The Guide to Infrastructure and Energy Investment

Third Edition

Editor
Claudette M Christian

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Contents

Foreword 1
Anthony S Harrington and James King

Introduction 5
Claudette M Christian

Part I: Public–Private Partnerships

1 Brazilian Infrastructure and Energy under a New Mandate: The End of a Cycle and Perspectives Ahead 15
José Virgílio Lopes Enei, Mauro Penteado and Ana Karina de Souza

2 Peru: Towards a Model for Developing Public–Private Partnerships in Accordance with International Practices and Standards 28
Juan José Cárdenas Mares and María Luisa Peña Hartog

Part II: Project Finance Models

3 The Role of Project Finance in Developing a Region: Trends and Considerations .. 41
Daniel D Bartfeld, Roland Estevez, Jaime E Ramirez and Genevieve Fox

4 How to Build Up a Region: Development Banks and Multilateral Financing 48
Thomas Hechl and Antonio de la Esperanza

Part III: Dispute Resolution's Evolving Role in Major Transactions

5 Two Key Considerations on Infrastructure and Energy Disputes with the Arbitral Seat in Latin America 65
Daniel E González and Juliana de Valdenebro Garrido

6 Investment Treaty Arbitration 76
Ignacio Torterola, Diego Gosis and Quinn Smith

Part IV: The Impact of Compliance on Project Development and Financing

7 Balance of Power between Local and International Partners in Infrastructure and Energy Projects in Latin America 91
Marc Z Michael and Juan C Garcia

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8 The Impact of Compliance on Project Development and Financing: A New Environment 103
Peter Spivack and Crispin Rapinet

9 Navigating Corruption Risks in the Brazilian Infrastructure Sector: New Trends to Guide Investors 113
Marcos Paulo Veríssimo and Raphael Rodrigues Soré

Part V: Securing the Future of the Oil and Gas Sector

10 The Future of the Oil and Gas Sector in Latin America is Now 125
Giovani Loss

11 Mexico 131
Carlos Ramos Miranda and Miguel Ángel Mateo Simón

Part VI: Transport Infrastructure

12 Developing Transport Infrastructure to Support Industry: Mexico 141
Juan Carlos Serra and Jorge Eduardo Escobedo Montaño

Conclusion

Moving Project Finance In Latin America Forward, Issues and Prospects 154
Claudette M Christian

About the Authors 165
Contributing Firms' Contact Details 177

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Part II

Project Finance Models

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3

The Role of Project Finance in Developing a Region: Trends and Considerations

Daniel D Bartfeld, Roland Estevez, Jaime E Ramirez and Genevieve Fox[1]

Latin America has seen a significant upswing in project finance activity since the lull of the Great Recession and its immediate aftermath. The region continues to suffer, however, from insufficient and ageing infrastructure, and the ever-growing demand for infrastructure investment cannot be met by local capital sources alone. Recent trends in Latin America continue to reinforce the importance of project finance, not only in the development of infrastructure and energy projects in the region, but also in the growth and viability of the region as an attractive centre for foreign investment.

Prior to the Great Recession, project finance in the region was driven primarily by soaring commodity prices, and investments in mining and other natural resource projects across Latin America represented a disproportionate amount of the investment activity in the region. As the global economy recovered, commodity prices dropped or remained stagnant, resulting in a significant slowdown in natural resource and export-oriented projects. However, the explosive economic growth in many Latin American countries prior to the financial crisis gave rise to a burgeoning middle class that in turn created a need to invest in the region's aging and underdeveloped social infrastructure. In response, and in an effort to promote long-term economic stability, many countries in the region began to develop ambitious programmes to overhaul their overextended infrastructure, with a strong focus on renewable energy and transportation. The transition from an export-focused model of project development to a more balanced model that focused on domestic infrastructure growth and long-term stability has allowed many countries in Latin America to weather what would otherwise have been a turbulent period for project development.

Project development and finance in Latin America continues to reflect this trend towards a more balanced economic growth model, but we also continue to witness the evolution of

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the region as an attractive investment centre for new forms of capital. As a result, increased private equity, institutional investment and M&A activity and related financing needs continue to drive project development in the region.

