SPOTLIGHT ON BRAZIL

Legal issues impacting oilfield-services companies in a dynamic fast-growing market

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Spotlight on Brazil: Legal issues impacting oilfield-services companies in a dynamic and fast-growing market

Brazil is likely to soon join the world's top 10 oil-producing countries, thanks to the recent discovery of oil and gas reservoirs in its offshore pre-salt basin[1]. The country's total proven reserve of 15.1 thousand million barrels currently ranks Brazil's reserves as the 24th largest in the world (and second among oil-rich Latin American nations[2]. Full exploration of the pre-salt basin could catapult the South American giant to a ranking of ninth in the world, perhaps even eighth, and establish it as a major source of oil and natural gas[3].

Brazil is currently the fastest growing market for oilfield-services companies and presents even potential for their future investment that is even more impressive. With these companies will growth the investment in new technology and the financial capital from external sources that Brazil must attract if it is to realize full benefits of the recent pre salt discoveries.

Yet that progress is being threatened by complex legalities, inflexible taxation policies and strict constitutional principles. The panel will address the three major issues in today's Brazil that most impact oilfield services companies and other industry players in this dynamic and fast-growing market – local content, REPETRO and risk allocation in oilfield-services contracts. But first, a little background on recent developments will better place the matter into context.

After the 2006 discovery of the Tupi field[4], located in the pre-salt basin, the exploration and production perspectives grew exponentially in Brazil, attracting foreign investors interested in new opportunities in the world's seventh wealthiest economy (2011 GDP US$2.2 trillion)[5]. Results from early wells drilled in the Tupi and other pre-salt areas leave no doubt about the technical and economic viability of the commercial development of the reserves that were found there[6]. Nevertheless, this potential faces technical challenges that require new technology[7] and large investment from external sources. Now, at the end of the first decade of the 21th century, those financial and technology needs are coinciding with the goals of foreign investors from several international services companies.

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[1] "The expression 'pre-salt' refers to an aggregation of rocks located offshore along a large part of the Brazilian coast that have potential to contain oil. It was called pre-salt because it forms a rock interval that ranges under an extensive layer of salt that can measure as much as 2,000 meters thick in certain areas of the coast. The 'pre' signifies that these rocks were deposited before the salt layer. The total depth of these rocks, i.e., the distance between the surface of the sea and the oil reservoirs under the salt layer, can be as much as 7,000 meters." See http://www.petrobras.com.br/minisite/presal/en/questions-answers/

[2] BP Statistical Review of World Energy June 2012. bp.com/statisticalreview

[3] The Impact of Pre-Salt. A long Term Perpective May 2010 a Reort prepared for Petrobras. Oxford Analytica.

[4] In May 2009, Petrobras kicked-off the extended well test for the Tupi area, capable of processing some 30 barrels of oil per day.

[5] See World Bank at http://www.worldbank.org/en/country/brazil/overview

[6] See http://www.petrobras.com.br/minisite/presal/en/questions-answers/

[7] Throughout the industry as a whole, new technology is essential in both conventional and non-conventional oil exploration and production because it reduces risks and cuts production time. See National Petroleum Council, "Topic Paper 26," 16.

Brazil offers rich growth potential for oilfield-services companies. These players are willing to invest in new technology[8] and increase manufacturing capability in the country[9]. Since 2006, they have been structuring transactions, including asset purchases, joint ventures and equity acquisitions[10]. The objective is to invest and to transfer technology[11] in order to assist Petrobras and other operators in overcoming exploration and production challenges. However the size, complexities and nuances of these deals and operations bring to the surface old and new business and legal issues. Service companies must address them carefully or risk encountering difficulties down the road. The panel will address the major legal issues impacting oilfield services companies as well other industry players in a dynamic and fast-growing market. The panel will address major three topics:

• Local Content

Local content is an obligation recognized in any exploration and production contract (such as a concession agreement) or by law or regulation that requires companies to procure a minimum percentage of equipment and services from local suppliers. The objective behind the local-content requirement is to ensure the involvement of Brazil's own industry, including its national companies, in the development of the exploration and production supply chain.

Local content can be perceived as an initial barrier for general foreign investors and international oil services companies, in particular. However, the local-content policies were not created to be inflexible protectionist barriers that discourage competitiveness; instead, they are meant to provide incentives for national companies to become and stay competitive in the multinational marketplace[12].

