RECENT DEVELOPMENTS IN BRAZIL’S OIL & GAS INDUSTRY: BRAZIL APPEARS TO BE STEMMING THE TIDE OF RESOURCE NATIONALISM

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I. INTRODUCTION: BRAZIL’S PROMINENCE IN GLOBAL OIL AND GAS DEVELOPMENT

II. BACKGROUND: CREATION OF A SAFE HARBOR FOR FOREIGN INVESTMENT
   A. Development of Brazil’s Legal Infrastructure
   B. Petrobras & International Competition

III. BRAZIL’S ENERGY MARKET: A SEA OF OPPORTUNITY
   A. Crude Oil: A Rising World Power
   B. Natural Gas

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C. Hydrocarbon Concessions: Attracting Foreign Capital ................................................. 265

IV. RECENT DEVELOPMENTS: A POTENTIAL BLOCKADE TO OIL AND GAS DEVELOPMENT ......................................................... 266
A. Analysis of the ANP Bid Round 8 Suspension: The Supreme Court Tenders Pro Foreign Investor Decision .................................................. 267
B. Unitization: The ANP’s Rising Storm .................................................. 272
C. Evolving Tax Incentives for Oil and Gas Development in Brazil: Will the Change in the Definition of Vessel Float with Investors? .................. 277

V. CONCLUSION: THE RESOURCE NATIONALISM SHIP HAS NOT SAILED, BUT IT MAY BE IN THE HARBOR ..................... 284

I. INTRODUCTION: BRAZIL’S PROMINENCE IN GLOBAL OIL AND GAS DEVELOPMENT

As the tenth largest energy consumer in the world (third largest in the Western Hemisphere after the United States and Canada), one of the world’s largest ethanol producers and the country with the second largest crude oil reserves in South America, Brazil is a critical player in the global energy market. Only a year after becoming a net oil exporter, Petrobras’s recent discovery in the Tupi field, off Brazil’s southeastern Atlantic coast, could add as much as “5 billion [to] 8 billion barrels [of recoverable light crude]—equivalent to 40 percent of all the oil ever discovered in Brazil.” Further, the recent rumors surrounding the Carioca field in the Santos Basin, indicate that there could be another large discovery on the near horizon, but there have been no definitive

1. The República Federativa do Brasil or Federative Republic of Brazil is referred to herein as “Brazil.”
announcements yet regarding such discovery. In a time where high crude oil prices and internal politics have caused much of Latin America to look inward and focus on recapturing dominion and control over their natural resources, Brazil continues to welcome foreign investment from international oil companies (IOCs) to increase direct investment in the hydrocarbon sector. This is not to say that Brazil is a panacea for oil and gas development, as it has its challenges and uncertainties as well. Petrobras's Tupi discovery and the resultant withdrawal of “41 of the most promising blocks” from Bid Round 9 introduced elements of instability and national preference that Brazil has heretofore avoided. This paper will highlight some of the more significant recent legal developments in Brazil and some pending concerns for investing in Brazil, principally in the upstream energy sector.

First, this Article will provide a general background of the Brazilian energy market and briefly touch on the events that have led it to be one of the most attractive countries for foreign investment in South America. A review of the current status of Bid Rounds 8 and 9 follows thereafter, including an analysis of two injunctions that suspended Bid Round 8 throughout 2007. Then, the Article addresses the increasing likelihood of reservoir unitization in offshore developments and potential constitutional challenges that may result. Finally, the Article examines a pending tax dispute regarding the reclassification of certain offshore oil and gas platforms that will have a material impact on the way most international oil companies structure their exploration and development programs in Brazil.

II. BACKGROUND: CREATION OF A SAFE HARBOR FOR FOREIGN INVESTMENT

A. Development of Brazil's Legal Infrastructure

A little over 10 years ago the Brazilian exploration and production sector was essentially closed to foreign participation. It was not until the National Congress enacted Constitutional Amendment No. 9 in 1995 that constitutional restrictions against private participation in the oil and gas sector in Brazil were relaxed by allowing private companies to invest and participate in the upstream sector. Prior to that amendment, all such activities were reserved exclusively for the government-controlled enterprise, Petróleo Brasileiro, SA–Petrobras.

After the Constitution was amended, a variety of laws were promulgated over the succeeding years which led to the opening of the Brazilian upstream market. In 1997, Law No. 9,478 (the Petroleum Law) was enacted, creating, among other things, the Agência Nacional do Petróleo, Gás Natural e Biocombustíveis (ANP) to regulate the oil and gas sector. The Petroleum Law also created the National Council on Energy Policy (CNPE), founded to assist and advise the President of Brazil and the Minister of Mines and Energy in the development of Brazil's


9. Constituição Federal [C.F.] [Constitution] amend. 9, art. 177 (Braz), translated in http://www.x-brazil.com/government/laws/titleVII.html. The original text of Article 177 of the Brazilian Constitution prohibited any assignment or grant of any participation in the exploration, production, refining, importation, exportation or transportation of crude oil and natural gas. Id.

10. Id. Petrobras was created by Law No. 2.004 of October 3, 1953, and was granted the exclusive right to perform virtually all oil and gas exploration and production activities within Brazil. Lei No. 2.004, de 3 de outubro de 1953, D.O. de 03.10.1953. (Brazil), available at http://www.planalto.gov.br/ccivil/leis/L2004.htm.

national energy policy. Most importantly for IOCs, the Petroleum Law revoked Law No. 2.004, which created Petrobras and regulated its activities. Petrobras is now purported to maintain the same status as new private investors in the oil and gas market.

B. Petrobras & International Competition

While competition from foreign investors continues to increase, Petrobras remains the dominant player in Brazil’s oil sector, holding a majority position in up-, mid-, and downstream activities. Since the enactment of the Petroleum Law, Petrobras has become the fourteenth largest oil company in the world with 2005 net revenues of $47 (U.S.) billion. Petrobras has become an internationally respected, integrated energy company that operates throughout the world and possesses technical expertise and capabilities that rival any IOC, especially in deepwater exploration and development.

