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HIGHLIGHTS

Latin American Energy Markets for 2011: Argentina and Peru

The second in a series provides an overview of developments in the energy sector for Argentina and Peru. *Page 3*

Obama Seeks to Promote Trade and Economic Ties with Brazil

In March US President Barack Obama visited Brazil as part of an effort by the US Administration to engage with the new government of President Rousseff in order to pursue economic opportunities. During the visit a number of agreements were signed including a Trade and Economic Cooperation Agreement. *Page 10*

Brazil Antitrust Rulings on Acquisition of Minority Shares

The Brazilian antitrust authorities have recently turned their attention to transactions involving acquisition of minority participation. *Page 17*

Indo-LatAm Trade and Investment on the Upswing

Trade between India and Latin America could exceed $30 billion by 2012. India's recent lowering of tariffs and other trade barriers, and its growing number of trade pacts with Latin American countries has begun a trend that can potentially boost the flow of goods and services between these regions. *Page 23*

Mexico to Award Up to 20 Oil Blocks

The number of oil fields operated by private companies in Mexico will jump by the end of 2012 as state oil monopoly Pemex speeds up the unwinding of a seven-decade ban on private investment. *Page 21*

CONTENTS

Contents ***Continued on Page 2***

Contents, *Continued from Page 1*

LATIN AMERICAN Law & Business Report

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Latin American Energy Markets for 2011 – Argentina and Peru

By Larry B. Pascal (Haynes and Boone, LLP)

Introduction

This is the second in a series of articles providing an overview of developments in the energy sector in Latin America. In this article, we look at Argentina and Peru.

Argentina

Background on Oil and Gas Sector

When Argentina passed the Emergency Law in December 2001 revoking its currency board/convertibility policy, the resulting devaluation of the Argentine Peso and subsequent measures to control the price of natural gas prompted an abrupt and significant reduction in new investments in the oil and gas sector, while at the same time generating an increase in the industrial and domestic market demand for gas. Argentina's 2001-2002 economic crisis (and the measures taken to deal with it) affected the historically successful oil and gas industry in a particularly severe way. The situation has also been aggravated by the artificially low price of gas established by law, which led many Argentine industries to move from fuel oil to gas, driving up dramatically the demand for gas, which in turn caused other strains. Gas power plants also contributed to such increase. As discussed below, by 2010, Argentina had changed from being an exporter to an importer of natural gas – a product more of policy than geology.

Second Generation Reforms

In February 2004, the Argentine government passed a number of amendments to this legal framework, issuing Executive Decrees Nos. 180/04 and 181/04, in an attempt to solve the critical situation described above and to encourage gas producers to make new investments in the upstream gas sector. The so-called "Second Generation Reforms" introduced important changes to the legal framework, such as abandoning the principle of uniform prices for all gas customers, resulting in a marked price distinction between consumers and large industrial concerns for these two market segments (with consumers paying a lower price).

Subsequently, the government issued additional regulations, including National Energy Secretariat's Resolution No. 265 that suspended certain authorized exports of natural gas in order to meet domestic demand.

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In May 2005, the National Energy Secretariat issued Resolution No. 752, which supplemented Decrees Nos. 180/04 and 181/04, and modified, but did not eliminate, price controls on gas. It also established a mechanism for bypassing distributors whereby certain categories of large consumers (i.e. those having an average monthly consumption of more than 9,000 cubic meters) could directly purchase natural gas at the injection point of the transportation system from producers. Large industries have been purchasing natural gas from producers at prices in US dollars with the market divided into four segments - industrial, power plants, residential users, and vehicles using compressed natural gas.

Third Generation of Reforms

In March 2008, the Argentine Government issued Resolution No. 24/2008, creating the "Gas Plus" Program, to provide an incentive to explore and develop gas reserves, by reducing re-sale restrictions for eligible companies. Then, in January 2010, Resolution No. 695 / 2009, issued by the National Energy Secretariat, modified the "Gas Plus" Program. The amendments broadened the circumstances under which projects could be classified as Gas Plus Program. By 2010, the National

Latin American Energy Markets, Continued on page 4

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Latin American Energy Markets (from page 3)

Energy Secretariat had already approved thirty-nine (39) projects under the Gas Plus Program. Moreover, shale gas production is expected to grow in 2011 and such growth may create opportunities for new investments in Argentine gas areas, particularly for service companies with shale gas know-how. Due to the Gas Plus Program, Argentina became the first country in South America to apply new technology in finding unconventional gas. To this effect, YPF has announced that it has invested approximately US$ 10 million in the drilling of its first shale gas well in Argentina, which is located in the Loma la Lata Field in Neuquen.

