

Long on sales, short in assets

01/12/2000

The backdrop is investor uncertainty. The region is Latin America. The sector is power. But despite the well-documented gap between theory (that vast surges in demand will spell a flurry of groundbreaking deals) and practice (that, this year, Latin power projects have been shuffling awkwardly to the market), at least one foreign muscle remains firmly flexed in the Latin power market ? Belgium's Tractebel.

The company's Latin strategy is, it seems, finally paying off. According to Eric de Muynck, Regional Manager for Tractebel's Latin American Electricity and Gas International (EGI) operations, the approach has been ?predominantly asset-driven. But now we're using our combined heat and power generation platform as a driver to kick-start our marketing and sales efforts in key regions.? These key regions include Peru, Chile, Argentina and, most extensively, Brazil. But, he cautions, ?it is important not to extend too many generalizations ? ultimately each country is unique.?

Broadly, this necessarily country-specific approach is based on a market driven philosophy, captured by Tractebel CEO Jean-Pierre Hansen's one-liner, ?longer in sales, shorter in assets? or, more exhaustively, ?to have more customers, but not necessarily a much broader asset base, given the capital intensive nature of the product.?

Fair enough for Chile, where over-capacity is becoming the catchphrase, and Peru, where economic decline will soon conduct the tune; but Brazil still demands immense generating capacity to nourish its needs.

Nonetheless, this line of attack so far has meant, since Tractebel's first regional incursion (with the first sputters of ? Litoral Gas' in Argentina) in 1992, a ?key region? portfolio of some 5,645MW installed generating capacity with another 4,620MW in the works. In addition, Tractebel is planning natural gas distribution on the order of 7.7 billion cu. m. per year.

The questions remain ? how profitable each of these regions will be and how quickly (and smoothly) cash can be plucked for the company's various generation and, ultimately ?market-focussed?, distribution and trading projects? There is no easy answer, as generally flawed market predictions already testify.

Financing projects in Latin America is a long process for foreign developers. ?There is the particular challenge of reconciling the concrete, formal approach of the international community with the specifics of the local environments, in which risks are not always ideally mitigated,? explains Tractebel's director of corporate and project finance for Latin America, Marc Franchimont. ?So it is as much of an educational process for the various local markets as it is for international communities involved, particularly when it comes to the issue of local risk.?

Of the key regions, Chile still sparks a groggy twinkle of interest from lenders. Tractebel first penetrated the Chilean market in early 1996, when the state copper corporation, Corporacion Nacional del Cobre de Chile (Codelco), sold off a controlling stake in the Tocopilla power station in the northern region. Tractebel, winning the contract, spun the name Electroandina. That same year, the company acquired one of Chile's largest power companies, Colbun Machiura SA, which now owns five hydroelectric power stations, totaling 780MW capacity, and a 370MW thermal unit ? an

unequivocal asset build-up indeed.

Chile has been privatizing major government holdings since the 1970's. With limited indigenous resources, the country has consistently looked abroad for the bulk of its energy needs; hence, the fact that its energy sector has largely succumbed to private clutches, through sell-offs that have served as models for privatizations worldwide.

Generalities aside, Tractebel, through its partial acquisition of local generators, has established itself as a formidable domestic presence. While the company goes about boosting its stake in both Colbun and Electroandina to 26% and 33% respectively (after Iberdrola's divestiture of its portions), it is also looking at certain projects, such as the long awaited expansion of Colbun's 370-MW gas-fired Nehuenco plant to 610MW. Construction is slated to begin soon, pending authorization from environmental agencies.

This development marks the first new generation project to move forward in the central interconnected system (SIC) in several years. This recent inactivity is mostly due to bickering between generators and the government over the issue of node price levels, and other policies deemed by generators as detrimental to power sector growth. Now, however, node prices are swinging upwards, concurrent with recent legislation further deregulating the electricity. The new regulatory framework will, among other things, limit vertical integration while also introducing the notion of energy trading. Changing regulatory conditions will likely increase competitive pressures for all players.

Further, the recent opening of Chile's gas sector has both increased the choice among competing energy sources and helped to satisfy growing demand in power generation sectors.

Chile's electricity generation capacity was 9,183 MW at the end of last year, of which 6,682MW was distributed through the SIC and 2,501MW through the northern interconnected system (SING).

Says Franchimont, "despite the regulatory concerns and the issue of node prices, the main drivers for profitability will remain hydrologic components, as well as the ease with which the whole environment absorbs the increased capacity of the last few years."

In any event, Tractebel will certainly encounter some heavyweight competition against players such as AES, who recently announced their intention acquire Chile's second largest generator, Gener, as a "superior alternative to TotalFinaElf's proposal" for the same acquisition.

Encouragingly, plans are in the works for a possible interconnection of the SIC-SING networks. Such a development could also spell the fusion of Colbun and Electroandina, thus making Tractebel the second largest player, in terms of installed capacity, in Chile's electricity market, according to Tractebel's Chile director, Yves Jourdain.

