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MCC INTERVIEW: Steven P. Otillar & Dino Barajas / Akin Gump Strauss Hauer & Feld LLP

Latin America Power Drive

Projects abound as energy players near and far pitch for a piece of fast-changing markets

Latin American energy markets are a source of tremendous opportunity, and no small amount of complexity, for international project developers and investors. The Mexican hydrocarbon and electricity markets have burst open after generations of government control, and wind, solar and hydro projects are in play across the region. That makes this a perfect time for MCC to check in with ***Akin Gump*** *partners* ***Steven Otillar*** *and* ***Dino Barajas****, longtime players in a wide range of energy projects across Latin America. Their remarks have been edited for length and style.*

For any energy company with a global focus, Latin America is a key piece for any energy portfolio.
– Steven P. Otillar

MCC: By most accounts, Latin America is undergoing a profound transition to renewable energy despite possessing significant traditional energy assets. What is driving the sector's growth, and what has it meant for your practices?

Barajas: Depending on the jurisdiction, that statement probably holds true in terms of the region's hydrocarbon resources. It's true for Mexico, where there's a lot of natural gas associated with their oil discoveries in the gulf. Prior to the mid-1990s, Pemex, the Mexican state-owned petroleum company, flared much of the gas. In the early 1990s, the secretary of energy decided to use the gas in newly developed power plants, rather than importing gas from the U.S., as Mexico had done for years. It launched a successful private investment program to encourage development of independent power projects to diversify the generation portfolio.

In Central America, you don't have a lot of fossil fuels indigenous to the region. A number of Central American countries are striving for energy independence by utilizing naturally occurring renewable energy resources, such as geothermal in Nicaragua and wind, solar and hydro in Honduras, El Salvador and Panama. Brazil, by contrast, is blessed with both fossil fuels and renewable energy resources. It has developed a sophisticated system of hydroelectric plants that supply around 97 percent of the power for the entire country. We closed a deal in Brazil for Canadian Solar, a firm client, for a 191-megawatt solar development as part of an effort to diversify the country's generation portfolio. In countries such as Chile, you have plentiful coal, but you won't find a lot of oil and gas, so they've tried to develop solar and wind to gain more energy independence, diversify their generation portfolio and help the environment.

Otillar: More than 53 percent of power in Latin America is generated by renewable energy sources. The worldwide average is 22 percent. Alluding to what Dino mentioned, however, most of that is hydro. When it comes to wind, solar and geothermal, Latin America has about 2 percent production, whereas the worldwide average is 6 percent. That means that there is still significant room for growth in a variety of renewable energy sources.

As to your question, I don't know if it's a profound transition to renewable energy as opposed to continued growth of renewable energy overall. With respect to my practice, in Brazil during the 1990s, when it stopped raining, they needed base-load power resources, and they turned to natural gas-fired assets. As power prices increased with the price of natural gas, there was substantial resistance from consumers, especially when hydro power was comparatively less expensive on a per-megawatt basis. When hydrocarbon energy prices spike, governments respond by trying to incentivize renewable development. A lot of our clients, whether they're financing, building or developing these projects, see a fair amount of opportunity when local governments endeavor to provide relatively clean and cheap power to their citizens.

MCC: Renewable energy investment in the region from China has received attention, but the energy interdependence of the U.S. and the region's countries seems at least as noteworthy. Some say that the new administration's policies could threaten that interdependence. How do you counsel investors and project developers regarding that uncertainty?

Otillar: We've seen a tremendous amount of activity by Chinese companies in Latin America. For example, China controls more than 75 percent of the oil produced in Ecuador. Typically with Chinese investment comes an obligation to use Chinese contractors and/or Chinese equipment. A number of our clients, and some of these countries, have wanted alternatives. Although the current administration seems to have created friction in the media between some Latin American countries and the U.S., I think the relationships are going to continue to thrive, particularly between the U.S. and Mexico. We're closely tied. Mexico is dwarfed by China in terms of export-import imbalances. With respect to Texas, depending on the source, 30 to 40 percent of natural gas prices are supported by exports to Mexico. Business ties such as these are too substantial to be completely eliminated overnight. Friction can, and will, delay project development; however, we continue to advise our clients on how to manage those inherent risks by taking a longer-term view and mitigating risks as much as possible from a contractual standpoint. The investment community has shown that it is willing to move from jurisdiction to jurisdiction to have the most favorable legal, commercial environment.

