Q2 2015 Earnings Call

Company Participants

- Ivan de Souza Monteiro
- Jorge Celestino Ramos
- Lucas Tavares de Mello
- Solange da Silva Guedes

Other Participants

- Alexander Burgansky
- Andre Sobreira
- Bruno Montanari
- Caio Carvalhal
- Christian Audi
- Diego Mendes
- Luiz Felipe Carvalho
- Paul Y. Cheng
- Pedro Medeiros
- Sergio Conti

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Petrobras Conference Call with Analysts and Investors for the Presentation of Second Quarter 2015 Results.

We would like to inform you that participants will only be listening to the conference call during the company's presentation as listeners only with simultaneous translation into English. Following the presentation, a Q&A session will begin in Portuguese and in English when further instructions will be provided.

Present with us today are Mr. Ivan de Souza Monteiro, Chief Financial Officer and Investor Relations Officer; Ms. Solange da Silva Guedes, Chief Exploration and Production Officer; Mr. Jorge Celestino Ramos, Chief Downstream Officer; Mr. Hugo Repsold Júnior, Chief Gas and Power Officer; Mr. João Adalberto Elek, Jr., Chief Governance Risk & Compliance Officer as well as other company officers.

I would like to remind you that this meeting is being recorded. And please be mindful as slide number two, which contains a notice to shareholders and investors. The words believe, expect and similar ones related to projections and targets are mere forecasts based on the expectations of executives regarding the future of Petrobras. To begin, we will hear Mr. Lucas Mello, Executive Manager of Investor Relations.

Then there will be the presentation of the results for the second quarter of 2015 results. Afterwards, we will answer questions from participants. Mr. Lucas, you have the floor.

Lucas Tavares de Mello {BIO 17682021 <GO>}

Good morning everyone. I would like to call your attention to slide number two, which has a disclaimer, and then I'll go to slide number three talking about the exchange rate and the outside environment. We noticed that between the quarters of 2015 and 2014 there was a depreciation of the Brazilian real by 40%. However, we also noticed that between the second quarter of 2015 and the first quarter of 2015 there was a appreciation of the Brazilian real.

Going to slide number four, going to speak about oil prices and Brent between the half year of 2014 and 2015, there was a reduction of 47% in those prices. On the other hand, when we look at Brent prices between the first quarter of 2015 and the second quarter of 2015, we see an increase in Brent prices by 15%.

Slide number five, we have the consolidated net income of the company that was R$5.9 billion. The net operating expense was down due to price reductions more particularly export prices, and there was also a reduction in the sales of oil products. In terms of the cost of products and goods sold, there was also a reduction in those costs because of lower import costs than also lower production tax costs and therefore the gross profit of the company was R$48 billion, 26% higher than the first quarter of 2014. In terms of operating expenses, they were impacted by tax liabilities of R$3.1 billion over IOF or tax liability, tax on intercompany loans Petrobras and related companies reaching an impairment of R$1.3 billion, with that the final result was R$23.2 billion, 29% higher than the same quarter of 2014.

In terms of the financial results, it was impacted by higher foreign exchange variation expenses and higher interest expenses and interest on IOF amounting to R$1.3 billion, so then we had a negative of R$1.2 billion to a negative of R$11.7 billion. With that our net result was R$5.9 billion in the quarter of 2015 that represents a reduction of 43% when compared to the first half year of 2014. Adjusted EBITDA in the first half of 2015 was 35% higher when compared to the same period of 2014. Investments amounted to R$36.2 billion representing a drop of 13% when compared to the same period of 2014 and net cash flow was in 2014 negative.

Now going to slide number six, the net consolidated result for the second quarter was R$500 million. The net operating revenue was higher, was up due to higher export volumes at higher prices and also higher sales of oil products. The cost was also higher mostly due to increases and the production taxes and that's why our net or gross profit was R$25.6 million and 14% higher than in the previous quarter. Operating expenses were impacted by tax contingencies of R$3.1 billion over IOF tax liability and intercompany loans. Impairment was R$1.3 billion and higher exploratory cost. In the first quarter of 2015, we had a reversal of allowance for losses in the electric sector of R$1.3 billion. All-in-all, our operating profit was R$9.5 billion, representing a 29% drop when compared to the previous period.

The financial result is impacted by the recognition of interest on tax expenses of IOF, R$1.3 billion and higher interest expenses even if we posted a reduction in the exchange variation expense, so we have R$500 million as a net result, which is a drop when compared to the previous period. So R$19.8 billion was the final result, a drop of 8% vis-à-vis the previous period that was adjusted EBITDA investments was R$18.3 billion, 3% higher when compared to the first quarter of 2015 and free cash flow was R$5.7 billion when compared to a negative R$1.3 billion in the first quarter of 2015.

