Q3 2008 Earnings Call

Company Participants

- Almir Guilherme Barbassa, CFO & IR Officer
- Eduardo Alessandro Molinari, Coordinator for Strategy, Portfolio Management of Exploration & Production
- Theodore Helms, IR Executive Manager
- Unidentified Speaker, Analyst

Other Participants

- Adam Arnato, Analyst
- Christian Audi, Analyst
- Emerson Leite, Analyst
- Emile Moody, Analyst
- Frank McGann, Analyst
- Gustavo Gattass, Analyst
- Marcus Sequeira, Analyst
- Paula Kovarsky, Analyst
- Ricardo Cavanagh, Analyst
- Robert Kessler, Analyst
- Sapo Giripa, Analyst
- Vladimir Pinto, Analyst

Presentation

Operator

Ladies and gentlemen. Thank you for standing by. Welcome to the Petrobras conference call to discuss the Third Quarter 2008 results. (Operator Instructions) As a reminder, this conference is being recorded. Today, with us we have Mr. Almir Guilherme Barbassa, CFO and IR Officer. And his staff.

At this time, I would like to turn the conference over to Mr. Theodore Helms, Investor Relations Executive Manager of Petrobras, who has some additional comments. Please go ahead, Mr. Helms.

Theodore Helms {BIO 15433381 <GO>}

Good afternoon, ladies and gentlemen. Welcome to our conference call to discuss Third Quarter 2008 results. We have a simultaneous webcast on the Internet that can be accessed at the site www.petrobras.com.br/ri/english.

Before proceeding, I would like to draw your attention to slide 2. We may make forward-looking statements, which are identified by the use of the words "will," "expect," and "similar" that are based on the beliefs and assumptions of Petrobras management and on information currently available to the Company.

Finally, let me mention that this conference call will discuss Petrobras' results prepared in accordance with Brazilian GAAP. At this moment, we are unable to discuss any issues related to US

GAAP results.

The conference call will be conducted by our CFO and Investor Relation Officer, Mr. Almir Guilherme Barbassa. He will comment on the Company's operating and financial highlights and the main events during this quarter. And he will be available to answer any questions you may have.

Mr. Barbassa, you may begin.

Almir Guilherme Barbassa {BIO 1921476 <GO>}

Good afternoon, ladies and gentlemen. Thank you, all for joining us on this webcast to discuss Third Quarter results and to update you on recent developments.

During the quarter, net income was a record of BRL10.9 billion. Higher production and higher price contributed to this record, as did a very substantial gain from exchange rate effect. During the quarter, for the first time in a long time, international oil price declined and the dollar strengthened against the real. These movements affected our results, as I will discuss later.

Despite the decline in the international prices, our internal cash generation remains strong as we continue with our investment plans. While we have entered a challenging new phase, our long-term outlook remains intact. We are confident that we can adjust to those new realities without substantially modifying our plans.

Look at the slide 3. Oil and gas production in Brazil grew by 2% during the quarter, mainly from the continued ramp-up of P-52 and P-54, which more than offset natural declines from existing units [ph]. Year over year, oil and gas production rose by 7%. P-52 will reach peak production of 108,000 [ph] barrels per day this month, while P-54 will achieve a peak production of 150,000 barrels per day during the First Quarter of next year.

Our average daily production of oil in Brazil year to date has been 1.851 million barrels per day. For the full year, we set a target of 1.95 million barrels per day, with a range of plus or minus 2.5%. We now expect to fall slightly short of this goal. We had assumed that P-51 and P-53 would contribute to our production growth. But it now appears they will only begin to make marginal meaningful contributions next year.

This brings us to our next slide, which details the status of major new production systems coming online. P-53 is already on location, with first oil expected in November. P-51 will be soon leaving the shipyard, with first oil expected in January. PFSO Cidade de Niteroi is en route to Brazil and should also began production in January.

No conference call would be complete without a brief update on the pre-salt. That is slide 5. As we announced last quarter, with the completion of the Guara, Iara and Jupiter wells, we have fulfilled a minimal exploratory program of the exploration phase for all of the blocks we operate in the Santos pre-salt cluster.

The oil exploration well remaining to be drilled will be the Block BM-S-22, operated by Exxon. That well has been spudded. And it should contribute substantially to our understanding of the basin.

We continue preparation for the extended well casting to be planted [ph] for the First Quarter of next year. The tests, as well as the pilot system, is on schedule. We can also report that we have begun production from well 1-ESS-103A in the pre-sale of Espirito Santo. We found the carbonate reservoir capable of producing 18,000 barrels per day. And were able to produce without experiencing any reduction in pressure, indication of sizable reservoir.

We are currently drilling two additional exploration wells in the pre-salt horizon of the Northern Campos Basin in the Baleia Azul and Baleia Franca fields. We are now evaluating where additional wells throughout the entire [ph] system will be installed in the Santos cluster. We also continue to make long-term plans for installing full production systems by 2015.

The turmoil in the world financial markets and the falling price of oil has no impact on our thinking with respect to the timing or feasibility of development of the cluster. We and our partners remain confident about our prospects. And we continue to believe these results are economical and even at crude oil price well below those of today.

During the quarter, lifting costs rose by $0.33 per barrel, even as oil declined by $6 in the quarter compared with the previous quarter. There is a strong correlation between the price of oil and the cost of oil shares [ph]. But at this stage, it is too still early to give any guidance on future costs in a lower price environment. Any decline next year could be offset by the three new production units coming onstream. Until these new units ramp up production, they will have higher per unit lifting costs.

