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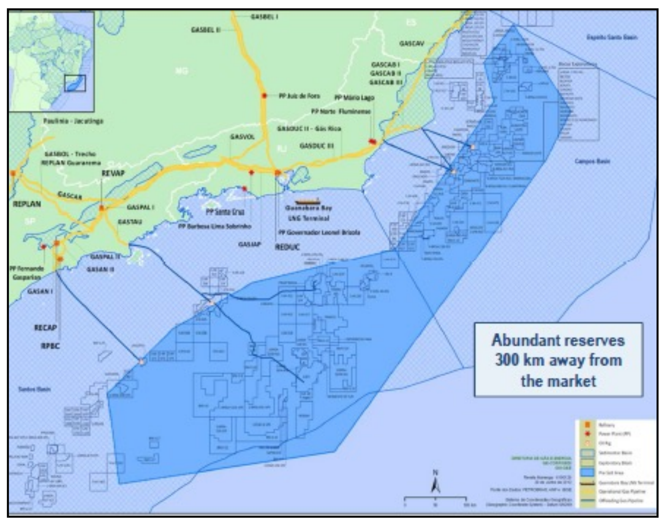
Brazil Oil and Gas – Where Next?

In parallel with the unfolding political and economic crisis in Brazil, the oil and gas industry, which traditionally is dominated by the state controlled Petrobras, finds itself confronted by a series of unprecedented internal and external challenges. Collectively, the industry continues to grapple with the harsh realities of a deteriorating macro-environment: declining exchange rates, lower oil price and waning investor confidence. At the same time Petrobras is being rocked by a devastating corruption scandal, struggling to service the world' largest corporate debt and remains handicapped by the continued interference and ideological constraints from its main shareholder, the Brazilian government. In the industry shake-out that is underway, Petrobras is forced into a major sell-off, shrinking in size and influence. A new structure will emerge that in time no-longer depends solely on Petrobras as the main driver of the industry. How this process might evolve and how to fill the vacuum left by Petrobras are the key issues addressed in this article.

There is no alternative…

In 2008 the huge discoveries in the Brazilian pre-salt were supposed to catapult Brazil into the top six countries in oil production by 2030 and establish an important new stable non-OPEC supply. So far, Brazil is producing around 2.1 million barrels per day of oil; a third of its ambitious target and growth is stalled. Meanwhile the industry has become a hostage to a devastating crisis in state-controlled Petrobras, increasingly subjected to political intervention and the victim of a deep-rooted corruption scandal that led to US$17 billion of write downs in April. Due to many factors, including the world's largest corporate debt, it is currently suffering a major financial melt-down and the repercussions are being felt throughout the whole Brazilian economy, which is expected to contract by more than three percent this year. Moreover, the development of the vast pre-salt resources is now under serious threat of ever reaching full potential. The Brazilian oil and gas industry thus finds itself at a watershed and faces monumental challenges. Business as usual is no longer a viable option.



Brazilian Campos and Santos Basin Oil Fields

A new agenda is required

As the crisis continues to unravel, it is widening into the political arena. New scandals involving the Brazilian political and business elite continue to grab the daily headlines. Insiders are still predicting worse to come. While the fall-out is spreading, paralysis is setting-in among policy makers, who appear more concerned about self-preservation than addressing the key issues. Leadership is lacking, as is the vision and readiness to see beyond the current upheaval. Whereas, more than ever it is necessary to take the long view and bring some insight into how the industry might be positively reshaped by the present crisis. If nobody rises to the challenge, then the set of circumstances will continue to spiral downwards.

The answers should be clear; a new competitive industry framework needs to evolve, in which Petrobras is allowed to operate commercially in the interest of all its shareholders, free from unwanted government interference. Brazil also needs to attract strong operating and capital partners to efficiently exploit its ample resources and to occupy the vacuum left by Petrobras. And so the extent to which Petrobras and its political masters are willing and able to relinquish control, together with the success in encouraging new players to participate will become the critical success factors going forward. Petrobras will lose much of its market clout in the process and will undoubtedly experience a painful adjustment as its influence declines. We ask how much worse the situation has to get; and more importantly will Brazil's political ideology ever allow such a transformation? Sadly history has no good precedents for this….