Next slide, slide number seven, we have some highlights. First, we have the highlights for the half year, higher crude oil production and also the operation startup of the early production system in Búzios, higher volumes of oil exports, lower cost of production. Taxes also reversal allowance for impairment of trade receivables of R$1.3 billion and free cash flow amounting to R$4.5 billion. Now in the second quarter of 2015, the highlights were the increase in oil production by 7%, also recovery of funds from Lava Jato operation amounting R$157 million. The reimbursement related to the insurance of the accidents in Chinook field USA amounting to R$259 million and provisions of IOF tax liability was R$3.1 billion. We also had impairments on gas and power downstream in E&P amounting to R$1.3 billion and that is in operating expenses line.

Now, I would like to go to slide number eight. We have the impairment of assets amounting to R$1.6 billion particularly on the nitrogen fertilizer plant number 5 of almost $600 million, $585 million. Now oil and gas fields in Brazil and the disposal of assets amounting to R$245 million, transfer and export offshore units, $198 million and others that when put all together amount to R$257 million and R$1.3 billion as operating expenses and R$300 million allocated in investments.

Now, I'll go to slide number nine. We will now refer to exploration and production of oil and gas. Between the half years, we experienced a 9% growth in production. The total production was 2.784 billion barrels of oil equivalent a day and between the quarters, the second quarter of 2015 and the first quarter of 2015 there was a decrease of 1%, it's a stable production but there was a slight decrease of 1%. So, then we have 6.746 billion barrels of oil equivalent for the year. Still speaking about exploration and production, we have the connection of new wells on slide number 10. Until now in the first quarter of 2015, we connected 39 wells, 28 wells were producing wells and 11 were injector wells. We hope to have 72 connections until the end of the year, so in the second half of the year, we intend to connect 33 wells in this area of exploration and production.

When it comes to downstream on slide number 11, the oil products output in Brazil between the half years, the first half of 2014 and the first half of 2015 there was a 6% reduction in the production of oil products. Even when we look at the quarters, the first quarter of 2015 and the – the first and the second quarters of 2015, we see an increase of 7% in the production of oil products.

Now, slide number 12 refers to sales of oil products in Brazil between the half years, we see a drop of 7% in the sales of oil products and also in the quarter there has been stability in sales with a growth of 1% in the sales volume of oil products in Brazil.

Now going to slide number 13, we talk about the balance of oil and oil products. On the left hand side of the slide, we refer to exports, specially exports between the half year. Exports were higher due to higher crude oil production. Imports drop and it drops both in terms of oil products and crude oil. And all-in-all, the net balance comparing the first half of 2014 and first half of 2015 goes from a negative 526 barrels a day to a negative of 125 barrels a day in the first half of 2015. On the right hand side we see the quarterly evolution and comparing the first quarter of 2015 with the second quarter of 2015, we also notice a reduction in that negative balance which was in the first quarter minus 225 and in the second quarter was minus 27 in the second quarter of 2015.

Slide 14 shows the operating income evolution between the half year periods per segment in the first segment. In the first half of 2014, the operating income was R$16.4 billion. Downstream area showed an improvement in the operating income due to better margins in the oil products volume and this was also due to drop in Brent prices.

Now exploration and production experienced a reduction in its overall result and this is due to a drop in Brent prices. The other segments did not suffer major alterations. And corporate includes tax contingencies with IOF, therefore we reach an operating income result of R$22.8 billion, 39% higher than what was posted in the first half of 2014.

Slide 15, we show the operating income evolution per half year. In the first half of 2014, it was R$10.4 billion net income. Sales revenue was affected by the export prices, lower export prices and lower volumes of oil product sales. COGS showed an improvement stemming from reductions in production taxes and lower import volumes of oil products. Operating expenses experience a decrease due to tax liabilities of IOF and impairment of assets. The financial result is also affected by foreign exchange variation in the period, higher interest rates and also interest on tax contingencies of IOF. Income tax or taxes was slightly higher, I mean the tax rate was higher concerning profits abroad, and therefore the net income for that half year was R$5.9 million, 43% lower than what was posted in 2014 in the same period.

Slide number 16 shows operating income evolution per quarter, per segment. Operating income was R$13.3 billion in the first quarter of 2015. Downstream experienced a decrease, a drop in the results due to worse margins in the quarter due to higher Brent prices. And we see the contrary when it comes to exploration and production and here we have better Brent prices and this improves the operating results in the E&P area.

Gas and Power had a decrease in the result. I would like to remind you that this area in the first quarter of 2015 had the benefit of reversal of losses coming from the electric industry. Corporate had IOF tax liability and therefore the operating income in the second quarter of 2015 was R$9.5 billion, 29% lower than the results that we had in the first quarter of 2015.

And slide 17, we have the operating income evolution in the quarters. We had net incomes in the first quarter of R$5.3 billion. Sales revenue was higher because we had higher sales volumes and higher volumes of exports at higher prices. Costs were worse because of higher production taxes. Operating expenses also had a decrease due to tax liabilities of IOF, impairment and also higher exploration costs. The financial results had higher interest payments, payments of IOF that were partially offset by the appreciation of the Brazilian real in the period. Our net income in the second quarter was R$500 million, which is 90% lower than what we had in the first quarter of 2015.

