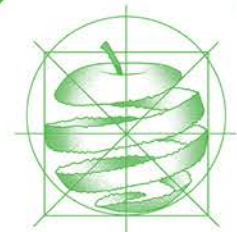


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**The Petrobras scandal:
an analysis**



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[Kasalana Limited](#)

Bedgebury Business Park
Bedgebury Road
Goudhurst
Kent TN17 2QZ
UK

Tel UK: 0844 593 0230
Tel Int: +44 (0)1580 212832
E: info@kasalana.com
W: www.kasalana.com

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The so-called '*Petrobras Scandal*' engulfing Brazil for the past 18 months looks set to run. It is likely to have profound implications for the way international companies operate in emerging markets, where the nexus between politics and business is much closer than the developed world. In order to understand better its potential ramifications, one of our Brazilian sources, an experienced business journalist and commentator, has kindly provided the following analysis of *Operation Car Wash*, as the investigation is known there.

Understanding *Operation Car Wash*

Operation Car Wash, launched in March 2014 by the *Federal Police*, is investigating a major money-laundering and embezzlement scheme involving state-owned oil and gas company *Petrobras*, major Brazilian contractors and politicians. It is the largest corruption and money-laundering investigation ever seen in Brazil. The investigations are mainly focusing on a corruption scheme, which has lasted for at least 10 years, in which major contractors organised into a cartel paid bribes to high level executives at *Petrobras* and to other public agents. The bribe value varied between 1% and 5% of the total amount of inflated large-scale (over \$250m) contracts.

To gain an understanding of the scheme, it is necessary to understand the different participants. There are four main types: contractors, *Petrobras* officials, financial intermediaries or operators ("doleiros"), and politicians.

The Participants

Contractors

The organization of contractors among themselves into a "club" or cartel was key to the corruption scheme. In a normal scenario, contractors compete with each other in tender processes to win contracts and do work for *Petrobras*. In the cartel, the prices offered to *Petrobras* were calculated and adjusted at secret meetings, at which the winner of the contract and its price were defined, inflating private profits to the prejudice of state coffers.

Petrobras Functionaries

Ensuring that these tenders were restricted to the "club" of contractors required collaboration and manipulation inside *Petrobras*. Company staff, including senior managers, were co-opted into the scheme through bribery.

These *Petrobras* functionaries not only tolerated the cartel, but also favoured it by restricting those invited to participate in the tender process and including the winner among the participants.

In 2014, as the scale of the harm done to *Petrobras* by the corruption began to emerge, its Chairman *Graça Foster* was dismissed, along with five other directors. Ex-*Banco do Brasil* chairman *Aldemir Bendine* is currently reorganising the company, selling off parts, dismissing personnel and renegotiating contracts.

Doleiros

The financial operators put in an appearance at all points of the corruption scheme, "greasing its wheels". They were the preliminary subjects of the *Car Wash* investigation and it was their whistle-blowing that brought to light most of the names of senior *Petrobras* managers and high-ranking politicians involved in the scheme. The *doleiros* were not only responsible for acting as intermediaries for paying bribes, but also for giving bribes disguised as clean money to the beneficiaries.

Politicians

The fact that *Petrobras* is a state company, and that many of its directors are appointed by political parties, helps to explain the involvement of Brazilian political figures in the scheme. In the view of Brazil's *Public Prosecutor's Office*, Board directors responsible for Supplies, Services and International, areas where large-scale contracts were common, were given to political "appointees". Each area of *Petrobras* was regarded as the "property" of a political party: bribe resources were illegally channelled into the parties, to leading politicians, to *Petrobras* executives and to the operators of the scheme.

In March 2015, Brazil's *Attorney General* obtained authorisation to investigate 53 people, including federal deputies, senators and two governors, from six political parties. The *Attorney General* decided that there was insufficient evidence to open an inquiry into *President Dilma Rousseff*, though she remains under intense political pressure, not least because she herself sat on *Petrobras's* Board of Directors from 2003 to 2010.

The Investigators

It is important to realise that *Operation Car Wash* was launched in the State of Paraná, outside the Rio/São Paulo/Brasília circuit where national decisions are made.

Paraná federal judge *Sérgio Moro* is responsible for criminal proceedings in *Car Wash* cases that do not involve politicians. A young magistrate renowned for ruling on financial crimes, he has been favourably compared to *Giovanni Falcone*, who led Italy's "mani pulite" corruption investigation before his assassination in 1992. Among *Moro's* colleagues at the *Public Prosecutor's Office*, he is greatly admired for his ability to expedite and manage investigations, even with the enormous number of accused. The justice system in Brazil is traditionally slow, and even more so when so many of the accused are in privileged positions.

The *Federal Police* has operated in cooperation with the *Public Prosecutor's Office*, carrying out investigations requested by the prosecutors and putting some of the most powerful men in the country in prison without buckling to pressure. The investigations now draw on no fewer than 17 whistle-blowers, including *Paulo Roberto Costa*, the former Supplies Director at *Petrobras*.

