Q2 2018 Earnings Call

Company Participants

- Hugo Repsold Junior, Chief Technology & Production Development Executive Officer
- Isabela Mesquita Carneiro da Rocha, Executive Manager-Investor Relations
- Jorge Celestino Ramos, Chief Refining & Natural Gas Executive Officer
- Rafael Salvador Grisolia, Chief Financial Officer
- Solange da Silva Guedes, Chief Exploration & Production Execuitve Officer

Other Participants

- André Hachem, Analyst
- Bruno Montanari, Analyst
- Christian Audi, Analyst
- Luiz Carvalho, Analyst
- Paul Y. Cheng, Analyst
- Pedro Medeiros, Analyst
- Regis Cardoso, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon, ladies and gentlemen. Welcome to Petrobras Conference Call with Analysts and Investors for the Presentation of the Second Quarter of 2018 Results.

We would like to inform you that participants will be in listen-only mode during the conference call – during the presentation, which will be conducted in Portuguese with simultaneous translation into English. Following the presentation, a Q&A session will begin in Portuguese and in English, in which time instructions on how to participate will be provided.

Today with us, we have Mr. Rafael Salvador Grisolia, Petrobras' Chief CFO and Investor Relations Officer; Mrs. Solange da Silva Guedes, Chief Exploration and Production Officer; Mr. Jorge Celestino Ramos, Chief Refining and Natural Gas Officer; Mr. Nelson Luiz Costa Silva, Chief Strategy and Performance Officer; Mr. Hugo Repsold, Jr., Chief Technology and Production Development Officer; Mr. Rafael Mendes Gomes, Chief Governance and Compliance Officer; Mr. Eberaldo de Almeida, Chief Human Resources and Services Officer; as well as other company executives.

We would like to remind you that this meeting is being recorded and please be mindful of slide 2, which contains a notice to shareholders and investors. The words believe, expect and similar ones related to projections and targets of the year forecast, which are based on the expectations of Petrobras' executives regarding the future of the company.

To begin, we will hear Mrs. Isabela Carneiro da Rocha, Executive Manager of Investor Relations, who will start with the presentation about the second quarter of 2018 results. Subsequently, the questions from participants will be answered.

Mrs. Rocha, you may proceed.

Isabela Mesquita Carneiro da Rocha {BIO 19730664 <GO>}

Good afternoon and thank you very much for your participation and attention. We will start the presentation of the second quarter of 2018 results. Let's go to slide number 3, and we start the presentation with focus on our top metrics.

We have the safety indicator, which is measured by the total recordable injuries per man-hour, which had a slight increase this quarter to 1.06. But the company remains committed to maintaining safety and is working to maintain the downward trend that we saw since 2015 and a commitment to go back to the lower than the alert limit of one injury per million man-hour at the end of 2018.

The leverage metrics, which is measured by net debt-EBITDA ratio, has incurred a reduction towards 2.5 times per year. We reached 3.23. And additionally, we made adjustment to exclude the effect of the Class Action agreement because this is the way it will be by the end of 2018 when the effect no longer will impact the adjusted EBITDA of the last 12 months. With this adjustment, we reached 2.86.

Going to slide number 4, we show the results of the discipline in the execution of our business and management plan, and we've had the (00:03:52) presented in 2017, in September 2017, and we have been executing with discipline, and we bring you the results of this execution.

We would like to highlight on the operational side, the start-up of the first production system in the area of Transfer of Rights in the Búzios field on April 20 by this platform P-74 and a new production system in the Campos Basin, in Tartaruga Verde in (00:04:22) Campos dos Goytacazes on June 22 and the last system to start operation in the Campos Basin was in 2015. And we highlight the arrival of P-67 to Brazil on July 18. It will be the eighth platform to operate in the Lula and Cernambi fields. We would like to highlight the increase of our exploratory portfolio by means of the acquisition of new areas in ANP Bidding Rounds, where we gave priorities to the great potential of the Campos and Santos basins and we added 13% in these areas since 2017.

The ongoing or consistent improvement in our financial results leads to a net income of the first half of 2018, BRL 17 billion, a 257% increase when compared to the first half of 2017 and the best results for the company since 2011. Operating income had an important increase, 18% higher than the first half of 2017, reaching BRL 34.5 billion.

Another highlight is the evolution of our deleveraging, reaching the lowest level since 2012, with gross debt remaining at $92 billion at the end of the first half and net income, net debt, $74 billion. The lowering debt has allowed us to reduce our financial expenses in the half year by BRL 1.6 billion. Besides, we have been maintaining the prepayment of remuneration to our shareholders in terms of interest on equity, BRL 652 million in equal proportions, equivalent to 0.05%, both for ONs and PNs. The year-to-date for the half year, BRL 1.3 billion.

On slide number 5, we show the consistent monitoring of our business and management plan with the results reached so far by means of this monitoring mainly, keeping unchanged our top metrics of the company such, as I said before, the TRI at 1 and net debt-to-EBITDA at 2.5, and we delivered our best estimates at the time to carry out investment and divestments for the year. As we said previously many times, our plan for partnerships and divestments is dynamic and all the time, we manage our portfolio and we expect the cash-in of $7 billion during this year. Of these, $5 billion have already flown in in the first half and we will talk in detail about that. And we expect to make investments of $15 billion this year, not considering the signature bonuses that we might have in the bidding rounds but then excluding reals.

On the next slide, we show the results of the quarter highlighting two very important (00:07:26) for our results. The increase in Brent that went up 36% year-on-year, reaching $74 per barrel, and also the depreciation of the real, which was 8% on a year-on-year basis, half year.

