Claiming the oil prize

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WHEN HUGE OIL RESERVES were discovered beneath layers of salt, under the sea, Brazilian officials celebrated as if the country had won a lottery. The year was 2007 and the new discovery, which became known as “pre-salt,” more than doubled Brazil’s proven oil reserves. For a country often considered the Saudi Arabia of biofuels, the discovery led to a major identity change (crisis?) in Brazil’s energy policy.

What followed were a series of policy overtures that sought to alter regulation by enhancing the state’s presence in the oil sector. By 2010, Congress had approved a proposal that established a different exploration and production (E&P) regime for the pre-salt reserves. Instead of the traditional concessions regime that had been in place since the sector was opened to international oil companies (IOCs) in 1997, the government instituted production-sharing contracts in which state-controlled giant Petrobras would have a predominant role as sole operator, with a minimum 30% stake in every project.

As if favoring Petrobras would not be enough to alarm investors, early in President Lula’s first term (2003–06) the government also introduced ambitious requirements that IOCs buy local goods and services across the oil and gas supply chain. This targeted protectionism became a cornerstone of the government’s general industrial policy.

To deal with rising production costs in the last few years, Brasilia opted to slow the pace in developing the oil sector. Because Petrobras had a full plate—the company also faced restrictions on raising domestic fuel prices and otherwise improving its financial situation—the government refrained from calling new oil auctions. The five-year hiatus (2008–13) further delayed oil production, and output has virtually stagnated since 2010. Many IOCs began to reassess their projects in Brazil due to increasing production costs and lack of scale.

There were two main reasons for the administration’s policy choices: (1) When the government approved its new E&P framework, Brazil was enjoying a robust economic recovery (7.5% growth in 2010) following the 2008–09 global financial crisis and Brasilia was not desperate to attract more foreign capital or investment.
When Brazilian legislators approved changes to the E&P framework that same year, the pre-salt area constituted one of the more promising oil frontiers globally. These two factors gave the government the confidence to pursue its oil policy options.

Now the winds have definitely shifted. So where is Brazil’s oil policy headed? After three years of very low GDP growth, the Rousseff government seems to be placing a higher premium on measures to ensure that a pipeline of investments will drive a more robust economic recovery. While Petrobras as one of the chief public investments is surely seen as part of the solution, the government now also seems willing to attract private and foreign investments in oil. In 2013 alone, it held three oil bid rounds, including the first pre-salt auction in October.

But since 2010 other challenges have been emerging. New oil discoveries around the world and the technological revolution that has occurred in shale gas and tight oil in the United States may not only contain or even lower oil prices but may also draw more investment from IOCs. Collectively, the competitive dynamics in global energy markets may lead to some countries pushing market-friendly energy reform to offer more favorable terms to investors. Look at what Mexico is trying to do.

While much could change in the next few years, the government should be ready to respond promptly if the energy sector challenges become more intense. After all, Brazil is betting that future oil production will not only drive economic growth and industrial development but also bring about social justice (100% of royalties from future pre-salt production will fund healthcare and education).

Brazil is still well-positioned to become a major global energy player in the next few decades. Nevertheless, the changes seen in the past few years serve as a cautionary tale that if the pre-salt oil reserves were a winning lottery ticket, the ticket may have an expiration date.

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