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NATURAL GAS FREE MARKET

Overview

The first regulatory framework specifically targeting the natural gas market in Brazil was created more than 10 years ago, through the enactment of the Federal Law No. 11,909/2009, followed by the Federal Decree No. 7,382/2010. However, less than five years later, in 2013, the first regulatory reform was proposed, Bill of Law No. 6,407 of 2013, as the original legislation did not seem sufficient to promote competitiveness and expansion of gas transportation infrastructure in Brazil at the time. This is because, despite the end of its legal monopoly to oil and gas exploration in 1995, Petrobras continued to exercise a dominant position in the entire gas value chain.

Discussions on the structuring of a new regulatory scenario for natural gas in Brazil have dragged on for years and only intensified in 2015, when Petrobras announced a divestment process to reduce its position in oil and gas midstream and downstream sectors in Brazil. Soon afterwards, the Federal Government launched the Gas to Growth (*Gás para Crescer*) initiative to guide the gas regulatory reform by establishing the guidelines for an open and competitive gas market, considering the expected reduction of Petrobras' role in this sector.

The National Energy Policy Council ("CNPE") stepped in during the structuring work of the new Brazilian Gas Market and published CNPE Resolution No. 10/2016, which set forth strategic guidelines for the design of a new gas market in Brazil, focused on the promotion of competition.

Other programs and initiatives followed, including an agreement between Petrobras and the Administrative Council for Economic Defense (CADE), the Brazilian Antitrust Authority with which Petrobras has agreed to several commercial commitments to support its voluntary divestment of the Brazilian gas market, to enable the diversification of players and the attraction of new investments to expand the sector's infrastructure.

After many years of debates among Federal and State governments, industry agents and Brazilian society, Law No. 14,134/2021 ("New Brazilian Gas Law") and Decree No. 10,712/2021 ("New Regulatory Gas Decree") were finally published to create the necessary basis for the new Brazilian gas market, based on efficiency, competition and best international regulatory practices.

On April 04, 2022, the CNPE published Resolution No. 03/2022, which established additional strategic guidelines to improve energy policies related to the promotion of free competition and created the basis for the transitional period to a competitive market.



1995

End of Petrobras legal monopoly in O&G activities to explore O&G activities

2013

Proposition of first gas reform (Bill of Law No. 6,407/2013)

2016

Federal Government initiatives to structure the New Gas Market, reducing Petrobras' dominant position; Enactment of CNPE Resolution No. 10/2016

2022

Enactment of Resolution No. 03/2022 with additional strategic guidelines to improve energy policies related to the promotion of free competition

2009/2010

Enactment of first gas regulatory framework in Brazil (Law 11,909 and Decree 7,382)

2015

Petrobras announced "a divestment in midstream and downstream sectors

2021

Enactment of New Brazilian Gas Law and New Regulatory Gas Decree to enable a competitive and efficient Gas Market



Inside the New Brazilian Gas Regulatory Framework

To understand the relevance of the rules created by the New Brazilian Gas Law and New Regulatory Gas Decree and their potential impacts on the Brazilian gas scenario in the next few years, take a look at the main changes promoted by the new Brazilian gas regulatory framework:

1 Authorization Regime for Gas Transportation and Storage

Under previous gas legislation, gas transportation activities were subject to the concession regime, preceded by a public tender process. The New Brazilian Gas Law defines authorization as the exclusive granting regime for gas transportation activities in Brazil, which include the construction, expansion, operation and maintenance of gas transportation facilities. The authorization regime also applies to gas storage activities, which were also subject to the concession regime.

2 Transportation Unbundling Rules

The New Brazilian Gas Law establishes corporate restrictions among the gas industry agents, preventing transporters from having (i) indirect or direct corporate control or (ii) an affiliation¹ relationship with companies or consortiums performing activities of exploration, development, production (E&P), importation, shipment and commercialization of natural gas.

3 Entry-Exit Model for Gas Transportation Capacity

Under the previous gas legislation, shippers had to contract the gas transportation capacity of each "piece" of the gas pipeline infrastructure, considering the physical flow of the molecule within the transportation system, "congesting" the transportation capacity and promoting inefficient use of the infrastructure. The New Brazilian Gas Law allows shippers to book capacity rights independently at the so-called "entry" and "exit" points, creating gas transportation through zones supported by virtual trading points (virtual hubs).

