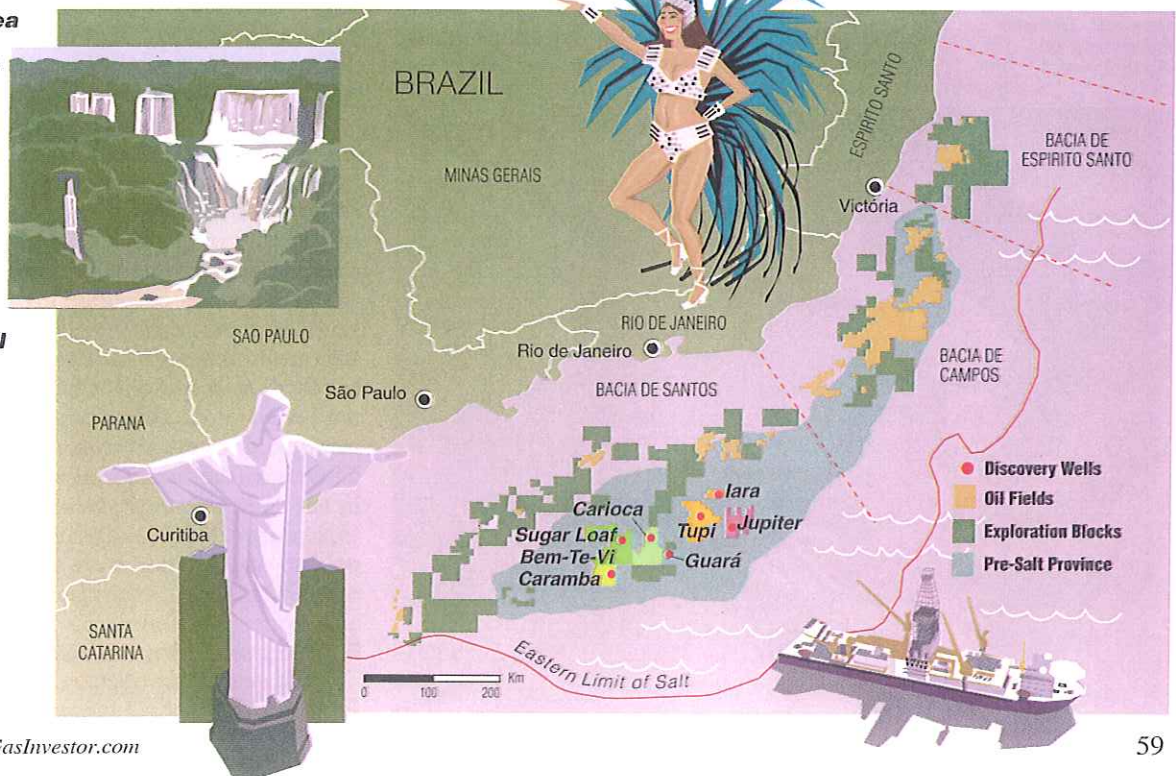
Despite being among the last to fall into recession, however, Brazil may be among the first to emerge from it. On June 10, the central

bank cut its interest rate to its lowest point since the 1960s. The value of the Brazilian stock market has rebounded to the level reached prior to the Lehman Brothers collapse in 2008. Many economists now believe the economy will soon return to 3.5% to 4% growth by 2010. This growth and the hike in oil prices make Brazil an even more attractive investment opportunity.

Investment in the pre-salt

The pre-salt area spans 500 miles along the coast of Brazil (from the state of Espírito Santo to Santa Catarina) and 300 kilometers off the coast of Rio de Janeiro. It includes offshore fields such as Tupi, Guar, Bem-Te-Vi, Carioca, Jupiter, Sugar Loaf and Iara. Tupi, discovered in November 2007, has estimated reserves of 5 billion barrels of oil—8 billion barrels of oil equivalent (BOE)—and may be the world's second-largest oilfield discovery in the past 20 years. Petrobras estimates that reserves at Sugar Loaf Field could be even larger, at around 33 billion BOE, and that Jupiter Field could contain reserves similar in

The pre-salt area spans 500 miles along the coast of Brazil and 300 kilometers off the coast of Rio de Janeiro, and includes fields such as Tupi, which has estimated reserves of 5 billion barrels of oil. Source: Petrobras Brazil



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size to Tupi's.

Development will be expensive, however. Petrobras estimates that Tupi could require as many as 200 wells and cost more than \$600 billion (all amounts are U.S. dollars unless noted) to develop. Petrobras began exploitation of the field in May.

Despite the challenges, Petrobras is banking on the pre-salt. The company plans to transform Brazil into a major petroleum exporter and has embarked on a massive round of investment to develop these finds. In February 2008 it unveiled its 2009-13 business plan, which contains an estimated \$174.4 billion in spending (a \$55-billion increase over its previous four-year plan), with \$104.6 billion earmarked for E&P, \$43.4 billion for downstream, \$11.8 billion for gas and other energy, \$5.6 billion for petrochemicals and \$3 billion for distribution.