Since December of 1998, the ANP has been holding licensing rounds whereby all interested companies, including Petrobras, can compete for oil and gas exploration and production concessions in specific exploration blocks. The bidding process established by the ANP created an even playing field that has allowed open competition among IOCs and has historically

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13. Id. § 1.2; Lei No. 2.004, de 3 de outubro de 1953, arts. 5–6.
14. Barreto, supra note 11. In addition to Petrobras’s being the overwhelmingly largest operator in the country, Article 42 of the Petroleum Law provides that in the case of a tie bid for an exploration and development block, bids are to be decided in favor of Petrobras, provided that Petrobras is not a member of the consortium with other third parties. Lei No. 9.478, de 6 de agosto de 1997, D.O.U. de 07.08.1997, art. 42. (Brazil), translated in http://www.anp.gov.br/doc/conheca/Lei_do_Petroleo_ingles.pdf.
fostered a favorable framework in Brazil for foreign investors.\textsuperscript{19} In addition, from a political standpoint, Brazil is stable and in all but the most recent bidding rounds has continued to pursue a transparent, open process focusing on high bonus payments, significant local content, and substantial minimum work programs.\textsuperscript{20} In order to foster transparency in the bidding process, the ANP announces winning bids publicly and discloses the economic terms of all bidders and the resultant bid score.\textsuperscript{21}

### III. BRAZIL’S ENERGY MARKET: A SEA OF OPPORTUNITY

#### A. Crude Oil: A Rising World Power

Without consideration of the Tupi discovery, Brazil has an estimated 11.7 billion barrels of proven oil reserves and is one of the fastest growing oil producers in the world.\textsuperscript{22} When combined with the Tupi discovery, Brazil would have at least the eighth largest proven oil and gas reserves in the world.\textsuperscript{23} In 2003, Royal Dutch Shell was the first foreign operator in the country, operating a single small field in the Campos basin.\textsuperscript{24} In mid-2007, “Devon brought its Polvo project (50,000 bbl/d) online... representing the [first major] oil project without any Petrobras

\begin{itemize}
  \item \textsuperscript{19} See Dyer, \textit{supra} note 18 (rating Brazil as the second most attractive place in the world for investment opportunities).
  \item \textsuperscript{20} See PAULO ALEXANDRE SOUZA DA SILVA, NAT’L AGENCY OF PETROLEUM, NATURAL GAS AND BIOFUELS (ANP), RULES FOR PARTICIPATING IN BRASIL ROUND 9 (Sept. 2007), http://www.brasil-rounds.gov.br/round9/Roadshow_London/Apresenta\%C3%87%C3%A3o_Paulo%20Alexandre_SPL_London.pdf.
  \item \textsuperscript{22} \textit{Brazil: Energy Profile}, \textit{supra} note 2.
  \item \textsuperscript{23} \textit{Id}.
  \item \textsuperscript{24} \textit{Brazil: Energy Profile}, \textit{supra} note 2. Shell’s Bijupira-Salema project in the Campos Basin came on stream in 2003 and produces about 50,000 barrels per day (bbl/d). \textit{Id}. “Shell also hopes to begin production at its BC–10 project (100,000 bbl/d) by the end of 2009.” \textit{Id}.
participation.” More recently, companies such as El Paso Energy and ChevronTexaco have announced that they intend to commence commercial production in 2008 or 2009.

B. Natural Gas

Development of natural gas has become a priority for Brazil, which currently has approximately 10.8 trillion cubic feet of proven natural gas reserves, 90% of which are controlled by Petrobras. Although Petrobras enjoys the majority control of the natural gas reserves, there are other important foreign participants in the natural gas industry, including Sulgas and BG Group. Currently, natural gas is a minor contributor to the overall energy supply; however, recent difficulties with Bolivia and other trading partners have highlighted the risks associated with relying on third party suppliers for the bulk of Brazil’s natural gas. As a result, Brazil is concerned with developing its internal natural gas reserves, and its recent focus on developing this area becomes evident upon analyzing the properties made available for Bid Round 9, which notably included many gas-prone areas.

C. Hydrocarbon Concessions: Attracting Foreign Capital

Both IOCs and national oil companies that are interested in acquiring the rights to explore, develop and produce hydrocarbons in Brazil must participate in a transparent and public bidding process (each a bid round) that is established

25. Id. The project, which produces approximately 50,000 bbl/d, was brought online in August 2007. Id.
27. Brazil: Energy Profile, supra note 2.
28. Id.
under the Petroleum Law and related regulations. Typically, the bidding process involves: (a) delivery of an “expression of interest”; (b) payment of a “participation fee”; (c) withdrawal of the “information package”; (d) legal, technical and financial qualification; (e) presentation of the required guarantees; (f) tender of the bids; (g) judgment of the bids; (h) the ratification of the judgment of the bids; and (i) execution of the concession agreement. In the first seven bid rounds, Brazil successfully granted 610 exploration blocks; however, the results of Bid Round 8 are still pending. In Bid Round 9, which concluded on November 27, 2007, 117 blocks were awarded.