The year in review

2018 thus far has been an active period for project finance. This time last year, Mexico had come to the forefront and re-emerged as the hub of energy-related project finance transactions, as well as the source of much of the region's project-related M&A activity. Project finance and M&A activity in Mexico has continued to thrive in 2018, with the first two quarters seeing a swell in activity as developers and investors sought to close financings prior to the 1 July presidential election. In addition to the strong pipeline of energy and infrastructure projects in Mexico, 2018 has seen a resurgence of oil and gas activity in Brazil and mining projects have continued to come online across the region, as developers, prompted by recovering copper, iron ore and gold prices, seek project financing for new or expanded mines in Chile, Panama, Ecuador and Peru. With sustained market strength and dynamism across Latin America for almost two years, the scope of project finance in the region continues to broaden in a way that is attracting traditional and non-traditional sources of investment. Set out below is a brief summary of the trends we have seen this year followed by a look ahead to 2019 and beyond to identify key drivers of project finance as Latin America continues its efforts to stabilise growth and promote future sustainability in the form of energy projects and core infrastructure.

A year of elections

2018 has been a year of political uncertainty in Latin America, with three of the region's four largest economies, Colombia, Mexico and Brazil, electing new presidents in the span of six months. Developers and investors looked on with caution as Mexico saw the rise of left-wing candidate Andrés Manuel López Obrador, who promised to investigate previously awarded projects for corruption and expressed fierce opposition to the privatisation of the country's oil industry. However, towards the end of his campaign and since winning the election by a wide margin, Obrador has been far less vehement in his criticism of projects that have already been awarded contracts. Obrador has additionally declared that he will respect existing contracts and the rule of law, including the Energy Reform enacted under Enrique Peña Nieto in 2013, which was established through a constitutional amendment and opened up the energy industry to foreign investment by both developers and investors. Despite Obrador's reassurances, investors continue to closely monitor economic and political developments in the country, with some concern that such developments may slow the pace of activity.

Meanwhile, in the lead up to the June elections in Colombia, the investment climate was less tenuous, as the two top candidates, Ivan Duque and Gustavo Petro, both promised to support the institutions and regulations that underpin the country's infrastructure development. With the election of conservative and business-friendly Duque, we expect activity in the market to remain strong. The President has voiced a commitment to reducing the government's fiscal deficit by, among other efforts, reducing public spending. Colombia's

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curtailment in governmental spending, coupled with the country's relatively small domestic capital market and business-friendly administration provides a climate ripe for foreign investment. This convergence of factors is likely to draw interest from various sources of international capital.

Finally, at the time of writing, Brazil is on the cusp of electing a new president, who will be tasked with leading the nation out of its worst-ever recession and the stigma of corruption scandals that rocked both the country and the region. Notwithstanding the uncertainty as to the outcome of the election, Brazil has seen a significant increase in attention from international investors who are attracted, in part, by the size of the country's market and the associated breadth of investment opportunities it provides, especially in the oil and gas sector.

Metals and mining

After years of depressed commodity prices, metal prices have rebounded to the point where we are now seeing several large-scale mining projects coming to market, including in countries such as Ecuador, where project finance has been relatively dormant in the past decade. The successful closing of the long-term financing of the Fruta del Norte gold project in the second quarter of the year could go a long way to opening up the project finance market in Ecuador. In other jurisdictions, such as Panama, Chile and Peru, large projects, such as the greenfield Mina Justa copper mine, have come to market with the hope of achieving completion towards the end of this decade. These projects are driven by a need to meet the expected surge in metal price and demand driven by a variety of governmental incentives for the construction of infrastructure, including the Chinese 'Belt and Road' initiative.

Bonds, institutional investors and private equity

Partly owing to higher capital requirements under Basel III, the project finance bank market has continued the trend of shorter tenors and more bank-favourable terms. While there are some exceptions for strong sponsors, lenders continue to assess their risk appetite closely and we expect that to continue in the short and medium term. Interestingly, this has provided an opening for private placement investors to come in and provide long-term financing solutions for certain projects, both in the development and completion phase. The private placement market has been active in Mexico, Peru and Chile this year, and is looking to expand to other countries. The year has also seen the emergence of hybrid bank and private placement structures in the region, such as the refinancing of the El Encino–La Laguna natural gas pipeline in Mexico and the greenfield financing of the EVM II 850 megawatt combined cycle natural gas-fired power plant, also in Mexico. Private equity has become increasingly interested in the region, as investors search for higher yields, and we expect this trend to continue for the foreseeable future. Finally, project bonds in the 144A/Reg S market have also been active and were a key component of the Actis acquisition financing and the CELSE LNG-to-power financing discussed in more detail below. These sources are not available for all projects and sponsors but they are certainly attracting large sponsors and funds who are able to structure projects to meet certain minimum market and rating requirements.