Every region in the world sees attractive energy development opportunities in Latin America, for oil in particular. It's a fungible commodity. If you produce a molecule of oil in Ecuador, you can use that in a variety of refineries around the world. In addition, a global market is developing with liquefied natural gas and the ability to transport and trade such LNG around the world. Lower prices and the fungibility of these products engender competition. For any energy company with a global focus, Latin America is a key piece for any energy portfolio.

Barajas: The Trump administration's public stance on immigration has awakened concerns in local Latin American economies about continuing to build on existing trade ties with the U.S. The uncertainty from the U.S. has led a number of Latin American governments, including Mexico and Chile, to turn to China and other trading partners. They're wary of dependence on their trade relations with the U.S., which has become a less stable trading partner. You're seeing a large number of China/Latin America trade missions across sectors, whether that's mining, energy, automotive or consumer products. Chinese companies are trying to expand their market share, and the Latin American governments welcome that. For Latin American companies, Asian markets, and perhaps the European markets, can become larger target export markets. That's going to be the trend for the next four years as everything gets realigned.

In terms of renewable energy, the new administration's policies favoring fossil fuels could challenge renewable development in the U.S. That means that a number of U.S. renewable energy developers may have to look to Latin America and other markets for opportunities. We've already seen that in the wind and solar spaces. Developers in the past simply looked to the U.S. as their main source of business, given the volume of domestic renewable energy development. You saw some very astute clients, however, develop a Latin America strategy earlier on and look to Latin America as a new frontier at the same time that a number of Latin American governments were trying to promote renewable energy development to provide for their own energy security. Now, it's either adapt or perish. Currently, all developers have to look to Latin America and move their business in that direction, or the businesses will suffer greatly.

I don't think anyone could have imagined that the Mexican market would have opened up as much as it has, and as quickly as it has. It's historic.
– Dino Barajas

Otillar: Nature abhors a vacuum. On the hydrocarbon side, the Chinese have been in Latin America for quite some time. We've seen some movement back recently to European- and U.S.-backed interests; however, if the U.S. continues to turn inward, maybe that trend is going to stop, and Chinese investment will come back into favor.

MCC: Some observers say that continued growth in private-sector investment in renewables could be threatened by the region's lack of legal frameworks and appropriate regulation. Is this a genuine concern? How does the state of the legal and business infrastructure in the region affect your work?

Barajas: The region as a whole is trending toward the development of policies favoring renewable energy. In terms of legal regimes, it's jurisdiction-dependent. Mexico, for example, has a well-defined private-sector push toward development of power plant assets, including renewable energy. Certain countries in Central America have developed incentive structures to promote renewable energy. The one concern that all developers have is change-of-law risk. As administrations change hands, the new administration may want to continue the promotion of renewable energy or, having reached an optimal level of renewal energy development, want to move back to promoting fossil fuels. In smaller jurisdictions with limited overall demand, you can only have so much solar and wind before you jeopardize how the overall grid functions because of the intermittent nature of power production. Grid operators and the ministries of energy are starting to see that there are challenges with moving too far into a renewable energy portfolio – that you need a balance of fossil fuels as part of the overall energy mix.

MCC: Hydroelectric power has long been a major energy source in Brazil and some other jurisdictions, and there are an array of other energy sources generating interest across the region. Where do you see the most interest, and what are the barriers to progress?

