In search of the perfect production partnership
Jonathan Wheafley

Nine months after the discovery of potentially rage deposits of oil off the coast, there is little doubt that Brazil will soon become one of the world's leading oil-producing nations.

There is much more uncertainty over how the country will manage its new-found wealth. The biggest immediate doubt -beyond the technical difficulties of getting at the very deep reserves trapped beneath a salt shelf below the ocean floor - concerns the regime under which oil companies will be invited to join Petrobras, the government-controlled oil company, in bringing oil and gas to the surface.

Moreover, oil has often turned out to be a curse for developing nations. "We are a late-coming oil power," says Aloizio Mercadante, a senator for the ruling Workers' party and an economic adviser to President Luiz Inácio Lula da Silva. "That means we can go more quickly and learn from other nations."

Many oil-based economies have engendered authoritarian or populist regimes that find it hard to industrialise and have difficult relations with the rest of the world. Brazil, a mature democracy with solid institutions and a diverse industrial sector, should be able to avoid the worst pitfalls, he says. But it must still take care to manage its wealth properly.

"We must create a sovereign wealth fund to create a post-oil society," he says. "We need to promote health, education and technological advance - not a wave of consumption."

Plans are under way to create such a fund, which could receive between $200bn and $300bn within the next five years once the new oil begins to flow from 2012, according to Guido Mantega, the finance minister. But while Mr Mantega wants to create a counter-cyclical fund that would be set up immediately by buying about $14bn in government debt - equal to about half a percentage point of gross domestic product - Mr Mercadante sides with those who would rather see Brazil use all its available resources to pay down public debt immediately, thereby producing the genuine, nominal budget surpluses (including debt repayments) that are the basis of many other sovereign wealth funds around the world. Brazil, in contrast, runs a nominal deficit expected to be a little more than 1 per cent of GDP at the end of this year.

Mr Mercadante is also at odds with those - including Sergio Gabrielli, president of Petrobras - who would like to see Brazil change its laws to introduce a "shared-production" regime to cover reserves in the pre-salt fields.

Under the present system, the Brazilian government sells concessions to companies - often working in partnership with Petrobras - to look for oil in geographical blocks. Concession holders have rights over any oil they find in return for the risk they take in looking for it, and pay royalties to the government.

Under the shared production model, the oil remains the property of the nation and companies are allowed to keep a share of whatever they produce. The main drawback of this model from the oil companies' perspective is that the government may decide to increase or reduce production according to noncommercial considerations such as the exchange rate or the rate of inflation.

Many in the government or close to it, including the director of the ANP, the industry regulator, would like simply to see a modification of the existing system, under which oil companies would merely pay a higher level of royalties for concessions in the pre-salt fields.

It is easy to see why the government would want to change the rules for the pre-salt region. The first field to be analysed, known as Tupi, holds between 5bn and 8bn barrels of oil and natural gas equivalent, a huge addition to Brazil's proven reserves of 14.4bn barrels. Initial estimates suggest the entire pre-salt field may be much larger, containing between 50bn and 70bn barrels. That would put Brazil ahead of Russia in the ranking of global oil nations.

As well as being big, the presalt fields contain light crude of much higher quality than the heavy crude normally found in the country. Indeed, it seems likely that much of the oil so far found has seeped up through the salt layer, expelling impurities on its way.

Crucially, every well that has so far been drilled through the salt layer has struck oil. This is why the government says selling concessions for the new fields would be like handing investors a winning lottery ticket, and why it wants to change the rules.

The biggest danger here, says Adriano Pires of CBIE, and energy consultancy in Rio de Janeiro, is that the regulatory uncertainty that has plagued so much private investment in Brazil will be perpetuated. "Any change involves a risk of change for the worse," he says. "Many people are worried about what is really being proposed and what could emerge at the end of the process."

Whatever the outcome, the government had already sold nine concessions to Petrobras and private partners for blocks in the pre-salt region before it decided to stop last November, pending a rule change. That will give Petrobras and its partners plenty to work on over the next decade.

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