Slide number 18 refers to lifting cost and refining cost. At the top of the slide, we have lifting costs and we notice that between the first and the second quarter of 2015, the lifting cost has been stable and once we look at the same cost in the half year period we see an increase of 17% mostly due to the real devaluation and higher expenses with workovers and subsea maintenance. Refining cost has remained stable. In the half, in the quarters and in the half year, it was high by 25% due to lower throughput and due to maintenance stoppages and higher personnel costs.

On slide 19, we talk about the company's indebtedness and in the last line, we see that net debt denominated in U.S. dollars has remained stable. However, the net debt denominated in Brazilian reals was 282% higher due to the depreciation of the Brazilian real that occurred during the period.

Slide number 20, refers to the financial ratios and indebtedness. The top line refers to net debt over EBITDA ratio but the net debt between the first quarter of 2015 and the second quarter has been stable, and then net debt over adjusted EBITDA went from 5 times to 4.6 times in terms of the debt ratio. We are using the EBITDA of the last 12 months instead of the annualized EBITDA.

On slide 21, we have the company's cash flow. In 2015, our cash position was $26 billion. We anticipate an operating cash flow of $26 billion. We had up to now $14 billion. Interest, amortizations and others, we anticipate $22 billion. Up to now we had $11 billion. Now, investments we anticipate $28 billion. So far we have invested $12 billion, divestments $3 billion, rollovers we concluded funding $12 billion. Therefore, I mean by now it's slightly over $10 billion, therefore by yearend our cash position should be $20 billion.

With that, I conclude the presentation of the slides. And we will now initiate our Q&A session.

Q&A

Operator

The first question comes from Bruno Montanari from Morgan Stanley.

Q - Bruno Montanari {BIO 15389931 <GO>}

Good morning, everyone. Thank you for taking my question. My question is about results and another about the business plan. About results, I would like to better understand the trend of imports. Oil product imports for the second half of the year numbers were very low, 27,000 barrels per day. Is this temporary or is the new level of net exports to expect from the company? And what about the business plan when we consider the target of divestment, is almost $47 billion. I would like to understand if the targets for cash generation and production presented already factor in this increase in disposal of assets, would it initially decrease the target for generation and cash? Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you, Bruno. Ivan Monteiro speaking. Answering the first parts of the question, I will give the floor to Jorge Celestino.

A - Jorge Celestino Ramos {BIO 1647841 <GO>}

Good morning, Bruno. Our projections or outlook are showing now that we have the startup of RNEST and the better production in refineries and the trend of the ethanol market to remain competitive. This is all generating this trends, so this is the best forecast we can give you right now and these are the figures we are working on for the second half of the year. Bruno, answering the second part of your question, all the data disclosed by the company are based on the new business plan, including the best expectation of the company vis-à-vis the divestment plan. Thank you.

Operator

The next question is from Andre Sobreira from Credit Suisse.

Q - Andre Sobreira {BIO 16337358 <GO>}

Good morning, thank you. I have two questions if I may. About divestments, Ivan and the target on a longer term basis. That's quite an ambition target R$48 billion. Could you explain the process? Do you think this number is conservative, aggressive? What kind of assets in your opinion can be addressed at first considering the best demand? Could you clarify this? I think this is critical for the deleverage of the company or net debt over EBITDA. Now CEO, Bendine mentioned something about this yesterday. Apparently, the company is more focused on lowering tax liabilities. There is a huge amount, $90 billion in tax, disputes going on. I wonder if you could give us some guidance to what extend this can be solved and what about the timeframe? Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Andre, thank you. About divestments, the information disclosed, first of all they relate to the challenge of R$15.1 billion in 2015 and 2016. Our goal for this year is R$3 billion. There are several processes underway and as they become more mature, the company would disclose them. We have a governance process for approval purposes and also how to carry on our divestment program and then a formal process of approval by the company level. So only once these processes are both concluded, we will be able to provide more visibility to the market. As to the tax question, just as what CEO, Bendine mentioned yesterday, we just had an ordinance issued by the National Ministry of Finance and whenever the company faces cases in the administrative arena and in order to continue discussion in the judicial area, it is requested to focus on collaterals and also cash burn. We also discussed with our legal department about how successful these processes can be and this is why the company decided to keep on discussing in the judicial area or more specifically simply comply to the new ordinance issued on August 3? Thank you.

A - Lucas Tavares de Mello {BIO 17682021 <GO>}

Thank you, Andre.

Operator

The next question is from Sergio Conti from Goldman Sachs.

Q - Sergio Conti {BIO 3441214 <GO>}

Good morning. My question is about price dynamics or brand realization and sales prices of Petrobras oil from E&P to downstream. On your slide, you show brand compared to the sales price. When I look at the international leverage for Brent in 2014 and 2013 percentage wise it is 90% Brent per barrel in dollars, it is around $10.3 that's the spread. In other words, Brent above the realization price. In the second quarter, it was lower, $9.78 per barrel, if you check the spread and percentage wise it was 84.2%. I would like to better understand the numbers. There are some significant implications for government stakes or E&P and downstream, so what about the dynamics, how do you come to the transfer price, should I consider percentages or dollars per barrel? In the second quarter, prices went down compared to what we had in 2014 and 2015, could you give us more color on this? Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you, Sergio. Jorge Celestino will answer your question.

