Fuel price policy: Who wins?

Petrobras losses and stagnation in the ethanol market make it urgent to redefine fuel price policy.





Cláudio Accioli and Solange Monteiro,
Rio de Janeiro

INTERNATIONAL OIL PRICES are up, demand for oil products in Brazil is growing, but the main Brazilian oil company is suffering from lower production and profits. This is more than just a corporate problem. Two government activities make a potentially explosive mixture: an energy policy that sets actual fuel prices, and short-term policies to stimulate economic activity and control inflation.

Since 2002 Petrobras has had the legal right to set domestic prices for oil products. In practice, though, the government, still traumatized by past hyperinflation, has always restricted this prerogative in order to ease the weight of fuel on inflation. Until 2008 there was not much controversy about what the government was doing, but then came the global crisis. To avoid a sharp contraction of the Brazilian economy, the government encouraged the purchase of durable goods, especially cars, through more credit and a reduced tax on industrialized products (IPI). At the same time, it restricted prices of gasoline and diesel, an important input to agriculture, which in recent years has led the growth of the economy and Brazil's external trade surplus.

Two government activities make a potentially explosive mixture: an energy policy that sets actual fuel prices, and short-term policies to stimulate economic activity and control inflation.

PROBLEMS

Increased demand took producers of hydrated alcohol (ethanol) by surprise, just as productivity was falling. The shortage of ethanol and an inability to expand the supply of gasoline due to refining bottlenecks further aggravated demand for fossil fuel. After 2011, the country lost self-sufficiency in gasoline, and Petrobras had to import fuel, paying more than it could sell it for in Brazil. To make matters worse, there is no prospect that ethanol production will soon recover, since its economic problems were aggravated by the competition that arose from gasoline price controls, which turned away investors and led sugar cane producers to direct less production to ethanol.

"It's a vicious circle," says Marcelo Colomer, energy economics researcher at the Federal University of Rio de Janeiro (UFRJ). Colomer also points out that Petrobras has little investment capacity and is thus unattractive to investors, which tends to perpetuate the market distortions. "It is not clear whether the population really wins with the current strategy," he says. Experts agree that the country urgently needs a transparent pricing policy for fuels. "Currently, the government insists on episodic interventions that create domino distortions," says Maurício Canêdo, researcher at the Institute of Brazilian Economics (IBRE).

Alisio Vaz, president, Fuel Distributors Union (Sindicom), shares the concern: "For consumers and retailers, the market seems to be functioning, but on a wider view of the economy, there are distortions that harm Petrobras and ethanol producers." Vaz also notes that it is hard to project demand accurately without proper signaling of the relative prices of gasoline and ethanol, and clarity about the share of each in fueling flex-fuel cars. According to Sindicom, from 2009 through 2012 Brazil's gasoline consumption went up 57% and ethanol consumption dropped 41%.

"Any government intervention in the gasoline market interferes with the ethanol market because they are linked by consumption. This explains why the ethanol market has become disorganized, even though the government has not intervened in it directly," says IBRE's Canêdo. "The low price of gasoline may be a good buy for consumers but it says do not produce it to producers." It is no coincidence that Petrobras is the only private agent interested in investing in refining capacity in Brazil, and that the market for ethanol fuel has become unbalanced.



