

Corruption & Petrobras: the Brazilian state and energy politics

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Beside ‘Lula’s’ charges for corruption, President Dilma Rousseff’s impeachment by the Senate on Aug. 31, 2016 almost seemed like an afterthought in Brazil’s tumultuous year of politics. Lula, the former President of Brazil, is the big fish. It is now apparent that he is the mastermind behind the massive money laundering and corruption scheme that has undone so many Brazilian legislators; a scheme that was first officially uncovered in March 2014 and involved Petrobras, the state-controlled oil company.¹

Petrobras has for many years become the play thing of Partido dos Trabalhadores (PT), the Workers’ Party and the Government of day since in the early 2000s. Petrobras is nearly two-thirds state-owned; the rest of its equity is traded on Brazilian and U.S. stock exchanges. Like state-owned oil companies everywhere it has become a direct instrument of the state.

- For example, in 2010, the PT-led Government passed a statute mandating Petrobras as the sole operator of production sharing agreements for ‘pre-salt’ production, amending the 1997 law. (Pre-salt refers to oil found in deep waters off-shore -- about 18,000 ft. below the ocean’s surface. Pre-salt was discovered in 2007.) Petrobras was also required to hold a minimum 30% stake in all pre-salt projects -- including privately-held international ones. The aggregate capital cost of developing pre-salt discoveries and adhering to the foregoing conditions was a staggering \$237 billion U.S. at the end of 2013.²
- Moreover, Petrobras was also required to buy all its supplies, ships, and platforms, locally, which prevented international suppliers from accessing bids.³
- Worse, in addition to cost over-runs and high expenses, Petrobras built an exceedingly high debt; estimated at “more than four times gross operating profits,” in late 2014.⁴ Its refining business is “bleeding money” in order to keep government-mandated domestic retail gas prices below international levels.⁵
- In fact, retail gasoline prices are capped at the pumps, which also limits prices for sugar-based ethanol, according to government edict said to be fighting inflation. “Investments in new ethanol production fell to \$256 million U.S. [in 2012] from a peak of \$6.4 billion in 2008.”⁶
- Finally, Petrobras was drawn into another scandal; it started as a cheap money laundering scandal but a couple of years after it was revealed to involve Petrobras and the entire governing structure of the country.

Oil & gas contributes to 13% of Brazil’s GDP. “Petrobras has been responsible for over 90% of total crude oil produced in Brazil in recent years, which accounted for nearly 2 million barrels per day.”⁷ “There are few countries with a company like Petrobras; the company accounts for 5% of Brazil’s GDP.”⁸

'Operation Car Wash' was the official name given to the corruption investigation starting on Mar. 17, 2014 "where it was alleged Petrobras executives accepted bribes in return for awarding contracts to construction firms at inflated prices." The operation was named after gas station and postal outlet in Brasilia where participants used its currency exchange and money transfer service to launder money. About \$5.3 billion changed hands over several years of the scheme.⁹

The mastermind of the scandal it has recently been determined was former President Luiz Inacio Lula da Silva. A previous union boss and leftist hero in the country, he was charged on Sept. 14, 2016. Lula is alleged to have led a kick-back scheme that caused an estimated 42 million reais (\$12.6 million U.S.) in losses to Petrobras shareholders and taxpayers." The scheme [was] aimed at keeping the Workers' Party in power by criminal means." Lula is reported to have personally accepted "3.7 million reais (\$1.1million U.S.) in bribes, including a luxury apartment of the coast of Sao Paulo."¹⁰

A virtual sideshow was the Dilma Rousseff impeachment; lots of *Sturm und Drang* but little else. Her prosecution was classic case of guilt by association; the public was going to punish someone for all the corruption, so it might as well be her. Mind you she did not help herself by bringing Lula into Cabinet so he could avoid prosecution in spring of 2016 -- Lula was her mentor inside the PT for years. It was all for naught, as a judge overturned Lula's appointment within a week of it being made. And she presided over Petrobras, being chair of the board, during the period under investigation. More wrong place, wrong time stuff, but the prosecutor could not pin any wrongdoing on her. Her final sin was to break a fiscal statute, in effect, an accounting manipulation: she delayed the transfer of money to state banks, which allowed her to expand public spending in order to boost re-election prospects in the campaign of 2014.¹¹ In the end, the public turned against her: three-fifths in final polling and up to 3 million out the streets during the spring of 2016 demanded her ouster.¹²

Rousseff lost the crucial vote on impeachment in the lower house in April. It was led by the Speaker and opposition leader, Eduardo Cunha who was later charged with corruption and money laundering, himself. Rousseff was officially charged with impeachment by the Senate in May, 2016, and thrown out of office at the same time. In her stead, Michel Temer, leader of the opposition PMDB (Partido do Movimento Democratico Brasileiro) took over as President. By August 31, the story was over for Rousseff, she had been impeached.

She would not be alone in the ignominy and resulting financial repercussions.

