Recent developments and financing outlook in the Brazilian upstream oil and gas sector

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**Background**

The upstream oil and gas industry in Brazil was opened to private companies in 1997, when Law 9478, the ‘Oil Act’ was published. Until then, the Federal Government exercised its monopoly in the upstream sector by means of Petróleo Brasileiro – Petrobras, the Brazilian national oil company.

The Oil Act created the Brazilian Oil Agency (ANP) as the regulatory body responsible for the supervision and regulation of oil and gas activities and established that the exploration and production activities would be performed under concession agreements, granted after public biddings open for Petrobras and private companies alike. The Brazilian concession agreement is a tax and royalty agreement, where the concessionaire takes the exploratory risk, is responsible for the exploration and production activities and receives full ownership of the oil produced subject to the financial payment of taxes and royalties (government take), being able to use the oil as it seems best – including exporting.

Following publication of the Oil Act, in 1998, Petrobras’ rights over existing areas were recognised by means of the so-called “Round 0” of concessions. In 1999, ANP held Round 1, which corresponded to the actual opening of the market, with 11 oil companies obtaining concession agreements. From 1999 to 2008, ANP promoted 10 yearly concession rounds.

The concession model proved to be very successful. According to the 2012 BP Statistical Review of World Energy, since 2001, Brazilian oil production increased from approximately 1.3 million barrels a day to 2.2 million barrels a day in 2011, while the gas production increased from approximately 1.3 million barrels a day to 16.7 billion m³, which means that the national production has practically doubled in one decade.

**Early capital sources for Petrobras**

As a result of the opening of the market, Petrobras needed resources to further explore and develop its fields – including in order to meet minimum investment obligations assumed in Round 0 – and to participate in the following Rounds, now competing with other oil companies. It is important to highlight that, despite Petrobras being controlled by the Brazilian Government, except as expressly provided by law, it is subject to the same legal regime applicable to private companies.

To obtain the abovementioned resources, Petrobras (i) sought partners for the exploration and development of its concessions, by means of farm-out agreements and (ii) used project financing structures to raise capital, among which we highlight the complex structure of the Marlim Field, currently the third largest oil producing field in Brazil, having produced 187,000 barrels of oil equivalent per day (boe/d) in February 2013, according to ANP’s measurement data of February 2013.

Farm-out transactions are equivalent to a sale of participation interest in areas that are already under concession agreements. One of the advantages of farm-out transactions is that they are usually fast and confidential, having as an immediate consequence the reduction of the concessionaire’s commitments with exploration and development activities. For this reason, farm-out transactions have been – and still are – a highly adopted fund raising option for oil companies.

In addition to farm-out transactions, Petrobras also sought funds by means of project finance transactions. Project finance transactions have become increasingly relevant as a financing tool in Brazil after the macroeconomic reforms in the mid-1990s, which resulted in a victory over hyperinflation and the adoption of stable regulatory regimes – such as oil and gas – and foreign exchange policies.

Project finance of its investments became an attractive tool for Petrobras at the time for various reasons. At the time, Petrobras was facing low oil prices ($9.20 brent barrel, on December 11 1998), which resulted in reduced cash to develop its activities and had its ability to raise capital using debt instruments limited by restrictions to public indebtedness resulting from agreements with the International Monetary Fund. Additionally, Petrobras could not count on any funds from the Federal Government’s budget. These factors required an off-balance, off-budget structure, so that neither Petrobras’ leverage ratio nor the Brazilian Government’s public debt limit were affected. Furthermore, due to strategic considerations, Petrobras was unwilling to farm-out any participating interest in the Marlim field or to allow lenders to have any claim over the field or rights connected with it.

Such challenges were the drivers behind the complex financial engineering and avant-garde contractual agreements in the Marlim project, the first project finance in the Brazilian oil industry. Its key aspect was the creation of a joint venture, with no interest in the concession, between Petrobras and a SPC owned by equity investors in the project. The SPC was responsible for raising debt to pay for assets to be used in the Marlim field. As consideration for such, the SPC received up to 30% of the field’s revenues, calculated in accordance with certain criteria. The Marlim project resulted in investments of approximately $2.4 billion in equity, quasi-equity and debt instruments, and was extremely successful and beneficial for all parties involved.

**The pre-salt and the resulting legal changes**

In June 2006, Petrobras discovered major oil and gas reservoirs located under a thick salt layer at the Santos Basin. These areas were then called the “pre-salt”. It is estimated that the pre-salt areas run for about 800km along the Brazilian Southeast coast, with an area of approximately 149,000km², of which 41,772km² are already under concession agreements. The exploration of the
the payment of R $74.8 billion ($37.3 billion). The direct grant was created as a means to capitalise Petrobras so that it can obtain funds to develop its pre-salt fields. Given that Petrobras had a high debt to equity ratio and did not have enough cash generation to finance its activities by itself, an equity contribution was the alternative sought. However, the Federal Government was not willing to make a huge equity contribution to Petrobras in cash, given budgetary constraints. For these reasons, the granting of oil rights was implemented as part of a primary public offering of shares to raise R$120.2 billion (originally R$115.1 billion). As a result of the offering, the Federal Government contributed R$12.3 billion in cash and R$67.8 billion in government bonds, while other shareholders contributed R$35 billion in cash. Immediately following this, Petrobras used the government bonds plus R$7 billion in cash to pay for the oil rights. Thus, as a result of the offering, Petrobras obtained R$45.4 billion in net cash and the rights to explore and produce up to 5 billion boe in certain pre-salt areas.