On the next slide, we summarize the main lines of our results. And in all our lines, we see growth vis-à-vis in the previous year and this shows the sound performance of the company, so our revenues were BRL 158.9 billion, 17% higher vis-à-vis the first half of 2017. Our gross profit, BRL 58.4 billion, 29% higher. Adjusted EBITDA at BRL 55.8 billion, 26% higher in relation to 1H 2017, and EBITDA margin of 35%. Net income was BRL 17 billion in the quarter, as I said before, the best since 2011 and much higher than the first half of the previous year. And the highlight also is the free cash flow of BRL 29.4 billion, 30% higher, vis-à-vis the same period last year and positive for the 13th quarter in a row.

On slide number 8, we explain the results per business segment. E&P was the one that brought the highest contribution to the improvement of our results with the higher Brent, and therefore, higher prices for oil exports and delivery of oil to the Downstream segment and lower expenditures with idle equipment. The higher Brent means 63% higher in government take in this half year.

In the Downstream segment, we had a lower volume of sales vis-a-vis the first half of 2017, nevertheless with an increase either volume of sales on a quarterly basis, with an increase in market share for diesel and gasoline, highlighting diesel 15% in volume of sales.

In relation to our margins, we reduced our margins. We had lower margins of diesel and gasoline vis-à-vis Brent, and this is important to explain that the 10:00 improvement in the result in the downstream area, EBITDA with 5%, was due to the realization of inventories that were performed at lower prices. As I said, in reality, the difference between the average realization price and Brent dropped 4% to 5% if you compare vis-à-vis the first half of 2017, and for the next quarter, we expect an increase in the cost of COGS due to this effect of the inventory.

Now, going to slide number 9. We have our operating income growing 18%, net income 257% as we said before due to the higher Brent and also the depreciation of the real vis-à-vis, the dollar, resulting to higher margins in exports, be it in oil and oil products, but here we have also lower G&A and lower expenditures with idle equipment and better financial results and this came from lower financial expenditures as well (00:11:05) reals, can become a reduction in our indebtness, and also the gains with the renegotiation of this – the debt would be a lack of our systems.

Now, on page number 10, we highlight the control and the discipline of our costs. G&A expenses reduced 4% vis-à-vis the first half of 2017 due to the lower expenditures with third-party services mainly. On the right of the slide, we show our cost for lifting and refining, and in the quarter, the cost of lifting was reduced by 7%, reaching $10.5 per barrel, which (00:11:46) Brazil and abroad.

In the half year, the lifting cost remained at the same level with the slight increase as compared to the first half due to the lower production and also higher expenditures with work-overs, the unit cost of refining had a reduction of 11% in the quarter, BRL 8.57 per barrel due to the lower expenditures and the higher cost of feedstock. In terms of selling expenses, we explained the increase due to the payment of tariffs after the sale of NTS and the gas pipelines which occurred last year amounted to approximately BRL 1 billion and also the higher credit losses expected recurring to electric sector of BRL 1.3 billion.

Now, going to slide number 11, we highlight the trajectory of our free cash flow and we are delivering a positive free cash flow sustainably since 2015. We reached BRL 29.4 billion in this half year coming from the higher operational generation and lower investments, which is in orange here. Operating generation is more than enough to cover our investments, interest payments and dividend payout. It is important to highlight that, that of the total of BRL 18.4 billion investment for the half year, 89% were allocated to E&P.

On the next slide, we highlight the reduction of our indebtedness, both operating generation and cash-in coming from divestments allowed us to amortize and retain debt that resulted into a reduction of 16% of gross debt and 13% of our net debt in dollars when compared to December 2017.

Thus, our net debt reached $73.7 billion, and we are already lower than the projection that we have informed you in the first quarter when we talked about $77 billion in net debt. So our level is already lower than we had informed before, and we have a very active liability management and we raised in the half year BRL 27.2 billion and we settled (00:14:16) amounted to BRL 81.5 billion by means of repos and redemptions and containment fee (14:22) in Brazil or abroad. With liability management, we were able to extend the term of our debt 8.62 years to 9.11 years, keeping the same level of average cost of 6%. So our leverage was reduced to 50%.

Now, going to the next slide, slide 13, we show the amortization profile that comes from our liability management and we also reduced our cash position, which at the end of 2017 was higher than $20 billion and on June 30 closed at $18.1 billion. I would like to remind you that we have access to (00:15:05) amounting to BRL 5.4 billion with 19 banks cash position, (15:12) currently to cover the amortizations that we have in the next four years, and the amortization profile has a much more comfortable situation than last year when we have very high values in 2018 and 2019.

Now, slide 14, where we show you the partnership and divestment program with a cash-in of $5 billion in the first half and the cash inflow was due to the closing of many projects and highlighted here as closed with the partnership of Total in the Lapa and the other fields, we received the second parts from Carcará. We also closed the petrochemicals plant in Sergipe, and as we know, sealed then the partnership with Equinor in Roncador. Many other projects continue, ongoing. Many of them are already in the binding phase and some are not in the binding phase yet. And besides these, we have the strategic partnerships that are underway.

Recently, we announced the partnership with Total in the renewable energies and with CNPC for the promotion of investments in Comperj and in the Marlim Cluster. I would like to remind you that some projects are suspended, amongst which CAG (00:16:33), the project in partnerships in refining and also Araucária nitrogen fertilizers due to a judicial decision.

Moving on to slide 15, we continue with our policy to remunerate our shareholders. The board of directors approved the second prepayments of interest on equity that should be paid by August 23. As I said, we will pay 5% of the reals equally to common and preferred shares, and at the end of this fiscal year, we will apply our remuneration policy which has set forth a minimum payment to preferred shareholders; 5% of stockholdings to the (00:17:20) shares of 3% of shareholders' equity would have been higher, in addition to a minimum compulsory dividends payout of 25% of adjusted net income.