4 Negotiated Third-Party Access to Essential Facilities

The New Brazilian Gas Law grants third-party access not only to gas transportation pipelines, but also to essential facilities (gas offloading systems, gas processing facilities and LNG terminals), which shall be negotiated in good faith and in a non-discriminatory manner by the facilities' owners, who will retain a preference for using its facilities. The third-party access to gas transportation pipelines will be further regulated by National Agency of Petroleum, Natural Gas, and Biofuels ("ANP").

¹ Under Brazilian Corporation Law (Law No. 6,404/76), "affiliation" means the relationship with companies in which the investor has significant influence, which is assumed if (i) the investor holds 20 percent or more of the voting capital of the company or (ii) the investor holds or exercises the power to participate in the financial and operating policy decisions of the company, even though not controlling it.

Gas Commercialization

The Brazilian Constitution (art. 25, §2) establishes the monopoly of the States to explore “local piped gas services”, also known as gas distribution activity. Gas distribution and gas commercialization activities have always been confused in several Brazilian States, whose local regulation on local piped gas services unconstitutionally incorporated gas commercialization activities into the scope of the State monopoly for gas distribution.

In many States, the rights of local consumers related to gas distribution is limited to the producers and importers, considering the obstacle imposed by the distributors by restricting competition for the molecule in the captive distribution market. Thus, specific regulatory frameworks reach the inconsistency of forcing the producer to sell its gas to the distributor in order to enforce its right of access to distribution, even in cases where the producer is the final consumer of its own product.

Other States, despite admitting the figure of the "free consumer", impose extensive classification requirements and regulations for such an agent, increasing the regulatory cost of these market transactions.

To enable a competitive market for gas commercialization in Brazil with the reduction of gas prices and an increased offering, it is necessary to: (i) end competitive limitations on gas commercialization in the States; and (ii) secure the regulatory separation of gas distribution and gas commercialization in States regulations.

Among other aspects, the CNPE Resolution No. 03/2022 established that:

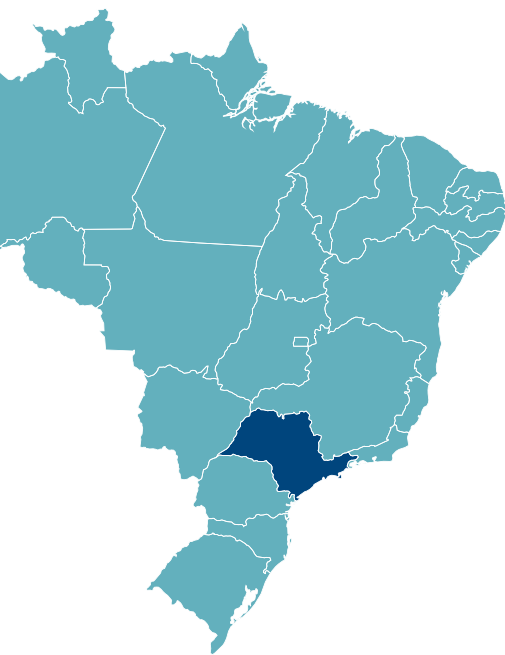
- Reinforcing the separation among competitive activities (such as production and commercialization of gas) from monopolistic activities (such as transportation and distribution) is a strategic guideline for the design of the new gas market in Brazil;
- The transition to a competitive gas market has the purpose to restrict the transactions among gas traders and gas distributors that are related parties;
- Implementation of gas release programs and stimulation of gas commercialization by producers shall be a policy for the opening of the gas market;
- The active participation of gas suppliers and buyers in the short term commercialization market to enable a higher liquidity and transparency of the gas market is in the best interest of the National Energy Policy.