A - Jorge Celestino Ramos {BIO 1647841 <GO>}

Good morning Sergio. In reality, the methodology of our domestic prices and transfer prices goes through the approval of crude oil quality. We have a planning model and this planning model also gives prices of oil. Due to international prices and also the quality of crude oil, what I mean by quality is the yield of middle products and light products, so considering what you process domestically, this is evaluated based on these models.

In reality, to come to this amount and value, we would have to compare whatever was processed in 2014 or in 2015 that might have shown variation. Certainly there was a variation due to the market and also owing to what we import or the oil imported to be more adapted to our refinery production profile. So given a straightforward answer, we have to consider what we chose in 2014 and also in 2015. So we can assess and give you a more straightforward answer.

Q - Sergio Conti {BIO 3441214 <GO>}

Just a follow up question?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Sergio, Ivan Monteiro speaking, just one suggestion, that's a very specific question you have. So, the IR department and the Downstream department can give you more detail but please follow on with your next question.

Q - Sergio Conti {BIO 3441214 <GO>}

If we analyze the company's numbers, my feeling is one of the explanations might precisely be the one you've just given, the heavy versus light oil mix, so the question is considering we have RNEST startup early this year and obviously it processes heavier oil, so I wonder if this new reality or new scenario in the second quarter might prevail. In other words, the profile of Petrobras refining capacity is changing and that might explain this event. Am I right to assume this?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

In reality, we don't have heavy oil in RNEST yet. We are still running with slightly lighter oil. We haven't come to our real target at RNEST. In reality, we pre-operated several plans, several units in the first half of the year. The whole package of sulfur for instance is just starting up now and possibly in the second half of the year, RNEST will still be with the same line of projects.

Q - Sergio Conti {BIO 3441214 <GO>}

Perfect. So maybe later on, we can have a follow up, so you can give me more detail. Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you, Sergio.

Operator

Our next question comes from Diego Mendes from Itau BBA.

Q - Diego Mendes {BIO 16313486 <GO>}

Good morning, everyone. I also have two questions. My first question refers to the Lava Jato impact, when it comes to services and CapEx, whether in the company's daily operation you've been experiencing any delays in the service rendering or delays in costs?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Can you please repeat your question but speak up a little please? We had a hard time understanding the initial part of your question.

Q - Diego Mendes {BIO 16313486 <GO>}

In fact the idea here is to ask you about Lava Jato's impact in the cost of the company and CapEx of the company, whether you're experiencing delays, or delayed services or whether you have experienced a more significant impact on your CapEx? The CapEx on the second quarter was lower, and probably, what I want to say is if you can give me the current status of that situation? My second question refers to cost reductions. In your plan you said that you are promoting a cost reduction and so my question is whether you can give us some guidance about that reduction and what are the areas that would be more affected?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Diego, the Lava Jato operation, when we discussed our business plan, Lava Jato operation had already impacted our supplier chain and this has been taken into account when we drafted the plan. We also included problems that could probably impact our CapEx. To give you more details about E&P, I'll give the floor to Solange.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

Good morning Diego. I mean, to elaborate more on that subject as Ivan said, considering delays we had to disclose PNG, we did that because we wanted to capture our business plan said that we wanted to capture contingencies concerning all of the events that needed to be further assessed by all of us. With that, we would be able to translate through investment targets and other targets applying to E&P related to restrictions of vendors that had to be included in our business plan. All of these contingency measures are still underway, once we publish the plan with a more clear landscape which already depicts this new reality. These deviations that you noticed are not significant but they are in keeping with our budget plan in that part of the year. There is a slight delay in some investments associated to some vendors but they are not very significant and again very well managed. We expect to be very close to our investment budget for the year, because all of the mitigation actions that were listed early on this year are now bearing some fruits.

Q - Diego Mendes {BIO 16313486 <GO>}

Thank you, Solange.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Diego, now about your second question, cost reductions. Cost reduction is a constant concern of the company. When we drafted our business plan, we already contemplated that and I think I can give the floor back to Dr. Solange who can elaborate more on the criteria for project selections and how things are being carried out with this new Brent price when it comes to renegotiating existing contracts with vendors.

Q - Diego Mendes {BIO 16313486 <GO>}

Very good then. So now I have a very specific question about the numbers that you showed on slide 21. So you're using the same foreign exchange assumption in the first quarter, R$3.1, or there has been any changes in that foreign exchange assumption for the year?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Well, we adjusted that to the new exchange rate, the exchange rate has been already adjusted.

Operator

Our next question comes from Luiz Carvalho from HSBC.