However, the fightback from the Brazilian establishment is under way. The *Supreme Court* is seeking to take away from *Judge Moro* those parts of the case not related to the central core of the original scheme. In private remarks, widely leaked, some *Supreme Court* judges have criticised *Moro's* posture as a "media campaign" which has depicted him as a hero to many Brazilians.

In the face of the *Supreme Court's* move to break up the investigation, the *Attorney General* continues to view the corruption as being perpetrated by a single criminal organisation acting all over the country and within different public organisations. As a result, the investigations are not losing momentum.

Foreign Firms' Involvement

More than 20 international companies have been mentioned to date in *Operation Car Wash's* plea bargains. These companies include *Maersk, Jurong, Kawasaki, Keppel Fels, Mitsubishi, Rolls-Royce, Samsung, SBM, Sembcorp Marine, Skanska, Techint, Toyo, Mitsui, Toshiba, Sargent Marine, Astra Oil, GB Marine, Trafigura, Glencore, Ocean Rig, Pirelli* and *Sevan*. Investigations have revealed a detailed bribe payment scheme from two multinational companies in the shipbuilding industry, *Keppel Fels* and *Jurong*, to *Petrobras* directors and to Brazil's ruling *Workers' Party (PT)*, through its treasurer *João Vaccari Neto*.

The companies allegedly involved remain unpunished, with the exception of the Dutch-based *SBM*, which is back on *Petrobras's* tender list having reached a confidential settlement reportedly worth some US\$250 million. Nevertheless, there are two clear effects of their involvement. First, foreign firms are being forced to change strategy after years of having, as the *Financial Times* put it, "*long faced pressure to pay 'grease' payments to speed up regulatory processes or fund bribe paying via third-party consultation services simply to compete with local players.*" According to the *Financial Times*, *Operation Car Wash* "*serves as the clearest compliance warning yet for multinationals operating in the country*".

Secondly, there is a trend for the government to encourage the opening up of the Brazilian civil construction market to more foreign companies. Law firms and investment banks in the country believe that partnerships between Brazilian and foreign companies will occur in the short term. There are no formal barriers to the entrance of foreign companies in this sector, but in practice, however, there are enormous hindrances, which end up creating a type of hold over the market. However, *Gil Castelo Branco*, from the *Contas Abertas* NGO, specialising in the disclosure, visibility and transparency of public accounts, stated in a recent interview to *Valor Econômico* magazine: "*I don't see anything wrong with opening up to foreign companies. It will create employment anyway. And now the major Brazilian contractors will have to sell assets in order to survive*".

Balance Sheet of *Operation Car Wash*

According to the *Federal Public Prosecutor's* office, the sentences so far handed down by *Federal Justice* to contractors and operators of the corruption scheme total more than 300 years.

Through agreements, the companies involved have already paid back one-third of the R\$7.2 billion (US\$1.9 billion) proven to have been channelled out of *Petrobras* to pay bribes. There have been 33 plea bargains and three leniency agreements.

Together, the three companies that have already signed leniency agreements - *Setal*, *Camargo Correo* and *SBM* - have paid back R\$1.64 billion, over half of the value recovered by *Justice*. Almost 80 deputies and senators, from both the government and opposition, have been caught up in the investigation.

The Political Crisis of *Car Wash*

Car Wash has been positive in terms of the consolidation of democracy and society in Brazil, but it has had paralysing effects on the country's politics and economy. *President Rousseff* is acutely aware of these effects. She was only narrowly re-elected in 2014, and her popularity has fallen since then. In October 2015, the *Federal Police* opened an investigation into alleged irregularities in *President Rousseff's* re-election campaign.

Rousseff has been forced to "surrender" to orthodox economic policies and appoint *Joaquim Levy*, a former executive of *Banco Bradesco*, as *Finance Minister*. *Levy* has been given the difficult mission of overcoming the deficit, and he faces criticism and resistance from his own *PT* party, and even from his one-time mentor, *Luiz Ignácio Lula da Silva*. With the weak economy, tax collection forecasts have not materialised; critics allege that *Levy's* economic policies have themselves deepened the shrinkage of the economy. In September, *Standard & Poor's (S&P)* lowered Brazil's credit rating below 'investment grade'.

The *President* has also lost the support of *Eduardo Cunha*, the *President of the Chamber of Deputies*. In July 2015, after accusing the government of seeking to implicate him in *Operation Car Wash*, *Cunha* announced that he was "breaking up with the government" and joining the ranks of the opposition.

However, following accusations of having illicit *Petrobras* corruption money in accounts discovered in Switzerland, *Cunha's* days maybe numbered as *President of the Chamber*. For now

Rousseff and *Cunha* have forged an uneasy truce as both face the risk of being ousted from office.

Moves to impeach *President Rousseff* seem, for now, to have stalled but remain possible. If this were to occur, *Vice-President Michel Temer* would take office until the end of the term (2018). New elections would be called if the *Vice-President* were to also be removed during the first half of the term. If he is removed during the second half the *National Congress* would elect a new *President*.