IV. RECENT DEVELOPMENTS: A POTENTIAL BLOCKADE TO OIL AND GAS DEVELOPMENT

Notwithstanding the relative optimism in the Brazilian upstream market when compared to the rest of Latin America, there are a number of concerns which make doing business in Brazil challenging. While there are many challenges to any

31. Lei No. 9.478, de 6 de agosto de 1997, D.O.U. de 07.08.1997, arts. 23, 36. (Brazil), translated in http://www.anp.gov.br/doc/conheca/Lei_do_Petroleo_ingles.pdf. Pursuant to Article 37 of the Petroleum Law, the bid invitation shall provide for the following: (a) the description of the blocks being offered, the estimated period for exploration and the investments in the minimum exploratory program; (b) the requirements to be fulfilled by the interested companies and the conditions for qualification of these companies; (c) the minimum government and land owner takes; (d) the list of documents required and the criteria adopted by the ANP for the verification of the applicant company's technical capacity, credibility and good standing; (f) the express warning that the concessionaire must respond to any indemnity for expropriation or servitude necessary for the fulfillment of the concessionaire's obligations under the concession agreement; and (g) the deadline, the location and the time in which the ANP will provide the interested companies the studies and basis that will enable them to tender their bids. Id. art. 37.


successful exploration and development project, the constraints of this Article do not allow a full discussion of all of the complexities that will be encountered in Brazil, such as the environmental permitting process, difficulties with customs and importation, and multiple layers of taxation. This Article focuses only on a select group of issues where current legal cases or disputes are pending or have recently been resolved. This section of the Article will address concerns regarding several of the recent bid rounds, including the withdrawal of numerous blocks from Bid Round 9 and the series of injunctions that led to the suspension of Bid Round 8. Next, the complicated issue of unitization in Brazil is addressed, which some upstream players will have to confront in the near future as the exploration and production blocks being offered for bidding have been reduced in size, and operators other than Petrobras continue to make commercial discoveries on adjacent blocks. Finally, this section of the Article discusses the continuing flux of Brazil’s highly complex tax structure, which necessitates careful planning by any IOC engaging in oil and gas activities in the country.

A. Analysis of the ANP Bid Round 8 Suspension: The Supreme Court Tenders Pro Foreign Investor Decision

While there have historically been several challenges or complaints regarding past ANP bid rounds, for the most part the ANP has been able to resolve such impediments and remove potential challenges that would delay the awards of blocks to winning participants. This was not the case in November 2006, when the ANP held Bid Round 8 to auction rights to 284 blocks in 14 different sectors (12 offshore and 2 onshore). After many

35. See, e.g., Dyer, supra note 18 (detailing political and environmental concerns in previous bid rounds); The ANP Round 8 Website, supra note 21 (notifying bidders of Round 8 legal suspension).


37. See CUNHA, supra note 16 (indicating recent politically driven tax changes affecting foreign oil and gas companies).

38. See Dyer, supra note 18 (detailing continued foreign investment despite political and environmental complaints and concerns).

39. The ANP Round 8 Website, supra note 21.
companies invested substantial sums in due diligence and bid preparation, the Bid Round was interrupted by two injunctions, one filed in the Federal District Court of Rio de Janeiro and the other in the Federal District Court of the Federal District (the Injunctions). Prior to the filing of the Injunctions, 23 companies were declared winners of 38 exploration blocks; however, in light of the Injunctions, the ANP could not complete granting all awards, nor could it proceed with negotiations on any concession agreements.

The plaintiffs complained that the tender protocols were unconstitutional and discriminatory in nature because they contained an arbitrary limitation on the number of bids one company could make in a particular sector of a basin. Further, the Injunctions were premised on the argument that the Petroleum Law empowered the ANP to regulate the oil and gas sector, the ANP bidding procedures in the Bid Round tender protocols are ruled by administrative laws in Brazil and as such, must follow the principles set forth in the Brazilian Federal Constitution.

The movants argued that Bid Round 8 restrictions unlawfully discriminated among potential bidders and deprived otherwise prequalified bidders from participating in bids for subsequent blocks. In their Injunctions, they contended that the loss of additional bidders, as a result of the discrimination, would yield less competition among the parties for later blocks and consequently result in lower revenues for the Brazilian government.

41. J.F. – 9, Processo No. 2006.34.00.035825–0, 27.11.2006 (Brazil), http://www.trf1.gov.br (follow “Consulta Processual” hyperlink; then select “JFDF” under “Orgão” field; then enter “20063400035825” in “N. do Processo” field).
44. Id.
45. Id.
The ANP defended the tender protocols by arguing that the ANP was the competent authority to establish limits and regulate the participation for bidding on petroleum exploration blocks, and the relevant restrictions were within its discretion as a matter of law.\(^{46}\) The subject restrictions refer to the operators of winning bids, not all bidders.\(^{47}\) Therefore, the ANP argued, it was possible for all the companies to participate in blocks in which they held a real interest.\(^{48}\) The ANP asserted that its bidding protocols would result in higher signature bonus payments because interested bidders would focus their efforts on the blocks they desired most and not spread out limited resources across a greater number of properties.\(^{49}\) The ANP claimed that the basic reasoning behind the restriction was to ensure all companies, large or small, had opportunities to compete for awards, as opposed to being a targeted attack on one dominant participant.\(^{50}\)

The Rio de Janeiro lower court suspended Bid Round 8 pending the determination of the allegations of impropriety in the tender protocol, a decision which was affirmed by the court of appeals. The courts held that the Injunctions were in the best interest of the public, because the restrictions in the tender protocol could damage public patrimony.\(^{51}\) The courts believed that the restrictions would cause the government to receive less compensation for the blocks because potentially interested bidders would be excluded from pursuing certain properties.\(^{52}\) Thus, both the lower court and the court of appeals believed that the arguments set forth in the Injunctions were credible enough to warrant granting the injunction to prevent the completion of Bid Round 8.\(^{53}\) The courts did not find that less competition would necessarily lead to lower offers and valuations; however,

\(^{46}\) Id.  
\(^{47}\) Id.  
\(^{48}\) Id.  
\(^{49}\) Id.  
\(^{50}\) Id.  
\(^{51}\) Id.  
\(^{52}\) Id.  
\(^{53}\) Id.
the risk of such consequences were found to be significant and evident, especially considering the gravity of the limitations imposed by the ANP.54

The ANP appealed the decision of the lower court and the subsequent decision of the court of appeals.55 Brazil’s Supreme Federal Tribunal (the Supreme Court) finally ruled on the matter in July 2007. The Supreme Court held the following:56

