

A funny kind of reward



SEEN from the dock at Angra dos Reis, the port south of Rio de Janeiro where it is moored, Petrobras's P-51 oil rig looks like a chemistry set the size of several apartment blocks. Once on board it is easy to get lost among all the tubes at its dark and claustrophobic centre. This being Brazil, however, space has been made for a football pitch. From the top deck the view is vertiginous; in the heat of a Rio winter the indigo water far below is inviting. In a few months this \$830m piece of kit, one of the world's mightiest oil rigs, will be towed 175km (110 miles) from shore and anchored to the sea bed, where it will begin sucking up oil and gas—and with it, creating a chunk of Brazil's economic future.

Last November Petrobras, a state-controlled oil giant, announced that it had found between 5 billion and 8 billion barrels of light, sweet crude in a field called Tupi, wedged under a layer of salt deep beneath the floor of the Atlantic Ocean. There is a strong presumption of more oil in other "pre-salt" fields. In April the head of the agency that hands out exploration licences casually mentioned a figure of 33 billion barrels, before sheepishly saying that he had been quoting from a Texan energy magazine. Next month the first barrels of oil will emerge from the new fields.

Exploiting Tupi poses huge technical challenges. The salt has acted as a "perfect seal" to preserve the oil, says Antonio Carlos Pinto, who directs Petrobras's projects in the pre-salt fields. But the oil sits between 5.3 and 7km below sea level, farther from the surface than any of the world's existing fields. The company already extracts oil and gas at a depth of nearly two kilometres and has the technology to go a kilometre deeper. But Tupi is a lot more complex. The oil comes out hot and then cools rapidly as it flows towards the surface, depositing paraffin that clogs up pipes along the way. It emerges under 230 times more pressure than the air in a car tyre. Some of the fields are 300km off the coast, making it difficult to get workers to them by helicopter.

Oilmen reckon that Petrobras has both the technical expertise and the financial muscle to exploit Tupi. It has drilled in deep water since the first steep rise in the oil price in the 1970s. The recent high price has sent the firm farther offshore and deeper under the sea, and set its 1,800-strong research department new tasks. Drilling the first well into the pre-salt took a year and cost \$240m. The latest wells take just 60 days, at a cost of \$1m a day.

Most of Petrobras's planned investment in exploration and production of \$65 billion over the next five years will be spent on the new fields. José Sergio Gabrielli, Petrobras's president, says that the company's plans for expansion are predicated on oil at \$35 a barrel. He also says that the company has the financial strength to raise more debt if necessary.

Yet just as Petrobras has struck a bonanza, Brazil's government is debating whether to create a new, wholly state-owned, oil company to maximise its profit from the new fields. This echoes a campaign in the 1940s that led to the creation of Petrobras in the first place, under the slogan "the oil is ours". But much of Petrobras's new stature and success comes from the decision of a previous government to float 60% of its shares on the stockmarket and to open up the oil industry, allowing foreign firms in as partners and competitors.



Uncertainty has now caused Petrobras's share price to wobble (see chart), taking the rest of the São Paulo stockmarket with it. At the moment, the government takes a royalty of up to 10% of the value of oil and gas. In addition, there is a second tax linked to production. Much of this second levy goes to the states where the oil is—mainly Rio de Janeiro. On top of this, of course, the government reaps dividends from its 40% share in Petrobras, which is the fifth-largest company in the Americas by market capitalisation.

A government committee is looking at how best to increase the state's oil take, and will give some preliminary findings on September 19th. One of two options seems likely. First, as has been suggested by President Luiz Inácio Lula da Silva and by his energy minister, Edison Lobão, the government could create a new company that would partner any firm (including Petrobras) exploring in the pre-salt areas that have yet to be auctioned. Second, taxes on profits could be raised for new concessions. Either change is likely to need ratification by Brazil's Senate.

Officials, including Mr Gabrielli, argue that since drilling in the pre-salt is now almost certain to yield oil, the rewards for investors in new blocks should reflect this lower exploration risk. That is in itself not unreasonable.

But there would be several dangers in completely rewriting the rules. Though Petrobras, subject to market discipline, is relatively lean, any new state company might quickly become puffed up by political appointees. Second, the government might be tempted to revisit existing contracts, which would be bad for confidence and disastrous for Petrobras and its partners (Britain's BG Group has a 25% stake in Tupi and Portugal's Galp Energia 10%). Third, shutting out Petrobras's outside shareholders might scare off foreign investors from Brazil in general. Whether Petrobras will stand up for those shareholders is unclear. The company's board is chaired by Dilma Rousseff, Lula's chief-of-staff and seemingly his candidate for a presidential election in 2010.

The oil find comes in the twilight of Lula's presidency. He seems to see ring-fencing social spending as a way to cement his legacy. He wants much of the oil money to be earmarked for education, which is one area where his officials are conscious of having fallen short. This has its own dangers: public education in Brazil is badly run and needs to be reformed before it is showered with money, or else much will be wasted. Yet before it gets ahead of itself, the government should first make sure that it does not damage the company that located the treasure in the first place.

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