Further north, Tractebel, through its domestic subsidiary Energia del Sur (Enersur), has been ploughing into an investment-needy Peruvian market. But, despite Enersur's bullish talk, and, also, the fanfare surrounding the recent inauguration of its latest thermal power plant, Ilo2, in south of the country, the nitty-gritty for Peru is far more sobering.

Standard & Poor's (S&P) has lowered its long-term local currency sovereign credit rating on the Republic to BB- from BB, and its short term local currency sovereign rating from B to A3. Recent political turmoil is bleeding investment prospects, ensuring that financing costs will remain high and trumpeting the stall of economic reforms. Moreover, the ratings agency expects the economy to slow to 3% growth next year. But despite these unfortunate spirals, S&P maintains an outlook of "stable," on the assumption that democracy will prevail.

Peru maintains one of the lowest levels of electricity consumption in Latin America. Yet despite these various deficits, a potential for further growth remains.

The Ilo2 project might best be thought of as symbolic of continued energy and economic development, albeit slight, in the wake of deepening political turbulence. However one reads it, the project undeniably heralds another advance in EnerSur's investment program, since the company was set up as Tractebel's wholly owned Peruvian subsidiary. Tractebel made its first Peruvian noises in 1997, when it bought the 135MW Ilo1 power plant from Southern Peru Copper Corporation (SPCC). It has since pumped in about \$230 million for the first acquisition, and the construction of the new one.

Supplying electricity to open-cast copper mines in Cuajone and Toquepala, Ilo2 will also supply the 883MW South Interconnected System (SIS). The plant, on which construction began in 1998, flaunts two 123MW combined cycle coal fired plants. EnerSur signed a 20 year power purchase agreement (PPA) with SPCC in 1997, and, with Tractebel's bulky investment, EnerSur's installed capacity should reach 455MW.

Curiously, financing for the entire EnerSur package was to have included \$330 million in loans from the Inter-American Development Bank (IADB). The bank had locked in place an A/B loan facility, split between \$75million from the bank's ordinary capital, and \$255million to have been syndicated among commercial banks, plus a private placement option. But the aftershocks of the Asian crisis abruptly rippled their way through Latin American markets, urging Tractebel to look for, as they concluded, cheaper financing options elsewhere. Says the IADB, "we were particularly keen on this project, but EnerSur felt the rates were better in the local markets."

Commenting on the deal, Franchimont, explains: "we had postponed project financing, and the project lagged on for two years, given the depression in the markets. But then we saw a better opportunity with the re-emergence of some local markets" accordingly, we opted for local market bond issue."

EnerSur may issue at least \$100 million in bonds in the local market to support the expansion, together with a generous slice of its own equity. Says Klaus Huys, EnerSur's General Manager, "we increased our own capital to ensure a perfect local rating. And we will continue to look at local financing possibilities. We're currently close to closing this deal through local bonds." More lyrically, he adds "a new chapter for EnerSur has begun with this inauguration."

He is referring primarily to a new block of SPCC demand coming on line with its smelter renovations and its proposed Quellaveco mine. The Tractebel strategy, however, still rings loudly, with its distinctive sales and marketing, or, as Hansen puts it, "smart play" bent.

Yet Peru, it seems, is merely a trim sample of Tractebel's continental pursuits. The heavier action is, by all accounts, taking place to the east "in Brazil. This may come as no surprise, given the size of the country's demand, a degree (though not quite the previously projected hunger) of commercial bank appetite, and continued multilateral and ECA backing.

But Brazil, though having recovered fast from the effects of last year's currency devaluation, is still struggling to birth all its anticipated deals. A series of delays in securing financing for greenfield power projects is the principal catch, and lenders are playing cautious. Part of the reason lies in underdeveloped capital markets, which lack the full armory of project instruments. Accordingly, Brazilian deals have typically taken on a heavily multilateral and development bank tint.

One of the most vocal lenders, involved in almost all domestic projects, has been the Brazilian state owned bank, Banco Nacional de Desenvolvimento Economico e Social (BNDES). According to many commercial bankers, BNDES has been pivotal in facilitating Brazilian projects, with its long term provision of Real denominated debt.

As important, though, are players such as the IFC, OPIC and IDB. Multilaterals have been actively furnishing the Brazilian project market with direct financing and helpful, diversely flavored guarantees, thereby easing the pressure on the more anxious, or risk-averse, private lenders.

Hydro projects have been the most conspicuously listless of Brazil's drawing-board power projects, a fact put down to complex procurement laws and environmental diligence demands. And the country's numerous gas projects, it seems, are still waiting for full market recovery, given the as yet prohibitively high cost, post Real devaluation.

Despite this hydropower ambivalence, a few notable projects are flooding the market with at least a measure of reassurance. This August, the IDB approved the \$160.2 million financing for Tractebel's 450MW hydroelectric Cana Brava project. The project, located 250km north of Brasilia, is owned by Companhia Energetica Meridional, in turn wholly owned by Centrais Geradoras do Sul do Brasil (Gerasul), Tractebel's domestic subsidiary.

Having flirted with several privatization bids in the late nineties, Tractebel made its first firm move, winning the Cana Brava bid, followed by the \$800 million acquisition of the formerly state-owned Gerasul, in 1998. Tractebel owns 70.5% of Gerasul's total capital, though its recent plans for a \$265 million tender offer for the remaining 29.5% are, according to one Tractebel executive, currently on hold.