In addition, several programs were implemented by the National Government to address the high demand of gas in the domestic market with the goal to eventually reduce such demand. To this effect, the Ministry of Federal Planning and Public Investments and Services (MINPLAN) introduced the so-called "Energía Total" Program pursuant to Resolution No. 459/2007 to encourage large industries (via the offering of subsidies) to replace their natural gas or electricity consumption with alternative resources.[1]

Under Decree No. 2014/2008 issued by the Executive Branch, the National Government has also created the so-called "Petroleo Plus" and "Refinería Plus" Programs aimed at promoting fuel production via the increase of oil production, the construction of new oil refineries, and/or the expansion of the refining capacity at existing plants. The National Energy Secretariat has regulated the requirements to be met by creating producing and/or refining companies in order to receive the incentives, which take the form of transferable tax credit certificates applicable to the payment of export duties for Liquid Hydrocarbons (i.e. crude oil and by-products such as natural gas and liquefied petroleum gas). In order to receive these incentive payments, the applicant is required to provide evidence of an increase in available oil or fuel production.

The "Gas Plus," "Petroleo Plus," and "Refinería Plus" Programs, along with the LNG import transactions, are considered part of the "Third Generation Reforms."

Finally, Argentina still maintains an export tax on liquid hydrocarbons (oil and by-products), whereby the export tax increases as the international market prices go up.[2] This was a measure adopted to encourage producers to sell to the local market, notwithstanding the higher international price.[3]

Electronic Gas Market

As a part of the "Second Generation Reforms," Decree No. 180/04 created the Electronic Gas Market ("EGM"), by which all spot gas supply and its respective transportation capacity are marketed. The EGM was subsequently launched in September 2005 and via a standardized irrevocable offer mechanism, direct customers have an opportunity to purchase gas from producers on a term basis offered by the EGM. Under the EGM, customers purchase gas by filing a standardized irrevocable offer to purchase the requested quantity of natural gas. If ten (10) days elapse without acceptance of the offer, then the National Energy Secretariat is required to assign the offer to a producer.

In 2006 and 2007, the EGM was the preferred marketplace whereby buyers and sellers of natural gas met to close operations. However, currently, very few gas contracts are offered in the EGM due to the current market condition, as parties are opting for longer term arrangements rather than spot market contracts.

Several programs were implemented by the National Government to address the high demand of gas in the domestic market with the goal to eventually reduce such demand.

Increasing Need for Gas Imports

In 2006, Argentina and Bolivia executed a long-term supply agreement, which contemplates Bolivia selling gas to Argentina at two and a half times the local gas price in Argentina.[4] In addition, in October 2006, the two countries signed an energy integration agreement, which contemplates the construction of a new northeast gas pipeline ("Gasoducto del Noroeste" or Northeast Pipeline) to be commenced in June 2007. As described in preliminary publications, the Northeast Pipeline was designed to facilitate the transportation of the Bolivian natural gas contemplated under the long-term supply agreement.[5] In mid 2010, per National Decree No. 1136/2010, the Argentine Government established a new route for the pipeline to the effect that the gas pipeline will now pass through the provinces of Salta, Formosa, Chaco, Corrientes, Misiones, and Santa Fe. However, the nationalization of the Bolivian oil and gas sector adversely affected the production of natural gas and this development impacted shipments to Argentina. For example, during the winter of 2010, Argentina imported from Bolivia an average of 5.91 MMm3/d of natural gas, notwithstanding that under the long-term supply agreement Bolivia committed to deliver 27.7 MMm3/d to Argentina.

As a result, and due to the high demand,[6] Argentina was forced to import LNG,[7] which in turn was re-liquidized in a mobile plant for injection into the transportation system to satisfy greater gas demand in Argentina. This interim project, managed by ENARSA, has grown, and has taken on a more permanent nature, with shipments expanding each year from eight shipments in 2008 to fourteen shipments in 2010. Specifically, during the second half of July and the first week of August 2010, the imported volume increased to 9.2 MMm3/d of an overall demand of 128.14 MMm3/d on average.

The Argentine power system is highly dependent on natural gas and to this effect currently near one-third of the natural gas demand is consumed by power plants.

Finally, the Argentine Government also announced the construction of two re-liquefaction plants with possible locations in Bahia Blanca, Punta Alta, Buenos Aires, located near the mobile re-liquefaction plant, and in Campana, located 70 km from the city of Buenos Aires.

ENARSA

In response to the growing foreign control of the Argentine oil and gas sector, in late 2004, the government formed a new state-owned oil and gas company, Energía Argentina Sociedad Anónima ("ENARSA") so that the government could play a more significant role in the sector and foster exploration and production activities in offshore basins where it holds seventy-two (72) blocks, particularly by potential joint ventures with other national oil companies from the region. For example, as mentioned above, ENARSA successfully led the LNG importation program.

Also, during the second half of 2008, ENARSA finalized its seismic campaign that involved a seismic investigation of the maritime surface from the Buenos Aires to the Tierra del Fuego coasts. ENARSA subsequently issued an international exploration and exploitation invitation to bid for the concession of licenses for offshore blocks. However, the bid was unsuccessful and was cancelled. ENARSA is now working on improving the commercial terms of the bid in order to attract investors and an offshore second round may be launched 2011. In particular, a small number of blocks have a critical location due to their proximity to the Malvinas Islands (Falkland Islands).

In 2009, ENARSA initiated its part of the Argentine effort to diversify the energy system by launching an international bid for the supply of electricity using renewable sources of energy. The bid was successful and ENARSA awarded power purchase agreements as follows: 754 MW from wind energy, 110.4 MW from biodiesel thermal plants, 10.6 MW from small hydro-electrical plants, and 20 MW from solar energy.