Q - Luiz Felipe Carvalho {BIO 16117456 <GO>}

Good morning. I have two questions, Ivan. Yesterday Mr. Bendine talked about the price policy during the press conference. In our understanding, there is a difference in the market. There is a mismatch between what the company says and what the market sees that price difference is much more related to the leverage levels of the company. And you are looking more at the consolidated results to justify your need or not need to raise prices. I just want to understand from you whether this need to increase prices given your internal policy, is that strictly related to the results from refining or this is related to the net debt over EBITDA ratio of the company?

Well, there has also been some impairments of assets that hurt your profit a bit. But looking at the projections for your net income this year, I mean you disposed of some assets and maybe the distributing company will be disposed in the next half of the year, but what would be the impact for the company? But what I want to understand is in terms of your dividends policy, how would you address the payment of ordinary shares or whether there would be a deferment or whether you would be giving more visibility to investors about your policy until the end of this year?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Luiz, referring to prices, pricing is not linked to a certain business area of the company. The company sells products and we face competition and we have to cater to you know the needs of the market and there is certainly a trade competition in the market, but I will give the floor to Jorge Celestino to elaborate more on the subject.

A - Jorge Celestino Ramos {BIO 1647841 <GO>}

Good morning, in fact referring to our commercialization policy, the competitiveness of our products vis-à-vis the domestic market relates to the international market, therefore our commercial policy is always based on the best use of our assets and also the best profit margins to our company coming from oil products or also looking for oil products abroad or also you know in the exploration of oil. If we look now, looking at the last 12 months and four months, therefore our commercial policy aims at achieving the best global results for the company, always with an eye at the competitiveness of our product both domestically and abroad.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Luiz, answering the second part of your question, since we drafted the business plan, the company made a clear message to prioritize value generation for shareholders, prioritize profitability to the detriment of volume. The main goal behind the management announced in the new business plan is predictability in oil production, the company's expectation in terms of oil production particularly over 2015 and 2016. This is the big business of the company and also more diligence when it comes to divestments, the whole CapEx of the company was re-prioritized and the main priority is on E&P and that's what you followed. You follow CapEx realization in the first half of the year and it will remain as such in the future.

The final result of the company, and as a result of distribution, we'll be subordinated to the business plan. We've been trying to be very diligent vis-à-vis the business plan despite macroeconomic challenges and all the variables that are not under the company's control like Brent prices and foreign exchange effect. But we're very disciplined and focused on what we disclose to the market, stability and predictability vis-à-vis our core business which is to produce, explore oil and more discipline as to the use of our resources, stemming from our generation, focusing on the core business of the company and a clear message to shareholders, prioritizing value generation to shareholders and searching for profitability regardless of our volumes. Officer Solange has something to say.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

I would just like to talk about the management's position that Ivan has just mentioned. I mentioned before the method we use to trade some challenges with our suppliers. However, at the same time we are also trying to translate to the company also the effects of the reduction of the oil and gas activity in our costs.

So, the renegotiation aspect of contracts for instance in E&P this is where we have the focus of the company and our action is very much specific to renegotiate these contracts, so that we can really perform our business plan in a very diligent manner, so we can bring to the company the benefits of the reduction in activities and also lowering costs, particularly capital costs. If you look at these results, you will see that due to the reduction in Brent there is a very positive side effect in terms of stakes. There was a dramatic reduction in our lifting cost comparing the second quarter of 2014 and 2015, basically reduction of 3% when you consider dollars per barrel in our operations. If we consider our scale for instance, we also highlight and here again coming back to the business plan that Ivan mentioned, when our business plan focuses on our pre-salt activities this is where we effectively reap more benefits. For instance, we have already lowered from $9 to $8 per barrel in our lifting cost in pre-salt in the second quarter. So I am just giving you some examples of the highlights mentioned by Ivan.

Q - Luiz Felipe Carvalho {BIO 16117456 <GO>}

Okay, if I may another question, considering the divestment plan of about 50 something billion dollars. There is a very strong reaction from unions recently. They even mentioned they would be on strike. Any negotiations between the company's management and all your companies and unions, apparently they are fully against disposal of assets or any more aggressive plan in terms of reducing the scope of some of the business of the company, so what about conversations with these parties? Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

The company's executive management published a business plan committing itself with shareholders and the market in general to generate value to shareholders and to have more capital discipline and also setting priorities, prioritizing productivity rather than volume. That's the commitment by the company and as you mentioned well, it goes through a divestment program. The divestment program, it is up to the company to clarify to all the parties involved including employees, staff and all the institutions that represent the company and the company is careful enough to clarify information. That doesn't mean however, that the company will change what it committed to do with the market. This program is a long-term program and it follows some conditions, conditions set by the market and they vary quite widely in recent months. However, it is a commitment made by the executive committee that will remain unchanged.

Q - Luiz Felipe Carvalho {BIO 16117456 <GO>}

Clear, thank you.

Operator

We have a question in English. Paul Cheng from Barclays has a question.

Q - Paul Y. Cheng {BIO 1494607 <GO>}

Thank you. Good morning, everyone. Two questions, please. First in 2016, your current budget is $25 billion, what's your flexibility in certain lower the CapEx if oil prices stay at the recent level, what are your CapEx requirement to make it a flat production and then on top of that at the existing commitment for the longer lead time construction project that is already under construction, that's the first question?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you for the question. Our CapEx expectation for 2016 is $25 billion. It has remained the same but could you repeat the second part of the question, please.

