BRAZIL - PETROLEUM EXPLORATION, EVALUATION, AND DEVELOPMENT UNDER THE PETROBRÁS RISK CONTRACT SYSTEM†

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For more than twenty-five years Brazil has prohibited any oil company other than the government's majority-owned oil corporation, Petroleo Brasileiro S.A. (Petrobrás),[1] from conducting oil exploration or development operations. As a result of a significant shift in Brazilian petroleum development policy in 1976, the government has issued a series of bid requests not limited to Brazilian companies for the performance of exploration, evaluation, and development services under the Petrobrás Risk Contract system. The third and most recent request was issued in April 1979. Pursuant to these requests many American and European oil companies have entered into Risk Contracts with Petrobrás and have commenced exploratory drilling operations. This article will discuss the more important legal and financial characteristics of the Risk Contract, including methods of operation, remuneration, and remittance rights, as well as tax consequences under Brazilian laws and regulations.

I. THE NATURE OF THE RISK CONTRACT

The Petrobrás Risk Contract is a contract for the rendering of petroleum exploration, evaluation, and development services by an independent contractor on behalf of and for Petrobrás. The contract covers *inter alia*, ownership rights, remuneration and financial obligations, accounting standards, assignments, and termination provisions governing the relationship between Petrobrás and the contractor. The

† Executed versions of Risk Contracts are treated as confidential by Petrobrás. Therefore, no references in this article to the Risk Contract are based upon a specific contract. Reference to the Risk Contract contained herein is derived from publicly available information in Brazil and from Petrobrás.

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1. Law No. 2.004 of October 3, 1953, *as amended by* Law No. 3.257 of September 2, 1957, and Decree-Law No. 1.288 of November 1, 1973.

contractor must agree to a specific minimum expenditure obligation for exploration and to commence drilling an initial exploratory well within a fixed number of months. Both the minimum expenditure and the drilling timetable must be presented in the bid proposal.

Payment for services rendered or costs incurred by the independent contractor will be made, if at all, in U.S. dollars based upon a negotiated percentage (submitted with the bid proposal) from the net income of the oil eventually produced. No payment shall be tendered unless a commercial oil field is discovered. It is generally understood that a commercial field is a hydrocarbon-bearing geological formation evaluated in accordance with the Risk Contract which can be developed economically according to normal practices of the petroleum industry.

The contractor furnishes all funds, management, equipment, and labor necessary for exploration, evaluation, and development. The contractor, as mentioned above, will only be reimbursed for costs and paid the agreed-upon percentage service remuneration fee after commencement of production and then only from the net income received from production. Net income is understood to mean the difference between the value of petroleum produced at market prices less production costs, and production is taken to mean petroleum recovered, saved, and delivered to the terminal of delivery. Additionally, market prices are calculated in U.S. dollars for the specific crude oil discovered and produced f.o.b. terminal of delivery, equivalent to the current price of crude oil in the international market when sold in freely bargained long-term transactions. The contractor is entitled to buy oil produced from the field limited, however, to the value of its percentage service remuneration due and provided Brazil is not then suffering from a petroleum supply crisis. The terms of the Risk Contract define a petroleum supply crisis as shortages which create a crisis as recognized and declared to exist by the Brazilian Government.

By the terms of the Risk Contract no concession or authorization to explore, develop, or own oil and other minerals is transferred to the contractor. Thus, the bundle of legal rights remains exclusively with Petrobrás.[2] Because all services are performed for and on behalf of Petrobrás, the contractor is required to submit budgets for approval by Petrobrás, and to furnish regular accounting and technical reports. The contract terminates either upon the failure to find a commercial oil field within the agreed exploration time period or after a commercial oil field is developed and production is commenced. In the latter case Pe-

2. Law No. 2.004 of October 3, 1953.

trobrás will substitute itself for the contractor and conduct production operations.