Promoting Exploration and Production Activities—Opportunities in the Provinces

In November 2006, in an attempt to develop oil and gas reserves, the Argentine Congress passed a law creating the "Promotional System for Hydrocarbon Exploration and Exploitation."[8] This law created a number of tax benefits for eligible companies (e.g. exemptions from or reductions in duties, income tax, etc.). However, to obtain these benefits, oil and gas companies must enter into association agreements with ENARSA. This promotional system still requires supplementary regulations to attract prospective partners for ENARSA.

Subsequently, during the summer of 2008, Law No. 26,197, known as the "Short Law" due to its length, was enacted by the National Congress, resolving the constitutional issue as to the ownership of hydrocarbons. To this effect, the Short Law confers the power to grant exploration permits and exploitation concessions to the provinces or the National Government, depending on the location of the blocks, for liquid and gaseous hydrocarbons.

The Argentine power system is highly dependent on natural gas and to this effect currently near one-third of the natural gas demand is consumed by power plants.

The Short Law introduces a substantial change to section 1 of Hydrocarbons Law No. 17,319, and although the Hydrocarbons Law remains in effect and, in particular, a part of the regulatory framework currently governing existing concessions granted by the National Government, it clearly acknowledges the provinces' right to grant concessions in the future.

To this effect, the provinces are allowed to exercise ownership over the hydrocarbons, thereby gaining a new role in the sector. Most of the concessions granted by the National Government will expire in approximately nine (9) years, and, the Short Law introduced new opportunities in terms of public bids. Nevertheless, a small segment of the exploration and production industry is still negotiating the extension of such concessions. In contrast, a large majority of the industry has already extended and finalized its concession with the relevant provincial governments. Although national energy policies are within the scope of the National Congress, this new role of the provinces could give rise to new business opportunities for investors, as provinces begin to call for new bids.

As discussed below, a large number of provinces have created their own oil and gas companies. These companies were all granted non-awarded oil and gas areas. Such province owned companies are now launching more rounds of international bids, which could prove attractive, if companies can avail themselves of the new government incentive programs such as Gas Plus and Petroleo Plus when a respective discovery is confirmed.

Latin American Energy Markets, Continued on page 6

Latin American Energy Markets (from page 5)

Table 1 – Peruvian Hydrocarbon Investment Opportunities

Project Name	Location	Description	Total Investment	Sponsors/Status
Exploration Projects (confirmed reserves)				
Block 39 – Perenco	Northern jungle	Heavy crude exploration; construction of local pipelines and storage facilities; contains approximately 100-120 million barrels of oil equivalent; daily production estimated to be 21 thousand barrels.	US$ 530 million	Sponsors: Repsol YPF (55%), Burlington (35%), Reliance Industries (10%). Production estimated to commence in 2012.
Block 67 – Perenco	Northern jungle	Heavy crude exploration; extraction facilities, construction of processing and handling facilities and pipeline; contains estimated 300 million barrels of oil; daily production estimated to be 100 thousand barrels.	US$ 1.5 billion	Sponsor: Perenco (100%). Construction of pipeline to commence 2011. Production estimated to commence in 2013.
Block 57 – Repsol/Petrobras	Central jungle	Natural gas exploration; construction of transportation and storage facilities; contains approximately 2 trillion cubic feet of natural gas.	US$160 million (estimated)	Sponsors: Repsol YPF (54%) and Petrobras (46%). Tender process available in June 2010.
Block 58 - Petrobras	Southern jungle	Natural gas exploration.	US$50 million	Exploration began in June 2010.
Expansion Projects				
Las Malvinas Separation Plant – Camisea (gas)	Southern jungle	Expansion of separation plant capacity by 30%, from 1,220 mmcf/d to 1,590 mmcf/d. Expansion of fractionation plant from 85 thousand barrels per day to 110 thousand barrels per day.	US$380 million	Camisea Consortium: Pluspetrol (27%), Hunt Oil (35%), SK Energy (18%), Tecpetrol (10%), Sonatrach (10%), and Repsol YPF (10%). Expansion to be completed in 2012.
Transportadora de Gas del Peru Dry Natural Gas Pipeline	Central mountains and central coast	Two stage expansion: 1. From 315 mmcf/d to 380 mmcf/d, by end of 2009. 2. 450 mmcf/d by end of 2010.	US$262 million	TGP Consortium: Techint (23%), Hunt Oil (22%), Sonatrach (21%), Pluspetrol (12%), SK Energy (11%), and Suez GDF (8%). Expansion in progress. Additional expansion being evaluated.
Calidda's Natural Gas Distribution Expansion	Lima and Callao	Expansion of distribution capacity from 255 mmcf/d to 540 mmcf/d.	US$280 million	Sponsor: Ashmore Energy International. Investment Plan submitted to authorities.
Ethanol Projects				
Maple Ethanol	Northern coast	11,975 hectares of land to grow sugarcane and distillery to produce ethanol. Capacity to produce 35 million gallons per year. Construction of 37MW power generation plant	US$222 million	Sponsor: Maple Energy. Commencement of power generation plant to begin in late 2011.