Government production tax rate rose by BRL2 per barrel as additional production from Roncador shifted income from the fields into a higher tax bracket when calculating special participation.

Next slide, please, downstream operation performance. Refineries' operating performance remained strong. Utilization factor during the quarter was 93% as we maintained ongoing programs to improve reliability. The percentage of the net crude in our throughputs declined slightly as we processed more imported light oil to maximize diesel production and minimize fuel oil. Ask spread widened between these two products during the quarter.

We are making concerted efforts to increase this output from our refineries and have grown production by 37,000 barrels per day since we initiated such efforts.

Volumes of oil products sold increased approximately by 3% during the first nine months of the year. Diesel and jet fuel were largely responsible for this increase, growing by 8%. Gasoline sales, which had been declining, grew by 3% on the base of growing real interim [ph] in this year and competitiveness with ethanol. These increases were partially offset by declining of fuel oil and petrochemical naphtha.

Next slide, please. Net imports into Brazil were slightly negative for the Third Quarter as consumption of imported products, primarily diesel, increased. Expanding inventories of diesel in anticipation of seasonal needs and the refinery maintenance also contributed to imports during the quarter.

While the devaluation of the real has reduced the price at which we sell long-term rates into dollars [ph], the devaluation has not been nearly as severe as the decline of oil and oil products' price.

Our revenue in reais has been constant, while costs have declined, thereby improving margins and cash flow on imported products. This impact will become apparent in future results if today's price and exchange rate levels remain constant.

Next slide, please. As I mentioned at the beginning of this call, we have experienced the market shifting direction for both the exchange rate and the price of oil and oil products. Since 2003, oil price gradually increased and the reais strengthened against the dollar. This year, oil rose sharply, followed by an even steeper decline. During the sharp increase in the oil price, the real did not strengthen to the same degree.

Since we did not raise our price to match this spike on approximately 60% of our sales, our earnings and cash flow through September 2008 never fully captured this peak price. Since Brent peaked at $146 per barrel on July 3, it declined by 56% as of October 31, while the real has devaluated 34% during the same period. Despite the downward movement in price and the exchange rate since early in the Third Quarter, we have continued to generate cash flow and earnings in excess of last year, as oil and exchange rate effects compensate for each other. Consequently, we continue to be confident about our future results, even in these lower price environments.

Next slide, please. We disclose each quarter the effect of the movement of the exchange rates and international internext [ph] prices on our average realization price. We compare our average realization price with US Gulf Coast price, using the Brazilian consumption market [ph], expressed in both US dollars and reais.

As a result of decline in crude oil prices, refining margins turned positive late in the quarter. Additionally, the gap between US and Brazilian prices when expressed in dollars was substantially reduced. When expressed in reais, our prices has been flat and are now higher than they were in 2007. This explains why the impact of the fall in the international price and our earnings and cash flow has been weakened.

E&P operating income, next slide, please. Turning now to segment results, operating income for our Brazilian E&P segment decreased by 7.8%. The net operating income from increasing volumes did not fully offset price declines. As mentioned earlier, lifting costs also increased slightly, as did the special participation price. Operating expense also increased as a result of the collective bargaining agreement reached during the quarter.

Next slide, please. Let's see the downstream operating income. While the downstream segment benefited during the full quarter from price increase in May, prices for each product, particularly imported products, were on average higher than June in the previous quarter. This led to a loss for the period. Higher operating costs relating to the greater complexity in the refineries, higher energy costs and provisioning for reduced market value of inventories.

Next slide, please. As I mentioned in our call on last-quarter results, our gas and energy segment is experiencing a positive turnaround. Higher gas price from the new contracts with distribution companies, higher volume of domestic gas available for sale. And infrastructure that is reaching completion and growing reliance of Brazil the last week on Camelot [ph] power are all positive in long life [ph]. Quarter-by-quarter results, however, will vary until we have greater supply of gas and the infrastructure is completed.

This quarter, the gas and energy segment reported a loss primarily as a result of higher costs for acquired gas, lower energy sales and a higher PLD [ph], which caused a reduction in margins and led to a penalty. High operating and maintenance costs for the Permalet [ph] plant also added to the loss.

Let's see the net income, next slide, please. US blocks [ph] was slightly lower as higher sales volume and price were offset by higher costs of acquiring and producing those volumes. A substantial portion of the increase in sales and cost of goods sold is a result of the devaluation of the real. The 20% of devaluation of the real quarter over quarter caused net financial income to increase by BRL4.4 billion.

Income tax expense was higher, not only because of higher operating income, including foreign exchange gains. But also because of the absence of a declaration of interest on capital during the quarter.

Next slide. Using the impact of the exchange rate variation on results, an explanation is in order. Platform and other oil production assets used in Brazil are owned through offshore subsidiaries. In our internal accounts, we had both an asset and, to the extent it is funded with a loan, a liability. Both assets and liabilities are recorded in dollars.

When preparing the PRS and PER gas [ph] statement, the assets and liabilities are supplied by the quarter and exchange rate. The net change in value is recorded as a gain or loss. If assets exceeds liabilities, a weaker Brazilian real leads to a monetary gain. During the quarter, assets also grew considerably as a result of investments in platform. So the gain was both a result of the devaluation and the growth in net assets.