The seeds of disaster

Most of those that bet in recent years on Brazil as the largest and most significant new oil-and-gas prospect of the last few decades are waking-up with sizeable hangovers. The seeds of today's crisis were sown back in 2008, when many were hypnotised by the frenzy surrounding the discovery of the pre-salt and the emergence of the BRICS as the new engine of the world economy. Over-optimistic plans, based upon the government agenda and unrealistic premises left Petrobras shackled to unachievable targets and one of the world's most ambitious capital programs. In this process, Petrobras became highly leveraged and unwittingly exposed to any deterioration in external drivers of value – oil price, foreign exchange and Brazil risk. At the same time, zero interest rates in the U.S. prompted investors to look to emerging markets for higher yields, providing dollar-denominated debt to companies like Petrobras. As a result of this irrational exuberance, Petrobras is now struggling to service a colossal US$124 billion total debt load, with about seventy per cent (over US$90 billion) of that dollar-denominated. Borrowing in dollars and paying in Brazilian reals was not a problem until the recent collapse in foreign exchange rates. This in turn has led downgrading of Petrobras debt to junk and is raising serious questions about a potential default. The negative effect on Petrobras, as the cost of servicing the company's debt goes higher, is increasing pressure to divert funds from operations in order to cover its rising interest payments and to reduce its capital spending.

Petrobras Debt

Indebtedness (R$ Billion)	06/30/2015	12/31/2014
Short-term Debt	44,7	31.6
Long-term Debt	370.9	319.5
Total Indebtedness	415.5	351.0
(-) Cash and Cash Equivalents [1]	91.6	68.9
= Net Debt	324.0	282.1
Indebtedness (US$ Billion)		
Net Debt	104.4	106.2

1) Includes government securities and time deposits (maturity longer than 90 days)
Note: Short-term debt include current portion of long term debt

The CEO's Agenda

Few Brazilians appear to appreciate that Petrobras is in such a desperate battle for survival and continues to be a victim of ill-conceived government policies. Meanwhile, the situation is worsening, impacted by the effects of a politically motivated strike and a collapsing share price in recent weeks.

There can be no doubts about the extreme challenges facing the new Petrobras CEO, Aldemir Bendine, who arrived from Banco do Brasil back in February 2015. Not an oil industry insider, Bendine has rightly focused on Petrobras financial re-structuring. At the moment his overriding aim appears to be to stop the bleeding. The key effort is therefore on deleveraging the company, together with a singular focus on pre-salt projects and maintenance only or divestment in all other areas.

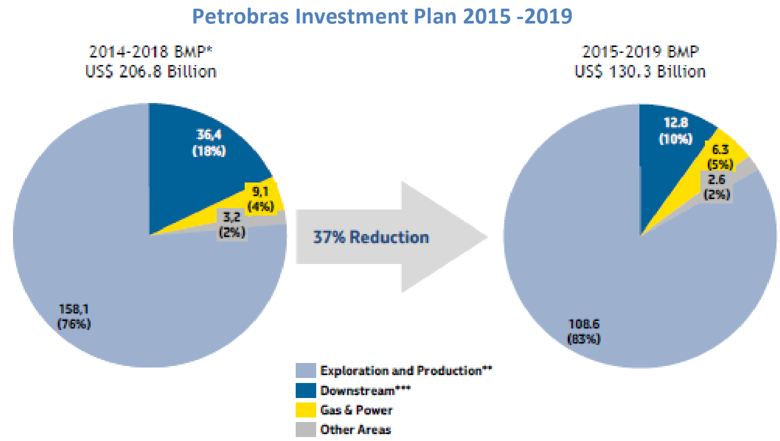
Key Strategic Aims - Petrobras Business Plan 2015 - 2019

Deleverage		Generate Value for Shareholders	
Capital discipline Strengthening of performance management		Focus on profitability	
By 2018	▪ Net Leverage below 40% ▪ Net Debt / EBITDA below 3.0x	E&P	Prioritization of oil production projects in Brazil, focusing on the pre-salt
By 2020	▪ Net Leverage below 35% ▪ Net Debt / EBITDA below 2.5x	Downstream, G&P and Other Areas	Maintenance of Operations

Bendine has set a time horizon of five-years to get Petrobras “back on track.” One can only hope for everybody’s sake that it will be a leaner, fitter, more focused and de-politicized Petrobras more able to compete in the real world that emerges beyond 2020.

The axe man cometh

Petrobras is working hard on its cost base. It has slashed its five-year capital spending by forty percent and has been cancelling drilling and shipping contracts with upstream suppliers, such as Sete Brasil and Vantage Drilling, among many cost cutting measures.