II. Constitutional Provisions and Applicable Laws

The laws upon which the Risk Contract system has been developed may be summarized briefly. Mines and mineral resources (including petroleum) located anywhere in Brazilian territorial lands and waters belong to the Federal Government of Brazil.[3] National territorial lands and waters include the continental shelf and a 200-mile territorial sea.[4] The right to prospect and mine is obtained by specific Federal Government authorizations or concessions.[5] These rights, insofar as they cover minerals in general, can be granted to Brazilian individuals or to corporations organized in Brazil, including enterprises totally owned by non-Brazilians.[6] However, the right to prospect and mine petroleum, other fluid hydrocarbons, and rare gases found within Brazilian territorial lands and waters vests solely in the Federal Government monopoly and can only be exercised by Petrobrás.[7]

Petrobrás was organized under the Petroleum Monopoly Law and general Brazilian corporation laws in 1953.[8] Controlling ownership must always remain with the Federal Government. The shares of Petrobrás, however, are registered with the Brazilian Stock Exchange and shares representing a minority but a sizeable interest are actively traded. Simultaneously, Petrobrás is a part of the Federal Executive Administration and has responsibility for exploration, development, refining, and transportation of petroleum and petroleum by-products under the jurisdiction of the Ministry of Mines and Energy.[9]

The Ministry of Mines and Energy is responsible for formulation, direction, and execution of national policy covering minerals and energy, and for the study and solution of related problems regarding production and commerce. The Ministry of Mines and Energy, headed by a Minister appointed by the President of Brazil, maintains under its jurisdiction a National Petroleum Council for guidance and control of matters related to petroleum and coal. The Council reports directly to

3. Constituição art. 168(1)-(2) (1967, *as amended* 1969) (Braz.); Decree No. 28.840 of 1950.

4. Constituição art. 4, §§ III-IV (1967, *as amended* 1969) (Braz.); Decree No. 1.098 of 1970, art. 1.

5. Decree No. 62.934 of 1968.

6. Constituição art. 168 (1967, *as amended* 1969) (Braz.).

7. Constituição art. 169 (1967, *as amended* 1969) (Braz.); Law No. 2.004 of 1953.

8. Law No. 2.004 of October 3, 1953, *as amended by* Law No. 3.257 of September 2, 1957, and Decree-Law No. 1.288 of November 1, 1973.

9. Constituição art. 169 (1967, *as amended* 1969) (Braz.); Law No. 2.004 of 1953; Decree-Law No. 200 of 1967.

the Minister.[10]

Petrobrás has the sole right to and responsibility for: (1) the prospecting and mining of petroleum, other fluid hydrocarbons and such rare gases as may exist within Brazilian territory; (2) the refining of both domestic and imported petroleum; and (3) the maritime and pipeline transportation of crude oil and petroleum by-products of national origin, as well as pipeline transmission of rare gases regardless of origin. The right to prospect for and mine petroleum as granted to Petrobrás by the Brazilian Federal Government is non-transferable.[11]

Several exceptions to the exclusive rights granted to Petrobrás should be noted. In 1965 the Brazilian Government declared that the mining of oil shale was not covered by the Petrobrás monopoly unless the products to be derived from the shale included LPG, gasoline, kerosene, diesel, fuel oil, signal oil, lubricating oil, paraphene, asphalt, and solvents.[12] Similarly, in a presidential decree also issued in 1965, the Federal Government declared that the petrochemical industry was not included within the Petrobrás monopoly rights and consequently could be owned and operated by private enterprises.[13] Additionally, federal regulations controlling exploration, evaluation, and development work on the continental shelf and in territorial waters require prior approval from the Ministry of the Navy and from such other ministries as are by law specifically involved in the matter. When work is to be executed by non-Brazilians, however, either for their own account when permitted by law or under contract to third parties, as with Petrobrás, prior approval must be obtained from the President of Brazil.[14]

III. Method of Operation, Structure of Participating Companies, and Remuneration

Oil companies are invited to submit bids for services to be performed under Risk Contracts using the forms and procedures provided by Petrobrás. A bidder's fee is required which entitles the bidder to certain geological and geophysical data covering the areas available for exploration. Petrobrás executes Risk Contracts with non-Brazilian oil companies that have demonstrated the financial and technical capacity for petroleum exploration, evaluation, and development, and that have presented the more competitive bids.