Let's see cash flow in the next slide. We are on pace to substantially exceed our cash flow from operation as compared to last year. Year to date, we have generated BRL34.6 billion, while investing BRL35.2 billion.

Internal cash generation is adequate to fund our capital expenditures, even as we increase spending for growth. Slightly less than half of our CapEx is for Brazilian E&P. The other half is invested to reach our long-term vision of expanding on an integrated basis.

The lower price has led us to reevaluate our capital values for 2009. We are currently reviewing investments for next year. And I am not yet prepared to announce the amount of spending. I expect we will not do so before we announce our 2009 to 2013 plan. This does not mean we have cut [ph] our spending until we announce our new long-term plan.

The new plan will be focused largely on investment that is incremental and farther into the future than our existing plans. Our region [ph] of CapEx spending for 2009 will make some adjustment as we focus on projects with more immediate returns. Given the nonmaterial upstream and downstream projects in our portfolio, we can adjust CapEx without materially affecting our long-term goals.

Next slide, please, debt profile. Much has been made of the lack of market access, capital and [ph] emerging market companies and other resource-based companies. We do not foresee any problems in raising funds. Like other major oil companies, Petrobras has regularly experienced market disruptions during the last 10 years, even as we were doubling our production in a lower oil price environment. Consequently, we have the ability to seek funds from a noncommercial source. More than 40% of our liability structure is owed to government-related entities such as development banks and (inaudible).

We maintain excellent relationships with these entities, like [ph] Japanese Bank for International Cooperation, Chinese Development Bank and the Brazilian BNDES, which is also one of our principal shareholders. We have an ongoing debt balance with them. And they consider Petrobras a valid and strategic relationship. They do not have funding capital adequacy issues and they remain committed to lending to Petrobras.

We will state [ph] our available options. This year, we have already contracted or are in the process of finalizing $9.2 billion of financing, of which $1.1 billion is from the capital markets and foreign commercial banks. Net debt contracted this year is $5.3 billion.

Thank you. At this time, I will be happy to answer any question that you may have.

Questions And Answers

Operator

(Operator Instructions) Marcus Sequeira, Deutsche Bank.

Q - Marcus Sequeira {BIO 4622700 <GO>}

I have two questions. One is, regarding imports, what kind of trends have you seen already into the Fourth Quarter regarding imports of refined products? And second question, more general, we saw that overall margins showed a very steep decline in the quarter. And now, given the changes in fundamentals since the end of this quarter, how do you see margins going forward?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Regarding the imported refined products, we expect to reduce for the First Quarter, since we imported in extra volumes to make inventory to phase our stoppage of fuel refineries in Brazil. So we expect to import more, because of -- import less, because of this. And also because we are producing more diesel in Brazil due to adjustments in our refining process.

Regarding the margins --

A - Theodore Helms {BIO 15433381 <GO>}

Where do you see margins going forward?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

When we reduce our imported products, where we were losing some margins, like diesel, we have reasons here to believe that margin may improve in this area. The other area is the reduction of (inaudible) that can cause us to have a larger -- mainly the EBITDA increase. Any other point he has? Any other point --?

Q - Marcus Sequeira {BIO 4622700 <GO>}

Okay. And one last quick question. Do you see any change in the dividend policy going forward, or should we continue to assume around 28% of adjusted net income?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Yes. It remains in the [ph] 28%.

Operator

Frank McGann, Merrill Lynch.

Q - Frank McGann {BIO 1499014 <GO>}

Just to follow up a little bit more on costs, costs obviously have been a key focus, I think, for people looking at the current quarter. And largely that is just responsible for the point of the cycle where you appear to be in. But I was just wondering if you could perhaps discuss a little bit more, in terms of costs that we saw in the quarter, how much of the special items that you mentioned in the release, such as the labor agreement and the inventory adjustments, how much of that do you think is recurring or not recurring?

Then secondly, in terms of the recent labor agreement, what do you -- how much did we see in the current quarter that will not be in future quarters that was specifically a onetime item?

Then finally, along the same lines, general and administrative costs I believe rose by about BRL386 million versus the Second Quarter. I was wondering if there was any special item in that, or is that likely to be a recurring increase that we will see?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Okay. Some of these costs are not recurring. For example, we don't expect to have another inventory adjustment. And even if it happens, it is going to be a much lower value because of the evolution [ph] of the oil price.

Regarding the labor agreement, a good portion, maybe more than 50% of it, is not recurring because it refers to a bonus that was accrued. It happened only once in the Third Quarter. And of course, this labor agreement gave a roughly 10% increase to the salary. And this is going to be recurring.

The G&A, we expect to have a reduction. We have implemented, the Board has oriented the Company to cut costs on this area just recently. And we expect we are going to see reduction on this area and in the operational extent as well in the short run. So we expect to have positive answers on this area.

Q - Frank McGann {BIO 1499014 <GO>}

Okay. Could you maybe go into a little bit more detail about what type of cost-cutting program, perhaps, you are doing?

Then secondly, in terms of the gas and energy sector, you mentioned that until gas supply increases, you are likely to see continued charges there. Do you know how big those will continue to be and when you expect to get to a situation where the gas supply is sufficient to avoid those extra charges?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Let me have Eduardo to help us in the gas supply

A - Eduardo Alessandro Molinari {BIO 21023582 <GO>}

About the charge, we're talking about two power plants, third-party power plants, that have supply agreements based on the PPG [ph] contract. So now we are importing [ph] supply from them. But this situation, I'm going to disclose it [ph] with the GNL, although the penalties maybe exist because it would be uneconomic to supply GNL, depending upon the price.