1. ***Neuquen*** –Neuquen has formed a state-owned company called GAS Y PETRÓLEO DEL NEUQUÉN S.A. ("G&P"). G&P holds title to 40 areas that are expected to be offered under a tender process. In 2009, G&P issued the first invitation for the selection of oil and gas companies that will associate with G&P. A second and third invitation were also successfully launched in 2010. At least one round is expected to be announced in 2011.

2. ***Salta's Onshore Opportunities*** – The provincially owned company RECURSOS ENERGÉTICOS Y MINEROS S.A. ("REMSA") holds the permits for all oil and gas areas that at the time of its creation had not been assigned. No public rounds are contemplated for the time being. But an interested party in an area may apply for an area under the "Private Initiative" mechanism (Law No. 6838 and Decree No. 805/1996). Six areas are still available for application under the Private Initiative mechanism: (i) East Tartagal Area; (ii) La Union Area; (iii) Malvalay Area; (iv) Morillo Area; (v) Chirete; and (vi) Hickmann Area.

3. ***Other Opportunities in Salta*** – REMSA's objective is to work with and provide incentives to the private sector in order to: (a) expand exploration and production of existing wells; (b) develop bio-diesel and bio-ethanol in the Province; (c) facilitate the use of natural gas in the industrial sector in the province, and (d) produce electricity from renewable source of energy.

4. ***Chubut*** – A bidding process has been launched by provincially owned company Petrominera S.E. of three onshore areas: (i) Nirihuau Sur; (ii) Río Guenguel Norte; and (iii) Colhué Huapi, as well as two offshore areas: (i) Norte San Jorge Marina 1 and (ii) San Jorge Marina.

5. ***Tierra del Fuego*** – The Province of Tierra del Fuego started in 2010 a tender process for the Area CA12 Río Grande Sur that is in its final stage. A new tender process is expected to be launched for the other five areas: (i) Castor; (ii) Tucán; (iii) Lince, (iv) Vela, and (v) Río Grande.

M&A Developments in the Argentine Energy Sector

In the area of M&A transactions, there have been two important transactions in recent years. First, in February 2008, the Spanish oil and gas company REPSOL sold a 14.9% interest in its important Argentine unit, RESPOL YPF, the largest oil and gas company in Argentina, to the Petersen Group from Argentina for US$2.235 billion. In addition, the transaction contemplates that the Petersen Group will be able to increase its interest up to 25% through the exercise of an option. The Petersen Group obtained financing from international banks and from Repsol YPF, the latter which loaned the buyer US$ 1.015 billion. In turn, the agreement provides that the Petersen Group will cause Repsol YPF to do an initial public offering of shares for about 20% of Repsol YPF, upon the closing of the exercise of the option.

More recently, in November 2010, BP announced that it was selling its 60% stake in Pan American Energy, the second largest oil and gas company in Argentina, to its 40% minority partner Bridas Corporation for US$ 7.06 billion. The sale is in keeping with BP's divestment plan stemming from the accident in the Gulf of Mexico.

Biodiesel thermal plants and other small segments remain eligible for new bidders. The National Law No. 26,093 established a biofuel element for all the fuels available for domestic demand. At this time, fuels must have at least 5% of ethanol and diesels oil must have at least 7% biodiesel. Also, some Argentine power plants are transforming their technology in order to use biofuel instead of natural gas, thus potentially broadening the biofuel market.

Peru

Overview

Since the early 2000s, Peru has experienced a period of political and social stability, and increased and sustained economic growth. Moreover, Peru's president, Alan García, has continued to apply the pro-growth economic policies established by his predecessors. Consequently, Peru's economy has been growing steadily for a decade with inflation at historically low rates. Private investment is at an all time high and reached US$ 22.4 billion in 2009. In addition, the World Bank has identified Peru as the top-ranked country in South America to do business in its "Doing Business" ranking for 2011.

As a testament to Peru's ongoing economic expansion, it has also entered into, and is currently negotiating, free trade agreements with different countries around the world. In 2006, the governments of Peru and the United States signed the United States-Peru Trade Promotion Agreement (the "PTPA"), a comprehensive free trade agreement. The PTPA entered into full force and effect in February 2009. One of its pillars is to eliminate trade barriers and allow foreign