Q - Paul Y. Cheng {BIO 1494607 <GO>}

The question is that if the oil price stay here, what is your flexibility to further reduce it, in other words there if I look at what is your minimum you have to spend to maintaining a flat production combined with what is the commitment you have on the longer lead time construction projects?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Paul, Solange is going to answer your question. She will make comments on the possible impact of Brent in oil output for 2016.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

I guess this answer is very much in line with all the explanations we gave before. Our production and our investment will continue to happen. And if we have an impact on prices or drop in prices, we might go for other options but they will not affect projects underway. These projects will continue strengthening our cost optimization. And this also goes to a direct relationship between cost and a drop in Brent prices. If that happens, there will also have an impact on production taxes and also in the cost of projects underway, but I want to highlight that considering planning scenario alone, I don't know if I fully understood your question. But we are planning to increase production by next year. Our plan is to grow 2.8% in 2016 compared to 2015.

Operator

Our next question is from Alexander Burgansky from Deutsche Bank.

Q - Alexander Burgansky {BIO 2173409 <GO>}

Yes, good morning and thank you very much for doing the call. I have two questions if I may. Firstly on slide 10, you mentioned number of wells connections to be continued to be completed in the second half of this year. And numbers slowly declined in the first half. So I wanted to ask you how that compared to your expectations of the production growth in the second half of this year and also do you have a projection that you can say with us on the well connections in 2016? And the second question if I may on the business plan, I did not quite get the answer on the details behind disposal program and in particular whether the 2020 production targets for the RNEST core production of 2.8 million barrels per day is already incorporated the disposals that you are planning to make between now and 2018? Thank you very much.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

I will give the question to Solange who will be able to speak about the connection of the new wells.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

I think, this chart illustrates the point quite well. In our plan for 2015, we are quite advanced in terms of our targets to connect all of the new wells. And as a recent fact, I can mention a new production unit in the (51:04) that is foreseen to happen in early September. This is part of our plan, but it happened on July 31, 2015, which is earlier than expected because we were able to complete and connect the production well of that unit. This year, if we look at the chart, we have a reduced number of wells when compared to the year before. 2014 was a very challenging year. This is when we were asked to optimize our activities and to work on the connection of subsea stations and that's why this year, we are very much in line with our target. There is no other different projection as compared to that of non-realizing the wells. On the contrary we may be able to anticipate from 2016 to the end of 2015 that interconnection of wells. I think that answers your question. Now concerning the second part of your question, the targets that have been discussed to the market vis-à-vis the investment project are still the same. However, these targets and we often say that it all depends on market conditions at the time that the company was part of its approval process and according to the company's governance and possible approval of a sale or the search for a partner to continue there its processes will be then considered at the time. But all of the targets are contemplated in the business plan of the company.

Operator

Our next question comes from Mr. Christian Audi from Santander.

Q - Christian Audi {BIO 1825501 <GO>}

Thank you, good morning, Ivan. My first question relates to those one-off factors that impacted your results in the quarter. I was trying to reconciliate the facts. On the one hand, there were one-off. But on the other hand based on the comments that were made, it seems to me that there is a potential of other impairments of other accounting write-offs related to those tax liabilities. But I am just trying to understand these dividends maybe there is a risk of this happening again. But now visibility is low concerning whether this will occur or not and then the second question relates to the impact of your disposal of assets and whether you will reach your target for 2015 and 2016 and maybe or I want to know whether you were surprised on the upside by the level of interest and also related to the target for 2017 and 2018, is it possible to maintain your target of R$43 billion? Could you give me an idea of what will be the percentage you will get from the disposal of assets or restructuring of assets, please?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Christian, thank you very much for your question. Well, in relation to your initial remarks on contingencies and impairment, we had two important events. First, was the release of the results of the company in the year of 2014. Then we had a major impairment event or projects that up to then had no visibility in terms of its future.

Cash flow of some of the projects were totally abandoned like Premium 1 and Premium 2 refineries and the others just follow the regular impairment flow, which is usually carried out by the company, that was an important moment. But now, what we see is the reflection of our new business plan. This new business plan also contemplates a re-prioritization of projects and those projects that were not aligned with our priorities like our nitrogen fertilizer plant. We look at its impairment and we notice that this was no longer part of our priority portfolio.

In terms of contingencies, we're constantly assessing contingencies and liabilities, the whole set of tax liability, the whole set is very high. We also communicated to the market the result of our internal assessment and they involved very specific situations involving the same process which involved the litigation of IOF. And then, administrative speaking, we reported on that and then how we transfer things that were carried out here and judicially through the infraction notice, there was recognition of a good economic advantage. Now, with a new ordinance, the company once again ran an evaluation of this same process when compared to previous years. And then we made a decision of recognizing that expense and also recognizing the results of the second quarter. So, according to what has been explained in the explanatory note, we are constantly conducting this evaluation. Once we recognize that there is any opportunity on the point of view of having economic advantages from the process, this will be then carried out through an internal evaluation and communicated to the market.