On slide 16, we have updated our cash generation expectations for 2018. So we expect a $30 billion of generation of operational cash. We review the production of cash coming from divestments from the $11 billion to $7 billion because of interruption of some projects. We reviewed our investments which were $2 billion of slight reduction compared to what we had announced in our plan and payment of $6 billion in interests. On these variables, we are fully confident that we will reach our goal of net debt over EBITDA of 2.5 times by year-end.

(18:15) operational highlights now. We start with production, (18:24) recent production reduction in the first half of 2018, compared to the same period of the previous year, mainly resulting from divestments in LATAM in Roncador and the natural decline in production and from the industry (00:18:38).

We have 2.7 million barrels of oil equivalent per day, it is in line with our goal of 2.7 million barrels a day. Production growth in Búzios (00:18:58) lower extremity 19:00 will help us achieve this goal. Finally, I'd like to highlight an important point that operated production in the pre-salt has exceeded the mark of 1.5 million barrels per day in the last days of April.

Moving to slide 19, please. Highlights going to Campos Basin. Campos Basin has a number of promising opportunities to increase production. In addition to concession extensions already granted by ANP in Marlim, Voador and Verde, we obtained one more, the extension of the concession contract of the Marlim Sul field for another 27 years. (sic) [34 years] We also closed our partnership with Equinor, which increased the recovery factor by at least 5%. We have the operation start-up of yet another production system in Tartaruga Verde field.

As we mentioned, we will have two new exploratory clusters formed by 12 blocks acquired in the bidding rounds of ANP that occurred in 2017 and 2018 with very promising prospects. We continue to tackle the expansion of exploratory portfolio in order to ensure the sustainability of our production in the future.

Here we highlight the quality of our portfolio. In the last ANP auction, Petrobras won 20 exploration blocks in the Campos, Santos, Paraná and Potiguar basins. And we also have been increasing our participation in pre-salt exploration ensured because in the fourth round of production sharing agreement held this past June, we exercised our right of first receivable in the blocks of Três Marias, Uirapuru e Dois Irmãos. And these blocks we won in partnership with great companies. For the fifth production sharing round scheduled for September, we have manifested to ANP our interest in exercising the right of first receivables in the Sudoeste de Tartaruga Verde.

On slide 21, moving to the highlights for this well at Sururu field. On July 13 with an oil column of about 550 meters above the average that we had in the five wells in the pre-salt was the largest oil column of 436 meters. So, now we have more than 500 meters in this oil column, so we would like to stress the importance of this. We are the operators in this field. I mean, our partners are Shell, Total and Petrogal.

In the next slide, we highlight the production of two new systems that started operating this year, P-74 in Búzios, which is a Transfer of Rights area, and with 30,000 barrels a day in Tartaruga Verde with two wells in a production of about 25,000 barrels per day. The start-up of these two new systems is contributing currently with more than 55,000 barrels a day of production.

Moving up to the next slide, we give you an update of the next platforms that should start operating this year. We have four, four platforms, and two in Lula and two in Búzios. They are at an advance stage of progress. We expect them to arrive on location of P-67 in the first quarter of 2018 and of P-75 also in the third quarter and Lula Extremo Sul. So P-67, P-69 should get a location in the first quarter. Actually P-69 should leave the ship yard in the third quarter. P-76 will be leaving the ship yard in the fourth quarter of this year.

So basically with new systems we would complete six systems in this Brazil. And it will have a mixed system in Nigeria that should start operating this year P-68, as we mentioned in the previous quarter. That should start operating in the beginning of 2018.

With that, we have 93% of the wells already completed and that ensures our production ramp up that we are considering in our plans.

On slide 24, the highlight is refining, transportation and marketing downstream. The sales volume decreased by 7% to 1.72 million barrels per day and production of oil products followed that movement given a reduction in the demand for oil products, lower sale of naphtha to Braskem, greater penetration of ethanol vis-à-vis gasoline and the increase in biodiesel and the mix.

In the quarter as mentioned before, both production and sales volume of oil products increased. We highlight, on the right, the high participation of Brazilian oil and the processed throughput about 94%, and the high availability of our refineries, reaching the level of operational excellence.

In the next slide, we talk about our market share of diesel and gasoline. We see a consistent reduction or regain in our market share, implementing our policy as we said in the beginning of the year. We had a market share of under 80% in the first quarter 2018, now increasing to around 85% in the second quarter. So, for diesel and gasoline and the utilization factor of our refineries grew mainly at around 80%.

And on slide 26, we highlighted the use and integration in the programming of our vessels. We were able to reduce by 10 the number of total navigation vessels, a 15% reduction in the unit cost of offload, an increase in the number of vessels with dynamic positioning, bringing higher safety in our operations.

In the next slide, 27, we see our exports balance. Crude exports reduced by 16% in the quarter and the imports of oil products reduced particularly given the reduced sale of naphtha to Braskem, but we continued to be largest exporter with an importing balance of 372,000 barrels per day.

The following slide we show you the behavior of the Natural Gas segment, around 77 million cubic meters a day. There was a slight increase in the non-thermoelectric demand in this quarter, a slight increase in the import of gas from Bolivia.

On the next slide, there was lower thermoelectric generation in the quarter but this was difference in the quarter given the reduction in the level of water of the reservoirs as we can see on the chart on the right. Consequently there was an increase in the spot price of electricity, represented by the different performance by spot prices as shown on the chart on the right of the slide.

With that, I finish my presentation and we'll move to the Q&A, please.

Q&A

Operator

Now we'll begin the Q&A session. We ask each participant to ask at least at the maximum two questions clearly and slowly, so that the executives will answer them.

Our first question comes from Bruno Montanari with Morgan Stanley. Mr. Montanari, go ahead.