Initially, the Brazilian Regulatory Agency for Oil, Natural Gas and Biofuels – ANP[13]– applied the concept of local content under a very moderate and reasonable approach[14]. Concessionaires had to ensure they would grant preference in hiring whenever possible during the exploration phase and development stage to Brazilian suppliers that propose price, time and quality conditions equivalent to other (international) suppliers invited to participate in the relevant tender. Up to the fourth ANP bid round, the local content percentage was established by the companies, themselves, as part of their proposals. In that system, their proposed local content was an important factor in the competitiveness of the bids they presented. Bidders with high local-content percentages in their proposals put themselves in much better positions for winning coveted contracts.

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[8] In the context of upstream, technology can be defined as the systematic knowledge of exploring and producing hydrocarbons with such knowledge being reflected in inventions, utility models, know-how, designs, and data forms. See World Intellectual Property Organization, "WIPO Intellectual Property Handbook: Policy, Law, and Use" (Geneva, WIPO, 2004).

[9] See Weatherford Annual report 2010.

[10] See Bloomberg Law Report, Corporate and M&A Law, Current Issues Involving Latin America Upstream M&A.

[11] A transfer of technology takes places through a contractual relationship by which the owner of a patented technology, copyrighted work, or know-how sells or grants a license to use the said technology, work, or know-how to another person or legal entity. See Secrets of Intellectual Property," International Trade Centre UNCTAD/WTO, World Intellectual Property Organization (Geneva 2004).

[12] Brazil raking in the competitiveness report of the world economic fluctuated from 56 in 2010/11, 58 2011/12, 53 2011/12 48 2012/13. See The Global Competitiveness Report 2012-2013 at http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf

[13] National Agency for Oil, Natural Gas and Biofuels (ANP): Linked to the Ministry of Mines and Energy, it also establishes rules for the activities in the petroleum, natural gas and biofuel industries in Brazil. ANP promotes bids and contracts with dealers in the exploration, development and production of oil and natural gas. See at http://www.brasil.gov.br/sobre/brazil/structure/1regulatory-bodies/br_model1?set_language=en

[14] See local content incentives in the first bid round for granting rights of exploration, development and production of oil and natural gas fields, held in 1999.

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By the fifth and sixth ANP bid rounds, the ANP approach was more compelling and persuasive. The ANP determined minimum percentages for local content for onshore and offshore blocks (shallow or deep water). By the seventh ANP bid round, some changes were introduced, both in the local content clause of the concession agreements and in the bidding process, that limited the percentage range of the proposals between minimum and maximum values, as well as established separate items and sub-items for investments. In addition to this mandatory minimum percentage, the ANP established the requirement of the certification of the local content percentage for each service or equipment, named "Sistema de Certificação de Conteúdo Local," and the obligation to deliver quarterly reports to ANP that indicated the local-content percentage achieved. This certification and report system was created in 2007, but it was made retroactive to the seventh ANP bid round – in 2005 – onward.

In case the companies or consortium do not reach the percentages established, heavy fines shall be imposed. ANP recently announced that a huge number of fines will be imposed in 2013 for non-compliance with these requirements. In the end of 2012, the exploratory phase of the blocks granted in the seventh ANP bid round will terminate and their local content percentage will be assessed. As per the quarterly reports submitted by the concessionaires, ANP says that they are below the target – which may vary from 55 percent to 65 percent – and the concessionaires are reaching an average 32 percent – which leads to the massive number of anticipated fines.

Therefore, depending on the services agreements' provisions, any obligation imposed on the concessionaires (license holders) shall subsequently be mirrored in contracts with their suppliers and contractors[15]. Therefore, international services companies are impacted by the local-content policy in two distinct ways. On one hand, they must compete on uneven footing with national companies in bidding to provide services to concessionaries. On the other, should they win a contract, they must continue to deal with local-content requirements as they deliver the services.

One of the major objectives of the ANP's local content policy is to nurture Brazil's own oil-and-gas services suppliers. Accordingly, the agency sees this new system as positive for the production of goods and equipment in Brazil. However, preferences for local businesses should not become a barrier to Brazil's access to new technology and better operational efficiency[16]; therefore, national content policy must be structured on flexible pillars that allow policies to stimulate national industry while, at the same time, they encourage Brazil's companies to compete with their multinational peers. For this reason, a new procedure is likely to be implemented in the next bid round. ANP is studying the inclusion of a bonus scheme by which the concessionaires could benefit if they exceed the minimum local content requirements.