So what you are going to purchase are solutions from the supply. But it doesn't mean that you are not going to have a penalty, because supplying can be a worse scenario than paying the penalty. So what you have is an option to supply. But it cannot be too punitive [ph] if it is not economical.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Regarding the cost optimization program that we just launched in the Company, it covers the smallest kind of costs, like avoiding trips and using tele -- videoconference instead since the Company has viewed activity [ph] by the Company. But the most important I believe is to reviewing our projects, our CapEx projects, in the sense that we are going to use more standard products in our projects that cost less than our customary projects, estimate [ph] goods or equipment. And working on the areas that cost us more in the operational area, for example, using with more efficiency the drilling rigs that cost a lot of money. And all this kind -- it's open for every other opportunity. And we opened a site, an internal site in the Company, to receive funds of the Company, the increase of the Company, suggestions where costs can be cut. And we have received in 10 days about 600 suggestions, from the smallest to the biggest ones.

Operator

Emerson Leite, Credit Suisse.

Q - Emerson Leite {BIO 4003528 <GO>}

I have a few questions. Number one is in relation to the investment program and your ability to finance the program. You mentioned earlier in the Portuguese call that we should expect for 2009 the same amount or somewhat a little higher CapEx, around BRL50 billion for the Company. So I was wondering, how do you plan to finance this much of an investment, considering that your operating cash flow will likely be substantially lower, given where oil prices are at the moment? If you look at this year, the Company had almost breakeven cash flow. All the cash flow that was generated was spent to cover the CapEx and I guess the dividend needs during the year, even adding some indebtedness. And that was with an oil price above $100 per barrel. So my concern is, how much funding would you need to make sure that this expanding will indeed be possible?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

We don't have yet finalized revision of our business plan that includes the next year definitely what we're going to include as a new project, what we may reduce, the pace of construction of our investments. This is under exam right now. So I cannot tell you how much we're going to need. And we don't have yet a price to work with for the next year. This is going to be important for determination of our cash flow.

What I said is what I am expecting, that we are not going to reduce our speed, our pace. And I don't see, if we need to raise 5 billion to 10 billion, you can look on the previous years. We had done this level. And we have very good relationship with many important suppliers of funds where we can fund what we're going to need. But of course, we are going to take into consideration all of these variables to establish our next-year program, that we hope to have it before the end of the year.

Q - Emerson Leite {BIO 4003528 <GO>}

But do you expect the spending, the CapEx should be around the same levels that we had this year?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Yes. This is a more personal feeling. I expect to be in the level of this year, or even larger than the current year.

Q - Emerson Leite {BIO 4003528 <GO>}

Okay. A second question has to do with these talks that we had in the market on a potential capital increase on Petrobras to allow a higher participation from the federal government. Do you think this idea can still progress in this environment and with this level of a stock price?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

I would say no comment on that, because it is a decision of the government. It is the right that -- the issue of [ph] the controller of the Company has to increase the capital, since they do the same opportunity for every other shareholder. Of course, the current situation causes the -- blurs the vision of everyone. And probably is going to take some extra time to decide on this point as well.

Q - Emerson Leite {BIO 4003528 <GO>}

Okay. Sorry, just one final question, if I may. You mentioned that you don't expect the inventory adjustment to be recurring, or even if it happens, it will be at a much lower amount. Don't you think that in the Fourth Quarter, we will likely have an important inventory impact as well, as we had inventory being formed during the Third Quarter at a much higher level for refined product prices and oil prices?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Yes. But this is not adjustment on the cost of inventory. Yes. It may happen. From what we have said, it may happen, because we have in Brazil inventories with a higher price. And this is going to feed the system in the next -- in the current quarter that oil prices are lower. So the new oil bought is going to cost less than the oil used in the system. So we will be transferring some high-cost inventories to feed the system -- having higher costs at this moment when we do that.

Q - Emerson Leite {BIO 4003528 <GO>}

So can you qualify which inventory adjustment you were referring to, then?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

I was referring to an adjustment on the international area. All our subsidiaries and our own inventories that are held outside of Brazil, that is held by subsidiaries. They were representing costs higher than the price. So according to the accounting rule, we have to adjust to the lower of the two.

Q - Emerson Leite {BIO 4003528 <GO>}

Perfect, understood. Thank you very much.

A - Theodore Helms {BIO 15433381 <GO>}

Can we just, in the future, just have maybe just two questions per person? We still have a number of people to get through. Thank you.

Operator

Adam Arnato [ph], JPMorgan.

Q - Adam Arnato

Actually, my question is a follow-up on the guidance for 2009. Let's assume your feeling of a higher CapEx in 2008 is right. I was wondering only what is the reason behind this increase, if it is just pressure on costs, or it's because of the inclusion of pre-salt's freight and development costs?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

No. The pre-salt, to be more directly, the pre-salt is not changing -- we expect not to change anything in the pre-salt, because next year pre-salt is going to take a very small amount of money. They do the drilling of fuel wells and having the long well test [ph]. But we may be drilling -- for example, as we are drilling two wells in the pre-sale of Espirito Santo at this moment, that this may become productive [ph] earlier than we were expecting, just by connecting with the platforms that are there in the year [ph] to come.

So it is not -- at this point, we don't see a possibility of cost increase during -- because of the pressure on the oil industry suppliers. On the contrary, it may happen that we have some lower costs than we were expecting previously. But it is still depending on what we are going to see. It is too early to say anything now.