Q - Bruno Montanari {BIO 15389931 <GO>}

Thank you. The first question has to do with the diesel subsidy program. Could you help me understand how this was recognized in the balance sheet, what has been received, what is the pending? And I want to confirm a point you said this morning in the press – conference about the imports. We understand that imports would be determining, but I had a different impression listening to the comments of the distribution companies yesterday. So, what kind of imports do you expect?

My second question is about divestments, particularly TAG. I want to understand what were the reaction of the companies that were negotiating this with you, does the company feel that the appetite remains the same when the restriction is removed, do you think that the process will go back to the very beginning?

And a quick question for Solange. I thought the Sururu field oil column was very interesting. We have a lot of information on the Lula, Sepia and Búzios and others. I would like to hear your opinion about the productivity of this cluster, because it seems to be bringing more and more positive data. So, I'd like to understand it, the flow rate trended to improve given the reservoir and its current characteristics. Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Good evening. This is Rafael Grisolia, thank you for the questions. Let's speak a little about the subsidy and how we recognize this in our financials and divestments. But first, I will turn the floor to Jorge Celestino to speak about imports, then I'll turn the floor to Solange, and I'll finally close your set of questions talking about divestment and subsidy.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Thank you, Bruno, for the question. Regarding the subsidy program, that is still – I haven't got the totally consolidated figures for July, but in our June numbers, there was increase of about 560,000 cubic meters, which is being discussed because the price model changed to ensure the subsidy. What we have noted is that the companies have signaled an operation at more or less that level. For example, I don't have any increase in the number of orders for August. I don't see a possible increase in demand for Petrobras. That may be too different from what we have in June. This is why we are signaling more or less the same level of imports. That means considering the clients that we have to recommend with Petrobras.

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

This is Solange. Bruno, thank you for your question. I really liked your question because it gives me an opportunity to show you what's happening. We have different realities in the pre-salt. And as time goes by, we get more experience and we are acquiring a lot knowledge, so it becomes clearer every day that every area is different, every area has a different characteristic. And the Sururu field, as you could see if you followed recent events in Sururu field which is showing positive data, both for well and for our test, our production test that we're running in different areas of the field.

That raises an interesting expectation for our partners. We look at productivity but we also consider (00:31:48) experience in trends of how we equip the wells and complete the wells. When we joined this experience of drilling wells at more affordable prices with higher productivity, then we're getting to a new generation of well. So, we have to measure the high quality of reservoirs.

But putting it all together, we can potentialize the productivity of this area. So, we do have optimistic prospects, but considering the whole – by the whole I mean knowledge about the reservoirs and knowledge about the ability to make them more and more profitable and yield more. So half of (00:32:38).

You asked about the financials. You have seen the explanatory note. We recognized accounts receivable of subsidiaries of BRL 590 million during the quarter. This amount basically refers to the second phase of the first part, which is the recognition that we put by revenue for the current part of accounts receivable. It is in the explanatory note. When we stretch the period, the first part of the second phase, the amount receivables that comes up in some days of July and that's why it's not included of BRL 870 million. So, BRL 590 million was updated into July days, $870 million, which is the first payment that we are getting from ANP. As I mentioned, during the press conference this morning, we don't doubt that we will receive this, but we understand there is a new procedure. ANP is still consolidating that.

And another point in the explanatory note is that in the first stages, there's a small amount that we are not recognizing as a revenue. It's not in the balance of receivables. So, we are talking with ANP about procedures to abide by the legislation as mentioned in our calculation, so we did not recognize that amount either.

Regarding divestments, as we communicated this morning to the press, we are maintaining the goal for the year. We're going for BRL 21 billion in our plan for the period. It is linked to the concept of timing, not completing a lot of projects.

In terms of cash flowing in, we're considering BRL 7 billion, actually BRL 5 billion happening in the first half. As for TAG, the process continues. We informed the market that the process is suspended. We can do internally to get a head start, we are doing, and we are awaiting the review that the judiciary power regarding this project. If it is no longer suspended, once it is no longer suspended, it will communicate with the market. Thank you.

Operator

Mr. André Hachem from Banco Itaú, you may proceed.

Q - André Hachem

Good afternoon and thank you for the question. I would like to ask a question about Upstream. You had these plans for 2018, and so far, two have been delivered, but I see in the plan that you have an additional two, P-69 that will leave the shipyard, and the other one in the fourth quarter of 2018. So, would it be considered that P-76 could be in 2019 and P-69 maybe as well?

And my second question had to do with the sale of assets. As you mentioned, you were expecting BRL 7 billion for this year, and I would like to confirm if this is what you expect for cash in 2018. So, when this is reviewed, the other assets would go back to signing or the sale of more assets would be in 2018 and the original target of BRL 21 billion would be maintained?

And the third question, I would like to better understand the dynamics of the Campos basin. We still see a very good acceleration there vis-à-vis pre-salt. Is it because of asset or lack of investments, and could you give us some more color about that?

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Thank you for the questions once again, André. This is Rafael, and I will turn the floor over to Hugo first, about the Upstream and operations, then the platforms, and then afterwards, I will be back talking about investments.

A - Hugo Repsold Junior

Hi, André. Thank you for the questions. In relation to P-69, it could be in August. And even if it takes some time or if we put it in production, we should start production this year. And our expectation would be at the beginning of the last quarter, and if possible, to bring this forward. P-76 is leaving the shipyard 38:00 and going to the location in the fourth quarter and we should – this should be at the end of the year. Even if it starts producing this year, it will only contribute to production next year. So any uncertainty in relation to the startup could affect that because it will be right at the end of the year, the P-76, but the major contribution of P-76 of production is for 2019. Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

André going back to your questions about investments. So once again, now we made it clear that the target for investment for the two years continue to be the same. And this is a time concept that is to say, the close of the operations in – we have already talked in public about the processes that have been suspended, and basically, our participation in Araucária in the nitrogen fertilizer plants and TAGs and (00:39:14) Northeast for the cash inflow what we expect for this year is seven plus five plus two, these are all cash inflows that are associated to the project that are affected by this suspension, temporary suspension, and that are in the binding phase. And we are going to the next phase as we close, so this is the estimate forecasted for this year. The processes have been suspended and some in-house work that we do while we work with these processes, we continue to do this. And Solange will be answering your other questions. Just a moment.

