

“Pre-salt strategic areas”

A new regulatory framework for the E&P industry in Brazil.

On September 1st, 2009, the Brazilian Government submitted to the National Congress its proposals for creating a new regulatory framework for exploration and production of oil and natural gas in the deepwater areas known as pre-salt and in other areas considered by the former as being “strategic areas”. Altogether the proposal consists of four legislative bills, whose objective is to permit the Government to; 1) increase its control over the exploration activity and 2) obtain higher revenues from the production of oil and gas in the pre-salt region.

The proposals submitted by the Administration are divided into four projects, as follows: a) a legislative bill formulating a new contractual arrangement for exploration and production of oil and natural gas in the pre-salt and strategic regions, i.e. a production apportionment arrangement (“E&P Project”); b) a legislative bill creating a new state company (“*Petro-sal* Project”); c) a legislative bill implementing a fund for economic and social development in Brazil (“Social Fund Project”); and d) a legislative bill for the capitalization of Petrobras, the national oil company (“Capitalization of *Petrobras* Project”).

It is worthy of mention that the interest of the Administration in establishing new rules for the pre-salt had already been manifest during the Ninth Round of Public Tenders of the National Oil, Natural Gas and Biochemicals Agency (ANP). At this time, by means of Resolution number 6 of the National Council for Energy Policy (CNPE), the Administration instructed the Agency to exclude from the round, 41 blocks situated in the *Santos*, *Campos* and *Espírito Santo* basins.

This Resolution of CNPE was justified by the results of preliminary tests by *Petrobras*, which suggested the existence of a new and significant oil province in Brazilian territory (denominated as pre-salt), at a depth ranging between five and seven thousand meters, and with huge potentially recoverable volumes of oil and gas.

On the date of its publication, this Resolution already instructed the Mines and Energy Ministry to analyze, within the shortest possible time-frame, the alterations necessary to the regulatory framework in order to take into account the new paradigm of exploration and production of oil and natural gas, introduced by the discovery of the new oil province.

The E&P Project is more comprehensive and proposes general rules for exploration and production of oil and natural gas in the pre-salt and other areas considered as strategic by the Administration, in addition to bringing some changes to Law 9.478/97 (Oil Law). If the E&P Project is approved by Congress, Brazil shall then have two laws relating to the activities of exploration and production in the country, with the Oil Law applicable to onshore areas and to offshore areas not situated in the *pré-sal* and which, at the same time, are not considered strategic for the Government.



Alexandre R. Chequer is a Mayer Brown LLP partner affiliated with Tauli & Chequer Advogados in Brazil.



Bruno Triani Belchior is an associate of Tauli & Chequer in association with Mayer Brown. Bruno advises domestic and foreign oil and gas companies in Brazil and West Africa, as well as companies involved in M&A and development projects.

For these areas (pre-salt and strategic areas), the E&P Project establishes the creation of a production apportionment contractual arrangement,¹ where *Petrobras* shall be the mandatory operator in all of the blocks, with a minimum participation of 30% in any consortium formed as a result of the public tender.

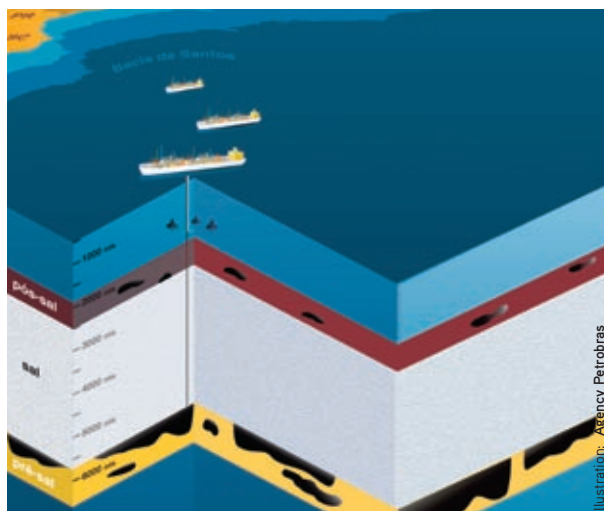
Worthy of mention is that, according to the E&P Project, the Union, through the Mines and Energy Ministry, will be able to enter into production apportionment contracts: 1) directly with *Petrobras*, in which case a tender is dispensed with; or 2) through public tenders with the auction format. In the case of a tender, *Petrobras* may participate, seeking to increase its participation in the proffered block beyond the minimum of 30%. As a result, all of the winners of tenders will be obligated to set up a consortium with *Petrobras* and with *Petro-sal* (public company linked to the Mines and Energy Ministry, and whose establishment is outlined in the pre-salt Project).