1. The suspension of the Bid Round caused a serious hardship on the public welfare, impacting economic growth of the country due to the impediment against exploiting national oil and gas reserves;

2. The suspension endangered Brazilian self-sufficiency on oil production, since the judicial suspension of Bid Round 8 created uncertainty regarding the bidding procedure and led to the withdrawal of desired private capital;

3. The suspension of Bid Round 8 directly affected the Brazilian energy matrix which in turn jeopardized Brazilian national security; and

4. The suspension portrayed a negative image for national and foreign investors which are responsible for providing a massive influx of the input of capital in order to fill the large gaps in the technology sector, which demands state of the art machinery and specialized personnel that Brazil does not have.57

Essentially, the Supreme Court believed that the ANP was created with the power to enforce energy policy without interference from the judiciary regarding its technical and political decisions.58 The Supreme Court’s decision overturning the lower court’s injunction was significant, especially in an era of resource nationalism throughout much of Latin America. Brazil was able to address a legal challenge while respecting the

54. Id.
55. Id.
56. Injunction Suspension No. 176, Official Justice Magazine n° 149, as of August 3, 2007–10–15 Minute n° 103 (Braz.).
57. Id.
58. Id.
rule of law and sanctity of contracts. While the ANP’s decision is a de facto limitation on competition and free markets, it is striking to note that it disfavors the national petroleum company. The ruling demonstrates at a minimum that the Supreme Court understands the need for Brazil to proceed with an energy policy that encourages direct foreign investment and respects that capital migrates to places where the best investment opportunities exist, and more particularly, in a politically stable environment that respects the rule of law.\(^59\) The ANP’s actions seem to indicate they too understand the importance of foreign investment and technology to ensure a robust oil and gas development program.

Nevertheless, the Supreme Court decision rendered by Minister Ellen Gracie reversing the lower court’s injunctions is a decision potentially subject to further review.\(^60\) The parties in either case could pursue an appeal to request a review by the entire Supreme Court in full session.\(^61\) In late October 2007, the Supreme Court ruled that it would be contrary to the public interest not to hold the bid round.\(^62\)

Even though the ANP had stated publicly that it intended to complete the Bid Round 8 awards prior to the commencement of Bid Round 9,\(^63\) the Bid Round 8 results are still suspended pending the legal proceedings mentioned above. Bid Round 9 was completed on November 27, 2007.\(^64\) At this time, it is unknown when the ANP will complete the Bid Round 8 awards.

The ANP initially appeared to have taken potential delays in the bid round process as a serious concern and made concerted efforts to mitigate such confrontations in Bid Round 9.

\(^{59}\) Id.
\(^{60}\) Id.
\(^{63}\) Brazil’s Supreme Court Clears Final Hurdle for Round 8, supra note 42.
\(^{64}\) Monsanto, supra note 34.
This initial optimism for future bid rounds has turned into concern as industry participants are waiting to see what will become of the blocks withdrawn from Bid Round 9.

B. Unitization.65 The ANP’s Rising Storm

Participants in the Brazilian oil and gas sector will increasingly have to deal with the process of unitization in the coming years. The principal factors which will drive this trend toward unitization are smaller exploration block sizes in present and future bid rounds and the release of acreage from previous awards, as commercial operations are commenced.

The average size of exploration blocks offered during bid rounds has reduced substantially since the first round.66 Reducing block size, particularly in promising reservoirs, makes good business sense for the ANP, as it will likely receive greater signature bonuses, even if it is from the same operator bidding on multiple blocks, in an effort to secure the full extent of a particular field or anticipated horizon. While the size reduction is partly due to the ANP’s desire to promote participation by mid-sized and smaller companies, the overall trend is clear.67 Concessionaires will increasingly encounter discoveries in the same hydrocarbon reservoir, which may require unitization under Brazilian law.68

Further, now that Brazil has already completed eight bid rounds (including additional grants in what is commonly referred to as Round Zero), smaller pieces of such early blocks are being returned to the ANP in accordance with the operator’s


66. The bid round and average block size offered (in million sq. km.): Round 1: 4.55; Round 2: 2.58; Round 3: 1.69; Round 4: 2.20; Round 5: 0.30, Round 6: 0.22 and Round 7: 0.35. Dyer, supra note 18.


concession agreements. These small, unevenly sized parcels are available for the ANP to release in future bidding rounds and will presumably be adjacent to producing fields. Consequently, the potential of encountering a reservoir already being operated by another concessionaire has increased.

The process of unitization can be quite difficult and contentious. Whereas members of a consortium bidding for oil and gas properties have had the opportunity to establish their internal rights and governance pursuant to the terms of a joint operating agreement or joint bidding agreement when evaluating whether to proceed with a particular investment, parties subject to a unitization plan typically have no choice.

If unitization is necessary for a particular field, the concessionaires will first seek to reach a mutual agreement and present a unitization plan to the ANP for approval. The ANP may serve as a mediator in the process to help ensure the parties reach an agreement that is acceptable not only to them,

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69. Federal Republic of Brazil Ministry of Mines and Energy, ANP Concession Agreement for the Exploration, Development and Production of Oil and Natural Gas, cl. 3.4 (2007), http://www.brasil-rounds.gov.br/round9/edital/Conc_agreement_11_10.pdf [hereinafter ANP Concession Agreement]. Section 8.4 of the ANP Bid Round 9 Tender Protocol governs the relinquishment of area for Bid Round 9, which is similar to prior bid rounds. Agência Nacional Do Petróleo, Gás Natural e Biocombustíveis (ANP), Final Tender Protocol for the Granting of Concession Agreements, cl. 8.4 (2007), http://www.brasil-rounds.gov.br/round9/edital/FT%20Protocol%202011-10_v2.pdf. In a manner that is typical to most countries with concession regimes, if a concessionaire does not declare a commercial discovery, it must release the acreage it received in an award at the end of the exploration phase. See id. (covering relinquishment of awarded areas). Thereafter, if it fails to successfully produce hydrocarbons after making a declaration, it will have to relinquish the declared acreage as well. ANP Concession Agreement, supra, cl. 5.19(c).