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

Good afternoon, André. Your question about the Campos basin is very interesting because it allows us to clarify some repercussions about this matter. Yes, you are correct, when you make your evaluation as it is performing slightly lower than we expected and it has – this drop is slightly higher than we expected that were the 9% of the business lines. So the opportunity you're giving me is that I can clarify that this has nothing to do with potential – our potential for the Campos basin, it's totally preserved. And we are only consolidating some dates of some producing wells or some platforms that are being consolidated with other demands and because of that, we are postponing this, because we have to fit these dates into our planning, so this is not a permanent situation, this is not a recurring situation and the Campos basin continues to be on the cash generation.

Q - André Hachem

Thank you, Solange. I would like to ask another question to Jorge. We saw a relevant increase in the imports of diesel by Petrobras, so how do you intend to supply the market in terms of diesel imports vis-à-vis by the utilization rate?

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

In relation to oil product, the planning model that we run is according to the price of oil, the differences in prices between diesel and oil, gasoline and oil and you run this models and the best result is the economic result in the overall balance of these products, and then, based on that, you decide whether you're going to export or import the oil product. And this has a lot to do with your availability, mainly in what we call conversion activity, the activities where you transform them in diesel, or gasoline in coking units and catalytic units and this we do permanently and for others for instance, given the diesel market that we have to supply and the availability of our oil and the availability of (00:42:50). For August, it showed that some imports were something economical. So it would be worthwhile to import and this was a decision that we made and this was the best decision based on the systems that I have just described.

Operator

Our next question comes from Regis Cardoso with Credit Suisse. Mr. Cardoso, go ahead.

Q - Regis Cardoso {BIO 20098524 <GO>}

Good morning. Rafael, welcome. This is your first webcast and the first earnings conference call with strong results. I hope it will be the first of many. I have two questions. First, it has to do with the dynamics of cash flow. Based on the projections that you provided, we had a higher concentration of CapEx along the second quarter, and comparing that with your cash generation, it seems that achieving your goal of 2.5 times value (44:10) you will be relying a lot on the operational cash flow generation. If you then look into the difficulties of having cash flow NIM from new projects, in addition to the ones that you already have in your pipeline for this year. For more objective, I would like to understand, do you expect a similar profile of cash flow?

In cash flow, that would be almost mutual for the second half of the year, and if the vision, making new investments, it would be necessary to achieve a net debt over EBITDA of 2.5 times or it really depends on the operational cash flow generation. That's my first question. But I would like to go back also to Downstream and talk about the subsidiary program.

The subsidiary program was adopted actually in the first few months, probably to diagnose it. Now, that things come down, it seems that the solution at the end of the day is not that bad as initially expected. Today, potential price control focused (00:45:30) might get huge, so that would happen during the truckers strike soon. What are the (00:45:38), for example the ability to use the prices above commercialization or marketing prices or do you think that bringing (00:45:58) days, the E&P price a bit open up the possibility of arbitration, are there any things in terms of the programs that could be worrisome? I'm (46:13) also talking about refining as a follow-up to the last question.

Somewhat level onwards, Celestino. An increment in the utilization factor, may be detrimental to the possibility of the refining park, I know that this is a complicated analysis, but overall, in an order of magnitude, we should expect a utilization factor of close to 100% has been good, that is truly good. (00:46:45) consumption needs to be at the 1 million barrels to 1.1 million barrels a day. I know it is substantially lower, about 850,000 barrels a day, so in 2014, even when Petrobras was operating at a 100% (00:47:11) production was about 800,000 barrels a day, and since then, new strategy (00:47:18) I guess should add 70,000 barrels a day of capacity. It seems that the whole refining park would be able to supply for domestic demands if necessary. So can you sequence in the same way, is it a fair statement?

A - Operator

Hey, Regis, thank you for the questions and for the comments. I want to address your question about cash generation and budget and the leveraging, and then, I'll then turn the floor to Celestino. You are correct and that is why really focused on informing, you know, as I do. But (00:47:56) message, with the current portfolio management with the current Brent oil price is what we can see is the best number of cash generation and the EBITDA will be the first indicator of the year. We most likely can achieve up the goal of deleveraging for the year.

Even with the cash earn coming from the management of our divestment portfolio with expectation of more than $2 billion in the second half alone, but this is true. This is the message that we want to convey. So again, we need constant monitoring of our portfolio. Then, we decide on new investments and on divestment, we will have to wait to develop the project.

So cash generation is important in maintaining the conditions that we saw in the second quarter, again linking with everything we're saying here, it is important to stress that the quality of Petrobras assets, the management and financial discipline that we have in terms of cost of capital, all of that allows us to capture the EBITDA that we have projected for the year.

And with the current variables, the current differential of oil price in the international market, I will turn the floor now to Celestino.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

Regis, regarding the subsidies, the model created for the program, is very, very competitive. We have the marketing price and the reference price, and they are linked to the international oil price. They vary with the dollar price and the exchange rate. So, premium in place, we'll have prices aligned with the international market, not just the marketing price, but the subsidy as well.