At the same time, the most significant casualties of the capital expenditure cuts were in loss-making refining. Dramatic capex reductions in the downstream and gas are an essential part of refocusing the core business towards E&P investments and the pre-salt. Meanwhile, in the downstream and gas sectors the key challenges remain the ability to provide sufficient investment to supply essential market needs and to sustain asset integrity, without creating un-necessary additional HSE and operational risks. There will be little or no capex to accommodate future expansion of infrastructure and demand growth in these sectors, effectively putting the brake on any development while still controlled by Petrobras.

Pressure on budgets remains intense. Within three months of issuing its 2015 to 2019 business plan, Petrobras made extra cuts of US$11 billion in capital spending plans for 2015 and 2016 in response to the slump in Brazil's currency and oil prices. A month later, following losses of US$ 1 billion in the third quarter, Petrobras are again revising investment targets downward a further US$ 3 billion. The company also plans to spend US$7 billion less in total costs and expenses for 2015 and 2016. Not only are these prudent steps given the current oil price and that the global economy is showing signs of a prolonged slow-down, but are forced measures imposed by Petrobras’ weakening financial condition. If sub-US$50 per barrel oil prices are here to stay, then, at minimum, stagnant revenue and earnings growth are on the cards regardless of the company's cost-cutting measures.

At the same time, production decline from existing fields is a huge challenge with around 200,000 barrels per day of capacity eroded each year. Hence another critical task is to postpone the falling production from mature fields in an environment of investment shortage. Concerns are now mounting that the cuts are becoming so deep that there will even be insufficient capital to maintain production growth. Should this pass the tipping point and production start to decline overall, it will only intensify the current financial crisis.

Unwelcome repercussions

If the situation was not bad enough already, Petrobras recently experienced the crippling effects of one of the worst strikes in the last 20 years. The twenty-day protest strike coordinated by oil workers' unions knocked around 270,000 barrels per day from Brazilian oil output. The main demand of the union was nothing less than halting the divestment plans, a critical factor for the company's financial recovery and non-negotiable for the management. Although the unions agreed to go back to work, it signals that Petrobras will continue to face resistance among its workers, adding further complications to the current chaos. Moreover, now production has been halted, it will take some months to bring production back to the levels of before the strike. As a result Petrobras shares, listed on the New York Stock Exchange are continuing their slide, falling a stark fifty-four percent over the past twelve months.

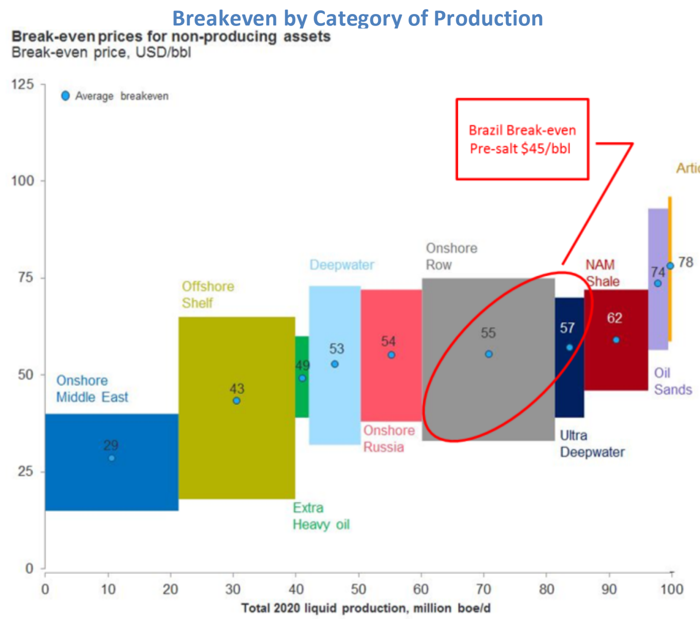
Damaging fuel subsidies

In addition, another major hurdle imposed by government has led to sustained losses for Petrobras. As part of the government’s measures to control inflation in recent years, it has limited the ability of Petrobras to increase fuel prices in the domestic market in line with international price movements. This indirect subsidy is estimated to have cost Petrobras over US$40 billion during the period 2010 to 2014; an even greater financial impact than the corruption scandal.

One positive outcome is that during 2015 fuel import costs have fallen, along with the price of gasoline and diesel in world markets, bringing import costs in line with domestic prices. Recently Petrobras has been given enough room by the Dilma administration to push through new fuel price increases in the domestic market against public sentiment. For the time being this avoids further value destruction in Petrobras, but a delicate balance must be maintained. Recent unofficial strikes by truck drivers protesting against high fuel prices are putting pressure back on the government.