Project Name	Location	Description	Total Investment	Sponsors/Status
Stratos del Peru Ethanol	Northern coast	Two phase project to produce ethanol: 1. First mill expansion from 750 tons of cane per day to 2,300 tons of cane per day, to produce 16 million gallons of ethanol per year. 2. Expansion to install 4 additional mills, to produce 180 million gallons of ethanol per year.	US$671 million	Sponsor: Stratos Renewables. First phase operative by end of 2010.
Petrochemical Projects				
Peru Nitrogen Complex – CF industries	Central coast	New plant to produce 3,330 tons of granulated urea per day and 2,100 tons of ammonia per day.	US$2 billion	Sponsor: CF Industries. Construction to begin by end 2010, commercial operations to commence by end 2013.
Nitratos del Peru	Central coast	New plant to produce 710,000 tons of ammonia per year and 350,000 tons of ammonium nitrate per year.	US$750 million	Sponsors: Grupo Brescia (51%) and Sigdo Koopers (40%). Commercial operations expected in 2013.
Orica Nitratos Peru	Central coast	New plant to produce 300,000 tons of ammonium nitrate per year.	US$500 million	Sponsor: Orica Limited. Construction to commence in 2011. Financing and equipment being sought.
New Pipelines				
South Andean Gas Pipeline (Kuntur Pipeline)	Southern Peru	Design, build, and operate a new 1,085 km gas pipeline from Camisea gas field to southern Peru. Minimum capacity of 400 mmcf/d.	US$1.2 billion	Sponsors: Conduit Capital Partners (49%) and Petrobras/ Odebrecht (51%). Conduit to sell its 49% stake.
Natural Gas Distribution for Ica	South-central coast.	Design, finance, construct, operation and maintenance of 2 pipeline branches: (a) 40 kms north to Pisco and Chincha, and (b) 240 kms south to Ica, Nazca, Marcona.	US$280 million	Sponsors: Empresa de Energia de Bogota and Transportadora de Gas del Interior. Commercial operations expected to begin 2011.

Latin American Energy Markets, Continued on page 8

Latin American Energy Markets (from page 7)

investment by US entities on the same terms and conditions as that made by domestic entities.

The government has maintained its commitment to attracting private investment, both from domestic and foreign sources. It has taken legal steps to partially privatize Petroperu, the state-owned oil company.[9] In February 2010, Petroperu listed 20% of its stock on the Lima stock exchange[10] to increase transparency and to obtain funds necessary for its projects from private sources. Additional steps were adopted in August 2010, with the promulgation of Legislative Decree 1031 and Supreme Decree 176-2010-EF setting forth the regulatory regime for such privatization.

As mentioned above, private investment in Peru in recent years has steadily increased. As of July 2010, investment in the hydrocarbons sector reached US$ 525.3 million, of which US$ 220.3 million has been used towards exploration and US$ 304.9 million towards exploitation. Additionally, private investment in the electricity sector is expected to reach US$ 1.7 billion in 2010.

The Peruvian government has also expressed its interest in promoting green energy with sound environmental principles. In addition, it is committed to securing energy sources from clean, reliable, and cost-efficient sources. Accordingly, the government has promulgated Legislative Decree 1002, which promotes the generation of electricity from renewable energy sources. As provided in such legislative decree, by 2013 at least 5% of electricity should be supplied from renewable sources, such as wind, solar, biomass, and hydro. In addition, this norm establishes a bidding process to ensure an adequate supply of energy based on market prices. In February 2010, the government held the successful first round of bidding. The government awarded in this bid two biomass projects, four solar projects, three wind projects, and seventeen hydro projects.

Oil and Gas Markets

Peru has proven oil and gas reserves. However, its oil production has decreased steadily since the late 1990's, while its natural gas production has increased during the last decade, particularly due to the Camisea natural gas project ("Camisea"). Camisea accounts for approximately 93% of Peru's natural gas reserves and 77% of its natural gas production.

In 2010, Peru LNG, the consortium operating Camisea,[11] reached commercial operation of the Melchorita plant, the first natural gas liquefaction plant in South America. Melchorita is located approximately 170 kilometers south of Lima, has a nameplate capacity of 4.4 million tons per year, can process up to 620 mmcfd of gas, and required a total investment of US$ 3.8 billion. The liquefaction plant also includes two LNG storage tanks and a maritime port to facilitate LNG exports.

Camisea not only serves as an important source of gas for Peru, but it serves as a testament to Peru's strong economic policies and investor confidence in the country. The project was primarily financed by the International Finance Corporation, the Inter-American Development Bank, and commercial banks. In addition, Peru LNG launched a successful US$ 200 million local bond offering to institutional investors.

As a consequence of Camisea, two LNG pipeline investment opportunities[12] are being considered by Proinversion, the Peruvian agency which promotes private investment ("Proinversion").

The first of these pipelines is designed to supply LNG from the south of Lima to Lima via a 250 kilometer pipeline. It is estimated that the pipeline will transport 1,000 tons of LNG per day. Proinversion projects a total investment of US$ 87 million, with a concession term of thirty years, plus thirty-six months for construction. It is expected that this project will be awarded during the second quarter of 2011.

The second project consists of the design, construction, operation, and maintenance of a pipeline for the transport of natural gas from the Camisea plant to the central mountain and northern coastal regions. Proinversion projects a total investment of US$ 1.3 billion, with a concession term of thirty years, plus forty-eight months for construction. It expected that this project will be awarded during the fourth quarter of 2011.

In addition to the Camisea-related projects, there are numerous other investment opportunities in hydrocarbons, as detailed in Table 1 (shown on pages 6 and 7). ❑

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1 See also Decree No. 2067/08 authorizing the formation of a trust fund for promoting the importation of natural gas under the Total Energy Program to assist the country with its supply needs.

2 See Ministry of Economy Resolution No. 394/2007.

3 For example, in January 2011, the domestic price for oil was approximately $52 / barrel, compared to an international price at that time of approximately $89 / barrel.

4 In 2010, pursuant to a twenty-year agreement, Argentina committed to purchasing 27.7 million cubic meters per day of gas from Bolivia.