The budget contains \$28.9 billion in pre-salt investments for 2009 alone (an increase from \$23 billion in 2008). Petrobras expects pre-salt development to be competitive even at prices under \$40 per barrel. The revised plan is based on an average of \$42 per barrel.

The company has already secured funding for its 2009 investments, with \$11.8 billion (R\$25 billion) in funds from the Brazilian Development Bank (BNDES), and \$5 billion (R\$11 billion) from international banks. Petrobras and China Development Bank Corp. signed a 10-year bilateral credit line worth \$10 billion (R\$20 billion) that Petrobras would repay by supplying 200,000 barrels of oil a day for the next 10 years to China's state oil company, Sinopec.

For oilfield-products and -services companies to benefit from this massive investment and expansion of energy-related spending, they must understand current market risks and

how Petrobras contracts with suppliers and service providers.

The petroleum is ours

President Getúlio Vargas established Petrobras in October 1953 by executive decree, popularizing its creation with the petro-nationalist slogan, "*O petróleo é nosso*" or "The petroleum is ours." The company was formed as a monopoly, with the sole purpose of executing the state's E&P, refining and transport of hydrocarbons. Later, this monopoly was extended to the import and export of oil products.

In 1997, Law N. 9.478 made Petrobras a semi-public company by opening it to private investment. Today, the Brazilian government holds 40% of the total stock and 58% of the voting shares with the remainder held by private investors who acquire and trade their shares on the São Paulo and New York stock exchanges. In addition to having majority voting rights, the Brazilian government also controls the Petrobras board, with the right to appoint seven of its nine directors.

Later in 1997, following the enactment of a new petroleum law, the Brazilian government broke Petrobras' monopoly and allowed private companies to develop Brazilian oil fields through open auctions. Though no longer a monopoly, Petrobras remains under the control of the state and continues to be the single most-dominant player in Brazil's energy economy.

The contract process

Foreign suppliers must have a local partner or subsidiary in order to register for the Petrobras bidding process. Most U.S., or U.S.-based, companies in Brazil contract with Petrobras through a *sociedade limitada* (or Ltda.)

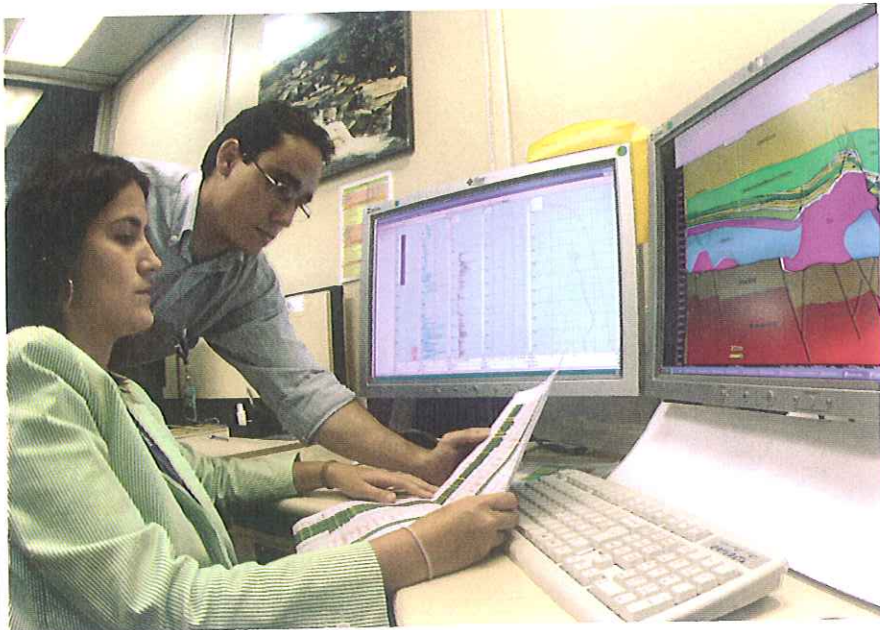
Limitadas are not only the most common form of participation by foreign companies; they are also the most simple, flexible and inexpensive. The *limitada* business structure does not require corporate formalities such as minutes or resolutions. *Limitada* owners' legal responsibility is limited to the value of their shares. A *limitada's* capital is divided into *quotas* (shares), and there are no minimum capital requirements. They are managed by one or more "administrators" who reside in Brazil and are appointed by the quota holders.

The Brazilian corporate tax regime is a traditional system, with no relationship between the tax on a company's profits and the tax on shareholders' distributions. Corporate income taxes are levied on income derived from all legal entities established in or operating within Brazil. Therefore, the *limitada*, like a U.S. corporation, is taxed at the entity level. However, unlike U.S. corporations, distributions or dividends paid to quota-holders are not taxed at the individual level.