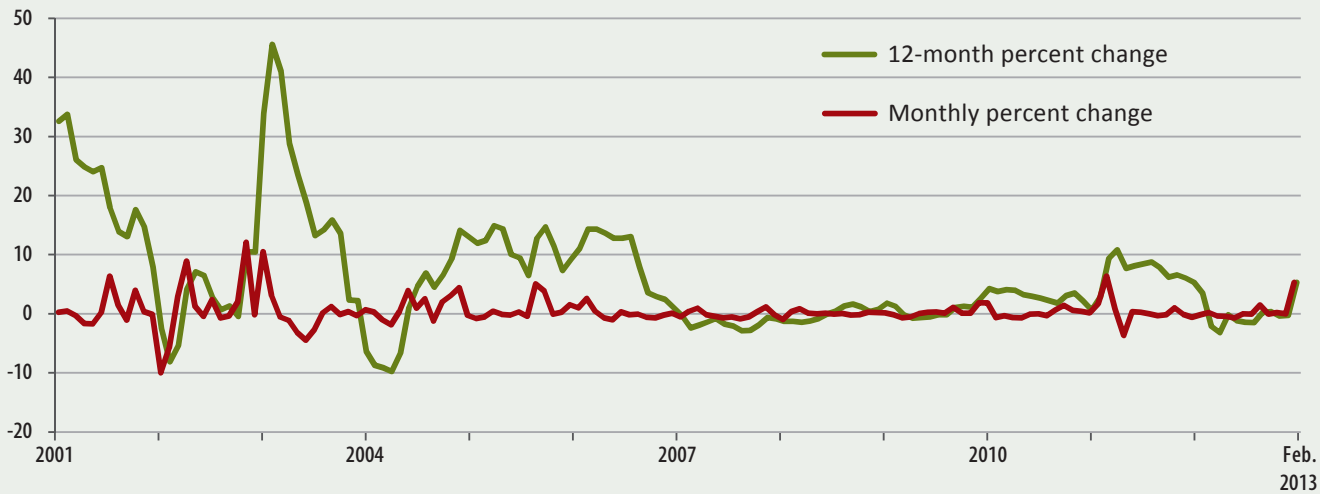
OLD HABIT

Using fuel prices as an instrument of economic policy is not new. Before the market was liberalized in the late 1990s, direct state intervention had a variety of different goals: keeping GDP growing after the first oil crisis (1973); bringing down demand to soften the second shock (1979); controlling inflation since 1985; and containing the public deficit after 1987. Former Finance Minister Ernane Galvêas (1980–85) explains, "In October 1973, a barrel of oil went from US$2 to US$10 [which] forced the government to redo the entire economic policy of import substitution and subsidies to industry," he says. To keep importing fuel , and to avoid suppressing economic growth, he adds, "The Ernesto Geisel administration opted to subsidize the balance of payments and borrow abroad to pay for it. In that period, the economy grew annually on average between 5% and 5.5%."

Galvêas recalls that "When the João Figueiredo administration took office, the price of oil shot up from US$10 to US$36. We had no resources, the country was in debt, and oil prices continued to rise. To curb imports, in the United States

Changes in gasoline prices in Brazil have virtually plateaued since 2007.

Gasoline prices, % changes



Source: Brazilian Institute of Economics (IBRE).

"Today, the government forces producers to sell gasoline and diesel below the international market price, generating cash-flow troubles for producers."

Adriano Pires

the Federal Reserve, led by Paul Volcker, significantly raised interest rates. This was a problem because high interest rates forced entrepreneurs to get rid of their inventory. In Brazil, exports plunged. We were hit by three shocks: oil, interest rates, and inventory adjustment. With the fall in exports, we had to reduce total imports almost by half. . . . It was the most difficult period in the economic history of Brazil."

That economic contraction did not affect Petrobras operations. Then the company was more focused on refining than on production; the profitability of gasoline, its most important product, far exceeded that of the other oil derivatives. "At the time, the government set prices for each fuel that were equal to or higher than the average of all prices of the refinery as a whole," said Adriano Pires, director, Brazilian Center for Infrastructure (CBIE). "Today, the government forces producers to sell gasoline and diesel below the international market price, generating cash-flow troubles for producers." He adds that currently gasoline and diesel together represent more than 60% of Petrobras revenues.

But the idea of fuel subsidies no longer fit into the new market opening scenario. "It was necessary to encourage Petrobras to compete with other companies, attract foreign investment, and encourage the construction of private refineries, export terminal, and pipelines in Brazil," says CBIE's Pires, noting that from 1998 to 2001, there was a transition phase in which the prices of all petroleum products were updated monthly, tracking the Persian Gulf oil price and the exchange rate. "It was pretty much the only time that Brazil followed the trends in the international market," he says.