Under the Risk Contract, work will necessarily be performed both

10. Law No. 4.904 of 1966; Decree No. 57.810 of 1966. *See also* Decree No. 63.951 of 1968; Decree No. 75.468 of 1975.
11. Law No. 2.004 of 1953, art. 29.
12. Decree No. 56.980 of 1965.
13. Decree No. 56.571 of 1965.
14. Decree No. 63.164 of 1968.

in and out of Brazil. For the work which is to be performed in Brazil, the creation of a Brazilian branch or subsidiary is required by law and by the terms of the Risk Contract. In this way, Brazilian corporate law permits non-Brazilian persons or entities to conduct business activities in Brazil through either a Brazilian subsidiary or branch.[15] The Brazilian branch or subsidiary must act as the contractor's attorney-in-fact for purposes of receiving legal notices or citations. There are no nationality ownership restrictions for a subsidiary which is organized to perform services under the Risk Contract. In many respects a subsidiary, under the form of a limited liability company (*Limitada*), is the preferable business organization under Brazilian practice because it takes little time to organize, is not required to publish its balance sheet and, if desired, can be organized so that it qualifies as a partnership for U.S. tax purposes.

The Brazilian branch or subsidiary is financed by its parent, the contractor. Funds required for exploration enter Brazil and are provisionally registered with the Central Bank of Brazil as non-interest-bearing conditional loans repayable by Petrobrás. The loans are conditional in that the funds expended by the contractor for exploration (evaluation services being treated as exploration expenses) shall be repaid only if a commercial oil field is discovered and production commences. Upon such occurrence, the assets of the branch or subsidiary will be transferred to Petrobrás. The branch or subsidiary must then be dissolved and cannot be utilized for any purpose other than for work pursuant to the Risk Contract.

Once a commercial oil field is discovered, the contractor must provide development funds. These funds must also be registered with the Central Bank of Brazil and are repayable by Petrobrás under previously established terms. Unlike the initial loan, development funds are treated as interest bearing loans. The contractor is to receive remuneration in U.S. dollars for services equal to an agreed upon production percentage.[16]

Payment to the contractor for the loan principal, interest, and percentage service remuneration for services and costs commences after the date of commercial production. Disbursement will be made quarterly and will never be greater than the net income received by Petrobrás from commercial production during the immediately preceding quarter. Any unpaid amounts may be deferred and added to subsequent quarterly payments.

15. Law No. 6.404 of 1976.

16. Law No. 4.131 of September 3, 1962, *as modified by* Law No. 4.390 of August 29, 1964.

IV. TAX REGULATIONS

Generally, Brazilian income tax law requires payments made by Brazilian sources to non-residents for services rendered to be taxed at the rate of twenty-five percent of the gross service payment.[17] While repayment of the loan principal is not taxable, interest paid to non-residents is subject to a twenty-five percent non-resident withholding income tax.[18] Present regulations, however, permit the Brazilian borrower to recapture an amount equal to eighty-five percent of the twenty-five percent tax withheld in order to lower the overall cost of foreign borrowing.[19] General corporate income tax is at the rate of thirty percent of taxable net profits.[20] The corporate income tax rate applies to all branches or subsidiaries.[21]

Payments to the contractor under the Risk Contract will fall within the above classifications and are subject to several important tax regulations. No tax will be due on payments made by Petrobrás to the contractor for funds applied by the contractor in its Brazilian branch or subsidiary to exploration and appraisal services. These payments are to be treated as interest-free loans even though repayment by Petrobrás to the contractor is to be due only if a commercial oil field is found and production commences. If a commercial oil field is not found, the contractor's branch or subsidiary is dissolved, no assets or funds are returned to the contractor, and no Brazilian taxes are levied. The Brazilian branch or subsidiary is not subject to corporate tax during its existence because it does not have any taxable income.[22]

Upon discovery of a commercial oil field and commencement of production, interest paid on development loans is taxed at the twenty-five percent non-resident withholding income tax rate.[23] Remuneration paid by Petrobrás to the contractor, *i.e.*, payments for services which are based on a percentage of production, is subject to the twenty-five percent non-resident withholding income tax. These payments are not subject to the Brazilian corporate tax of thirty percent.[24] Most tax treaties in which Brazil participates provide for lower withholding tax rates. In some cases, the twenty-five percent non-resident withholding tax is reduced to ten percent. Therefore, as a protective measure