Without failing to acknowledge the arguments concerning the unconstitutionality of directly contracting *Petrobras* and of the minimum mandatory participation of 30% reserved for the company in all consortiums, the proposal underscores the control and interference role to be played by *Petro-sal* over the consortiums made up of *Petrobras* alone or with other oil companies. According to the E&P Project, *Petro-sal* will appoint one half of the members of the operational committee of each consortium, including its president, who shall have veto power and casting vote.

Notwithstanding that *Petro-sal* will have no responsibility relative to the operation, costs or risk involved with the exploration, development and production activities, nor with marketing oil and gas, the fact that the new state company will exercise control over operational committees has been subject to criticism, and concurrently, causes concern about the regulatory stability of exploration and production in Brazil.

It is perfectly understandable that the state company should be attributed competence relative to monitoring and auditing (overseeing) the costs and investments necessary for the activities of exploration, survey, development and production of oil and gas or even to the extent of evaluating the technical and economic soundness of their plans. However, the intended day-to-day control of operations does not satisfy the industry.

Once again, looking beyond the aspects of unconstitutionality, it is clear that the mandatory participation of *Petrobras* as an operator in all of the consortiums also causes a great degree of apprehension for foreign companies that operate in Brazil, mainly due to the technological factor involved in oil operations, which would become totally concentrated in *Petrobras*.



Furthermore, this model of compulsory participation in consortiums with a minimum of 30% may become prejudicial to *Petrobras* itself, who may not have very much control over what is being offered by other companies that participate in the auctions, and may conceivably have to shoulder huge operational costs in exchange for meager profits with oil and gas.

For this reason, the Government must be attentive with respect to the rules that will be formulated for the auctions, particularly with respect to the portions of cost oil and profit oil that will be allotted to the Union. What is being perceived in the international scenario is that the model of mandatory participation of *Petrobras* as an operator tends to disinterest the *super majors* and consequently attract the Asian oil companies, the state owned companies in particular (known as *national oil companies* or *NOC's*). Such companies adopt different standards of economic viability, and in their points of view, the important factor is not the portions of cost oil and profit oil, but the guarantee of the availability of energy resources for their own internal needs, both present and future.

Another issue that is provoking widespread controversy in the oil industry is an amendment made to the E&P Project that alters the rules for distribution of royalties under this new Production Apportionment. The subject had not even been touched upon in the Congressional Bills, and its approval in the House of Representatives has had significant repercussions in the national political scenario. However, the future of this amendment is uncertain, as it is subject to approval by the Senate and to presidential sanction.

The current expectation of the Government is that the regulatory framework of the pre-salt will be approved during the first semester of 2010, which would allow for new public tenders to take place this year. Meanwhile, the international industry anxiously awaits the outcome of the definition of the rules for the pre-salt and hopes that they will be clear and just and, above all, that they will have judicial stability. ■

¹ The E&P Project defines *share of production* as "the regime of exploration and production of oil, natural gas, and other fluid hydrocarbons where the contractor exerts, on its own and at its own risk, the exploration, evaluation, development, and production activities, and acquires, in the case of a commercial discovery, the right to retain the oil cost as well as part of the surplus oil in the proportion, under the conditions and within the period established by the contract.