At the same time, with few options left, Petrobras management are lobbying for new fuel price increases, as a way to improve profitability, but are meeting strong resistance from the government concerned about the inflationary impact.

Other oil price dilemmas



With oil prices today close to the break-even of much of the prize pre-salt resources, we are at levels where new deep-water drilling is no longer viable. This presents a serious risk to new projects. One or two year delays are now the norm for the pre-salt projects, as part of the greater capital discipline and cost cutting. Even so, Petrobras' ability to pull through its current predicament and generate future shareholder value in the medium to long-term will be critically dependent upon whether low oil prices are the new normal or the forward curve for oil price will establish a floor at above $ 70 per barrel, as some have predicted. Only in this latter scenario would there be a sustainable platform for Petrobras profitability.

The 'Big One'

Against this background the next significant stage of development is the largest project in the pre-salt layer, the giant Libra field. It is believed to contain between 8 billion and 12 billion barrels of oil. The estimated investment is equally huge; as much as US$400 billion over a thirty-five year life of the field. Petrobras and the government did well to attract solid international partners to the project in its 2013 auction: Shell, Total, China National Petroleum Corporation (CNPC) and China National Offshore Oil Corporation (CNOOC). It is also a key test of the government's new production sharing contract model, in which Petrobras automatically becomes operator of pre-salt projects. Paradoxically, with Petrobras under increasing financial pressure creating delays and placing even greater constraints on capital spending, its non-operating partners are probably in the best position to help. In turn the partners are lobbying for changes in the participation model. However, until now the politicians have been unwilling to shift their position and seek greater involvement of foreign oil companies, sticking to their nationalist rhetoric, with populist slogans such as: *the oil is ours.* If this attitude does not change then it will almost certainly limit future growth in the pre-salt.

And the 'Big Bet'

Shell's acquisition of the BG Group hinges around reserve replacement for Shell and BG's principal assets in the pre-salt. BG's Brazilian portfolio was set to become a key growth driver for Shell globally. Should the deal complete as anticipated in early 2016 it makes Shell by far the largest foreign investor in Brazil's oil and gas sector. However, by increasing its exposure to Petrobras, while it is encountering serious difficulty maintaining its pace of investments in the pre-salt, Shell is facing a substantial risk of under-delivery on the deal. Moreover, in an environment where Shell has trimmed its capital expenditure this year considerably and expects low oil prices could last several years, current events could force it to scale-back significantly on its Brazilian investments. Even so, it will probably not prevent consummation of the BG transaction. At the same time, the

Brazilian authorities should be wary of losing already committed partners, such as Shell. Attracting new players will be even tougher.

Supply chain hardest hit

The oil services sector has been hit hard, shrinking by around forty percent since the peak in 2012. Many contractors are implicated in the payment of bribes to Petrobras executives, government officials and political parties, while others have suffered from a slow-down in Petrobras orders and payments. It is therefore in a precarious financial position. In the current market climate we expect to see a continued decline in oilfield service purchases through 2017. Any recovery post 2017 will be critically dependent upon the next stage of project development and whether further postponement of projects like Libra occurs. While this is looking increasingly likely, the only possible light at the end of the tunnel depends upon a rebound in oil prices.

It is proving difficult for operators to comply with local content rules that require a minimum percentage of goods and services to be acquired from Brazilian sources. These rules have become progressively more prescriptive and bureaucratic over the years; and impose significant fines for failure to achieve local content commitments. On the other hand, the fragile home-grown supplier base, incentivised through these local content rules, is already uncompetitive due to the high *Brazil cost,* and is unlikely to survive intact. The consensus is that more flexible rules must be created that a tough dose of realism is need if the authorities are to maintain a regulatory environment which is competitive when Brazil is being considered as an investment destination.

Failure to launch

A prime example that the Brazilian authorities are out of touch, came with Brazil's 13th exploration round in October. In the current weak and uncertain environment it was impossible to generate any enthusiasm for the bid round, which predictably fell significantly short of expectations. Of 266 blocks on offer only 37 received bids and will be licensed. Petrobras, mired in crisis, and traditionally the largest bidder decided not to take part. This failure only served to underline the malaise in Brazil's once promising oil and gas industry.