About the divestment process, this is nothing new. This is something that had already been taking place in the company but the level of leverage of the company. In terms of that, we expedited values in 2015 and 2016, all the projects are still underway. And then, your question was about the level of interest. The level of interest is quite high in terms of the assets of the company. Now, looking at 2017 and 2018 given the fact that we have more time as you said it yourself, it's only a matter of divestment but also a matter or reorganizing a set of businesses within the company. This has been carefully crafted but always looking at what the company has been committed to do in our business plan, generating more value to the shareholders, greater discipline and greater prioritization of projects. The company masters the technology and we are executing with good profits. Thank you.

Q - Christian Audi {BIO 1825501 <GO>}

Let me see if I understood it right. So there is a good potential but it is very difficult to quantify it at the moment in terms of provisions related to tax liabilities. And if there are other impairments, I mean in other words this potential is present but it is difficult to estimate anything or to give us any guidance. But the fact that this may occur again is something unknown but it may be present, did I get it right?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

No, you are not right. What is correct is what the company releases and discloses, or discloses through material fact or through the financial results. It is very clear if you look at the papers that the company has identified the processes and let the process do if unresolved. So if it was not there is because the company had no expectation at that moment in relation to any other process. Because if that were to be the case in case of impairment or any tax liability or litigation what is in the explanatory node is that the company is still assessing that tax liability.

You know in compliance with the ordinance, the ordinance is a very recent one, dating back from August 3rd the company is still assessing what it could be, but this is a very sensitive evaluation and that is then together by the tax area, financial and legal areas of the company and is only after the analyses are concluded that we will make a decision in line with Petrobras governance and that's when Petrobras will release its decision. Now about impairment, I would just like to emphasize that a large set of imparities you know from last year and also as a consequence of Lava Jato and as a consequence of this new business environment and now more particularly linked to the new business plan of the company.

Q - Christian Audi {BIO 1825501 <GO>}

Thank you very much.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you, Chris.

Operator

The next question is from Caio Carvalhal from Brasil Plural.

Q - Caio Carvalhal {BIO 16605563 <GO>}

Thank you for taking my question. My first question is very specific. We can see there is an increase in oil exports even though there was a slight drop outputs. And there was also the use of inventory build over the first quarter which makes all the sense in the world. In the first quarter, oil prices were slightly less expensive, so considering the reality of the third quarter with significant drop in oil prices, should we expect to see build up of inventory again, and the volume of exports will be slightly lower in the third quarter considering you will be working on opportunistic building inventory related to oil prices, so does it make sense when you consider building and using inventory.

My second question is slightly broader. If you consider the gross margin, there is a gross margin of 32%, better than the 30% of the previous quarter. For the last three years the gross margin is always between 24%, 25%, so there has been a significant increase not only in this quarter but the first half of the year. So, I have the feeling this is non-recurring. Possibly we expect to see a lower margin on a long-term basis. I think this is more related to a reduction in oil prices and also reduction of domestic use allowing you to improve your refining operation. But it might also have a recurrent effect considering to Pernambuco in the northeast. I wouldn't expect to see that because the refinery is not so large considering the whole refining capacity but precisely how do you see the behavior of the gross margin or COGS vis-à-vis the revenue for the second half of the year and how do you see it at a broader view? These are my questions.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Caio, thank you for your question. Regarding the strategy of inventory of oil and the company's behavior for the second half of the year, Jorge Celestino is going to answer your question.

A - Jorge Celestino Ramos {BIO 1647841 <GO>}

Caio, good morning. Regarding the better performance of the oil position, you're right, oil prices were very low in the first quarter. The market kept an eye on prices and we managed to have a good strategy and to slightly increase our inventory levels at the end of the third month of the year in March and capture all the margin gains in the second quarter. By the way, the market in the first quarter was much lower and then we managed to optimize our operations in the refinery very well, searching for better yield of our refining capacity and better management of our oil inventories in the first half of the year.

As to the next quarter, the market usually will be a little bit busier, oil output will remain good. And we are paying attention to the market's behavior. Possibly, we won't reap all the gains that we had in the first half of the year, but we also expect to see some gains by trading and selling crude oil. Caio, answering the second part of your question, there is a clear answer. There was a substantial increase in downstream, so there is a significant contribution and we also see ongoing increase in oil outputs, now far more predictable than before. So the combination of these two variables, number one, substantial improvement in downstream results added to better prices and also continuous increase in the company's oil production, this brings to better results and better margins to the company.

Q - Caio Carvalhal {BIO 16605563 <GO>}

Perfect, thank you very much. Can I just have a last follow-up question. The media show that the company would be revisiting the long-term strategic plan for 2030. Considering the new reality and oil curves, do you have any timing for this? When do you expect to have this discussion underway?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

This discussion is still very preliminary. It is not mature yet to be disclosed to you or to the market, it's still very embryonic.

