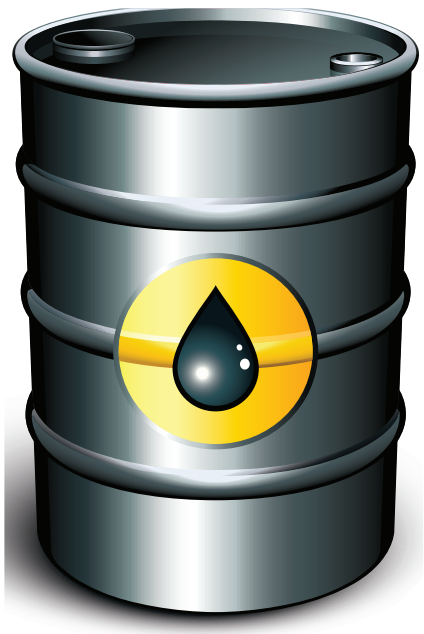
# Price controls and deep-sea oil

**Wagner Freire**
Engineer and FGV Energy consultant



THE UPSTREAM SEGMENT of the oil industry developed remarkably in the 1960s, thanks to oil company investments in the North Sea and the Gulf of Mexico. That brought about extraordinary technological innovations and changes in the operations of companies that partnered to search for better technologies, cost savings, and reduction of exploration risks. In Brazil, with the breaking of the monopoly of state-oil company Petrobras, passage of the Petroleum Law (Law 9478 of 1998), and creation of the National Petroleum Agency (ANP), the ANP in 2000 launched the first round of bids for oil blocks, which attracted a large number of international and national companies.

The Petroleum Law created an additional tax called the Special Participation, which applies to fields with high production and high productivity. Ultimately special participation revenue reached levels similar to royalties. When significant discoveries were made in 2005 and 2008 in several blocks in the Santos Basin (often referred to as pre-salt, but also known as deep-sea oil), the Lula administration, in our view, moved hastily. The result was a series of measures approved by Congress in 2010. Among them were definition of an area of 149 square kilometers (58 square miles) of pre-salt oil reserves from the coast of São Paulo state to Espírito Santo state; changes in how oil exploration is regulated by replacing concession agreements with production-sharing agreements for oil exploration in pre-salt blocks only; and a special exploration contract that can only be granted to Petrobras, in violation of constitutional provisions, on pre-salt blocks chosen by Petrobras, against prompt payment to the federal government of the equivalent present value of the oil to come.

The new laws limited the association of Petrobras with other companies. In a way, that

was a concealed ploy to reinstate the Petrobras oil exploration monopoly. When the government then exempted the special exploration contract from the special participation tax, the State of Rio de Janeiro filed suit in the Supreme Court against this decision; that suit is still in the trial process. The new measures also prevent oil companies from selling any of their rights in the blocks to other companies, as happens often with concession agreements. However, Petrobras, which owns several pre-salt blocks, can sell part of its interests in these blocks, to its economic advantage.

Another serious problem is that the oil market is pegged to international prices of Brent crude oil. Since the Brazilian market for petroleum products is not competitive, it used to be regulated by ordinance MME-MF 03/27/07/98, which indexed prices of petroleum products produced or imported by Brazil to the average prices of the Gulf of Mexico market, which is very competitive. The ordinance, however, expired in 2002. Thereafter, the government, with clear political motivation, started to control the prices that oil companies could ask. This forced Petrobras to keep domestic oil product prices below prices on the international market, which greatly undermined its financial situation and performance. It is time for a new ordinance, similar to that of 1988, that can ensure the solvency of oil companies and establish principles to discipline oil product pricing policy.

In late April of 2015, the global corporate market was surprised by Shell's decision to purchase British Gas (BG) for US$70 billion. This decision, which was widely reported, has major implications for the Brazilian market, Petrobras, and many companies investing in Brazil. As is widely known, Petrobras, Shell, BG, and many other companies hold stakes in Santos pre-salt blocks, some of which are already producing oil. This opens up enormous potential for companies to buy and sell interests and associate in joint ventures; that would create opportunities for investment that has great potential for technological advances and innovations and will undoubtedly increase the production potential of the area. Currently, only two fields are pumping Santos pre-salt oil: Lula, which produced 299,000 barrels of oil equivalent per day last December, and Sapinhoá, which produced 180,000 barrels. At the time Brazil's total oil production was 3 million barrels per day. Thus, pre-salt oil fields were already accounting for almost 15% of the country's production.

**It is time for a new ordinance, similar to that of 1988, that can ensure the solvency of oil companies and establish principles to discipline oil product pricing policy.**

Our survey of Brazil's oil sector suggests that not only does Petrobras have significant rights, but that, once properly regulated, markets will provide adequate support for investments. Regulation is particularly important because the ANP is scheduled to open the 13th bidding of oil blocks on October 7, 2015, although this round does not include pre-salt blocks.