Everything suggests that *Rousseff's* presidency will be remembered as a time of fighting corruption - although not in the way the *President* might have liked. In her favour, it can be argued that she has not interfered much in the actions of the *Federal Police*, and this is the major factor that has allowed *Operation Car Wash* to be run with little or no interference from the judiciary. However, the major contradiction is that many of those involved in the corruption scandals are part of her government. Ironically, the freedom that *Rousseff* is giving to the investigations is undermining her popularity, which is already low: the population identifies her government with corruption, while the political and economic establishment, affected by the crisis, believes that she has let the scandal spin out of control, thereby damaging the foundations of politics and the economy in Brazil.

The fact is that the corruption scandal is helping to fuel an economic and political crisis, leaving Brazil in a climate of constant instability for a year or more.

Car Wash and the Economy

At a meeting with ministers in July, *President Rousseff* stated that the effects of *Operation Car Wash* had resulted in a one percentage point drop in Brazil's GDP and fostered a climate of uncertainty throughout society. The *Central Bank* has already estimated that the eventual default of all the companies involved in *Operation Car Wash* will have a major impact on the country's wealth.

Effects on *Petrobras*

The effect on *Petrobras* has been severe. The company's market capitalisation has fallen by 80 per cent over the past five years and it has US\$170 billion in both long and short-term debt. The company's bonds now trade at up to a 30% discount and international bondholders remain nervous.

The company has promised to divest billions of assets and to halt US\$13 billion in major projects, leading to the loss of as many as 30,000 construction sector jobs. A major strike on 29 October 2015 by five trade unions forming the *National Federation of Oil Workers (FNP* in Portuguese) was well supported by *Petrobras* employees. In addition to wage adjustments, the *FNP* is protesting against the plan to sell *Petrobras*'s assets. Total sales planned for 2015-2016 amount to US\$15.1 billion.

In addition, the crisis at *Petrobras* unleashed by *Operation Car Wash* has reopened the debate on the rules of exploiting the country's largest oil reserves - the pre-salt reservoir. If *Petrobras*'s exploration capacity is curtailed, this could open up room for foreign oil companies, in both the exploitation of the pre-salt oil and in the production chain. This relaxation of the rules is being debated in the Senate.

Risks to *BNDES*, the *Brazilian Development Bank*

An informal advisor to former *President Lula* and a personal friend of *President Rousseff* recently warned: "*I really fear what could happen with regard to BNDES [Brazilian Development Bank], as the bank, which is extremely important for the country's development, could be thrown into this scandal. If we didn't have BNDES and entrepreneurs only had access to traditional banks, there is no doubt that Brazil would have a much smaller economy today*".

The slowdown currently underway at *BNDES*, due to the political scenario has already disturbed local entrepreneurs. "*Car Wash is not only an investigation operation, but also a major police operation. We are seeing Federal Police operations that are worthy of American movies, and this leads to a high level of propaganda*", the source declares. "*I have held long conversations with Luciano Coutinho [chairman of BNDES], who is very calm and has nothing to fear*", he says. "*Based on what I see in the media, they want to pin it on Lula at all cost*".

Lula

Indeed these suspicions seem to be playing out, as the net around former *President Lula*, who is starting to rehearse his campaign for 2018, is being closed in different areas of the investigation. *The Federal Public Prosecutor's Office* and the *Federal Police* are currently running six concurrent investigations into him. One of these is a *Criminal Investigation Procedure* opened in the *Federal District*, into alleged influence-peddling in favour of construction giant *Odebrecht*, including its

business in Africa.

The *BNDES* investigation is into allegations that the bank violated an internal regulation prohibiting the granting of loans to companies whose bankruptcy has been requested from *Justice*, by granting a loan of R\$101.5 million to a friend of *Lula*.

Antonio Delfim Netto, an influential former *Finance Minister* and informal economic advisor to the Presidency, believes that in terms of investigations in *BNDES*, the only thing that could have a major impact on authorities and politicians would be proof of payments of bribes. *"It is very difficult for you to prove whether or not there was influence over BNDES loans. It is a different issue to what happened with Petrobras, where deposits were made that proved payments of bribes. I don't know if that type of thing happened with BNDES"*, he asserts.

Outlook

There is no obvious end in sight to the crisis gripping Brazil. Its political leadership has yet to approve "unpleasant" measures such as raising taxes.

By the end of October, Brazil's main banks and consultancy companies started forecasting a drop in Gross Domestic Product (GDP) of up to 3.5% in 2016. With high levels of uncertainty about the country's political environment, and the difficulty of pushing fiscal adjustments through Congress, the recession will be longer and harder-hitting than expected, they argue. Meanwhile, any foreign companies willing to invest in Brazil need to tread very carefully in terms of understanding their compliance and regulatory obligations in a shifting commercial and political environment.

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