5 The Northeast Pipeline will be operated by ENARSA. In December 2010, the Executive Branch authorized US$ 2.61 billion for the construction of the pipeline as part of its budgeting process.

6 From June until September 2008, Argentina sourced LNG from Trinidad and Tobago.

7 This arrangement proved expensive to Argentina, which paid a higher price for this gas.

8 Law No. 26,154, adopted as of November 9, 2006, will govern all national Exploration Licenses awarded under Hydrocarbon Law No. 17,319 or by the provinces, provided such licenses explicitly adhere to this system.

9 The plan is to allow Petroperu (the Peruvian national oil company) to have the flexibility of raising capital on the market.

10 Petroperu is registered with the Peruvian Securities Commission, but its shares are not yet traded and the Peruvian Government remains as the sole shareholder.

11 Peru LNG is the operator of the LNG facility. Camisea, the gas fields, are operated by a different consortium, PLNG, which consists of Hunt Oil, Repsol, SK Energy, and Marubeni.

12 The two projects are a gas pipeline to the North Coast and a natural gas liquids pipeline to Lima.

The Brazilian Law On Workers' Profit-Sharing Vs. The Argentine Bill

By Daniel Orlansky (Baker & McKenzie)

In the Republic of Argentina as well as in the Federative Republic of Brazil, workers' profit-sharing plans are constitutionally based.

Since December 2000, Brazilian law No. 10.101 has governed the ways in which workers can obtain a share of their employers' profits. This regime is substantially different from the bill proposed by Argentine Representative Recalde (the Argentine "Bill").

According to the Brazilian law, workers' profit sharing plans must be the subject matter of a negotiation between the company and its workers, either through a committee elected by the parties, formed by a representative appointed by its class trade union (negotiation with an internal committee) or by means of a collective agreement (collective bargaining).

In Brazil, there is no obligation to implement said plans. The inclusion of this benefit may be the result of successful bargaining. The Brazilian law only sets forth the minimum conditions which must be met in private agreements. The same must clearly state the nature and amount of the share as well as how it will be calculated and a method of data verification. The agreement must state the duration of said plan and whether an extension or renewal is necessary. The new agreement may establish conditions other than those mentioned above.

Among the criteria and conditions which must be established are the following: (a) the company's productivity, quality or profitability level; or (b) milestones and achievement-based schedules, within terms previously agreed to. That is to say, objective and verifiable criteria are required.

The Brazilian legal framework is so flexible that such agreement may include, without limitation, a percentage of the annual gross revenue, or a payment on condition that a certain minimum billing milestone is achieved, or different percentages as different billing milestones are achieved.

As these examples show, the parties have a wide scope of action to determine the mechanism and duration of the profit-sharing plan and also, to implement a new mechanism for said plan.

On the other hand, the Argentine Bill seeks to impose on all sectors, by law, a form of a profit-sharing plan (sharing of the annual net income subject to income tax payment) and a percentage (10%). The program is presented in the Bill as a single system (no other options may be established), general (it cannot be negotiated on a per-sector-basis) and permanent (it cannot be modified). In short, while the Brazilian system is based on the freedom of negotiation (it only sets forth minimum guidelines), the Argentine system is based on a legal imposition (it sets forth all the rules).

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For Brazilian companies, granting this kind of profit-sharing plan constitutes an incentive because the payment is tax-deductible by the company (the workers pay Income tax) and does not cause labor effects on vacations, compensation, the guarantee fund known as FGTS, or the employer's contributions.

The Local Needs

When the parties are allowed to establish the payment terms and conditions for a profit-sharing plan, the system becomes simpler. The Bill establishes the creation of a system of control to be carried out by the workers; said system raised objections from the employers, who are reluctant to its implementation. It further establishes the creation of a bureaucratic entity (the National Council of Workers' profit sharing plans), formed by Government, employers' and workers' representatives which are vested with broad powers to regulate and construe the law, as well as with jurisdictional powers (there may be a conflict between said powers and the AFIP'S authority to assess the profit amount).

It is a common need that payment of said plans does not impact on the costs of labor or affect remunerations. In both cases, it is worth mentioning that said payment may not be granted in lieu of the remuneration or benefit previously granted to the workers. In connection with payment periods, the Brazilian law sets forth that no advanced payments may be made for periods shorter than 6 months: There will not be more than two advance payments per year.

In Brazil, said payment is defined as a non-regular remuneration which does not impact on the costs of labor, while in the local Bill it is defined as a non-remunerative

The Brazilian Law, Continued on page 10

The Brazilian Law (from page 9)

consideration (therefore, it does not cause an impact on the costs of labor), but its non-remunerative nature is conceptually objectionable and has raised criticism in this regard.

For Brazilian companies, granting this kind of profit-sharing plan constitutes an incentive because said payments are tax-deductible by the company (the workers pay Income tax) and does not cause labor effects on vacations, compensation, the guarantee fund known as FGTS, or the employer's contributions. However, if the employer grants a plan which fails to meet the minimum conditions set forth by Law No. 10.101, said employer shall be subject to the conversion into remuneration of the payments made to its workers, and as such, all of employer's contributions shall apply. The mechanism intended to be implemented by the Argentine Bill does not constitute an incentive to employers, since payments made under these plans are not tax-deductible. They may only represent an incentive for workers in connection with the money the workers will receive, on which an exemption to the income tax is applicable.