Operator

Sapo Giripa [ph], Morgan Stanley.

Q - Sapo Giripa

I've got two quick questions on the accounting issue. I don't know if Marie Angela [ph] is there. But I just wanted to refer back to the inventory adjustment here. If I understood correctly the whole situation, under current accounting practices, the Company needs to adjust or convert inventory levels set in dollar terms based on year of -- end of the period of the FX rate, which in the Third Quarter was around 1.9 instead of the average.

As the Company migrates into IFRS new accounting rules, would we expect in the Fourth Quarter this, let's say, excess in terms of the accounting adjustment to be reverted back in the Fourth Quarter, as the Company will likely be using the average FX rate?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Just a moment, please.

A - Unidentified Speaker

This is Paulo [ph] (inaudible) speaking. As was said -- as Marie Angela said in the conference call, in the presentation during the morning, we expect a change in terms of accounting in the way that we converge -- consider the exchange rates. We expect a change, because our base [ph], following the actual rules, we convert the dollars in terms of (inaudible). We converted (inaudible) on the final rate. Then following the P-52 is that new rule considering the amortization (multiple speakers) in terms of accounting, we should convert -- we have to convert the inventories by this average exchange rate of what we can reproduce in the consolidated financial statements -- we produce in effect, the account [ph] estimates this effect (multiple speakers). It will depend on the volumes (multiple speakers). But in fact, we will have some effect in the Fourth Quarter.

Q - Adam Arnato

Okay, that's clear. Then also following up on this same issue, I just wanted to make it clear. The reason why you are converting -- you had, let's say, an accounting or a loss -- the reason why you had an adjustment in inventories is related to the fact that your diesel or your refined products are in foreign subsidiaries. And that is the reason why once you sold into the internal market you had to convert it using the final extension rate? Is that the case?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Yes. That's it.

Q - Sapo Giripa

Okay. And just quickly, you guys have the effect of this FX rate into the operating expenses, we know that the effect on the gross margin line, on the gross profit. Do we know this same effect on the operating expenses line?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

One moment, please. Yes. The interest on the operational expense happens when we have an exchange rate variation. We don't have details now. But we're going to release showing where the change on this subject in our side [ph].

Q - Adam Arnato

That is great. Thank you very much. Sorry for the extra question.

Operator

Robert Kessler, Simmons & Company.

Q - Robert Kessler {BIO 15093691 <GO>}

I've got two quick questions, one on financing capability and the other on a Jubarte pre-salt long-duration test well.

On financing, I guess I'm most curious as to -- I recognize you're still in the process of working through the long-term strategic plan. But is there some sort of parameter you could provide on the absolute funding thresholds, the high point on, say, net debt to capital, or total billions of dollars of debt outstanding, for example, just to give us some limit on how far you might be willing to stretch the balance sheet?

Then on the pre-salt well, did I hear correctly that the 103A well did in fact reach your 18,000 barrel per day target? And is there any way to extrapolate that well to the pre-salt in general? What are your expectations at this point for initial rates of production for a typical development well in the pre-salt?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Okay. Regarding the finance, stressing our balance sheet, our target is to be between 25% and 35% in terms of leverage. And we are in the lower area of this range. So we have room there. And the Company is growing. We are investing heavily. So this gives us more strength, more production. The balance sheet becomes healthier.

The pre-salt, we at this point -- maybe Molinari can tell us something more on the production opportunity. It can be expanded to the pre-salt quote [ph]. But as far as I understand it, this is important information that's too early to extend to all pre-salt. Of course, with that region, while the well is in production, it can give out some information. But to extrapolate to Santos, that is about 800 kilometers away, is difficult. But now, can you --

A - Eduardo Alessandro Molinari {BIO 21023582 <GO>}

We are going to do this extended well test in March 2009. And this will be very important to see the productivity of future wells. We are testing two wells, one at a time, in Tupi for six months each. One is already drilled (inaudible). And the other one will be drilled. So we are doing this extended well test with (inaudible), which is already completed [ph]. It has a capacity of 30,000 barrels per day. So these questions we will be able to answer with this extended well test.

Q - Robert Kessler {BIO 15093691 <GO>}

Thank you. We will look forward to the increased information going forward, then. Thanks very much.

Operator

Ricardo Cavanagh, Raymond James.

Q - Ricardo Cavanagh {BIO 1702523 <GO>}

I have two questions. The first one is related to prices. Over the past, well, few years, oil prices have gone up and the real has depreciated, allowing the Company not to worry prices significantly. And keeping track with international prices. Now we have a situation where oil prices have come down well beyond what the Company has -- the currency has depreciated.

My question is, at current levels of gasoline and diesel prices, could at some point you be forced to reduce these prices? That could be the case. And second question is, well, given the extraordinary set of conditions that the world economy is going to, if you think there is any possibility, or do have any flexibility, to renegotiate day rates or any prices with oil service providers?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

The second question is, you have to be tested [ph] in the market. Of course, the contracts we have are going to be honored. New contract is going to have new weight. But I don't see much opportunity for the long-term contracts we have signed to have adjustments. That can happen. But I don't see this happening.

Regarding the prices, we keep our policies just on the long run, not on the short. Maybe the spike is going to be profitable to bring products to Brazil. But at this moment, with very high volatility, these are very risky activities, because in one week you can have a completely different scenario.

