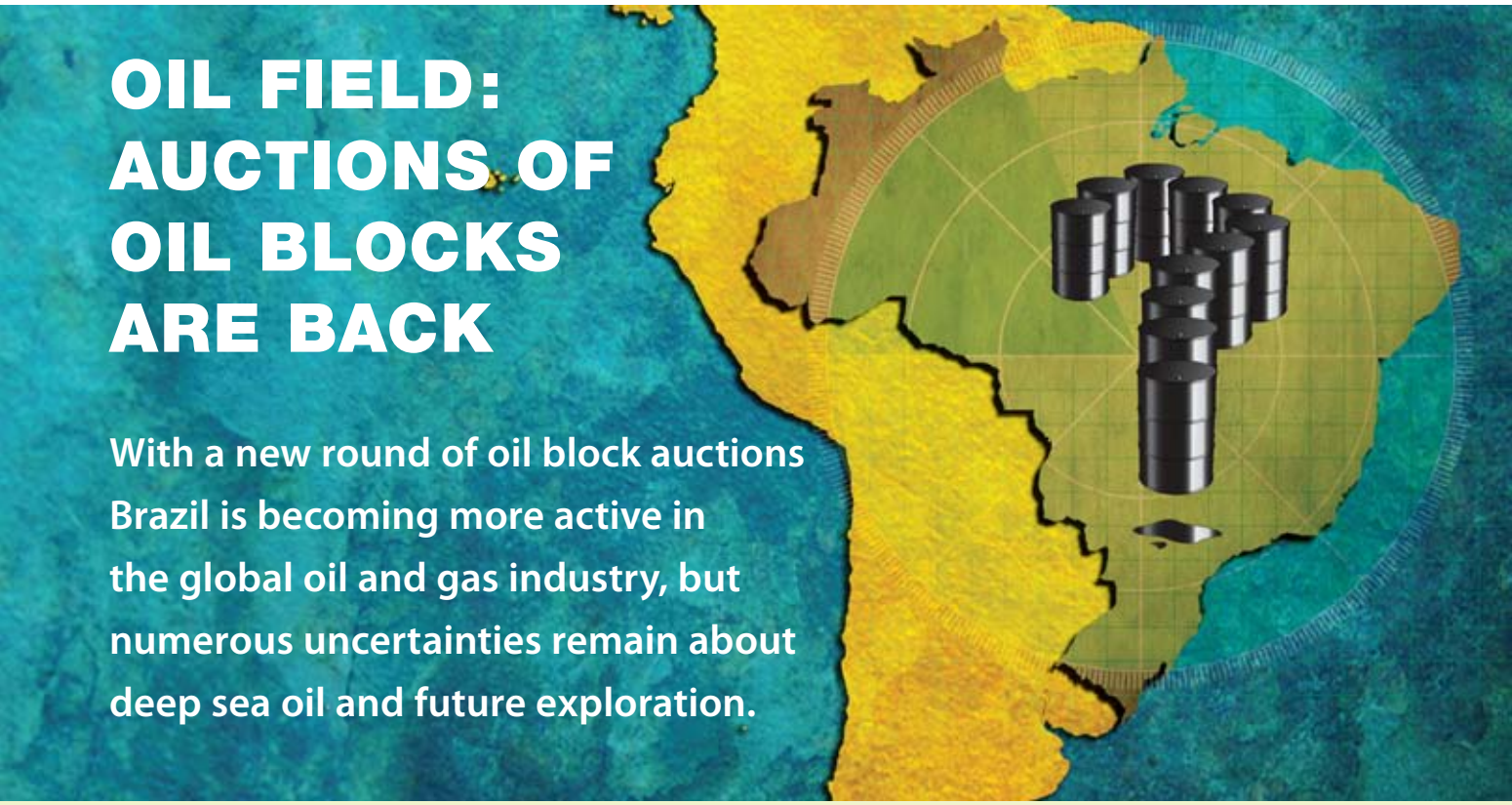


OIL FIELD: AUCTIONS OF OIL BLOCKS ARE BACK

With a new round of oil block auctions Brazil is becoming more active in the global oil and gas industry, but numerous uncertainties remain about deep sea oil and future exploration.

Solange Monteiro, *Rio de Janeiro*

THIS YEAR THE AUCTION OF oil blocks in May after four years of no activity brings Brazil back near the center of the global oil and gas industry. With 142 blocks purchased by 30 companies from 12 countries and record signature bonuses and investments, the auction suggests that oil exploration has excellent prospects in Brazil.