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Looking forward

The future looks to largely continue recent trends; additionally the expected re-emergence of once-active markets in the region will present several opportunities to further drive growth. As discussed below, we expect project development to continue to be driven by renewable energy, an expected increase in activity from re-emerging markets and M&A activity.

M&A

Driven in part by the region-wide aftershocks of the corruption scandals plaguing Brazil earlier in the decade, individual and large portfolios of projects are becoming available, and these projects will, in turn, require financing to acquire and complete development or continue operations. Non-traditional project finance participants, such as private equity and hedge funds looking for higher-yielding investments, are increasingly active. Actis' acquisition of InterGen's 2,300+ megawatt Mexican portfolio of businesses and Macquarie's acquisition (and equity and debt restructuring) of the 907 megawatt Norte III power plant were groundbreaking in their complexity for transactions in the region and are representative of the increasing level of interest in the region from large US and internationally based private equity funds. One of the notable trends of the past couple of years is private equity firms' fundraising of billions of dollars earmarked for Latin America, thereby raising the visibility of and demand for investment opportunities throughout the region. We expect non-traditional project finance investment activity to continue as additional and more desirable assets come to market.

Infrastructure and energy

Infrastructure finance should continue to be active into 2019, particularly in Mexico and Chile, and we see improving prospects for project financings in Brazil and Peru.

Mexico

As noted above, 2018 has been an active year in Mexico, with various large oil and gas and power projects reaching financial close. Despite the election of Obrador, the pipeline of similar energy projects is strong, and 2019 should see several other energy projects come to market both for greenfield development and refinancing of projects reaching completion. Mexico also continues to push for the development of solar and other clean energies and has sought and secured a regular succession of renewables deals through its auction system, such as the 377 megawatt solar PV project in the Aguascalientes region, won by French renewable energy developer Neoen in November 2017. Sponsors in this space are also expected to benefit greatly from the combination of experience gained by lenders (and their internal credit committees) in financing the Chilean PPAs and the familiarity of those lenders in Mexico with the well-known Mexican power purchaser, the Comisión Federal de Electricidad.

Chile

Chile also remains active in the energy and infrastructure space with continued development of renewable and gas-to-power projects. The capital costs required for these projects

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total in the billions of dollars, with a majority of the funds expected to be raised on a limited recourse project finance basis. There has also been a push towards other infrastructure projects, including water desalination facilities tied to the growth of capital expenditures in the mining industry, such as the desalination plant for BHP's Spence copper mine, which was financed earlier this year. Chile also continues to be a regional leader in solar and wind development. As it finds itself with more projects in the pipeline than it needs, we expect lenders to become more selective and to focus on well-structured projects with experienced sponsors. We expect deal flow to continue on the back of the Chilean government's stated goal to have 70 per cent of the country's energy come from renewable sources by 2050. In addition, the continually decreasing technology cost curve creates an opportunity for those developers willing to make investments based on continued cost curve reductions in the next five years. It is safe to say that those best able to accurately predict such cost savings will find themselves at a competitive advantage.

Re-emerging markets

Brazil

As noted above, the corruption scandals and political instability that have marred Brazil over the past few years have had far-reaching consequences on international finance in the region and in Brazil in particular. While developers remain cautious about investing in large-scale oil and gas projects in the country in the short term, this year we have seen new focus on the development of projects with a longer investment horizon. This new investment interest has been driven by an abundance of inexpensive gas globally and the cost efficiencies associated with using liquefied natural gas to fuel new build power plants. This year, Brazil saw the financing of Latin America's largest gas-fired generation project, the CELSE 1.5GW Porto de Sergipe I thermoelectric plant, which employed a novel back-to-back, local debenture and international bond structure along with development bank and agency-related features. The project, located in Barra dos Coqueiros in the state of Sergipe, is also the largest cross-border, energy-related transaction in Brazil in recent years and could help pave the way for Brazil to emerge from its current slump in project financing. Since the closing of the CELSE transaction, the country has attracted a significant amount of attention from international investors, particularly in connection with several other oil and gas projects that have come to market. CELSE, and the strong pipeline of oil and gas projects in the country, will undoubtedly have a substantial impact on Brazil's energy sector by providing a new source of power to meet the country's growing energy demands that complement its present heavy reliance on intermittent hydropower.