With Gerasul comes a generating portfolio of 2,724MW in hydro assets, 1,075MW in thermal assets, and an additional 3,430MW, including Cana Brava, in construction. The pending projects call for an estimated investment by Tractebel of around R\$714 million.

Cana Brava, one of the first project financed IPPs in Brazil, fits nicely into the government's 10 year expansion plan. Its situation in the north is significant, as the region has been generally less successful in charming private investment.

“Although energy sector growth has been limited by the recent currency devaluation,” says Gerasul's Chairman, Mauricio Bahr, “Cana Brava is just one example that large scale project financings can get done, and that Gerasul is wholly committed to seeing through their completion.”

Financing for the hydro plant includes an IDB chunk, comprising a \$75 million A loan, and a successfully syndicated \$85.2 million B loan. R180 million in debt is also being serviced by BNDES. 30% of the cost, \$150 million, is being tended by Tractebel-shaped equity. Lead participant banks are ANZ, Fortis and Dresdner, all of whom will sell on their commitments to the international market. Financial close is expected by the end of 2000.

As persuasive is Gerasul's latest play in southern Brazil ? the construction of the 1,450MW Ita hydroelectric project. The plant sits imposingly on the Uruguay river, on the border between the states of Rio Grande do Sul and Santa Catarina. Its late October inauguration, much ahead of financial close, spells the birth of a project that has been gestating in various positions for over three decades.

Financing consists of a \$165million IDB term loan split between a \$75 million A loan and a \$90 million B loan. Additional funding will allegedly include BNDES bridge financing and another dose of sponsor equity. As with Cana Brava, financial close is expected by the end of 2000.

But further financing issues pose potential concerns for lenders and sponsors alike. Often cited is that fact that the Brazilian government is unwilling to link electricity tariffs to dollar pricing. Frozen in nominal terms, tariff rates have effectively been cut by one third. The vagaries of real-denominated revenues have teased away some prospective investors. Tractebel's Franchimont, however, remains buoyant: “in the long term, it's reasonable to expect the dollarization of the sector, whether or not it is explicitly stated.” He explains that the trend will be to restore the distribution margin according to an equivalent dollar margin. As for Cana Brava and Ita, he continues, “since they were hydro developments, most of the costs did not have foreign components, so the lack of indexation was not a problem.” Nonetheless, “even if there still remains some reluctance to link tariffs, it is starting to happen.”

Indeed, the regulatory framework is changing fast, with the institution of rules for a more competitive market, including fuller adoption of spot prices.

As for future deal structuring, Franchimont suggests an ever-refined tool box. Securitization, for example, though not yet a technique applied to any Tractebel transaction in the continent, is nevertheless "one we'd very much like to consider," he says. In fact, he adds, it is a move currently being considered for one of the company's Brazilian projects. But, of course, the nature and magnitude of risk is particularly high in Latin America, so any kind of securitization scheme is much more difficult to implement. The company is, however, "willing to look at that structure to the extent that it will help us finance our projects profitably."

Multilateral and ECA financing will naturally serve the bulk of power deals for the next few years, given the impossibility of securing, say, uncovered international debt. But local banking appetite is growing. With an improved economic climate, and favorable changes in the regulatory environment, Brazilian banks lately have experienced some plump loan growth. This, in turn, may feed their willingness to look to medium term financing, and the extension of more local tenors for project finance deals.

Brazil's energy mix is dominantly hydro, at 95%. Speculating assuredly on future Brazilian power progress, Bahr maintains that "the trend will be growth on the thermal side, with gas coming on line from Bolivia. Cogeneration will comprise a sizeable portion of that mix soon." As for Tractebel strategy, Bahr explains that "we shouldn't forget consumers are also in this changing market - they're starting to understand what it means to be in an open market." In other words, the ever more pressing need, for companies, to develop the tools to sell.

Situated firmly in Tractebel's (and Gerasul's) immediate future is the construction of the 1,140MW Machadinho plant, along with the 350MW Jacui plant, and a 40MW expansion of its William Aronja project.

Other interesting developments include the possibility of Spanish company Endesa's divestiture of its Brazilian distribution assets which, in light of Tractebel's current marketing efforts, is, as Franchimont puts, "naturally something we would consider." This prospect, however, is far from certain.

Proposed privatizations also linger temptingly, despite some setbacks. The country's privatization program faltered recently after all pre-qualified investors withdrew their bids for a controlling stake in Companhia Energetica de Sao Paulo, or CESP Parana, Brazil's third largest power generator. Tractebel did not bid. But Duke, AES, Southern Energy, EDP, Endesa and EDF were all interested bidders in the sale - until, that is, issues such as financial guarantees, CESP's short term debt, and the price of the sale (at R\$1.74 billion, possibly too high) apparently halted the process. But the sale, one of the last chances for developers to acquire a hefty stake in this fast growing market, is still likely to retain appeal. And when it happens, it may also further inspire the country's banking and electricity sectors, thereby commanding fresh cash and, as significantly, yet more possibilities for Tractebel and its kin.

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