However, the expectations generated by the first auction of the deep sea oil blocks scheduled for October are stratospheric. Open for bidding will be the new jewel of the Brazilian oil industry, the Libra oil field—an area of 1,548 square kilometers (598 square miles) deep in the waters of the Santos Basin off the Rio de Janeiro coast. "Today Brazil's proven oil and gas reserves are 18.2 billion barrels of oil equivalent. In the Libra oil field alone the expectation is for another 8 to 12 billion barrels," says Clayton Pontes, general coordinator of oil and gas reserves, Ministry of Mines and Energy (MME). He notes that investment in oil exploration and production is expected to be US$162 billion for 2013–17, of which the state-owned Petrobras will be responsible for 81%.

Sharing doubts

These enormous projections are not enough to guarantee the success of the October auction because there are

PRODUCTION-SHARING CONTRACTS

Brazil has mandated production-sharing contracts (PSCs) for the deep sea oil and other strategic areas whereby oil companies (operators) are granted the rights to explore, develop, and produce oil at their own cost. The costs the operator incurs are later reimbursed by the government through an allowance referred to as "cost oil." The PSC stipulates a maximum percentage of total production that may be characterized as cost oil, although, if a development is successful, over the term of the contract the operator would expect to recover all of its costs. The oil remaining after deduction of cost oil is referred to as "profit oil." This is shared between the operator and the government in percentages stipulated in the PSC. For the deep sea Libra block, the government will receive a minimum of 40% of the oil revenues after oil costs. Moreover, the government may award PSCs to Petrobras as sole operator without holding a licensing round, and if it tenders blocks to other oil companies, Petrobras must be the operator, with a minimum 30% interest. Petrobras may bid alone or in a consortium to increase its participating interest beyond the minimum specified in the tender notice.

Bidders will specify a profit oil split, subject to the minimum percentage for the government specified in the tender notice. The operator or consortium that bids to give the biggest share to the government will be granted a PSC for that block. The tender notice may specify that this percentage will vary in relation to the economic efficiency, profitability, or volume of production or variations in the prices of oil and gas.

The operator will also be required to pay a signature bonus set by the government, royalties, and for onshore blocks, 1% of the value of production to landowners.

The attractiveness of this regime to independent oil companies will depend on a number of factors that are still unclear, such as maximum cost oil, minimum government share of profit oil and terms of the profit oil split, term of the PSCs (subject to a maximum of 35 years), the Petrobras share in the oil block, minimum exploration programs, and required signature bonuses and royalties.

The switch to PSCs was widely anticipated by the industry, but the preferential treatment of Petrobras came as a surprise, given that the current concessionary regime treats it like other companies. Its predominance may worry oilfield service companies and suppliers investing in the region, who would be increasingly dependent on a single major client. However, Petrobras already has a leading role in the Brazilian market because of its local knowledge and deepwater expertise, so many international oil companies may elect to work with it in any event.

serious doubts about the production-sharing contracts defined by law in 2010. "Starting this year, we will test the degree to which this type of production-sharing contract will attract private investors. Along the way, we will also test whether it will ensure good management of exploration and production activities," says Luiz Gustavo Kaercher Loureiro, law professor at the University of Brasilia

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Edmar de Almeida

(UNB). Loureiro highlights the centrality of Petrobras, which will hold at least 30% in all the production-sharing contracts besides being the sole operator in all contracts for deep sea oil. "The state deep sea oil company, PPSA, will also be quite powerful in terms of business decisions," Loureiro says.

MME's Pontes believes the production-sharing contracts ensure exploratory opportunities for a wide number of industries. But analysts and market participants argue that they increase insecurity, and the technical and economic parameters of the Libra block auction discourage competition. The signature bonus, set at US$7.5 billion, is considered too high. "The government has prioritized short-term tax revenues," says Edmar de Almeida, professor at the Economy Institute of the Federal University of Rio de Janeiro (UFRJ). He notes that unlike the concession agreement, in which the competition is focused on signature bonus offers, the production-sharing contract seeks the highest return, with the government's minimum share at 40%. However, with high signature bonuses, "companies that do not have cash now will be out of the game and we will have less competition; as a result, the production and government's share may also be lower," he says.

Surplus

Almeida also points out two constraints for companies: setting the price at US$105 per barrel of crude oil for calculating the minimum value of oil revenues transfers the risk of changes in oil prices to companies, and ceilings for recovery of costs are set at 50% of the gross value of production in the first two years and 30% thereafter. "We're talking about a large investment—the Libra field is the size of a country—and it is clear that fixing a ceiling for revenue will lengthen the time to recover investment," he says.

He also is concerned about the policy of hiring staff and buying parts locally, commenting that there is a need to be more realistic about the capacity of Brazilian industry. "We cannot turn an opportunity into a problem," says Almeida, noting that the local staff and parts policy has resulted in production delays on existing commitments. He argues that an appropriate policy must permit progressive specialization in products and services in which the country has a comparative advantage.