"Of 513 members in the lower house, 303 face charges or are being investigated for serious crimes. In the Senate it is 49 of 81 who are being investigated."¹³ Up to 93 individuals have been convicted, mostly in the political and economic elite.¹⁴ The Congress voted to expel Speaker, Eduardo Cunha, for fraud, and banned him from running for office for 8 years.¹⁵ He took \$40 million in bribes, which he hid a Swiss bank account. On conviction he faces 184 years in prison.¹⁶

As a result of the scandal, Petrobras reported net income losses of 34.8 billion reais (\$9.6 billion U.S.) for 2015, and 21.6 billion reais in 2014. Since the Car Wash investigation started Petrobras lost more than \$100 billion in market value. Its stock was worth \$11.00 U.S. in September 2014; in March 2016 it was worth \$2.24, an 80% decline.¹⁷

It was also forced to cut back capex investments and announced the sale of \$13.7 billion of assets over a two year period.¹⁸ The company currently has a disinvestment plan, “but has made little progress on its assets sales.”¹⁹

Petrobras has a debt of \$130 billion, having made overly optimistic investments with lousy returns. In April 2015, Petrobras “disclosed that a write-down \$17 billion as a result of graft and over-valued assets; it also suspended dividend payments for 2015.

One bright spot in the dark shadows is pre-salt production. In recent years, there was tremendous growth in this off-shore resource. From 41,000 barrels per day in 2010 to 1 million b/d in mid-2016; there has been a nearly 24 fold increase. “This accelerated growth in production proves the high productivity of the wells in operation in the pre-salt and represents a significant milestone for the industry.” Petrobras in 1984 needed 4,108 wells to reach the 500,000 b/d mark. “In the pre-salt, they reached double that output with only 52 wells.” Nine of the 10 highest-producing wells are in the Santos Basin, right in the heart of the pre-salt.²⁰

Michel Temer is a 75 year old, constitutional scholar and the new President of Brazil -- starting in May 2016. He leads the PMDB, a market friendly party, unlike the PT before it. He and his Cabinet have as their first order of business a massive restraint program: shrinking annual deficits, reform of the nation’s costly pension system, as well as attending to a deep and abiding recession -- “estimated at more than 3% negative growth this year.”²¹

One of the energy reforms pushed by Temer is a change on Petrobras’ obligations on the pre-salt. Senator Jose Serra introduced a bill that would revoke Petrobras’ “mandatory participation” in the pre-salt, for example, it would not be the exclusive operator in all pre-salt areas and no longer have to take a 30% stake in all projects.²² The purpose of the reform is to enhance Petrobras’ operational flexibility and allow room to manoeuvre in its management decisions -- notwithstanding the errors of past executives. Also, Petrobras simply does not have the financial resources to continue investments in the pre-salt. Moreover, local content requirements are being relaxed; indeed, several local suppliers have been black-listed over the corruption scandal. This leaves more room for international firms to enter the bidding process.

On Feb. 24, 2016, the Senate approved the bill to cancel the 30% rule on pre-salt. The Senate bill stopped short of entirely removing Petrobras from pre-salt plays; it will have a “30-day right of first refusal to elect and hold a minimum 30% interest.”²³

Moving on to ethanol, Petrobras has been on receiving end of vacillating government policy in this area as well. “In 2014, Brazil produced 7 billion gallons of ethanol, making it the second largest producer after the U.S. Nearly all of it went to the transportation sector, accounting for almost 50% of vehicle fuel consumption.”²⁴ In 2013, Petrobras was commissioned to import money losing quantities of gasoline, 25.5 million liters by 2020 to be precise. This kind of subsidization hurts the ethanol sector. It has forced up to 14 ethanol-producing mills to shutter their operations in 2013, as there were 16 closures the year before. “The sugar cane industry won’t invest in new capacity until it is confident it will play a large part in the country energy supply, claims Felipe Rocha, an analyst at Omar Camargo Investments”²⁵

In the wake of corruption scandal, the government pursued three different policy options to assist the ethanol industry. First, it “increased the required ethanol share in gasoline from 25% to 27%.” Next, it

required Petrobras to raise gasoline prices in late 2014. Third, the government re-introduced the infrastructure tax on gasoline in 2015. This assisted the ethanol industry in terms of encouraging increased production and sales.²⁶

A new president of Petrobras, Pedro Parente, appointed by the Temer government in June 2016, and a former ethanol executive, announced a policy of lower gasoline subsidies and disengagement from the ethanol sector.²⁷ Two weeks later Petrobras announced it was selling off some of its biofuel assets -- specifically its ethanol plants.²⁸ In August, a government spokesman said it would not extend the tax break for biofuels.²⁹

In our December 2014 review of Brazilian energy politics I warned against moral hazard. (Energy@Nordex vol. 1 Issue # 10) Clearly Brazil has moved up on the corruption curve. I concluded by suggesting Brazil did not differ from many other countries. This is no longer the case; things have degenerated. It one thing to have a few members of the leadership get caught with their hands in the cookie jar, but when broad swaths of the political and economic elite are investigated and convicted, and the majority in Congress suffers a similar fate, we are at whole different level of rot. Sad to say Brazil's elite culture is operating in a culture of corruption. While hope is kept alive for President Temer's prospects and that of Petrobras president Parente, it is difficult to be optimistic.

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