NEW SCENARIO

Since 2002, the government, availing itself of the Petrobras refining monopoly, has had a policy of cushioning the effects of variation in international oil prices on domestic fuel prices. "Petrobras has operated taking into account the long-term evolution of prices, alternating between periods of gains and losses, keeping its cash flow balanced over time, and removing the perceived risk to shareholders," UFRJ's Colomer notes.

Until 2010, the oil price oscillations did not have much financial impact on Petrobras. Since then, however, the fuel market has become bipolar. On the demand side, the flex-fuel car fleet, growing thanks to tax incentives, has increased demand for fuels. On the supply side, fuel producers have not been able to respond to this growth in demand. Economic difficulties have affected investment and production of fuel ethanol, further swelling demand

for gasoline. The expected increase in fossil fuel production, however, was halted by Brazil's historic refining deficit. Colomer explains that "During the financial crisis of 2008, there were already some signs of trouble, but the alcohol sector managed to supply the market. In 2009, the downturn in economic activity reduced demand for fuels. However, with the beginnings of recovery in 2010 and a stronger economy in 2011, imports of gasoline increased significantly."

In this new scenario the gasoline trade balance moved from a surplus of US$1.8 billion in 2007 to a deficit of US$2.9 billion in 2012, and the diesel trade deficit widened from US$2.5 billion in 2011 to US$6.3 billion. "We have a structural problem with diesel, regardless of the international price; we have always imported this fuel. It is a peculiarity of our refining, which is not adapted to our demand profile and our transportation choices," Colomer believes.

Gradually, the policy of offsetting fuel prices has lost ground to a policy of mitigating the effect of the price changes on consumer price inflation. The difference between domestic gasoline and international fuel prices began to widen, directly undermining the Petrobras balance sheet. In 2012 the company reported a 14.15% decline in operating profit. The R$21.2 billion profit was the worst in eight years, down 36% from 2011.

INFLATION

According to Salomão Quadros, assistant superintendent, FGV Inflation, gasoline is one of the main items that influences the Consumer Price Index (IPCA), very close to household spending on electricity, medicines, and education. The last adjustment of 6.6% in refinery fuel prices reflected a 5% increase in retail prices, and about 0.19 percentage points in the IPCA. However, Quadros does not think the numbers justify government price controls: "These tricks are totally counterproductive. I am always in favor of a realistic approach. This type of micromanagement is also used to adjust the relative portion of anhydrous ethanol in gasoline. But it must be clear that if on one hand fuel is cheaper, on the other hand you are buying low-energy gasoline."

"The low price of gasoline may be a good buy for consumers but it says 'do not produce it' to producers."

Maurício Canêdo

Petrobras will have a difficult 2013. The recovery of the U.S. economy is likely to raise the price of oil above US$100 a barrel, which would widen the gap between international prices and Brazil's prices. That will also affect the company's cash flow, increasing its debt and risking the loss of its international investment grade rating. "The company operates with revenue far below potential. It is losing twice—by importing fuel at high prices and selling it domestically at lower prices," says Luiz Francisco Caetano, analyst at Planner brokerage. For 2014, the scenario is not

"If on one hand fuel is cheaper, on the other hand you are buying low-energy gasoline, a mixture of poor quality."

Salomão Quadros

very encouraging either, but the size and reputation of the company weigh in its favor, Caetano believes, so that Petrobras stock reacts quickly to any positive sign

With a management style that is far more pragmatic than her predecessor, Petrobras CEO Maria das Graças Foster has declared outright that the current fuel pricing policy is not sustainable, and that investment in refineries will resume only when Petrobras can afford it. The company projects that the current deficit of 300,000 barrels of gasoline and diesel a day will last at least until 2020, when new refining units come into operation. "Let's not forget that any investment in deep sea oil will require a payment of 30% from Petrobras," recalls the former minister Galvêas, crediting part of the problem to the new sharing contract model for oil exploration: "In the previous model, we attracted investments and technology, which allowed the first discoveries of deep sea oil. In the last five years, there has been no bid for new blocks, and oil production has stagnated at 2 million barrels a day. "

WHO PAYS THE BILL?