So I believe neither us nor any player is going to take this kind of risk. We are not going to adjust before we are convinced that we are in a long-term level of price. And bringing oil depends on the appeal of [ph] different players, oil products. But we are going to keep our price policy.

Operator

Emile Moody [ph], Goldman Sachs.

Q - Emile Moody

Sorry to go back to the inventory question. But just really trying to understand the underlying profitability in the downstream segment, absent any one-time inventory liquidation or currency adjustment. Can you provide what the magnitude of that one-time liquidation and currency adjustment were in the supply segment, just a number?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Just a moment, please.

A - Theodore Helms {BIO 15433381 <GO>}

Emile, could you just quickly repeat the question, please?

Q - Emile Moody

You mentioned, Ted, in the press release the liquidation of inventories acquired at a higher cost in the previous quarter accounted for some of the decline in supply segment earnings. I'm just wondering, I'm trying to separate the one-time impact of the inventory adjustment versus just how you account for cost of goods sold. So how much of the decline was really because you wrote down the inventory levels as opposed to just the accounting of the cost of goods sold during the quarter?

A - Theodore Helms {BIO 15433381 <GO>}

Just to clarify, I think there's two things. One is there was the write-down of inventory related to, as I understand it, inventory held in international subsidiaries? Was that correct? In general, Okay, then, maybe do you want to try, then, to help me?

A - Unidentified Speaker

This is (inaudible) speaking again. We had in the previous quarter BRL1 billion for the whole Company as an effect in terms of inclusion [ph] of prices we paid in our inventories. We've sold inventories strongest in this quarter. The real is negative this effect [ph] in the Third Quarter.

On the other hand, consider that price is to increase until the middle of this quarter, mainly in July. And consider that we had exchange appreciation of dollar in relation real. We had an increase in terms of costs during this Third Quarter. Then in September 30, we had another effect, that what we realized is the next quarter, it's is almost BRL800 at September 30.

Again, in this quarter, Third Quarter, we revaluated BRL1 billion that was retained in inventories in June 30. We expect to have another effect to the next quarter about BRL800, considering that we continue to have increases in terms of costs during the Third Quarter.

Q - Emile Moody

Understood. Thanks. That is helpful. My other question was just on demand. I noticed oil products, domestic demand was up a little over 1% during the quarter. Was this indicative of the overall demand environment, you would say, in Brazil? And how has it trended since then, given the deterioration we've seen in demand in other markets around the world? Can you comment on how that oil product demand number is trending so far in the Fourth Quarter? Thanks.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

As far as we can see, October was a very good month for selling oil products in Brazil. It remained the same trend. Maybe for the remaining of the year we will see some change. But so far I cannot anticipate that.

Operator

Gustavos Gattass, UBS.

Q - Gustavo Gattass {BIO 1702868 <GO>}

I had two quick questions here. First, relating to CapEx and basically the decision of announcing a strategic plan probably around the end of the year, I just wanted to have, let's say, a guidance from you, not in the sense of how big it will be. But some of the driving forces.

What I wanted to understand was, first, is Petrobras today, I would say, in a situation that you would consider comfortable enough to simply go out and say that in your CapEx plan you will need a certain amount of additional leverage? Or is that something that you would prefer to avoid from the point of view of trying to make credit better for both you and your potential suppliers? That is the first question.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Let me see if I fully understand your question. You are asking if we'll feel comfortable in funding part of our suppliers. And by doing that we will be leveraging the Company in --

Q - Gustavo Gattass {BIO 1702868 <GO>}

I was actually thinking more -- the reason I ask is just a lot of the suppliers that you're starting to deal with are pretty new to what they are doing. Apparently, they are not that capitalized, depending on who we talk to. And I would assume that your credit ratings are incredibly important for them to be able to get financing.

What I was trying to get at was, do you feel, given market conditions, that it would be good for Petrobras and for all that you really want to do to come out and announce a CapEx that is big enough so that you have to admit you are going to be taking a significant amount of debt in your books?

A - Theodore Helms {BIO 15433381 <GO>}

Are you saying would we, let's say, change the terms under which we are planning to contract now because they don't have enough capital. So that it would in some way bring those -- let's say we sign long-term contracts. On the basis of those long-term contracts, these operators obtain funding, build a rig. And then we bring it back and we pay the day rate. Are you suggesting -- are you asking whether we would do something that would -- to help them, if you will, because they are having difficult. So that in a way that this debt would come back on our books? Is that what you're asking?

Q - Gustavo Gattass {BIO 1702868 <GO>}

No, no. It is much simpler than that, Ted. If I look at your historical CapEx plans, they have always included a provision that a certain amount of the cash flow would be raised as debt.

What I just wanted to understand is, the world has changed massively. Historically, saying something like that was very believable and very easy to do. What I was wondering is, is Petrobras going to be more conservative as far as how they think about funding the next five years, or should we just expect that this CapEx plan is being done under the light of things are going to be okay?

A - Theodore Helms {BIO 15433381 <GO>}

In other words, how much debt are we going to -- what is our philosophy with respect to assumptions made about debt as we go about putting together our plans?

Q - Gustavo Gattass {BIO 1702868 <GO>}

Yes.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

The policy that is in place for some time is to have a leverage between 25% and 35%. And what has happened in the latest year was that we were below the 25%. So we may be looking, since the market will be down, looking to reach the 35% that will be an optimal situation for the Company. We can keep our programs, as far as financing is available. And optimize our results. But we have no decision to go beyond that level in any circumstances.