In contrast, when the oil price was higher than US$100 per barrel, many Brazilian investors with limited oil and gas experience were entering the small onshore sector, which represents about ten per cent of production. Many of these undercapitalized investors are today suffering losses and looking to exit. Meanwhile, the midcap independent segment has been decimated by the high profile bankruptcy of Eike Batista's OGX and the weak performance of HRT, the two erstwhile national champions. In addition, Petrobras has an aggressive plan to reduce its exposure to small and mid-size fields and focus on pre-salt projects. With the low oil price there are good opportunities to pick-up an attractive portfolio from these distressed assets for those willing to take a risk.

Brazil for sale

At the same time, the Petrobras board is concentrating on the most immediate solutions to deleverage the company via asset sales for cash, as an essential part of its funding plans. J.P. Morgan estimates that Petrobras needs US$79 billion in 2016-2019, with US$6 billion on demand, as soon as next year and another US$16 billion for 2017.

However, current market conditions are not conducive to disposals and consequently it has only managed to divest US$700 million in 2015. Nonetheless, Petrobras is sticking to its earlier divestment target of US$15.1 billion overall in 2015 to 2016 and intends. Despite this, its plans are continually being pushed back. The sale of TAG, the gas transmission pipeline company and BR Distribuidora, the marketing and distribution company, both failed to get traction in 2015. Among the challenges are unbundling assets from Petrobras' holding company, which initially restricts divestments to businesses that can be easily separated and put up for sale.

Petrobras thus faces a serious dilemma, as it wants to avoid further borrowing, but cannot dispose of assets at an acceptable price in such weak market conditions. In more normal circumstances Petrobras could slow things down or even hold on for a better moment, but has little room for manoeuvre. As oil prices have continued to languish and the real weakens further, many of the price and asset-sale assumptions of its plan are already out of date.

Among current plans is the divestment of a 25 to 40 percent stake in BR Distribuidora; and although Petrobras initially considered an IPO, it now plans to build "strategic partnerships." Debatably, the sale of a minority stake with limited governance rights has very limited attractiveness to potential investors. Such a strategy is expected to create little value for Petrobras and the strategic investor, as it restricts the freedom for an acquirer to design and deliver a full restructuring plan. An alternative approach accruing governance rights would attract attention from more investors and generate greater value for Petrobras, but threatens political repercussions. Thus Petrobras continues to wrestle within a political straight-jacket, testing alternatives in a drawn-out process of trial and error.

The long-term solution to attract capital partners to many of the businesses, given perceived risks needs to be more thought through. A divestment strategy must be appealing for investors and be accompanied by a regulatory regime and governance, which create a healthy and competitive landscape. Meanwhile, Petrobras continue to impose conditions such as: dependency on Petrobras value chain; and a minority sale only and given the resultant risks, it will continue to experience problems in interesting investors.

There is an opportunity for new midstream entrants in certain areas to undertake traditional Petrobras roles, such as gas transmission pipelines and oil products storage distribution. However, Petrobras and the government are struggling to find suitable business models to replace the current Petrobras quasi-monopoly and have publicly stated they do not wish to replace the current situation with a 'private monopoly.' Unless a more strategic view of divestment develops then in all likelihood Petrobras divestment will continue to disappoint.

A murky picture

In addition to facing roadblocks in the form of various internal and macroeconomic headwinds, Petrobras is grappling with a mass of problems imposed by its principal shareholder and backlash by the unions. Investor confidence is at an all-time low. However, what really worries the company is the apparent lack of any perspectives on recovery. The absence of a well-articulated vision and a clear path forward is arguably the biggest barrier to progress. In essence Petrobras are running out of ideas and cannot see a way forward to pay back the debt. Privatisation of Petrobras also remains the bête-noire of the left-wing government politicians. Here we anticipate that there will be continuing conflict between ideological and pragmatic. It also poses a key question, if earnings fall short and the mountain of debt becomes overwhelming; will the treasury step-in to underwrite Petrobras?

We see two alternative scenarios developing:

Slice at a time

In the first, Petrobras muddles through and is successful in selling-off slices of its business to meet the majority of its funding commitments. This requires a more enlightened political environment, in which politicians understand there is no alternative and are prepared to oversee a sell-off of substantial Petrobras asset portfolio. As this process evolves it progressively moves towards the sale prize pre-salt asset and opens-up a more competitive market with broad based international participation.