70. See id. cl. 3.6 (stating that only the ANP has the right to dispose of the blocks in a new bidding process).


72. See ANP Concession Agreement, supra note 69, cl. 12.1–7 (detailing the agreement for the unification of production).
but to ANP as well.\textsuperscript{73} If the parties are unable to agree upon a plan, the Petroleum Law provides that:

In case of fields extending over adjoining blocks, operated by other concessionaires, the parties involved shall agree on the unitization of the production.

\ldots\textsuperscript{73} In case of non-agreement within the maximum period established by the ANP, the ANP shall, based on an arbitrator’s award, determine how the rights and obligations to the blocks will be equitably allocated, based on the applicable general law principles.\textsuperscript{74}

To date, there have been virtually no unitization cases in Brazil, but there will likely be constitutional challenges as the above referenced legal provision attempts to require or force the parties to initiate an arbitration proceeding.\textsuperscript{75} Dissatisfied parties to an arbitrators’ decision on a unitization plan may likely challenge such decision based on the fact that the parties were compelled to arbitration without an express written arbitration agreement.

Such an argument may be unsuccessful due to arbitration language contained in the bid concession agreements. For example, the Bid Round 9 Concession Agreement (similar to earlier concession agreements) tracks the language of Article 27 of the Petroleum Law and contains a mandatory arbitration clause, which states: "If no agreement is reached by the parties, in a maximum period set by the ANP, it shall be responsible for deciding, based on an arbitration award, how the rights and obligations of each Concessionaire shall be equitably distributed, based on the general principles of the applicable Law."\textsuperscript{76}

Further, the Agreement goes on to say that "[i]f, at any time,

\textsuperscript{73} Id. cl. 12.17. Clause 12 of the Concession Agreement for the ninth bid round sets forth the process for unitization for a Bid Round 9 concessionaire, and such provision is similar to that contained in earlier concession agreements as well. Id. cl. 12.1–18.


\textsuperscript{75} See ANP Concession Agreement, supra note 69, cl. 12.17 (giving the ANP the power through arbitration to decide how the rights and obligations of the concessionaires should be equitably distributed).

\textsuperscript{76} Id.
any Party considers that there are no conditions for the amicable resolution of a dispute or controversy [arising from this Agreement], it must submit this dispute or controversy to ‘ad hoc’ arbitration.”

While there are several cases in which the Brazilian Supreme Court ruled that arbitration is not unconstitutional, there remains an unresolved issue as to whether or not the

77. Id. cl. 31.5.
If, at any time, any Party considers that there are no conditions for the amicable resolution of a dispute or controversy . . . it must submit this dispute or controversy to “ad hoc” arbitration, using as a parameter the rules established by the Regulations of the International Chamber of Commerce Arbitration and in accordance with the following principles:

(a) The choice of arbitrators shall be in accordance with that established by the Regulations of the International Chamber of Commerce Arbitration;
(b) There shall be three arbitrators. Each Party shall choose one arbitrator. The two arbitrators chosen shall appoint the third arbitrator, who shall act as president;
(c) The City of Rio de Janeiro, Brazil, shall be the location of the arbitration and the place of the delivery of the award;
(d) The language to be used in the arbitration procedure shall be Portuguese. The parties may, however, submit testimonies or documents in any other language if the arbitrators so decide, without the need for official translation;
(e) Regarding the merits, the arbitrators shall decide based on the substantive Brazilian laws;
(f) The arbitration award shall be final and its content shall be binding on the Parties;
(g) If it is necessary to use preparatory or incidental writ of prevention, or other precautionary measures, the interested Party may require them directly to the Judiciary, based on the applicable Brazilian legislation.

Id.

78. Adriana Noemi Pucci, Arbitration in Brazil: Foreign Investment and the New Brazilian Approach to Arbitration, Disp. Resol. J., Feb.–Apr. 2005, at 82, 84 (citation omitted). The 1996 Arbitration Act was challenged shortly after it was enacted. Pedro A. Batista Martins, Arbitration in Brazil: A Look at Recent Developments, Disp. Resol. J., Feb.–Apr. 2003, at 68, 71. The issue was whether the Act violated Article 5, Item XXXV of the Brazilian Constitution, which states “the law may not exclude from the judgment of the judiciary any violation or threat to a legal right.” Id.; Constituição Federal [C.F.] [Constitution] art. 5, § XXXV (Braz.), translated in http://www.v-brazil.com/government/laws/title1.html. In December 2001, the Supreme Court resolved that the 1996 Arbitration Act was constitutional. Martins, supra, at 71. Other cases have addressed and upheld the constitutionality of allowing state-owned companies to resolve disputes through arbitration if they have express legislative authority. Pucci, supra, at 86–87 (citation omitted).
mandatory arbitration clause in Bid Round 9 is constitutional. The Supreme Court case upholding the validity of Brazil’s 1996 arbitration law hinged on a number of factors, including the fact that the parties had agreed in the concession agreement to an arbitration clause to resolve their disputes in an arbitration proceeding.\(^79\) Conversely, in an arbitration proceeding regarding the unitization of an oil or gas field, the rights, duties, and obligations of two independent parties that agreed to arbitrate with the ANP are compelled into arbitration with one another. In other words, unitization arbitration between the ANP and the concessionaire of a given block is clearly constitutional, because the concessionaire voluntarily agreed to such arbitration when it signed its concession agreement; however, the constitutionality of forcing arbitration between two parties that have not previously agreed to arbitrate any disputes that may arise between each other remains in doubt. Thus, in the case where a reservoir extends outside of a concessionaire’s awarded area, and such adjacent area is not under concession, the concessionaire would not be able to argue the constitutionality of its agreement to arbitrate with the ANP as to the allocation of rights and responsibilities between it and the ANP with respect to such reservoir.\(^80\)

Alternatively, when the ANP imposes arbitration between concessionaires who are not signatories to the same agreement, it is arguable that it is an unconstitutional deprivation of a party’s right to avail itself of the Brazilian judiciary for disputes.\(^81\) Any challenger to the ANP imposing arbitration runs the risk of dealing with substantial delays if it is allowed to pursue a remedy in the Brazilian legal system, and it runs the greater risk of having its concession terminated by the ANP for refusing to sign a unitization agreement.\(^82\)

\(^79\). See Martins, supra note 78, at 75 n.28 (explaining that after the enactment of the Arbitration Act, the arbitration agreement inserted in the concession agreement was considered valid and enforceable).