Peru

After the 2016 general elections in Peru, many market participants expected an increase in project development activity to address the backlog in infrastructure investment. This time last year, project activity was a bit disappointing as projects were slow to come to market, while others were (and some continue to be) impacted directly and indirectly by Odebrecht's alleged violations in the country. Nevertheless, the size and stability of the Peruvian economy makes it an attractive market, and the country has seen increased activity in 2018 in

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a variety of sectors, such as mining, with Marcobre's closing of the Mina Justa financing, and LNG, with the Peru LNG bond offering of nearly 1 billion dollars. We also expect there to continue to be an active M&A market for a wide range of energy-related assets along with related financings, as evidenced by recent acquisitions in the country.

Argentina

While still very much in the early stages of its international re-emergence, Argentina presents a broad and exciting array of opportunities for project development. Many regulatory issues still need to be resolved, and the recent currency crisis may forestall international project financings in the country in the near-term, but we expect thermal, renewable and transportation infrastructure projects to lead the way in the international project finance market in the coming years. International banks and other debt and equity sources may initially enter the market with caution, but the sheer volume of projects expected to come from the underdeveloped infrastructure and energy market presents an opportunity that in the long term will be too attractive for local and international financial institutions to forgo. Since assuming office in late 2015, President Mauricio Macri's administration has prioritised bolstering the country's framework to attract foreign investment. This effort is perhaps best reflected in the Public-Private Partnership law that was passed in early 2017, which, among other features, provides for clear compensation adjustment mechanisms in the event of a change in law, removes capital control and repatriation restrictions and establishes a new tax amnesty scheme. The Macri administration has also promoted renewable energy development in some of its recent reforms and initiatives. In an effort to achieve the administration's stated goal to grow renewables to 20 per cent of the country's energy matrix by 2025, the government has already awarded PPAs for over two gigawatts of new renewable capacity through its RenovAr programme. As noted, the country's current currency crisis, combined with expanding corruption scandals, make it unlikely that Argentina's recent initiatives will progress substantially in 2018. Additionally, upcoming elections will determine whether the market can expect continuity in the country's new policies.

Infrastructure

Notwithstanding the strength of recent development in Latin America, the region is still faced with serious infrastructure limitations that present opportunities for project developers and investors. Colombia has already expanded its 4G programme to the development of river transport infrastructure with the broad Magdalena River project, which unfortunately remains stalled as the government seeks to re-tender the project following the termination of the concession due to Odebrecht's alleged bribery schemes. There are airport projects planned throughout the region – with expansions and upgrades that are viewed as very attractive, particularly to non-local companies that are looking to expand outside their home regions. We are also seeing a renewed interest in many port-related projects and several metro-related transactions planned in the region, which will inevitably keep local and international players active.

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Asset sales

Due to ongoing reorganisations and shifts in corporate strategy, we expect sales of project-related assets in the region to continue and, in some instances, increase. In addition, there are multiple 'private transactions' throughout the region, sometimes for an entire asset and other times for minority interests. This activity will continue and prices should remain attractive to sellers for the short to medium term. Furthermore, in most cases, these transactions will involve financing, and we expect the project-related acquisition finance in the region to be an active and evolving sector in the market.

Conclusion

Thus far, 2018 has been defined by a regular, strong stream of traditional greenfield project finance and largely brownfield M&A activity, which in turn is expected to drive financing activity in connection with the acquisition, development, expansion and operation of these assets. Driven by rising commodity prices, global demand for such commodities and general economic strength, the Latin American market has matured and is proving resilient to international and even local slowdowns.

The shift to energy and infrastructure projects is a positive sign that the region is recognising the importance of infrastructure development as a means to support long-term economic growth and a rising middle class. It is also encouraging to see that asset turnover in the region is active in the face of restructurings and reorganisations, and is a recognition of the viability of project development and the underlying strength of economic and social fundamentals in the region. Accordingly, project-related acquisition finance, infrastructure and energy investment will continue to be key drivers in the project development market in Latin America.

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Appendix 1

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