Q - Gustavo Gattass {BIO 1702868 <GO>}

Okay. The second question I had regards the potential product imports into Brazil to capture, let's say, future spreads that may be favorable. Since so much has happened over the course of the last five years with you guys buying Ipiranga -- basically, Manganga is not operational anymore -- I just wanted to understand. In your point of view, how easy is it for an independent, non-Petrobras, to actually bring a diesel tanker and be able to offload into Brazil without having to use one of your pieces of infrastructure?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Can you give them your opinion on that? Really, I don't have this experience. I never leave the office situation [ph].

A - Unidentified Speaker

It is not that difficult. There is enough access in Brazil. So bringing product without using the infrastructure of Petrobras is much more difficult. But there are rules here that establish the open access. So it seems that it is not that difficult.

Q - Gustavo Gattass {BIO 1702868 <GO>}

So someone would have to use your infrastructure to offload?

A - Unidentified Speaker

Yes, probably.

A - Theodore Helms {BIO 15433381 <GO>}

That has always been contemplated. That is why we had to create Transpetro with equal access -- with rights to third-party access.

Q - Gustavo Gattass {BIO 1702868 <GO>}

Okay, perfect. Thank you, guys.

Operator

Christian Audi, Santander.

Q - Christian Audi {BIO 1825501 <GO>}

Just to clarify two points, first, on that other item, which amounted to 2.3 billion [ph], I just want to clarify, what was the biggest element that caused that number to be so much higher quarter over quarter? Was it the labor-related adjustments?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Sorry, Christian. Could you repeat the question?

Q - Christian Audi {BIO 1825501 <GO>}

Sure. On the income statement, the operating expenses, you have that other expenses item, which amounted to 2.3 billion for the quarter, which was a big increase on a sequential basis. I'm trying to understand what drove that number to be so much bigger. What was the main element of that bigger increase?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

You mean the item, the other on the operating expenses? What is the composition, the breakdown of these other expenses? One moment, please. (inaudible) wish to provide later on, on our site, the breakdown of this item so everyone can access it. We don't have all the details now.

Q - Christian Audi {BIO 1825501 <GO>}

Can you at least tell me what was the main driver for that increase? Was there one single element that was the main cause for the increase, or was it a combination of several smaller elements?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

There are several. But there is one important item, at least now, is the labor agreement done in the Third Quarter, where, that I have said already earlier, that we paid bonuses to all the employees equal to 8% of their salary. And this is only one-off kind of payment. And of course there are other expenses, like the thermal plants, when they are idle, the costs are in this area. And yes, we are going to give you all the details on this.

Q - Christian Audi {BIO 1825501 <GO>}

And the second question is another question for clarification on the answer that you gave about, when we look at the main costs that drove the lower margin, you touched on the inventory costs, import costs and these labor costs. And you were explaining which ones are recurring and which ones are not. Can you just go through that again? Because it wasn't clear for me. So in terms of inventory costs, we had the inventory costs related to foreign subs and then the inventory adjustments in Brazil. Which ones of those do you see as being recurring and which ones are not?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

You said inventory costs --

Q - Christian Audi {BIO 1825501 <GO>}

Import costs, yes.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Import.

Q - Christian Audi {BIO 1825501 <GO>}

Import, inventory and these labor cost issues. Can you just, without going into too much detail, as simply as you can, talk about what parts of it you think are recurring and not recurring, looking out to the Fourth Quarter?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Yes. Inventory costs, there are two kinds -- the inventory costs due to the adjustment of costs to price that were done in our international subsidiaries. And there is the possible inventories ex the cost from inventories that will flow as we use inventory that is costing more in this year during the Fourth Quarter.

The second one, the usage of inventories in Brazil, we are doing some extra costs in the Fourth Quarter. The international subsidiary, I don't expect it to repeat. If it repeats, it is not going to be as high as in the Third Quarter.

And labor costs, labor costs, the decline [ph] of the labor costs is the further [ph] increase we gave that is about 10%. All the other costs which are in labor are not recurring. And so, I anticipate that most of what we expense of the quarter costs in this area relating to labor is not going to be recurring.

Operator

Paula Kovarsky, Itau.

Q - Paula Kovarsky {BIO 15363001 <GO>}

I have two questions. First question, relating to a comment you made in the previous call, where Barbassa was saying that Petrobras' investments are more or less split half and half between upstream and downstream. Should we expect the same kind of split in the strategic plan? And if so, I am assuming pre-salt stuff will be very much part of the upstream, which means you will still have a big portion of your CapEx coming into downstream and additional refineries.

So could you talk a little bit about that? Is that the idea, to keep up with this idea of matching refining capacity with upstream production capacity? So that is the first question.

Second question relates to the rise in lifting costs, which reached more than $10 per barrel this quarter. So I would like to understand how much of this increase you think is recurrent. And whether in this increase there is already the impact of the three new platforms that are due to come onstream within the next three months?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Your last question could you repeat it, please?

Q - Paula Kovarsky {BIO 15363001 <GO>}

Sorry, the last question?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Yes.

Q - Paula Kovarsky {BIO 15363001 <GO>}

Yes. It has to do with lifting cost increase. And how recurring this increase is, or shall we expect lifting costs to go down in the next quarters? Then I would like to understand how much of the rise has to do with the fixed costs associated with the three new platforms that you mentioned are due to come onstream within the next three months?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Okay, one moment, please. Okay, regarding CapEx, first question, I believe I was not clear enough. If you understood that we were replacing 50% of CapEx in the upstream and another 15% in the downstream. Now, if the right indication is that upstream will take the 50%, as it is today, I was explaining the 2008 CapEx. And not anticipating what is going to come for the next business plan.