\(^80\). Nevertheless, in such a situation, it is highly likely that any concessionaire would prefer arbitration over resorting to the Brazilian courts.

\(^81\). Constituição Federal [C.F.] [Constitution] art. 5, § XXXV (Braz.), translated in http://www.v-brazil.com/government/laws/titleI.html (stating “the law shall not exclude any injury or threat to a right from the consideration of the Judicial Power”).

\(^82\). Clause 12.18 of the Bid Round 9 Concession Agreement states: “The refusal by
C. Evolving Tax Incentives for Oil and Gas Development in Brazil: Will the Change in the Definition of Vessel Float with Investors?

Anyone who has ever done business in Brazil is familiar with the fact that it has an extremely complicated tax system.\(^8^3\) To encourage investment in the petroleum industry, on September 2, 1999, the Brazilian Congress enacted Decree No. 3.161, providing for a special customs regime called REPETRO.\(^8^4\) REPETRO is a tax incentive that allows the use of special customs arrangements such as Temporary Admission,\(^8^5\) Suspension Drawback,\(^8^6\) the symbolic exportation system,\(^8^7\) and the bonded warehouse regime.\(^8^8\) Further, REPETRO suspends any of the parties to sign the Agreement for Individualization of Production shall imply termination of the [concession agreement].” ANP Concession Agreement, supra note 69, cl. 12.18.


85. AMORIM, supra note 84. Under the temporary admission system (ITA), “a Brazilian entity leases, rents or borrows the equipment from the nonresident producer without incurring customs duties and taxes . . . based on a ratio that represents the time the equipment remains in Brazil and its useful life.” Rubens Branco & Leonardo Braune, Brazil: Acquisition of Oil and Gas Industry Equipment for Brazilian Operations, INT’L TAX REVIEW, Feb. 2001, at 71.

86. Suspension Drawback “allows importing raw-materials, semi-manufactured goods and finished products for the oil industry in order to export these products later.” AMORIM, supra note 84.

87. Basically this system extends ITA tax benefits to goods, even when purchased from a local producer. Branco & Braune, supra note 85, at 71. “[T]he goods are fictitiously exported to a nonresident company, that pays for them in hard currency and then immediately leases, rents or lends them to a Brazilian company . . . , who will use them in its exploration and production activities.” Id. The goods do not actually leave Brazil’s customs territory due to the application of the Temporary Admission System. AMORIM, supra note 84.

88. See BAKER & MCKENZIE, supra note 67, at 184 (explaining that the Bonded Warehouse Special Customs Regime provides for the suspension of the federal taxes
federal taxes \(^{89}\) on the importation of goods and equipment for the term of any concession agreement if the equipment is returned to its country of origin when the concession terminates. \(^{90}\) Most IOCs rely heavily on the aforementioned tax incentives, and any adverse changes to those benefits could have severe ramifications on future investment. \(^{91}\)

Recently, a controversy has emerged concerning the definition of the word “vessel” which could negatively impact IOCs investing in Brazil. The term vessel is important because Article 691 of Brazilian Income Tax Regulations (RIR), approved by Decree No. 3.000/99, eliminated the imposto de renda retido na fonte or income tax of 15% (Withholding Tax) applicable to the charter, freight, rental, or lease of foreign vessels. \(^{92}\) Based on Article 691 of the RIR, companies engaged in the Brazilian oil and gas industry have been taking advantage of the zero percent Withholding Tax rate, while chartering floating platforms, rigs, and other vessels from non-Brazilian entities to carry out oil and

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89. Decreto No. 3.161, de 2 setembro de 1999, D.O.U. de 03.09.1999, 2, art. 4. (Brazil), available at http://www.receita.fazenda.gov.br/legislacao/decretos/Ant2001/1999/Dec316199.htm. REPETRO suspends the Import Duty, Excise Tax (IPI), PIS and COFINS on goods and equipment used by the oil and gas industry. AMORIM, supra note 84. IPI stands for Tax on Industrialized Products and “is a value-added tax that is levied by the federal government on most manufactured products and paid by the manufacturer or the importer.” Stuber & Amaro, supra note 83, at 56. For imports, it is normally calculated on the customs value plus the import duty. Id. PIS stands for Program for Social Integration and is a contribution based on an “entity’s gross revenues from the sale of goods, provision of services, or results of transactions on third parties’ account.” Id. at 55. It is normally assessed based on monthly gross operational revenues. Id. COFINS stands for the Contribution for the Financing of Social Security and is “assessed based on monthly gross invoicing of goods and services.” Id.

90. Decreto No. 3.161, de 2 setembro de 1999, arts. 2, 4.

91. See BAKER & MCKENZIE, supra note 67, at 180–91 (listing tax incentives relied upon by foreign oil investors doing business in Brazil).

gas exploration and production activities along the Brazilian coast. The net effect of the Withholding Tax is that oil and gas platforms, mobile offshore production units, floating production, storage, offloading units, and similar equipment would cost operators 15% more. Some of these types of equipment are chartered at day rates in excess of several hundred thousand dollars per day, and the RIR tax relief translates into substantial savings that companies rely upon when making decisions about their levels of investment in a particular project.