Q - Regis Cardoso {BIO 20098524 <GO>}

And the question is if the reference price is above $0.30 of the subsidy, if the cap is $0.30 that exceeding amount would be compensated, offset in the following months considering the marketing price. So, in a general way, the length of the prices are used in the subsidy program are very similar to the prices that the market will be exercising dynamically day-by-day. The model that was implemented is one that is competitive and they add competitiveness to market operations. When it exceeds $0.30, that amount will be offset in the following months, so that is one important point and something that you mentioned. The operation of the model, given the volume of information, the volume of invoices that take place, well, it always feels like a learning period for ANP and for market agents.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

So, regarding the subsidy program, this is the best view that we can give you. Regarding operating efficiency, obviously, I will try to simplify the discussion which is a little bit more complex. But, let's consider the following. When you look at crude oil, there are three products that are worth more than crude oil: diesel, jet fuel and gasoline. These products, despite seasonalities, they are always worth crude oil plus the margins. And you have to simplify fuel oils and naphtha that are worth less than crude oil, minus $15 or $20 per barrel.

When we run the refinery with crude oil, it produces a set of oil products. You run the refinery, you import crude oil and it will come out as diesel, naphtha and fuel oil. And depending on the costs that we have, for example, if you produce fuel oil in Brazil, the best destination of this product is China so you have to consider freight costs. So, when you produce more diesel, the margin of diesel that we produce, if you have a lot of fuel oil and naphtha, when you add up all the products that you produce, it is all worth less than crude oil. When that happens, it's worthwhile exporting crude oil than importing diesel, and this is the rationale of the model.

For example, when you have a thermal that use fuel oil in Brazil, thermal power plant, obviously, your diesel production in the Brazil refining park will be competitive because the market is coarser when you open up the possibility of instead of exporting oil and importing diesel, it opens up the possibility of producing diesel domestically. So this is how the model gets all of the calculations. I am not sure that I was able to explain this to you.

Q - Regis Cardoso {BIO 20098524 <GO>}

Perfect, Celestino. I understand the mechanics. And exactly because of your limitations in hardware that you mentioned, the coking model and others, typically secondary utilization factor very close to 100% despite pushing our freights internationally and domestically, typically, we've been transforming oil into fuel oil. I understand and correct me if I am wrong. The utilization factor is very close to 100%, seems to be bad or worse, then the utilization factor close to 95%. Is this a fair statement? And the other question was regarding the diesel balance because it will have a utilization factor above 90%.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

This is very – it would be possible to supply the whole domestic demand with production in the Brazilian refining park which was not possible in 2013, for example. Localize to have to give the assessment permanently. Every product condition is not to be analyzed.

Operator

Christian Audi from Bank with Santander.

Q - Christian Audi {BIO 1825501 <GO>}

Thank you. My first question has to do with CapEx, as you are in a run way that is today you had given the objective of BRL 15 million and it is low now, do you still intend to reach BRL 15 million or is something changing along the year that could maybe lead to levels lower than 2015 because I know that there is a seasonality there coming into play? The second question has to do with the theme that you were talking about, refining, and this was not quite clear to me in a more simplified or over-simplified way. I would like to ask if you are happy with 80% give or take percent, which is ideally the level that allows you to have the market share that makes you happy, and at the same time, having high margins or do you still see room for improvement there, and lastly, about prices, given everything that is going on, what do you suggest to the market in terms of how we could think about gasoline prices for 2019 and the remainder of 2018?

Could we use the model of prices in line with international prices now or not? So, anything you say about it will help us a lot, if you can.

A - Operator

Thank you very much for the question. The question about CapEx, I would like to ask Hugo to answer, but in fact, we have a different run rate for the second half. And this is why we are reinforcing this as intended, so we'll say a few words about that. And I would like to remind you that we are not changing production of our business, and that has been planned. Then, we will come back to your question, and then, Celestino will answer.

A - Hugo Repsold Junior

I think your question has already been answered because what we are doing, these adjustment has to do, this including what we'll be realizing this here and also based on the pace of the third quarter and the implementation of the first half of the implementation that we have for the second half of the year. So, we already did this as the guidance. That is to say that it will reach 15, still by the end of 2018, and the remainder will be in 2019. And this does not change whatsoever the investment plan that we are finalizing and within our plan or our business and management plan.

This relation of the message for our refining culture, I would like to reinforce once again that we run refining for – in order to give the maximum return, maximum value to our shareholders, there isn't much regarding market share or utilization factors. We will have the market share and de-utilization factor. We have a very adequate target for that investment in quality, and the quality of conversion, so our guideline is to operate ROEs in order to maximize profit to our shareholders. So, this is our guidance, our guiding lines.

And regarding prices, price is always aligned with the financial markets. So, this is a statement that the management has been making over all these years, and this is what we have been putting into practice, and we will continue to put into practice.

Operator

Our next question comes from Luiz Carvalho with UBS. Mr. Carvalho, go ahead.

Q - Luiz Carvalho {BIO 18040760 <GO>}

Hello, everyone. I have three questions. First to Rafael, you showed a slide with a free cash flow of $16 billion when you break down operational cash flow generation investment, et cetera. I have two questions regarding that. First, would you consider dividends there? So, just looking forward, that number should be lower. And given the perception so far, I understand that you will be paying dividends this year.

My second question is regarding capital allocation. Looking forward, we're going to have cash generation that will be very strongest in the industry on a price, we'll continue to be at this level and with a pricing policy and everything we do. So, what would be the EBITDA level for capital generation? Do you want to deleverage the company even further, how should we see this looking forward?

My second (sic) [third] question goes to Solange. Solange next week the Senate House will go back to your activities and we have an expectation that you will probably vote the transfer of ROI for months on the sands. Regarding Petrobras as much as you can share with us, what are the procedures that we still need to do? How close are you in disagreement with the government, assuming that this small goal pass at the Upper House? These are my questions. Thank you very much.

