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Oil euphoria puts Lula's legacy at risk

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Brazil is flying high. Having emerged unscathed from the financial crisis, its economy has been growing at 9 per cent a year. Its hugely popular president, Luiz Inácio Lula da Silva, now in his last months in office, seemed set to retire with a chorus of praise – until he plunged into the complications of deep-water oil. Just as Icarus saw his wings of wax melt as he flew too close to the sun, so Mr Lula is risking his legacy as controversies multiply over his petroleum policies.

The April blowout of **BP**'s Macondo well in the Gulf of Mexico dramatised the difficulties of oil exploration in deep waters. The next phase in that drama could come in giant fields recently discovered by **Petrobras**, Brazil's state-controlled oil company. They lie 7,000 metres below the Atlantic, beneath unstable salt beds up to 2,200 metres thick, far deeper than the layer of salt capping the Macondo.

These discoveries come with formidable production problems. But they also fed Mr Lula's geopolitical ambitions, while fuelling election fever in the months before his successor is chosen in October. Banned from re-election by the constitution, Mr Lula is using the image of Brazil as a rising oil power as a political weapon, invoking feelings of triumphalism to help his Workers party to victory.

This possible rise to power is not illusory. The Santos Basin may hold anything from 9bn to 14bn barrels of oil and gas, which could double Brazil's reserves, placing its holdings far above the likes of Shell and BP. The politics of the discovery are awkward, however. Mr Lula's favoured candidate – for whom he is campaigning ardently, and who is favourite to win – is his former chief of staff Dilma Rousseff. But as well as being an economist and former guerrilla fighter, Ms Rousseff also chaired the Petrobras governing board just as technicians were drafting the legislation that granted the company a virtual monopoly over the new discovery. Economic advisers to the Brazilian senate have since found "myriad unconstitutionalities" in the proposals, exposing it to litigation.

Safety issues are raising further concerns. While the BP blowout was 120km from shore, the Santos Basin finds are up to 350km from the Brazilian coast. This poses daunting logistical problems. If a big accident were to occur so far out, neither Petrobras nor Brazil's navy nor private shipping could mount an emergency effort on the scale seen in the Gulf of Mexico.

Mr Lula called such exploration risks "negligible" while oil euphoria bred in the political class an illusion of limitless resources on the horizon. Members of Brazil's congress fought furiously to divide future oil royalties among states and municipalities. But even if Petrobras could overcome these safety difficulties, its ambition is pushing too fast, on too great a scale and with too high a profile.

In recent decades the company has become a pioneer in deep-water production, and is now among the most successful of the state-owned companies that control the bulk of world oil supplies. Its ability to develop a world-class corps of technicians has been especially impressive, not least in a country short of basic skills. But it is moving now to a new level of enterprise, in which the financial and technical challenges are so great that they will severely test the capacities of Petrobras and Brazilian suppliers.

In the first instance current plans provide a new state-owned company, Pré-Sal Petróleo, with veto powers over all operating decisions. Planned legislation designates Petrobras as the sole operator of all future oil concessions in the area, with a 30 per cent minimum stake. But such an expansion would spread thin its financial and technical capacity, while shortages of trained personnel could expose it to safety issues. Indeed, the company's president has stressed that it lacks sufficient technicians to carry out such ambitious projects.

In the medium-term, Petrobras plans a $224bn (€171bn, £141bn) five-year investment programme, requiring $96bn in new financing. This will include floating the company in September – probably the largest share offer in history, worth at least $25bn – alongside new borrowing. But this will strain Brazil's government, which has already borrowed heavily to fund both Petrobras and the national development bank, BNDES, which in turn is lending even more to Petrobras and its suppliers. The company's financial needs are now so great that they dwarf the meagre investment capacity of Brazil's federal government, in a country that desperately needs to spend more on infrastructure and education.

The risk for Mr Lula is that these requirements will take money away from other priorities. Some $80bn is needed to prepare Brazil for hosting both the 2014 World Cup and the 2016 Olympics. A bullet train between Rio de Janeiro and São Paulo – talked about since the 1980s but unlikely to be ready for the Olympics – will cost $18bn. Another $15bn, meanwhile, would finance Belo Monte, a giant dam in the Amazon talked about since the 1970s. Having already delayed its stock offering once, Petrobras's capitalisation plans remain mired in technical and legal problems over how to price the newly discovered oil that the government plans to use to increase its stake. This is causing controversy in financial markets, and could ultimately have political consequences.

When Mr Lula took office in 2003, he had the wisdom to recognise that Brazilians would not accept a return to the chronic inflation that had impaired their welfare for decades. Critics now argue that the surge in recent government spending, along with the financial controversy that has surrounded the recent oil discovery, may signify a regrettable return to the past. If Brazil does not straighten out its priorities, Mr Lula may soon find his reputation sinking as deep as the oil deposits that have so enthused his country.

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