Notwithstanding the common charter practice described above, in 2003, the Brazilian Federal Taxing Authority (IRS) assessed Withholding Tax against a major oil and gas concessionaire, demanding payment of Withholding Tax on certain charter payments for an offshore platform. The IRS contended that the term vessel used in Article 691 of the RIR only encompassed structures that were used for the transportation of goods and people. Because the offshore platform was engaged in oil and gas exploration and development activities as opposed to transportation activities, the IRS contended Withholding Taxes were due, together with interest and a penalty of 75% of the taxes that should have been withheld.


94. Branco & Braune, supra note 85, at 71.

95. See, e.g., Piyush Pandey & Nevin John, Soaring Charter Rates Force Oil Exploration Giants to Buy Rigs, ECON. TIMES, June 6, 2007, http://economictimes.indiatimes.com/articleshow/2101709.cms (noting that the average daily rig charter rate was $137,509 in December 2006 and that one fourth generation submersible was earning $477,000 per day).


97. Id.

98. Id.

99. Id.
The defendant filed an administrative appeal against the assessment of the tax, which was later remitted to the Brazilian Taxpayer Council for a ruling. The Council was deadlocked on the decision, and the casting vote by the Council President confirmed the assessment of Withholding Taxes. The ruling, issued on April 20, 2005, accepted the IRS’s position that the concepts of vessel and platform provided by Federal Law No. 9,537/97 (the law that governs the safety of traffic in Brazilian waters) should be utilized to interpret the tax relief provided by Article 691 of the RIR. According to Article 2 of Federal Law No. 9,537/97, vessel and platform are defined as follows:

Vessel: any construction, including floating platforms and fixed platforms when towed, subject to registering with the marine authority and capable of moving in the water, by its own means or not, carrying people or goods;

Platform: premise or structure, fixed or floating, destined to activities directly or indirectly related to the research, exploration and exploitation of resources from the seabed of interior waters, sea or continental platform.

The IRS contended that in order for a particular structure such as a platform to be considered a vessel, and thus avoid Withholding Tax, it would have to be designed and utilized for the transportation of people or goods, not drilling, research, exploration or development activities. The IRS also successfully used an analogy to the Harmonized Commodity Description and Coding System (HCDC). According to the IRS’s rationale, Chapter 89 of the HCDC, which refers to vessels and floating structures, implies that floating structures are

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100. Id.
101. Id.
102. Id.
105. Id.
separate and distinct from vessels and not a subset thereof. Accordingly, the IRS argued that vessels were structures that functioned as a way to transport people and goods, whereas floating structures had a primary use other than for transportation.

In addition, it was argued that according to Article 111 of the National Tax Code, the granting of a tax exemption or exclusion of a tax credit should be interpreted restrictively. The Taxpayer Council held that: (i) the concept of a vessel entails a transportation activity, (ii) the HCDC differentiates vessels from other floating structures such as platforms, and (iii) tax exemptions should be strictly construed, and therefore platforms and vessels are different categories, and, as such, the values paid under the title of lease (rental) of platforms are subject to Withholding Tax.

The defendant appealed the decision to the highest administrative chamber, the Superior Chamber of Tax Appeals, and that appeal is pending. It is unknown when the appeal is likely to be heard, and if unsuccessful, the defendant will be able to appeal to the Brazilian judiciary, which would again be a lengthy process. This issue is a significant concern to participants in the Brazilian oil and gas market, because the rationale employed by the Taxpayer Council could be extended to other types of equipment used in oil and gas exploration as mentioned above.

Although the potential imposition of taxes is disconcerting, there are several arguments to be made on appeal. However, as the Superior Chamber of Tax Appeals is constituted similar to the Taxpayer Council, with the casting vote held by the
Treasury Department’s appointee, the defendant may have to wait until it is able to argue its case before a Brazilian court in order to prevail.

Notwithstanding the imposition of Withholding Tax in the instant case, there are arguments to be made which should give the defendant and other participants in the oil and gas sector some reason for optimism. As a counterargument to the view that tax exemptions must be construed narrowly, the Brazilian Constitution, in Article 150, Section I, provides that the creation or increase of a tax burden requires the enactment of a statutory law; thus, the Taxpayer Council should not be able to impose or create a new tax through its rulings, rather it must create a new statutory law framework to impose any new taxes. Article 108, Section 1, of the National Tax Code, embodies the foregoing constitutional principal and provides that analogies may not be used to require a new tax to be paid that is not specifically provided for under law. The Brazilian Constitution and National Tax Code can be interpreted a contrario sensu to forbid the use of broad analogies or interpretation of terms to demand payment of taxes in cases where the law expressly excluded such a burden. As a civil law society, extrapolation and analogies that are frequently used in common law systems are not always accurate in Brazil. For example, the Taxpayer Council utilized definitions contained in Federal Law No. 9.537/97, which was established for the purposes of regulating water transportation safety. In addition, the HCDC relied upon by the IRS is designed for import customs classification purposes.

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112. Internal Rules of the Brazilian Taxpayer Council (as approved by the Minister of Finance Ordinance MF # 147, of June 28, 2007, as amended by the Minister of Finance Ordinance # 222, of September 04, 2007).
only.\textsuperscript{117} Using water safety regulations or customs classification systems as a basis to deny tax relief that had theretofore been allowed is arguably not in accordance with the National Tax Code.