Q - Caio Carvalhal {BIO 16605563 <GO>}

Perfect, thank you very much.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you, Caio.

Operator

The next question is from Pedro Medeiros from Citigroup.

Q - Pedro Medeiros {BIO 16187063 <GO>}

Good morning. Thank you for taking my question. Actually, I have three questions but most of the questions are very straight forward. The first question Ivan, I would like to better understand because I saw this quarter a significant change in the foreign exchange exposure of your cash generation despite exchange depreciation this quarter. Could you talk about the company's policy about the balance and exposure to foreign currency? Any forecast for the second half of the year that might lead to significant changes in exposure? The second question.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Pedro, just answering the first question. We've been trying to keep most of the company's cash generation exposed. Well, we bring the natural hedge to the company's liabilities, so the cash position is the lowest in our Brazilian currency

Q - Pedro Medeiros {BIO 16187063 <GO>}

Okay, but don't you add any other derivatives strategy to that or anything beyond or in addition to exposure to natural cash?

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Yes. Pedro, we had more earmarking in head account in March. So, the company's expectation vis-à-vis foreign exchange, by the way there are some components particularly interest payment and pre-payment operations for instance, and they are more stable. They are paid on a longer timeframe and therefore they would a point of concern when it comes to the exchange exposure. So, the company decided to earmark more like Jorge Celestino said before, we had an effective increase in the company's exports stemming from the lower demand in the domestic market and also the highest oil production by the company. And we've been making use of hedge account in order to be hedged and protected vis-à-vis the company's exposure in strong currency, hard currency exposure?

Q - Pedro Medeiros {BIO 16187063 <GO>}

Thank you. My second question, well, I just want to confirm your investment plan considering the progress achieved up to now in July and the forecast for August, and considering the floating exchange rate. Can we talk about CapEx in dollars lower compared to the guidance of R$28 billion for the year? And just a follow on question about Solange's comment. As to the revision process of contracts with suppliers and reevaluation of unit costs vis-à-vis the drop of prices in E&P products and services extend, has this already been taken into account in the five-year investment plan? Could you still or at least qualify improvement in cost of equipment and services or should we consider this as a potential upside vis-à-vis the numbers you gave in the guidance. And my third question actually is very straightforward, just a follow up question to Solange. You have the number of well connections, could you give us an objective number or the size of the development wells that were already drilled and pre-sold but they have not been connected yet, I believe this number is growing, vis-à-vis the portfolio of rigs available and the change in the timeline of the projects? Thank you.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Pedro, Solange is going to answer your question but about the guidance, there has been no change in the guidance vis-à-vis CapEx. In the first half of the year, we were slightly lower with the comparative guidance compared to the previous business plan, it is way below and fully prioritizing E&P. This is the major fact considering the new reality of the company's net debt over EBITDA ratio. And now Solange is going to answer your second question.

A - Solange da Silva Guedes {BIO 16088234 <GO>}

Good morning. Answering your first question, you want to know to what extend the exercise that we're doing in terms of lowering cost with suppliers were included to the plan. Well, it was partially included to the plan because at first, we did not have these negotiations under way but now they're very well above our expectations and will effectively deliver our promise of the part committed to the plan but we also exceed our early expectations vis-à-vis this set or dozens of suppliers that we're negotiating with and we expect to conclude negotiations over the next two months. In your second question, you mentioned development well inventories. I would like to clarify, how we consider this and how we address the implementation of these projects.

Once we get or once we envisage an E&P project that might lead to a delay in your platform, what we immediately do is to adjust the well construction plan, so we don't run the risk of having any anticipated investment in well butane and avoid a backlog of wells that are not connected, we don't do that. We have a scale that allows us to have an immediate adjustment to projects in order to make them in line as much as possible to the closest connection. So they will be closer and more effective in terms of our interconnection to the platforms. So from the moment you adjust these projects, they are not partial, they are full adjustments and they apply to all resources and funds. They are all delayed and reallocated. And because we work with standardization and that's characteristic of pre sold projects. We work with all pieces of equipment, all standardize and all standardize project. So mobility at the end of the day becomes much easier and it has a huge potential to add value to the daily management of our implementation projects. So we don't have a backlog of either wells simply because we already adjusted in our curve, the building process according to our plans and as we expect to have the unit in our production.

Q - Pedro Medeiros {BIO 16187063 <GO>}

Okay, I understood it, thank you for the answer Solange.

Operator

Thank you everyone. Now we conclude the Q&A session of this webcast and conference call. And with that, I would like to give the floor to Mr. Ivan de Souza Monteiro for his final remarks.

A - Ivan de Souza Monteiro {BIO 16420543 <GO>}

Thank you very much. I would like to thank you very much for participating. And we, our IR department are available to take any further questions.

Operator

Thank you very much. Ladies and gentlemen, the audio of this conference call for replay and slides presentation will be available on the IR website of the company at www.petrobras.com.br/ir. And with that, this webcast is concluded. Thank you very much for your participation. Please disconnect your lines and have a good day.