A - Operator

Luiz, thank you for your questions. I'll try to answer the first two questions, and then, obviously, Solange will be answering the third question. Regarding the guidance for cash generation, we have been careful in terms of operational cash generation. And assuming net EBITDA number slightly different, because in cash generation, we're considering a dividend payout policy in the way that it is previously informed. Some capital evaluation in terms of the non-cash elements that make up the EBITDA. So, we think that this operational cash generation, we're working to according to what was informed in our dividend policy.

In terms of cash generation, we continue have the same driver to achieve our goal. So, we have informed the market. In terms of our debt goal with that indicator, net debt over adjusted EBITDA ratio and we're amazed when we compare Petrobras with its main international peers and competitors. Internationally, our debt levels remained high even if we've achieved our goal. And this is something that we are considering internally at the management level and with the board, we will all decide on the future goals for the next year.

Now I'll turn the floor to Solange.

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

Good afternoon, Carvalho. Thank you for the question about the Transfer of Rights. In terms of procedures, necessary procedures to finalize, no assessment would have worked ahead of us in the next steps are. When the Senate House vote the laws that regulates from assets after previous law took an amendment to the previous law, right? And then, you stumble and we have to give you a step ahead of us. You can create a step, so that the amendment will be agreed upon by the parties, and so, that the government and that should rise and move on to our respective deliberations. So we have to wait for the voting and just to keep on standing.

Operator

Pedro Medeiros from Citibank. Mr. Pedro Medeiros you may proceed.

Q - Pedro Medeiros {BIO 16187063 <GO>}

Good afternoon, everyone, and congratulations for the results, Rafael. Welcome and I have a few questions. Some of them are already a follow-up of previous questions. I would like to still talk about the capital allocation of the company. I think you should expect the business plan to be reviewed. So, as you have already reported the expected cash generation and it could have been even better if it were not for the consumption of cash for your working capital, when we look at a business plan, it was totally prepared with the power price much lower than the market price that we have today that the company at the beginning of the year just decided to build this strategy of our partial hedge of the oil price in such a way as to facilitate reaching the target full year deleveraging. So, how do you consider the maintenance of this strategy, of locking in the price of oil from now on? How do you see that for 2019? So, this is my first question.

And the second question is for Solange. Solange, I would like to understand what you could say about improving operation and the use of the compensating asset. We haven't seen the industry working in a more opportunistic way because of the oil price hike and (01:06:39) more competitive prices for companies regarding like drilling campaigns, et cetera, because of the reservoirs. So you have the projects of mining in Roncador revitalization projects and Parque das Baleias. What else could we expect from Petrobras regarding the Campos basin?

And one last question about the lifting cost for the quarter, we saw an improvement – a relevant improvement in the lifting cost in spite of the fact that the company has a slight loss in production, and with a startup of two new systems that have not yet had a ramp up, so what was the driver for this drop in your lifting cost this quarter and does it has to do with the divestments you made in Roncador? Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Pedro, thank you for the question and for the welcome. The first question, which was about the creation of our hedging policy and what we're thinking of planning, and Solange will be answering the other questions.

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

Pedro, good afternoon. Thank you for the questions. Starting with the hedging policy, this is re-evaluated on an annual basis and at the time when we made the decision was after we make a risk analysis that is always a basis for our decisions, we understood that this was a best measure to be taken at the time in order to decrease the risk of not reaching the target at the time, and of course, from then on, the market has evolved positively, and Brent surprised us positively in the sense of being quite higher than we had in the plan, it was $53.

And the policy or the in-house process of establishing a reference in Brent, this had to do with our governance. And this is a very detailed process and it takes around two, three months; and you have all the governance because of approval (01:09:10) with the executive board and the board of directors. And when we look at the Brent now and when we look at the $53 that we had in our plan for 2018, you see that it was rather conservative with every time and we had to publish these figures. Some people do not but we do. But more or less, all the oil and gas operators were around $50 or slightly higher level or low level but it was correct at the time. So we made the right decision at the time and we will continue to do our work, and always complying with the very strict governance that we have for that.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Pedro, good afternoon. Answering the first part of your question regarding the use of the company's (01:10:09) assets, we have three different fronts here that should be mentioned. Actually, for less expensive equipment, then we are continuing or going back to hiring the rig. And before doing that, I have to have a different project generation. It could really as you said, are projects that are very much applied when you have an offshore typically such as ours that requires a differentiated way to treat these interconnections.

So it has more to do with the way we generate the interest winning profits (01:10:56) and then supplementing them with the more favorable weight mix for this project of work-over that already answered your other question about the lifting cost in this quarter. We were able to have or kill the impact of work-overs that were necessary and you see this more favorable mix of rigs for these work-overs or in other words fine-tuning based to the profile or fine-tuning the type of rig to our needs. But we are placing our bets consistently on the evaluation made by Petróleo Brasileiro. A liability now is in the – cost management of the contemplating, and this has to do with the recovery factor and also reserves. So we have to have three operational practices in practice and that lead us to increase production with the capacitors that is already installed to a different approach to generate new opportunities. But on the other hand a more truth behavior regarding the – what we should have in terms of installed capacity in the consolidations.

Operator

Our next question is from (01:12:35). Go ahead, sir.

Good day, everyone. I have two quick questions. (01:12:47) talk more, then we have to if Petrobras has to work with every business, can you expect an increase in this signing, and please correct me if I'm wrong, (01:13:03) with the international markets? In the last two months, look at the, just to compete with ethanol, which is a lot cheaper, why can't this be considered a strategy for the last – until the end of the year? Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

So thank you for the question. Celestino, will be answering your question.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

(01:13:33) good question. Regarding if we will have to increase the production of (01:13:40) to impact under the refining cost, will be quite small, marginal actually. We have a set of operators, and so, this was not very sensitive, perhaps that's 500, so nothing much about that. In natural gasoline, we have grades of symmetry with ethanol, and it's hard to combat by a price (01:14:20) is more than BRL 400 per cubic meter. And as we maintain the (01:14:28), the margins will compete with ethanol.