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[15] See Local Content in Brazil oil Industry at T&B Petroleum page 28 at http://www.hrblaw.com.br/files/local_content_in_brazilian_oil_industry.pdf

[16] See Brazil Local Content Policy Inhibits Oil Development at http://www.rigzone.com/news/oil_gas/a/119419/Brazil_Local_Content_Policy_Inhibits_Oil_Development

• REPETRO

Brazilian customs authorities created special taxation regime for import and export of goods to be used in the research and exploration of the country's oil-and-natural gas reserves. Under REPETRO regime, taxes incurred on imported equipment generally are suspended upon the equipment's entry into Brazilian territory. This policy operates basically through a special category of temporary admission and an exportation system that allows Brazilian companies to acquire equipment and spare parts to be used internally, as if such assets had been exported and subsequently re-imported according to the temporary-admission policy described above[17]. REPETRO suspends all federal import taxes, provided that the applicant is either a concessionaire authorized by the ANP to research and explore oil and natural gas in Brazil or a service provider engaged by a concessionaire to provide services in support of the country's oil and natural gas exploration.

Despite the fact that REPETRO was created to reduce tax burdens on investments for research and exploration, currently the administration of the system is facing challenges. Primary issues are:

1. The Interim period between the filing of the Repetro extension request and the decision denying such extension. This is very important in order to determinate when Temporary Import Taxes (proportional II, IPI, PIS Cofins) become due.

2. Restrictive interpretation of REPETRO rules, particularly involving rental of equipment and providing of services. Modifications to the legal frame and the restrictive method of interpretation are used to make the following conclusions by the Agency:

a. Lack of express provisions allowing service providers to qualify for REPETRO based on their rental agreements.

b. The new ruling (IN) RFB nº 1.070, effective September 13, 2010, excluded express provisions regarding rental or loan agreements that result in denial of REPETRO extensions.

c. REPETRO is applied only to rental or loan agreements covered by article 17, §9, which specify: the direct release of goods by a foreign company to the concessionaire.

3. Issues related to electronic tracking – inaccurate information or lack of data may cause suspension of a company's PEPETRO benefits or prohibit a company from qualifying.

4. New rules govern REPETRO qualification in 7a Fiscal Region (Rio de Janeiro and Espirito Santo States)-Ordinance 615, effective August 28, 2012. These issues are still being analyzed.

It is important to note that oilfield-services companies are considering different rules to structure their bid prices, taking consideration they may need to apply IN 285 (proportional taxes) because of the delay of DIANA to allow or deny REPETRO. This issue can affect contracts and prices established with operators and other subcontractors.

REPETRO was conceived as a special system intended to reduce the tax burden on investments for research and exploration[18] in a country where tax rates and tax regulations are the two most problematic factors for doing business[19]. However, new modifications and interpretations of the law are distorting the function of this special taxing structure.

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[17] See summary of Latin lawyer Giovani Loss Mattos Filho, Veiga Filho, Marrey Jr e Quiroga Advogados.

[18] BNDES. Studies of regulatory, corporate and financial alternatives for the exploration and production of oil and gas and the industrial development of the oil and gas production chain in brazil at http://www.bain.com/bainweb/images/LocalOffices/BNDES_Consolidated_Report_BNDES_eng.pdf

[19] World economic Forum, the Global Competitiveness Report 2011- 2012.

• Risk Allocation in Oilfield-Services Contracts

Oilfield-services contracts are generally granted by international oil companies and national oil companies to small multinational service companies. These services can be divided into two categories, drilling[20] and support activities[21]. Contracts governing these types of services have been revised and supplemented over the years to address certain unique aspects. The technological[22], operational, strategic, legislative[23], regulatory and judicial[24] issues are some of the factors and aspects that have major influences in contracting practices. A very good example of this impact to the contracting practices is the Macondo Effect.

Recent trends in contracting and important new legal precedents resulting from the Macondo-well incident[25] are expected to add ever more complexity to service contracts over the next few years. The implications of the Macondo incident were instantaneous for the oilfield-service companies established in Brazil. Petrobras, which is responsible for approximately 80 percent of the revenue of the oilfield-service companies in Brazil, is proposing stronger terms and conditions that go beyond the usual international oilfield services contract standards. In addition, Petrobras' inflexibility to negotiate changes and/or include new wording in order to balance the allocation of risk[26] based on an "operational risk versus economic benefit" is overburdening the services companies.