Historically, it can be shown that oil and gas platforms have been considered vessels. In 1974, the Brazilian Supreme Court concluded that self-elevating drilling platforms were deemed to be vessels and would qualify for federal excise tax (IPI) exemption.\textsuperscript{118} Although the case did not discuss the Withholding Tax specifically,\textsuperscript{119} the grounds that led the Supreme Court justices to conclude that platforms are vessels would likely also apply to the income tax withholding case discussed herein. The Supreme Court justices based their decision on documents issued by the Marine Authority and ruled that the Marine Authority was the competent body to rule on the definition of a vessel.\textsuperscript{120}

According to Marine Authority Rules (NORMAMs), a floating production, storage and operating unit (FPSO) is a vessel adapted to operations of production and/or storage and transfer of oil, whereas a fixed platform is defined as a construction permanently installed, destined to activities related to the exploration and exploitation of oil and gas and is not considered a vessel.\textsuperscript{121} Additionally, the Brazilian Maritime Court’s ordinary sessions of June 19, 1975, concluded that moveable platforms qualify as vessels, and therefore were required to be registered with the Maritime Court.\textsuperscript{122}

\begin{footnotesize}
\textsuperscript{119} Id.
\textsuperscript{120} Id.
\textsuperscript{121} NORMAM-01, ch. 9, § I, item 0902 (2005).
\textsuperscript{122} Primeiro Conselho de Contribuintes-Sexta Câmara, Ap. No. 139.827, Relator: Luiz Antonio de Paula, 24.02.2005 (Brazil) (on file with Author).
\end{footnotesize}
Because Article 691 of the RIR does not expressly limit the Withholding Tax exemption to vessels destined for transportation activities and does not specifically carve out movable oil and gas platforms, the analogies utilized by the Taxpayer Council appear to be overly broad and intended to select definitions to ensure that the concessionaire would be assessed Withholding Tax.

V. CONCLUSION: THE RESOURCE NATIONALISM SHIP HAS NOT SAILED, BUT IT MAY BE IN THE HARBOR

Since opening its oil and gas market to foreign participation, Brazil has increasingly become a preferred destination for IOCs. By comparison to many of its neighbors, Brazil arguably has a stable political system that has not elected to limit or eliminate foreign participation in the development of its natural resources, albeit with certain regulatory and operational challenges. While the supermajors have not been very active in Brazil to date, Petrobras continues its substantial development programs and independent producers such as El Paso, Devon, BG, Repsol-YPF and others have filled the void. Investments from IOCs in the Brazilian upstream market are expected to exceed $20 (U.S.) billion through 2011. In addition, Petrobras has developed into a strong partner for many companies as it continues to expand its own operations. For example, Petrobras has already announced it is committed to spending at least $39 (U.S.) billion on exploration and production projects in Brazil through 2011.

125. CUNHA, supra note 16.
126. Id.
127. Id.
Despite the growth in the market, significant challenges remain. The suspension of Bid Round 8 was disappointing for the ANP and, despite the directive published by CNPE on November 14, 2007, directing the relaunch of the bid round, as of February 2008, it had not completed its award of exploration properties from such bid round, even though all legal challenges seem to have been resolved. Bid Round 9 did produce winning bids equal to a record $1.15 (U.S.) billion, although the largest single investor was a Brazilian company, OGX Petroleo e Gas, a subsidiary of EBX Group. Without a doubt, the withdrawal of blocks from Bid Round 9 has raised serious concerns about the future of foreign investment in the Brazilian oil and gas sector. There is an argument to be made that the magnitude of the Tupi discovery was so significant that it warranted the government taking a step back to analyze the surrounding areas to make sure that it receives fair value from minimum work programs and bonus payments. Notwithstanding the problems the ANP experienced in 2007, competition is likely to increase as more European, Asian, and domestic companies become involved with exploration and development activities in Brazil.

The ANP must also prepare itself for the unitization cases that are going to increase over the next several years. The Authors of this Article are aware of at least one unitization case that is currently pending, but many more are likely to follow. The ANP must develop adequate infrastructure and technical expertise to handle the complexities that will inevitably arise when dealing with multiple parties and competing geological opinions to give confidence to concessionaires, especially when unitization plans may have to be imposed on unwilling parties.

129. Resolução No. 6, de 8 de Novembro de 2007, D.O., No. 219, de 14.11.2007. (Brazil).
130. See The ANP Round 8 Website, supra note 21 (stating “until the present moment there is no legal decision regarding this matter”).
The ANP must be able to handle these matters in an expeditious manner, or risk delaying substantial development projects and subject itself to further litigation from dissatisfied parties.

With the current state of high crude oil prices, it is inevitable that taxing authorities will try to take a larger portion of the income that is generated. High prices have led many countries to renegotiate their underlying contracts with IOCs or create new taxes that cause the de facto expropriation of producing properties. However, as most of the Brazilian market controlled by foreigners remains under development, taxing authorities must be careful not to hinder additional infrastructure investment. So far, Brazil has successfully resisted that trend, and recent evidence suggests that it will continue to do so.

That is not to say things will continue as they are. The REPETRO benefits described above relate to Federal taxes only, and each state may adopt similar legislation for its taxes, but such relief is not mandatory. As recently as August 29, 2007, the State Finance Secretary for the State of Rio de Janeiro proposed to end certain ICMS tax exemptions similar to REPETRO that would essentially have imposed a tax of 18% on goods and services used in oil and gas exploration and development in that state.

The federal government, in an apparent effort to help streamline at least a portion of the taxation system in Brazil, issued Convenio ICMS 130/07 on November 27, 2007, authorizing the States and the Federal District to exempt and reduce ICMS taxes on imports under REPETRO for certain

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134. Brazil: Energy Profile, supra note 2.
In a positive move as far as most foreign investors are concerned, Rio de Janeiro, arguably the most important state in the oil and gas sector, recently adopted regulations in accordance with Convenio ICMS 130/7, reducing ICMS taxes to as low as 3%. This is particularly important because approximately 80% of oil produced in Brazil comes from the Campos Basin, which is offshore in the State of Rio de Janeiro. If all Brazilian States adopt Convenio ICMS 130/07, as the Authors hope they will, then ICMS tax treatment for transactions under REPETRO will become substantially more consistent. Until then, potential concessionaires must evaluate the existing state of the market, keep informed as to potential future developments, and endeavor to mitigate such risks as much as possible in their contracting strategies.