Operator

Our next question comes from Lilyanna Yang with HSBC (01:14:50). Please go ahead.

Hello, good afternoon. If possible could you elaborate regarding that gross of BRL 120 billion (01:15:05), regarding the sale of assets, could you (01:15:11) in regions, leading to a reduction in CapEx for this year? And another question, when you say that is a 15% reduction in the unit cost of outflows, what would be the comparison base for that? Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

(01:15:45) this is Rafael. Thank you for the question, but could you repeat? The sound wasn't clear.

Operator

Go ahead, sir. Please repeat your question.

So to repeat my question, I would like you to give us more color on (01:16:56) when we are speaking of loss; we recognize the loss of more than BRL 1 billion in the second quarter results, referring to the sale of other assets.

My second question is regarding the main drivers that you add to the reduction in your CapEx estimates. And my third question regarding what you mentioned in the slides regarding your 15% reduction in the offloading costs, what would be the comparison base for that number? Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

This is Rafael Grisolia. We are very sorry, we couldn't hear your question for first time and we apologize. Okay. Your first question, could you give more color regarding the debt reduction effect is basically related to the Roncador investments we are recognizing in the quarter. The finalization of the operation. When we close the deal, completed the deal, we have to account for it, little bit more on that, we can take offline.

And as for the CapEx question, you mentioned this, we just wanted to illustrate the provision guidance of our cash generation. We anticipate that we continue to invest – we are not cancelling any investments. It's just what we were expecting for the year. Our investment indicators announced that the NPR maintains is just that for cash utilization, we expect BRL 18 billion and not BRL 17 billion. But again, this is not impacting any of the key investments, no cancellations whatsoever. This is just a better indication of what the operation will be until the end of the year. Any further questions?

I will turn the floor to Jorge for answering the last question.

A - Jorge Celestino Ramos {BIO 19059339 <GO>}

And this is regarding the reduction of offloading costs. If you look at the number of vessels for early June, from 37 to 26, somehow you can see the color of the increased inefficiencies in offloading operations because you have a better utilization factor of the vessels, we use our trips better. The easy way of operating, this easy way of finding offloading is all of this left with a reduction in the offloading cost.

Operator

The next question comes from Mr. Paul Cheng from Barclays. Mr. Paul, please proceed with your questions.

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

Yeah, this is Cheng.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Hello?

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

Hi, good afternoon. Three quick questions. First, what is your concept at your refining system and do you have any plan of the maximum remote to the upcoming level to new spend at the IMO 2020? Second question, in your press release, you said the downstream is benefit from the failure of the inventory, can you quantify the benefit? Lastly if you can get the activity improvement to concern how that you worked through this, which is going to change. We are driving reps, we are going to change how that certainly is? Thank you.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Mr. Paul, can you repeat your question, please?

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

Yeah. The first question is what is your hindsight of your refining system now you're planning any investment related to the upcoming new Global Greenfield Standard to IMO 2020. The second question was in your press release, you mentioned a balanced (01:21:43), what is that benefit in the second quarter? Lastly, with the productivity have been increased in the (01:22:00) period, how is that impacting (01:22:04)? Do you want me to repeat the question?

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

No, thank you for the question. First, let me try to answer them, and if you have any additional doubts, we will be pleased to answer them afterwards. With relation to your first question which was about the adaptation of our products in order to comply with the IMO 2020 ruling. Petrobras has a very good position regarding low sulfur because we produce oil with low sulfur, so this the way that oil is produced. So, it will not be necessary to make any adjustment to the refinery facilities in order to adapt our production to the specifications of a new broker. In fact, we see this as a competitive advantage for Petrobras because of the availability of oil with low sulfur.

Now, regarding the gain in terms of prices vis-à-vis inventories between the upstream and the downstream areas; in fact, this does not bring any results outside the company itself, so this is something internal to the company.

Regarding productivity, your question about productivity, since the beginning of our activities of our exploration to the pre-salt as we see ourselves with a unique type of reservoir with just a handful of similar reservoirs in the entity layer. We were very careful when we made the forecast for productivity and after eight years producing in the pre-salt, we saw that our most probable view is we realized and with a bullish bias, so to say, because it's slightly higher than what we expected in terms of the most probable level of use, and we are fine tuning our capacity to understand how the well engineering projects can also under the project can increase our productivity, so we have a lesson learned in these last few eight years, and this led us to improve the way we place this reservoir in production.

And in these eight years, we saw no events that could draw our attention to some kind of deviation vis-à-vis what we are projecting, and we also saw that the initial decision that we made were very good because ever since the beginning of production of the fields, we had an alternate injection of oil and gas, and it has been proving to be very good, and so, this is our best estimate.

Operator

Thank you very much. Now, we close the question-and-answer session of this webcast. And we would like to give the floor to Mr. Rafael Grisolia for his closing remarks. So, Mr. Rafael Grisolia, you may proceed.

A - Rafael Salvador Grisolia {BIO 16673583 <GO>}

Once again, I would like to thank you all for participating in our call. In case you have any additional doubts, our whole Investor Relations team of Petrobras will be available to you as always. So, once again, thank you and I wish you a very good afternoon.

Operator

Thank you, ladies and gentlemen. The audio for replay of the slide presentation will be available at the Investor Relations website at www.petrobras.com.br/ir.

This concludes this webcast. Thank you very much for participating. Please disconnect your lines now and have a very good afternoon.