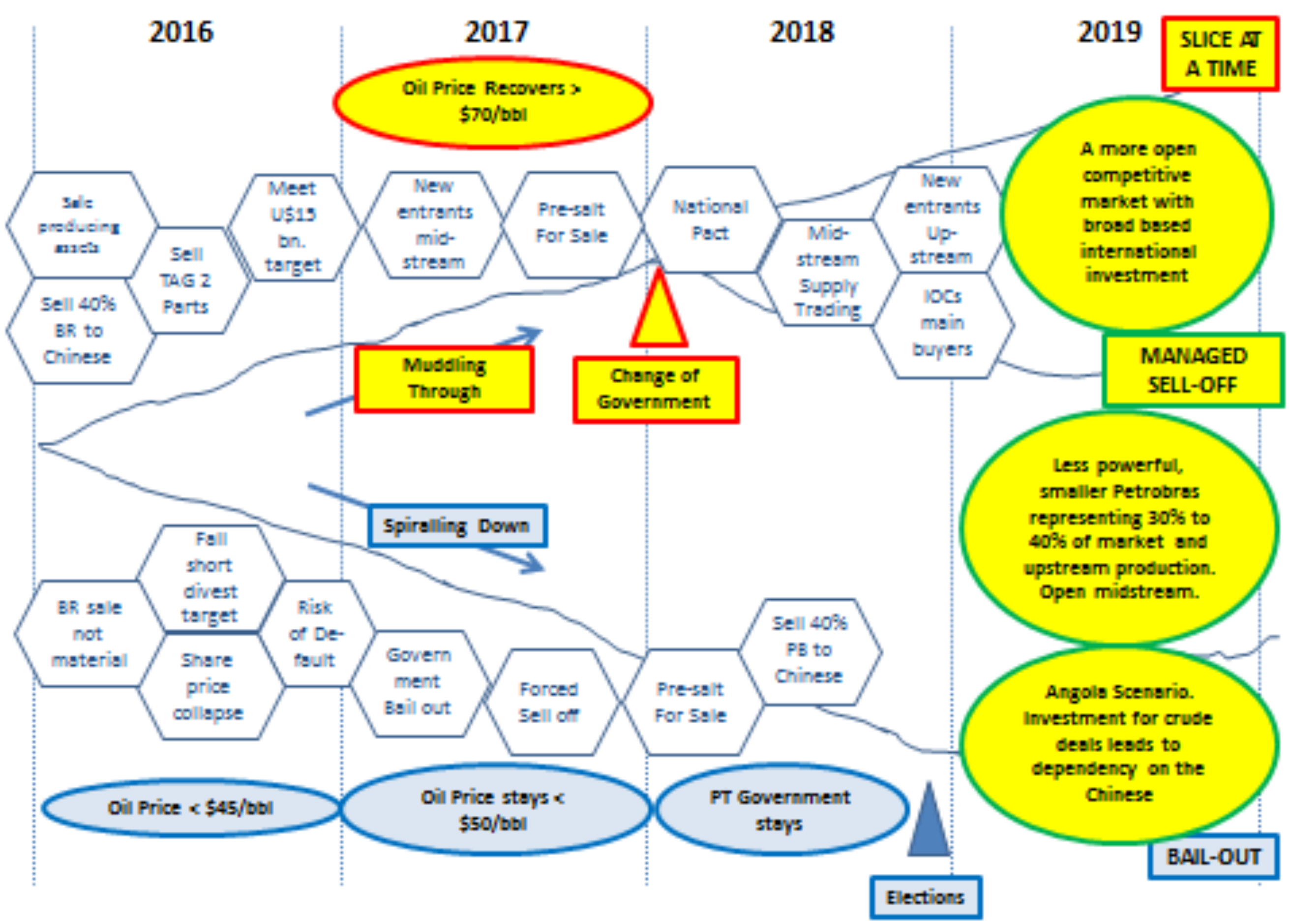
Bail-out

While in the second scenario, the ruling PT party maintains power and sticks to its dogmatic approach, with significant resistance to change and Petrobras disposals. Divestment falls far short of funding targets and consequently the only possible outcome is for the Brazilian Treasury to step-in to bail out Petrobras. Lurching forward from crisis to crisis, bilateral government-to-government negotiations take place with the Chinese, who acquire a substantial proportion of Petrobras and enter into long-term investment in exchange for crude reserves, similar to the Angolan situation today.

The outcome

Regardless of the path, we see Petrobras shrinking in size and influence over a five year horizon to represent 30 to 40 percent and not 90 percent of Brazil upstream production. Depending upon the scenario it will determine to what extent a more competitive and open market will develop in the midstream, breaking Petrobras' quasi monopoly and allowing in new players and essential investment.

Brazil Oil & Gas Scenarios



About the author

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