The private sector is not likely to invest in Petrobras projects, especially in refining. UFRJ's Colomer says, "There has to be at least a sign that the long-term trend of cash flow is positive"—rather than the current context of inflationary pressure and high taxes.

Pires of the CBIE identifies the issue as the fact that "there is no fuel price policy in Brazil." He believes the government's recent 5% increase in diesel prices, which made Petrobras shares rise, surprised the market—"and there is surprise only because there is no transparency," he says. Despite the adjustment, he estimates that the gasoline price is still 16% less than the international price and diesel is still 15% behind. Quadros agrees: "If the government is not letting the market set prices, and [is trying to] prevent transmission of the volatility of international prices to the economy, it is essential to set a clear rule." He calls attention to the fact that Petrobras regularly adjusts the prices of other petroleum products that have less weight on inflation, such as jet fuel.

The million-dollar question is: who pays the bill? The consumer? A new state fund? Petrobras? For Pires, the best alternative would be for the company to exercise its prerogative to set prices that it was given in 2002. An inferior alternative, he says, is for the government to recognize that Petrobras is losing money on the fuel it has to import and compensate the company. "It's still a bad choice, but better than the situation we have today," Pires says. IBRE's Canêdo adds that if the true costs were made explicit, "Brazilians will be able to evaluate whether it's appropriate to transfer billions of dollars a year to car owners."


Photo: Tânia Rêgo/Agencia Brasil

Maria das Graças Foster

Petrobras still committed to investment

The Brazilian Economy talks with Maria das Graças Foster, CEO of the state-owned oil company.

Solange Monteiro, Rio de Janeiro

THE MARKET HAS SEEN a downturn in Petrobras investments, reflected in the significant drop in the company's results. How do you expect to keep attracting investors and prove that Petrobras is viable?

We are not pulling out of investment. On the contrary, investments have been increasing: In 2012, they were US$42 billion, 16% more than in 2011. The Petrobras Business Plan for 2013 provides US$49 billion for investment. With regard to resources for investment, the viability of the Petrobras Business and Management Plan for 2012–16 will be guaranteed by cash flow from operations, borrowing US$80 billion, and selling US$15 billion in assets. Equally important to the viability of our business are management programs established in 2012: the Program of Operating Cost Optimization (Procop), which will potentially save US$16 billion by 2016; the Program for Increasing the Operational Efficiency of the Campos Basin (Proef), which seeks to ensure the reliability of our supply of peak oil through interventions and maintenance of oil rigs and undersea systems; and the Program of Logistics Infrastructure Optimization (Infralog), which will ensure integrated management of logistics projects for reducing the costs of investments that may save US$1.6 billion by 2016.

Brazil's current fuel pricing policy has been blamed for discouraging development of the market for hydrous ethanol. As indirect control of fuel prices continues, what can be done to stimulate the domestic market for ethanol?

The recent adjustment of gas prices and increase of alcohol added to gas from 20% to 25% last May has created conditions for making ethanol more competitive. For 2013, the outlook is for a bigger and better harvest of sugarcane and therefore lower costs, which will help improve sector competitiveness. The projected increase in the volume of ethanol in the Brazilian market is about 26 billion liters (6.9 billion U.S. gallons). The government is also working on new measures, more structuring, to improve the environment for investment in the sector.

Since 2009, Petrobras has been investing in ethanol production and plans for growth and investment in the sector through three affiliates, Guarani, New Frontier, and Total. In 2013, ethanol production is expected to increase by 28%. The goal is to produce 1.1 billion liters (0.3 billion U.S. gallons) in 2013, a significant jump from the 0.2 billion liters in the previous harvest. Petrobras continues to focus on efficiency and reducing production costs. It also invests in technologies to increase productivity from second-generation ethanol produced from sugarcane bagasse, which would increase production from the same planting acreage by 40%.