It is noteworthy that, under the direct grant contract, Petrobras commits to implement a minimum exploratory program that will require substantial capital expenditures. The public offering is intended to partially fund these expenditures while, at the same time, improving the debt to equity ratio and creating room for incurring into additional indebtedness to finance these investments.

**Local content requirements and impacts in the offshore industry**

One of the main features of the Brazilian oil and gas sector is the local content requirement. Local content corresponds to obligations of the oil companies both to give preference to Brazilian suppliers and to reach a minimum percentage of its total exploration and development expenditures that is purchased from Brazilian suppliers. The purpose of this policy is to increase the participation of the Brazilian industry of goods and services, on a competitive basis, in oil projects. As the policy does not intend to benefit inefficient local companies at the expense of efficient foreign companies (as this would reduce the attractiveness of oil operations in Brazil), the concession agreements require that Brazilian suppliers and service providers are given preference only when their price, delivery timeframe and quality are equivalent to foreign companies invited to submit proposals.

The applicable minimum percentages are defined in connection with the original bid for the area. A local content commitment is part of the bid submitted for the block and corresponds to a portion (in the 11th Round, 20%) of the total points a bidding company can achieve. ANP establishes minimum and maximum percentages that oil companies must take into account when preparing their bids, but the final decision is made by the bidding company. Non-compliance with the local content commitment may result in the application of fines by ANP.

The local content policy exists since Round 0. However, in 2005 (Round 7), ANP introduced a relevant change regarding the requirements to evidence compliance with the local content commitment. In concessions prior to 2005,
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offshore oil assets such as supply boats and oil platforms. Other large projects are expected in the offshore supply industry, involving this project will require at least $20 billion in investments over a 10-year period, industry and has acted as a driver for the re-birth of the local shipbuilding industry. According to its 2013-2017 Investment Plan, Petrobras plans to invest $147.5 billion in exploration and production activities, including investments to increase its fleet of offshore oil assets, focusing on vessels able to operate in the pre-salt layer. It is expected that offshore services companies with high local content indexes will have an advantage in securing charter and services contracts with oil concessionaires.

In this context, to meet local content requirements in the construction of drilling rigs, Petrobras, pension funds, local banks and international funds incorporated Sete Brasil, to build and operate at least 28 ultra-deep water drilling rigs, in partnership with various Brazilian and international drilling contractors. This project will require at least $20 billion in investments over a 10-year period, being the largest exploration expenditure program currently developed by Petrobras. Other large projects are expected in the offshore supply industry, involving offshore oil assets such as supply boats and oil platforms.

Outlook: reserve based lending and other project finance structures likely to increase
After almost five years since the last bidding round promoted (Round 10, in 2008), the Federal Government announced three bidding rounds for 2013. Round 11 of concessions (that does not include pre-salt blocks) began in January 2013 and the bid is scheduled to occur in mid-May. The first pre-salt round is expected for November and a special round focused on areas with possible accumulations of unconventional resources is expected to occur in December. The resumption of bidding rounds has attracted more than 70 oil companies to Round 11 and various other companies and investors aiming at the business opportunities in the oil and gas offshore supply chain.

Activities in the pre-salt areas will require large sums of capital and are likely to impact Petrobras in particular, given that will be the sole operator and have at least a 30% participation in pre-salt blocks to be awarded under production sharing agreements. Accordingly, the early 2000’s trend may repeat itself and Petrobras may require its partners to “carry” Petrobras’ investments in the exploration phase. This practice will transfer the financial pressure from Petrobras to its private partners, which will need to seek innovative sources of capital.

In this scenario, private companies with producing fields may use reserve based lending (RBL) structures to “recycle” its capital invested in producing projects to invest in exploration projects. Although more common in the United States, where ownership over the land also grants ownership over the underlying oil reserves in the most relevant oil producing states, RBL and other oil producing financing structures are also possible in Brazil, where ownership of oil by the concessionaire begins only after its extraction. Early innovative structures – such as the Marlim field financing – may be revisited and updated by lenders and oil companies seeking this financing alternative still underused in Brazil.

In parallel, the demand for offshore oil assets and the construction of new shipyards to serve this demand is also a strong driver for project financing transactions. In this sense, not only banking but also project bonds transactions have been used by offshore drilling contractors to raise funds backed by operating drilling assets chartered to Petrobras. New off-balance projects sponsored by oil companies, such as Sete Brasil, may involve the construction of oil platforms (FPSOs, FSOs), support vessels and other offshore oil equipment.

Finally, shale gas reservoirs are a business opportunity largely unexplored in Brazil, which, according to the International Energy Agency, may have the 10th largest reserve in the world. Inspired by the gas monetisation strategy used by the EBX group in the Northeast of Brazil, which is building the largest gas-fired thermoelectric complex in Latin America close to its onshore gas reserves under development, ANP has signaled that it will take into account and make available the location of power transmission lines when offering onshore areas with gas potential.

The Brazilian oil and gas sector has shown less activity than expected during the past five years, given the suspension of bidding rounds by the Brazilian Government. This scenario is expected to change in 2013 as a result of the resumption of bidding rounds for concessions, the announcement of the first bidding round for pre-salt areas and the technological development for the exploration of unconventional resources, such as shale gas. Large investments and financings of oil companies’ and offshore contractors’ are underway and more are expected in the years to come.

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