In conclusion, we recommend that the Argentine Bill should take into account the benefits of the system implemented in Brazil, including the freedom of negotiation and the possibility of an optional system, the wide scope of action in order for the parties to execute and renegotiate the plan (design flexibility) and the purpose of providing an incentive to workers (by gaining benefits from the milestone achieved) and to the company (by permitting a tax deduction). ❑

BRAZIL

Obama Seeks to Reinforce Trade and Economic Ties with Brazil

By Justin Miller (White & Case LLP)

From March 19-21, 2011, US President Barack Obama visited Brazil, where he met with new Brazilian President Dilma Rousseff in an effort to promote greater commercial ties, investment and regional security. US Treasury Secretary Timothy Geithner, Commerce Secretary Gary Locke and Energy Secretary Steven Chu accompanied President Obama on the trip, which was part of a tour through Latin America that also included visits to Chile and El Salvador. The trip resulted in the signing of several bilateral agreements, including an Agreement on Trade and Economic Cooperation (TECA) and an agreement on Air Transportation, as well as an agreement on the launch of a Brazil-US "Strategic Energy Dialogue". We provide below a brief account of the main issues discussed during the visit.

Trade and Economic Cooperation

During the visit, the United States and Brazil signed a Trade and Economic Cooperation Agreement (TECA) with the objective of expanding bilateral trade and strengthening economic relations. Under the agreement, the two countries agreed to establish a joint Commission on Economic and Trade relations, which will meet at least once a year and which will be co-chaired by representatives from the Brazilian Ministry of Foreign Affairs, the Brazilian Ministry of Development, Industry and Foreign Trade, and the Office of the United States Trade Representative (USTR). The Commission's work will consist of discussions on: i) facilitation and liberalization of bilateral trade and investment; ii) cooperation on shared objectives in the World Trade Organization (WTO); iii) cooperation in the US-Brazil Consultative Committee on Agriculture; iv) sanitary and phytosanitary (SPS) measures; v) technical barriers to trade (TBTs); vi) intellectual property rights (IPR); vii) other regulatory issues affecting trade and investments; viii) information and communication technology (ICT) and e-commerce; ix) trade and technical capacity building; and (x) trade in services.

In addition to the TECA, President Obama and President Rousseff agreed to establish a "Brazil-US Economic and Financial Dialogue", which will seek to coordinate positions on global economic policy, find opportunities for greater bilateral economic cooperation, and increase cooperation between their respective officials charged with engagement at the G20. The Dialogue will build on the relevant work conducted by the existing Bilateral Consultative Mechanism on Trade Policy and the Commercial Dialogue, and will hold its first meeting in the second half of 2011.

Furthermore, the two Presidents issued a joint declaration which underscored the importance of enhanced private sector engagement through both the

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VI CEO Forum Meeting and the launch of the Business Summit that took place in the context of President Obama's visit. This declaration also reaffirmed the strong commitment of the two leaders to bring the WTO Round to a successful, ambitious, comprehensive and balanced conclusion, and both stated that they had directed their negotiators to intensify and expand their direct engagement to complete the negotiations, building on the progress already achieved.

Strategic Energy Dialogue

Taking into account the converging interests of Brazil and the United States in energy-related matters such as oil, natural gas, biofuels and other renewable sources, the two Presidents agreed to establish a bilateral Strategic Energy Dialogue. The Dialogue will encompass both the existing Working Group on Energy and the proposals contained in the Memorandum of Understanding (MoU) to Advance the Cooperation on Biofuels that the parties signed in 2007, which included an agreement to launch a Partnership for the Development of Biofuels for Aviation. In addition, the Dialogue contains a Plan of Action on Energy Cooperation, which includes the development of nuclear energy with a focus on: i) probabilistic risk assessment; ii) reactor life sustainability; iii) development of human resources; iv) licensing; v) prevention, management and emergency response to serious accidents; and vi) combustion efficiency.

Air Transport

With regard to the aviation sector, Brazil and the United States concluded an Air Transport Agreement that aims to liberalize their respective markets for airlines, offer the travel and shipping sectors a greater variety of service options and foster competition and lower prices. In this regard, both sides agreed to grant the airlines of the other party the right to i) fly across its territory without landing; ii) make stops in its territory for non-traffic purposes; and iii) operate routes between it and third countries.

Other Issues

During the visit, President Obama and President Dilma Rousseff also signed the following:

- A Framework Agreement on Cooperation in the Peaceful Uses of Outer Space;
- A Renewal of the Agreement on the Employment of Dependents of Diplomatic and Consular Personnel;
- A Protocol of Intentions for the Expansion of Technical Cooperation Activities in Third Countries;
- An MoU between the US National Science Foundation and the Brazilian Federal Agency for Support and Evaluation of Graduate Education on Dimensions of Biodiversity;
- An MoU on Major Global Sporting Events, aimed at increasing bilateral cooperation on infrastructure, safety and security in light of that Brazil will host the 2014 FIFA World Cup and the 2016 Olympic and Paraolympic Games and taking into account US experience in organizing events of this magnitude;
- An MoU for the Implementation of Technical Cooperation Activities in Third Countries in the Field of Decent Work; and
- An MoU for the Establishment of the Brazil-US Strategic Dialogue Program to be inaugurated by the Brazilian Federal Agency for Support and Evaluation of Graduate Education and the Commission for Educational Exchange between the US and Brazil (Fulbright Commission).