But usually, we have more than 50% or more of our CapEx dedicated to the upstream area and one-fourth of fleet dedicated to downstream area. And the remaining fourth to the other activities. Of course, we intend to remain an integrated company. As we grow our production, we plan to increase our refining capacity as well. But this will depend, the pace and the timing of each one is going to increase, depends on many other variables.

Q - Paula Kovarsky {BIO 15363001 <GO>}

I was just trying to check on numbers that were floating around, talking about 30 billion to 40 billion worth of investments in refineries coming in.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

The business plan that we had announced last year contemplates 30 billion for five years in the downstream area, including transportation, quality products, petrochemical. And we are not present today in the petrochemicals, for example. That is still a small business for us. But we don't have at this point indication on what is going to be our future plans. As far as now, we have a very good set of projects in all areas, mainly in the upstream area. We may keep our share in the CapEx.

Regarding the lifting cost increase and the new platforms and how it's going to perform, I cannot say much on that. It depends on the new -- new platforms that are coming is a sizable amount of extra capacity. As it happens, at the end of last year, when we had even more capacity installed, in the beginning it always happens. But don't forget that today we have a large team that is going to work on the platform. They are already there. They are getting prepared and get trained and get the knowledge of how to operate. So the costs are there. This I don't believe is going to be the case that will increase our lifting costs for the next quarter.

Operator

Marcelo Lima, Unibanco.

Q - Vladimir Pinto {BIO 1554020 <GO>}

This is actually Vladimir Pinto from Unibanco. I have two questions. The first one is, if you could please explain why the minority interest line reported such a large variation in the 3Q in relation to the previous quarters.

And the second question would be, what is the fair discount or which discount would you believe that could be viable to import derivatives, let's say, in the northeast of Brazil? We believe that Petrobras' own large logistics on the field distribution center could match international competitors. But I believe there will be a number, a discount number that would you see importers coming to Brazil.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

The minority, just a moment, please. Let me try to explain the case of minorities. The minorities, we have many FPDs [ph] that, they raise money in dollars that had a loss. And so it was consolidated on the Petrobras balance sheet as a loss. In the minority line, we are developing this situation. That's why it increased. This is one of the impacts of the exchange rate.

Regarding discounts necessary to accumulate -- to import oil products into Brazil by other players, it depends on each player, the risk they want to run and the costs of the capital. Really, I have no figure to help you here.

Operator

Emerson Leite, Credit Suisse.

Q - Emerson Leite {BIO 4003528 <GO>}

Thanks for the follow-up opportunity. I would like to talk a little bit about exploration. I know you guys have for now performed the minimal exploratory program required in the Tupi cluster area. Do you plan to drill further appraisal wells in the cluster during 2009? And if you could anticipate a schedule, a drilling schedule, or which well is going to be the first? I'm not referring to BM-S-22. But within your blocks in the cluster, which is going to be the next well. And when should we hear from Petrobras again on new estimates of potential volumes in the cluster?

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Okay, let me have Molinari to help us on these questions.

A - Eduardo Alessandro Molinari {BIO 21023582 <GO>}

In 2009, we expect to have three more drilling rigs that are able to drill up to 2400 meters water depth, which should arrive in September. They are serve-on drill [ph], less powers [ph] and less (inaudible). The last two are contracted from field drills. Today, we have only two drilling rigs that are able to drill in such conditions. So Orschen Peak [ph], which is drilling in Jikichinoia Basin [ph]. And (inaudible), which is drilling in the Santos Basin.

So unfortunately, I cannot tell you the wells that we will be drilling. We are preparing the drilling program that we're going to do next year. But we don't publish these drilling programs. We are drilling right now outside the cluster blocks of the Santos Basin, the pre-salt, in Baleia Azul and Baleia Franca. And in Espirito Santo state north of the Campos Basin. That is all I can tell at this moment.

Q - Emerson Leite {BIO 4003528 <GO>}

Still on this topic, we had earlier this week, or actually last Friday, we had ANP, their head regulator, here commenting on a number of between 50 billion and 80 billion barrels for reserves in the Tupi Cluster area. And apparently, this time they were basing the numbers in technical information. And I assume the technical information can only come from Petrobras. Do you have any comments on that estimate, how that fits with your own assessment of the potential of the area?

A - Eduardo Alessandro Molinari {BIO 21023582 <GO>}

I cannot comment on what they said. They have also data on the blocks. And what Petrobras publishes is that we may have some 8 billion to 12 billion barrels of oil equivalent in Tupi and Reala [ph] together. So that is what I can tell right now.

Operator

Thank you, ladies and gentlemen. There are no further questions at this time. Mr. Barbassa, please proceed with your closing remarks.

A - Almir Guilherme Barbassa {BIO 1921476 <GO>}

Thank you, all for being here. I hope that next quarter, we can have as good results that we had this time. See you then.

Operator

Ladies and gentlemen. your host is making today's conference available for replay starting one hour from now. You may access this replay at IR's website or by dialing +1-412-317-0088, with code 424279#. Enter 1 to start the playback until November 19.

This concludes Petrobras' conference call for today. Thank you very much for your participation. You may now disconnect.