17. Decree No. 76.186 of 1975, art. 344.
18. *Id.*
19. Decree-Law No. 1.411 of 1975; Central Bank of Brazil Resolution No. 335 of 1975; Central Bank of Brazil Circular No. 266.
20. Decree No. 76.186 of 1975, art. 226.
21. *Id.* art. 96.
22. Opinion of the Coordinator of the Taxation System, C.S.T. No. 802 (1976).
23. *Id.*
24. *Id.*

against possible future increases, it would be helpful if the United States and Brazil signed and ratified the tax treaty which is presently being negotiated. In the alternative, the contractor should be a company which is organized and exists within a country with which Brazil maintains a tax treaty.[25]

Payments made by the non-resident contractor to third parties outside of Brazil for services rendered in or out of Brazil are not subject to Brazilian taxes. However, if the Brazilian branch or subsidiary makes payments to third parties outside of Brazil for services rendered in or out of Brazil, such payments are subject to the twenty-five percent non-resident withholding income tax.[26]

A deduction for a "severance tax" is made in order to arrive at the net value of production. The net value of production is used to determine the amount available for payment to the contractor for services rendered. The severance tax is an indemnity for use payment ("royalty") and is payable by Petrobrás to the Brazilian Government at the rate of five percent of production value.[27]

V. IMPORT DUTY EXEMPTIONS, CONTRACTING WITH THIRD PARTIES, AND ARBITRATION OF DISPUTES

Companies operating under Risk Contracts are granted import duty exemption or suspension under two situations. First, equipment utilized during exploration and evaluation services may enter Brazil under a temporary suspension of duties. The equipment is thereafter exempted from duties upon departure from Brazil at the end of the contracted term or upon the equipment being transferred to an entity in Brazil such as Petrobrás which has been granted exemption from duties.[28] Second, a contractor may be exempt from the levy of duties when its branch or subsidiary imports exploration machinery, equipment, and supplies which are not manufactured in Brazil.[29]

The Risk Contract permits the contractor to subcontract with third parties for the performance of services under the contract provided the contractor does so at its own risk and responsibility. All subcontractors must agree to be bound by those Risk Contract provisions which relate

25. As of January 1, 1979, Brazil has tax treaties with Austria, Belgium, Denmark, Finland, France, Japan, Norway, Portugal, Spain, Sweden, and West Germany.

26. Opinion of the Coordinator of the Taxation System, C.S.T. No. 1.956 (1977).

27. Law No. 2.004 of 1953, art. 27.

28. Decree No. 76.055 of 1975; Order of the Minister of Finance (*Portária*) of January 26, 1976; General Instruction No. 4 of February 12, 1976, issued by the Secretary of Federal Revenue.

29. Customs Policy Council Resolution No. 2.901 of December 21, 1976; Order of the Minister of Finance No. 323 of December 24, 1973 (for excise tax exemption).

to the services to be executed by the subcontractor. Furthermore, all subcontracts and amendments to subcontracts are subject to prior approval by Petrobrás. In practice, however, Petrobrás is usually only concerned with those subcontracts in excess of $50,000 and the value limit of the subcontract may be negotiable.

The Risk Contract provides that the parties will settle all disputes arising under the contract by arbitration in Brazil and under the rules of the Brazilian Code of Civil Procedure. Standard Risk Contract clauses clearly mandate arbitration if requested by either party, even if one party should refuse.

VI. NEGOTIATING THE RISK CONTRACT

The general form and terms of the Risk Contract under Brazilian policy and guidelines are apparently rigid and established, but with each succeeding round of negotiations, Petrobrás has issued additional interpretations of existing terms bringing about a better understanding of specific provisions. Oil company representatives have found that discussions with Petrobrás executives both before and after the formal presentation of bids have clarified many issues and have even possibly taken some of the "risk" out of the contract.

The bedrock rule of international negotiations is to be certain to obtain the latest, most complete information available on the subject before embarking. This applies in particular to Risk Contract negotiations. Even though much legal and financial information is now publicly available, potential contractors can obtain the most recent interpretations and rules directly from Petrobrás only after receiving acceptance by Petrobrás as qualified bidders. The overall concept of the Risk Contract and its fundamental provisions are now more readily understandable and workable as a result of the adoption and issuance of specifically applicable laws, rules, and interpretations. The crystallization of the Risk Contract provisions can be attributed in great part to the extensive work that Petrobrás and oil company bidders have carried out over the past two years in negotiating and drafting final versions of workable service contracts. The evolution of the Risk Contract system will continue to benefit each succeeding generation of bidders.