Recent Free Gas Market Regulations: São Paulo and Rio de Janeiro

Although some States have updated their gas distribution regulations trying to meet the reforms proposed by the New Gas Law and promote the creation of local competitive markets, there are still many outdated regulations obstructing the development of free gas markets. The main issue is the conflict of competence at the Federal and State levels, as well as incompatible regulations between different States, which create gas markets with different levels of maturity in Brazil, depending on the region in which they are located.

In that context, it is appropriate to highlight the experience of two highly relevant states for the Brazilian economy: São Paulo and Rio de Janeiro.

São Paulo



Although praised for not establishing a minimum consumption level for the consumer to migrate to the free market, São Paulo's regulation is criticized for exceeding the scope of its competence. This is because its regulatory agency ("ARSESP") intends to regulate the commercial aspects of natural gas, which is unconstitutional and illegal.

In this sense, the relevant free market regulation (ARSESP Deliberation No. 1.061/2020) illegally (i) establishes that ARSESP will manage the Gas Sale Agreements between free consumers and trading companies; (ii) provides for penalties arising from commercialization activities, as default and lack of guarantee in the scope of GSA; and also (iii) sets forth rules contradicting those already provided for in the Antitrust Law (Federal Law No. 12,529/2011).

These rules are contrary to the best regulatory practices, which makes the gas regulation of São Paulo State a discouraging framework for captive consumers to enter the free market and, consequently, impairs the implementation of new projects and investments in gas distribution infrastructure in the State's territory.

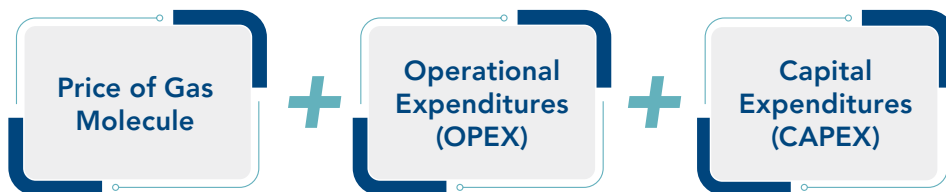
Rio de Janeiro



On the other hand, Rio de Janeiro started the drafting of a more attractive regulation for free consumers. According to its regulatory framework (AGENERSA Deliberation No. 3.967/2019), users with minimum consumption levels of 10,000 m³/day can migrate to the free market. Besides that, the free consumers may choose to build their own gas pipelines (“dedicated/exclusive pipelines”), observing certain conditions. Dedicated gas pipelines limit CAPEX costs in the calculation of the distribution service and relieve these consumers from having to pay for the expansion of the distribution network, providing predictability and cost control in the gas distribution tariff.

Unfortunately, AGENERSA has started public consultations to create regulations that are still standing without conclusions. Another negative point is that AGENERSA is also following the regulation of the state of São Paulo to propose a regulation to authorize the activity of commercialization of gas in the free market, a foreseen constitutional competence of the Federal Government delegated to the ANP, under the terms of Law No. 14,134 /21, creating an entry barrier for gas trading agents that will make natural gas molecules more expensive in the State of Rio de Janeiro.

Gas Distribution Fee for the Captive Market in Rio de Janeiro



Gas Distribution Fee for the Free Market in Rio de Janeiro



In Rio de Janeiro’s free market, a special fee will apply (*TUSD-E*)* if the consumer builds a dedicated pipeline at its own expense, with the fee charged depending on whether the state distributor or free consumer has built the relevant gas distribution infrastructure. Also, the free consumer has new responsibilities, such as bearing the price of the gas molecule negotiated with the trading company, the penalties from withdrawal over Scheduled Daily Quantity (“QDP”), imbalance and Price of Excess Gas (“PGU”).

*In Portuguese, means fee for the use of a specific gas distribution system.

The Free Market Scenario

Considering the new Brazilian natural gas framework and Petrobras' repositioning in the Brazilian gas market, it should be noted that the distributors have been carrying public calls for the contracting of gas supply. In this sense, the gas distribution companies of Bahia, Espírito Santo, São Paulo, Ceará, Rio de Janeiro, Santa Catarina, Pernambuco, Mato Grosso do Sul, Paraná, Paraíba and Rio Grande do Norte launched public tenders for the acquisition of gas.