Bidding and direct contracting

Prospective contractors must participate in a formal bidding process. All procurement con-

Petrobras has embarked on a massive round of investment to develop the pre-salt finds and solve its technical challenges, and service and supply companies that participate in the formal bidding process stand to benefit. (Photo courtesy of Petrobras.)



tracts with Petrobras are regulated by Decree 2,745/98 (or "Regulation of the Simplified Tender Proceedings for Petrobras").

According to the decree, Petrobras may use several types of bidding for procurement purposes:

Call of bids (*concorrência*). Call for bids is the most complex method of tender procedure. Any interested party can participate as long as it has the requirements stipulated in the call notice provided by Petrobras.

Price consultations (*tomada de preços*): These are similar to call of bids, but participants are individuals or companies previously registered with Petrobras. Therefore, the bid evaluation occurs beforehand, as the interested participants are registered before the receipt of commercial proposals.

Letter of invitation to present proposal (*convite*): Bids are requested by interested parties, whether or not they are registered with Petrobras, and a minimum number of three are chosen. This modality is usually used for services of lower value.

Contests (*concurso*): This method is used to select technical and artistic works, and winners are paid through prizes or in cash.

Public auction (*leilão*): Any interested party can participate. It is reserved for the sale of Petrobras assets to the highest bidder, above a minimum floor value.

The complexity and specialization of the goods or services contracted for determine whether contracts are awarded based on lowest price, best know-how, or a combination of these two factors.

Decree 2,745/98 permits Petrobras to enter a goods or services procurement contract without the use of a formal bidding process in certain circumstances:

- Emergency cases, characterized by the need for urgent responses to situations that could cause loss or affect the safety of people, work, services, equipment and other goods;

- Purchases of standard or "off-the-shelf" materials, equipment or items by a governmental agency when it is not possible to establish objective criteria for analyzing the different proposals; and

- Purchases of parts and spare parts from the manufacturer of the original equipment so as to maintain warranties.

Petrobras is also exempt from engaging in a formal bidding process whenever "competition" is not feasible. Examples of such situations include:

- Purchases of materials, equipment or items that are supplied by only one manufacturer, company or commercial representative (mere brand preference does not exempt the requirement for bidding);

- Contracting for technical services of a singular nature with professionals or companies known for their specialization in the granting of opinions or their special expertise; and

- Formation of partnerships, consortiums and

Selected Service Contractors With Petrobras

Company	Principal Brazilian Subsidiary
Halliburton	Halliburton Produtos Ltda.
Baker Hughes	Baker Hughes do Brazil Ltda.
National Oilwell Varco	National Oilwell Varco do Brasil, Ltda.
Smith International	Smith International do Brasil Ltda.
BJ Services	BJ Seviles do Brasil Ltda.
Cameron International	Cameron do Brasil Ltda.
FMC Technologies	FMC Technologies do Brasil Ltda.
Pride International	Pride do Brasil Serviços de. Petróleo Ltda.
Exterran Holdings	Exterran Brasil Ltda.
Enesco International	Enesco Brazil Servicos de Petroleo Ltda.
Grant Prideco	Grant Prideco Equipamentos para Petroleo Ltda.
Oil States International	Oil States Industries do Brasil Ltda.

Source: Looper, Reed & McGraw PC

other forms of contractual association to perform activities included in Petrobras' business purpose.

Registering

Companies that want to provide services or goods to Petrobras must enroll with the "Corporate Reference File" and/or "Local Register."

The Corporate Reference File is a registration database for vendors that provide goods and services listed in the "List of Permanent Interest of Petrobras" (available for review and registration on the Petrobras website). This list includes critical goods such as chemical products, drills, structures and components.

Registered vendors obtain a certificate of registration and record classification (CRCC). The certificate is a prerequisite for participating in all solicitations for bids related to the List of Permanent Interest. Unlike the Local Register, bidding for items on the Corporate Reference File is conducted by Petrobras' procurement office and not the individual business unit that may ultimately acquire the goods or services.

By contrast, the Local Register is a registration database for vendors that provide goods and services directly to individual Petrobras business units. Each Petrobras business unit has its own Local Register procedure. These procedures are explained in each business unit's "Manual of Documents for Registration."

Trends in contract pricing

Petrobras is reevaluating some contracting clauses to include price-adjustment mechanisms to deal with unpredictable price increases in key materials, such as steel. These flexible pricing clauses will benefit not only Petrobras, but also its suppliers, as they will prevent any fall in key input prices after the contractual award. □

Attorneys Aaron Ball and Paula Galhardo are members of the Latin American Projects Group in the Houston offices of law firm Looper Reed & McGraw PC. They focus on international transactions and planning for oil-field and manufacturing companies.

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