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Brazil: The Law That Could Change Everything

The Senate wrote it. The House is sitting on it. Bill 4567 will be a political fist fight that surely will rally a badly bloodied Left. But it will open Brazil's "pre-salt" oil fields to privatization, freeing Petrobras (PBR) from its obligatory 30% ownership mandate, and usher in a new wave of foreign direct investment. PBR shares undoubtedly would rally on the news of its passing, bringing the iShares MSCI Brazil (EWZ) with it.

How long will this take? What is at stake? What likely scenario will emerge?

Brazil's President Dilma Rousseff has 180 days to defend herself before impeachment proceedings in the Senate. During the interim, Vice President Michel Temer, of the big-tent, Democratic Movement Party (PMDB), takes over. While we don't expect any major laws to be passed in this interim, we believe Dilma is finished. Once she is impeached by the Senate, Temer will have a mandate to approve the bill. Although he may not promote it aggressively, he won't reject a House vote to privatize Brazil's deep water oil.

The bill began in the Senate under the sponsorship of Social Democrat (PSDB) Jose Serra. It enjoys the support of that body with a considerable majority.

Specifically, it takes PBR out of the role of being a mandatory partner to new oil exploration ventures in deep-water fields. It also frees up PBR to sell its existing stakes in all existing deep water oil ventures. The House is now considering the bill, but no date has been set for debate.

Lobbyists in the oil and gas industry say there is a high chance of its approval during the next 12 months. Politically speaking, without Dilma, we don't find formidable opposition anywhere, and Temer would sign it into law.

Opposition Senator Aecio Neves, should he ever become president, would sign it too, as would any member of his PSDB Party. PMDB is minimally divided, but congressional members would likely vote with the party's majority in this case.

Dilma's Workers' Party (PT) and the Communist Party of Brazil (PCdoB) are against it, but – as we saw in the impeachment vote on April 17 – they lack fire power. They are the minority now.

That does not mean the PT and Communists are completely impotent. They still will be able to galvanize social movements against this proposed law using the angle that the new, unelected government is giving away its "prized possessions." Indeed, this is why we do not expect movement on the bill during Dilma's impeachment proceeding. The bill is so politically charged, no one in the financial press is writing about it. In fact, PMDB's

"Bridge to the Future" manifesto, reported on by **Reuters**, doesn't even mention the word "pre-salt." PMDB's manifesto, made public in October 2015, lacks specifics as well. But worth noting is a policy platform to develop oil and gas based on "the private sector."

What changes would be made?

PBR is currently obliged to participate in all of Brazil's deep water oil field concessions, as a 30% minimum partner on any new development field. This policy worked during the weak-dollar days of 2007 when the company and country became the darling of the oil industry, after oil and gas deposits were discovered deep under the Atlantic. PBR hit one field after the other and every major exploration and production firm and oil services firm came to Brazil. Dollars flowed into the economy, and super-charged Brazil's commodity boom.

Today, PBR has an estimated 35 billion barrels of recoverable oil in fields it owns. Development of its existing reserves is expected to take 20 years, industry insiders tell us. The attractiveness of Brazil's oil fields improves for foreign capital if investors can avoid the minority partnership with PBR; not to mention the political baggage the scandal-ridden state-owned company now brings with it.

Implications of the Senate version of this bill are huge.

If the a bill permits PBR to sell off some of its existing partnership stakes, it enjoys balance sheet repair as soon as the ink dries. The cash payment from selling development stakes would immediately improve PBR's $130 billion debt burden, which could get credit rating agencies rethinking PBR's junk status.

The law also dovetails neatly under PBR's multi-billion-dollar divestment objective under new CEO Aldemir Bendine, who set $14 billion of divestments as the target this year. He's not even close. The company has sold just $2 billion in assets to date, and not one was in Brazil.

Freed from the burden of investing in every little oil field in production, PBR can then invest in other things like building refineries to convert part of country's heavy crude oil into light crude that is easier to turn into gasoline and diesel.

On a practical basis, the bill makes sense for the country as much as it does for Petrobras.

Opening deep water oil concessions to 100% non-PBR ownership brings more revenues to the government. These oil firms have to pay taxes and royalties. The government has a reliable income stream from fees and taxes, and PBR doesn't have to spend any capital to explore and/or develop fields it really does not need.

Brazil's pre-salt oil and gas deposits are highly valued and will be an easy sell. Some of these fields are enormous. The Lula field has an estimated 8 billion barrels of oil under the surface. Shell and Galp partner with PBR on this field. Most of Brazil's offshore fields produce at least 20,000 barrels per day while the global average deep sea field produces between 3,000 and 8,000 barrels per day.

Perhaps the biggest risk is that the House gets bogged down in gridlock as lawmakers debate how this affects royalties or rules governing PBR selling stakes it already has in partnership oil wells with foreign drillers. If they don't allow PBR the freedom to sell existing partnership stakes, then PBR's debt woes are likely to dog the company further. On the other hand, PBR will no longer be forced to take on additional projects it can't afford.

The Left in the House will argue that the "oil is ours!" But that argument is paper thin. Brazil is **already** an exporter. Brazil's heavy crude is sold to the United States, China, Africa and refineries in the Middle East, where much of it is turned into importable gasoline. In other words, the Left would be raising an objection that is already common practice. In fact, more exports could be refined domestically if PBR had the capital to build and modernize its refineries.

The odds of the law passing are much greater than it failing. But when would it pass? There is no date set for the House vote, but once it does pass, the Senate would approve it swiftly and hand it to the president.

Although we doubt anything of this magnitude would be signed into law under an interim presidency (while Dilma is on trial), House deliberations will bear monitoring. Dilma's trial ends in October, if she doesn't resign first. We believe that any major bills such as this will be taken up late in the fourth quarter.

It goes without saying that, if Dilma survives impeachment and returns, the law would wait until after the 2018 elections. With her departure, it is likely that only a small majority would approve the bill in the House, followed by a slightly wider majority in the Senate.

Longer term, we would put odds of passage at 75%. The bill stands a good chance of becoming law even under a new elections scenario where a skilled Left-leaning politician wins. For instance, former President Luiz Inacio Lula da Silva likely would sign it into law, provided he bargains to keep social programs in the exchange.

The passage of this legislation is likely to be a blockbuster move for PBR and it will take EWZ with it if/when it happens.

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