Ongoing Public Tenders for Gas Acquisition

Last June, the gas distribution company of Minas Gerais, Gasmig, has published a public tender to acquire 260,000 m³/day of natural gas in the short term.

In July, 2022, the gas distribution company of Rio Grande do Sul, Sulgás, controlled by Cosan group, has launched a new public tender aiming at acquire 220,000 m³/day of natural gas in 2023 and from 220,000 to 480,000 m³/day between 2024 and 2026.

Also in July, the gas distribution company of Sergipe (Sergás) has published a public tender to acquire 300,000 m³/day as of 2023, from any source of supply, including onshore, offshore and resulting from LNG regasification.





Some gas distribution companies as Bahiagás and Sulgás have also launched specific biomethane public tenders, aiming at promote biogas industry within their territories.

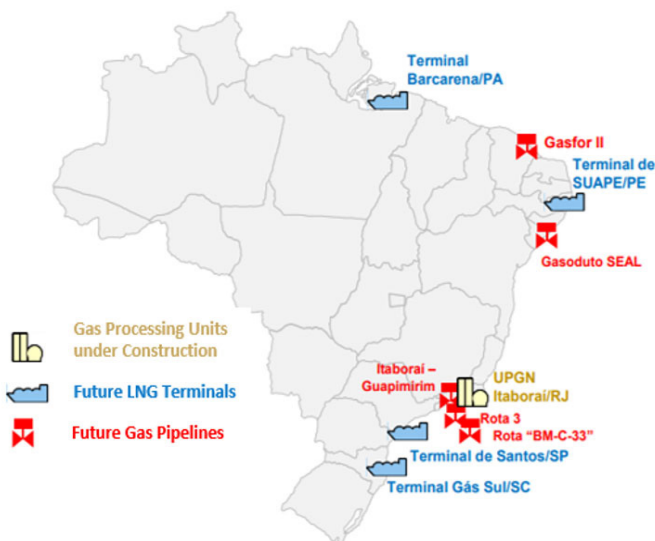





Additionally, the current natural gas infrastructure has been improved in this context of regulatory transition, arising new business opportunities from the market opening:

Brazilian Natural Gas Infrastructure

Current Gas Infrastructure

-  **9,409 km** of gas transportation pipelines
-  **6,329 km** of gas offloading and transfer pipelines
-  **16** Gas Processing Facilities (UPGNs)
-  **5** LNG Terminals in operation



-  New offloading gas pipelines and 2 new gas transportation gas pipelines are under planning;
-  4 future LNG terminals are under development;
-  In addition to the LNG terminals for importation of great volumes, there are small scale LNG terminals under study along Brazil shore.



What to expect

- New players are expected in Brazil's gas supply chain sectors as of 2022, especially in gas trading and LNG importation. New biogas projects are also under development.
- New LNG Terminals, Gas Processing Facilities (UPGNs), and Gas Pipelines are currently under development to meet national demands.
- Increase in national production is expected, especially in pre-salt offshore projects.
- Upcoming regulations are expected to create a more reliable investment environment and promote competition in the new Brazilian gas market.

Finally, all economic agents are interested in the creation of a mature competitive environment capable of leading to the improvement of regulation in order to reduce the molecule price. Given the new practices in the Brazilian natural gas market, the ANP's Regulatory Agenda for 2022/2023 establishes the following regulatory actions:

- **LNG Activities.** Revising ANP Ordinance No. 118/2000 related to LNG acquisition, reception, storage, transportation and commercialization to update regulations and simplify the applicable rules to interested agents.
- **Gas Transportation Pipelines.** Revising ANP Resolution No. 37/2013 related to the criteria for the expansion of gas transportation pipelines to improve regulation regarding the entry/exit gas model for the gas transportation system.
- **Independency and Autonomy of Transporters.** Preparing regulations to ensure the independency and autonomy criteria of gas transporters to promote competitiveness in the natural gas chain.
- **Third-party Access to Essential Infrastructure.** Preparing regulations to govern the non-discriminatory access of third parties to gas-essential infrastructures (LNG terminals, production offloading gas pipelines and gas processing facilities), setting out the basis for the negotiated access among interested players.

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