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[20] Drilling services include the supply of land and sea rigs, other specialized equipment, and expertise to oil and gas producers.

[21] Support activities include various services, such as seismic imaging and analysis, used in the exploration and evaluation of potential wells; wireline services like measurement-while-drilling which supports the drilling activity itself; and artificial lift and stimulation services See United States International Trade Commission Oil and gas Fields Services. Impediments to Trade and Prospects for Liberalization, http://www.usitc.gov/publications/docs/pubs/332/pub3582.pdf

[22] Technological advances have broadened service offerings by oil and gas field services providers and improved industry efficiency. For example, the use of computer technology to create two-, three- and four-dimensional images of oil and gas reservoirs increases the likelihood of success in finding oil and gas, and horizontal, or directional, drilling, whereby the drill bit can be turned to run parallel to the surface, increases the amount of retrievable oil from a single well.

[23] Contracts frequently have been modified to address legislative or regulatory requirements relating to pollution and disposal of waste. In the U.S. Gulf the Oil Pollution Act of 1990 prompted contractual revisions addressing the operator's responsibility for provision of a certificate of financial responsibility while the Clean Water Act, Resource Conservation and Recovery Act, Refuse Act and Rivers and Harbors Act required contracting parties to further delineate responsibility for pollution abatement and cleanup, fines, environmental damage and disposal of waste.

[24] Rulings in litigation involving U.S. admiralty and maritime law have established that a party may lawfully agree to indemnify another party even in the event of negligence or other culpability by means of traditional "knock-for-knock" oilfield indemnities, where each party generally assumes liability, without regard to cause, for its own personnel, equipment and property, including the operator's well-related risks. To quote the U.S. Court of Appeals for the Fifth Circuit decision in Theroit v. Bay Drilling Corp., 783 F.2d 527, 540 (5th Cir. 1986), such provisions generally are enforceable if they are "specific and conspicuous."

[25] On April 20, 2010, the Deepwater Horizon rig explosion killed 11 workers; the incident ultimately resulted in the release of some 5 million barrels of oil into the Gulf of Mexico from the Macondo well deep below on the ocean floor. The size and scope of the event – and the 87 days that followed when neither the company, BP, nor the U.S. government, could plug the gushing well on the ocean floor – riveted the nation and drew significant attention to practices in the offshore oil drilling industry. In the aftermath, many officials pledged to investigate the root causes and establish whether or not industry practices needed to be changed.

[26] Risk is defined as the probability of physical, psychological, social or economic harm occurring as a result of participation in a specific activity.

Furthermore, Petrobras, as a national oil company, is subject to special regulations that greatly complicate negotiations for goods and services. The result is that Petrobras does not deviate from its pro-forma contracts, which creates a take-it-or-leave-it environment for potential industry partners.

Although standard Petrobras contracts are considered ambiguous in terms of risk allocation, Petrobras' clarifications during the tender phases might establish better understandings of the risk allocation structure. However such lack of transparency is not an ideal way to foster business relationships that would be better based on full disclosure.

Contracts of this nature can create a significant risk exposure. Service companies now face scenarios in which the management of each company must decide whether risks can be reduced operationally and determine whether a contract's exposure fits within a company's risk tolerance profile.

Conclusion

Brazil, as one of the biggest and competitive[27] economies of the world and a major oil and gas producer, offers oilfield services companies an attractive environment to invest. After the pre-salt discovery announcement, Brazil was considered the place to invest. But the anticipation created by the announcement of Brazil's oil and gas reservoirs in the pre-salt is being diluted by complex legal framework, ineffective administration of norms and public policies, and unclear contractual terms from Petrobras. There is room for improvement in terms of simplifying rules, administrating rules effectively and clarifying terms and conditions that govern services companies' activities.

Despite issues detailed above, the world oilfield market is greatly anticipating Brazil's 11th round of bids, which was announced September 18, 2012. That round, scheduled to begin May 2013, will cover 174 blocks onshore and on the equatorial margin, as well as early studies to one round for the pre-salt basin. However details are still pending a final decision of the National Congress

In the meantime, the challenges discussed here will provide fresh viewpoints as the country's decision makers chart the healthiest paths in the journey toward maximizing the impressive potential of Brazil's oil-and-natural gas reserves.

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[27] Ranked 53 in the World Economic Forum, the Global Competitiveness Report 2011-2012.