Otillar: We've seen a lot of hydroelectric in Brazil, even when the market opened up for hydrocarbons in the mid-1990s. We have worked on run-of-river projects, but most renewable investment has been in solar and wind. But in terms of generating interest among operators, interestingly enough there's been a movement away from tax incentives and things of that nature to incentivizing renewable power development without subsidies. Chile, Brazil, Mexico, Argentina – all focus more on auctions for renewable energy, where bidders submit the price at which they are willing to sell power. That has been very successful. For example, in Mexico, the government has had tremendous success in auctions with very low renewable energy prices with implied rates of return below 10 percent. This is great for the country, but not sustainable long-term for investors, as such returns are extremely low for an emerging market developer. The larger countries are generating a fair amount of interest from larger, industrial-scale renewable projects, which leads the smaller players to move to more challenging jurisdictions that can offer higher rates of return.

Barajas: A number of the hydro resources have already been developed. Brazil may be the gold standard; it has one of the most sophisticated hydro systems in the world. They've put a dam everywhere one can put a dam and have maximized the efficiency of the overall system. In other jurisdictions, one of the challenges is the environmental and social impact of hydro. If a country has good hydro resources, as we've seen in Mexico and Guatemala, they will do large hydro developments. I worked on a hydro project in Guatemala called Xacbal, a very successful 94-megawatt development. The sponsor was able to develop it on a merchant basis, which was unheard-of then, and the financing was probably one of the most sophisticated up to that point.

You're going to see wind and solar outpace hydro, simply because the technologies are newer in the region. Solar likely will outpace wind, which needs to be much larger to be competitive, thanks to the costs of prepping for construction. Solar development can be much more modular, so you can start with a development as small as five megawatts and still be cost-competitive. It's becoming a trend to see solar equipment prices set record lows every year, as has been the case in El Salvador, Panama, Mexico and Chile.

Regardless of the technology, clients must be cognizant of environmental and social impacts, especially in dealing with indigenous communities. That's critical. Make sure that you put together a team that isn't learning on the fly but has done development work in that jurisdiction. Whether the past experience was a fossil fuel or pipeline project, you can bring those lessons to bear on renewable energy projects.

MCC: Brazil is widely seen as the regional leader in developing clean energy, despite its well-publicized economic and political challenges. What's the state of investment in renewables in Brazil today, and are conditions improving?

Barajas: I'm not sure I totally agree with the premise that they are the leaders in renewable energy. They're definitely the leaders if you consider large-scale hydro as renewable energy, but if you're looking at wind and solar, you're going to see much more penetration in other jurisdictions.

One of the challenges that wind and solar developers have in Brazil has to do with local content requirements. Unless you have a project large enough to justify building factories and meeting national content requirements, you're going to be challenged. Everything is bigger in Brazil. It has to be a larger-scale project to be cost-competitive, given the overall demand for energy and the need to compete with hydro. In order to develop new large-scale wind or solar projects in Brazil, you have to be very comfortable with where you believe the market is going before making any bets. In other jurisdictions, you can take smaller steps and still be competitive. It's much easier to look at a project in Central America, learn the local regulations and compete on more even footing than making a bet-the-farm investment decision on large-scale projects in Brazil.

Otillar: I can speak to the oil and gas sector. After the Cardozo administration, the Brazilian government became much more nationalistic in its approach to oil and gas, and investment fled the country. On the other hand, countries such as Colombia, and most recently Mexico and now Argentina, have garnered a lot of interest and foreign investment dollars by creating investment regimes focused on increasing direct foreign investment. While the current Petrobras "Carwash" scandal is painful for everyone involved, Brazil should emerge as a more robust investment destination, with a stronger focus on the rule of law. Legal certainty and a stronger compliance culture will lead to lower political risk and greater investment. Brazil recently announced several new oil and gas bid rounds in an effort to bring investors back to the country. It's an interesting dynamic – not an arms race per se, but certainly a recognized competition between Latin American jurisdictions vying for foreign investment dollars. Host governments are realizing that it is not just about putting together bid rounds that make sense from your own country's perspective; they realize that they are competing with other countries in the region for investment dollars.

MCC: Mexico's deep-water auction, along with Pemex's decision to farm out development of the Trion deep-water field, has piqued the interest of investors. What, if anything, is Mexico doing to further incentivize energy investments?

Otillar: I was lucky enough to work with the government of Mexico for several years as it developed its initial bid rounds in the oil and gas space. Trion is very interesting. It was the first so-called farm-out by PEMEX, the Mexican national oil company. As a result of the way that the constitution and subsequent legislation was drafted, PEMEX has to have public auctions to select their oil and gas partners. I was at the opening of bids in December, and it was amazing to see the participants and feel the energy in the room. By all accounts, both Trion and the other deepwater auctions were a success and brought in a number of world-class operators into the Mexican market.

We need to understand that PEMEX is one of the global leaders in shallow-water oil and gas development. However, deep-water development is probably just as challenging as going to the moon. PEMEX needed assistance, and now BHP Billiton will provide it as the operator in the Trion block. Round 2 is already underway in Mexico, and winners from earlier awards in Round 1 are already drilling and developing their prospects, with some interesting announcements coming soon. Mexico has put out a sign in the energy industry that clearly states that they are "open for business," and not just in the oil and gas sector. We already mentioned the power auctions, and the midstream sector has opened up as well. It is an amazing opportunity – a complete opening of an energy sector that has been a government-controlled monopoly for more than most of our lifetimes.

Barajas: Mexico, to its credit, has provided a very flexible investment environment to the private sector. Companies can go in by themselves and bid these projects, or do it in a joint venture with Pemex or another of the local players. That's allowed foreign players that have been looking at the market for years to get very comfortable quickly. I don't think anyone could have imagined that the market would have opened up as much as it has, and as quickly as it has. That's historic, and something that other governments could look at. Mexico has gone above and beyond in making the process transparent, getting the word out and bringing in as much competition (local and international) as possible.

MCC: You have each worked on significant projects in many countries. What is the single most unusual legal and/or business challenge you've confronted, and how did you overcome it?

Barajas: A lot of these projects are the first of their kind in the jurisdiction, such as the first project financing in Nicaragua with the Polaris project, a large geothermal deal. You end up cutting things out of whole cloth because there isn't any precedent. It's important not to come with a U.S.- or U.K.-focused model and think that you're going to impose the standards from your jurisdiction on the local market. It's important to see what's happened in the region. For example, explain your experiences of how things have been done in Colombia from other deals and analogize those examples to what you're trying to do in Brazil or Mexico. Taking lessons learned from neighboring countries as opposed to thinking that every solution has to have a U.S.-based precedent probably has been the most challenging. It's also been the most rewarding, because when you move on to the next project of first impression in another jurisdiction or sector, you at least know that you've been able to do it before.

Otillar: The most rewarding opportunity was to work with Mexico on their energy reform. The most unusual was working with the Bureau of Public Enterprises in Nigeria to improve the efficiency of their port system by incentivizing foreign participation. The port authority didn't know what they had – what they owned or what contracts were in place – which made it fantastically difficult. We overcame those obstacles by spending a lot of time in Lagos and Abuja in Nigeria interviewing people, conducting due diligence and looking at documents. Some of our projects are so challenging that it is not possible to do it all over the phone or on the computer. You have to look people in the eye, shake their hands and work face-to-face. That's a big part of what Dino and I do. Working on a project in an emerging market with an investor that can make an acceptable rate of return, where you also can make things a little better in the host country, can be wonderfully rewarding.

Barajas: To echo Steve's point, I like thinking that even though I'm doing what I do in a corporate setting, the infrastructure projects that we're working on benefit, on a long-term basis, the local population. They make that jurisdiction much more cost-competitive on the world stage for local products exported internationally. It's nice to see some of these jurisdictions later going head-to-head with other jurisdictions that have been world leaders in automobiles or whatever is being exported. By helping to build power plants, pipelines and other types of public services, you're improving the livelihoods and lifestyles of the people living there.

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