During the visit, the United States and Brazil signed a Trade and Economic Cooperation Agreement (TECA) with the objective of expanding bilateral trade and strengthening economic relations.

Outlook

President Obama's trip to Brazil took place as part of an effort by the US Administration to engage with the new government of President Rousseff in order to pursue economic opportunities in the country. As such, the US Government made clear before the visit and in speeches that President Obama gave in Brazil that it wants to take the relationship with Brazil to the next level – mainly in response to the recent improvements in Brazil's economic credentials (e.g., its rapid recovery from the international financial crisis, the strong 7.5 percent GDP growth rate posted in 2010, the expanding middle class and the fact that the country is now the 7th largest economy in the world). Brazil and the United States already enjoy a solid bilateral commercial relationship, with US exports to Brazil having doubled in the last five years and two-way trade reaching USD 80 billion in 2010. However, the United States was surpassed by China in 2010 as Brazil's main trade partner, and both countries have consistently noted that there is potential for further improvement.

In spite of this strong US rhetoric, however, the concrete proposals that President Obama put forth during the visit were much less ambitious and failed to address issues important to Brazil such as the liberalization of the US market for ethanol and other several agricultural products, which President Rousseff will likely raise when she visits the United States in the second half of 2011. Nonetheless, local analysts consider that, although the visit yielded shallow outcomes, it was an important movement toward improving the bilateral relationship and establishing personal ties between the two presidents. ❑

What A Party in Brazil

By Walter Molano (BCP Securities, LLC)

While the Brazilians celebrated Carnival before the start of lent, the data released in early March by the national statistics agency (IBGE) confirmed that the Brazilian economy had a huge celebration in 2010. It expanded 7.5% y/y. This was the highest growth rate in decades, and it confirmed last year's market optimism. However, a close look at the data revealed a mixed picture. Fixed capital formation increased 21.8% y/y, a good sign that investment was an important engine of growth. However, imports greatly outstripped exports, rising 36.2% y/y versus 11.5% y/y. Moreover, the fourth quarter GDP data had a few unpleasant surprises. The Brazilian economy grew only 0.7% y/y, with fixed capital formation expanding only 0.6% y/y. In other words, there was a sharp slowdown in economic activity. The only sectors that continued to grow at a faster pace than GDP were household consumption, imports and exports. They grew 2.5%, 3.9% and 3.6%, respectively. The real appreciation of the currency and the continued expansion of consumer credit are pushing the Brazilian economy into an uncomfortable situation of persistent external imbalances. Unless the government takes serious measures to improve productivity by modernizing its infrastructure, the economy will find itself in an unsustainable trajectory.

It's not that Brasilia is not doing anything. The interminable traffic jams in some of the major urban centers, such as Sao Paulo, are living proof that the government is in the midst of major construction projects to improve transportation facilities. The new fleet of buses that grace the streets of Rio are a noticeable departure from the smog-spewing monsters that used to plod along. However, President Dilma's Rousseff's recent announcement of an R$50 billion reduction in government outlays is creating fears that she is going to try to cut out some of the muscle without touching the fat. She recently took the nation by surprise by announcing a 45% increase in outlays for Bolsa Familia. The Brazilian welfare program is designed to support the poorest segments of the country, as well as the well-organized supporters of the PT. While it is noble to help the poor, Brazil should be taking steps to cool consumption and keep the country from overheating. Furthermore, millions of people already moved into the middle class, thus reducing the pressing need for social assistance. Furthermore, it looks like the R$50 billion fiscal adjustment will involve a lot superficial statistical adjustments, as well as reductions in much needed investments. This means that the Central Bank will need to work overtime to help keep inflation in check. The SELIC could easily rise above 13% this year, which means that the currency will most likely remain where it is or become stronger.

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The strong Real, booming credit markets and high level of consumer confidence are making the country a consumption paradise. The streets are teeming with new cars. The only Bentley dealership in Latin America is in Brazil. Fashionable boutiques line the avenues, and tony restaurants have long queues of hungry customers waiting to enter. The currency is also somewhat overvalued, and Brazil is particularly expensive for foreigners held captive in the hotels and restaurants of Jardims and Leblon. A short trip outside the compounds will reveal food, lodging and transportation costs that are more reasonably priced. Still, Brazil cannot afford to allow its currency to appreciate any further. The country's current account deficit could approach $70 billion in 2011. The massive investment program dictated by Petrobras as well as the preparations for the 2014 World Cup and 2016 Olympics mean that capital imports will continue to arrive, thus keeping pressure on the external accounts. Likewise, the economy is starting to slow. The fourth quarter GDP data already confirmed a sharp slowdown in economic activity and the average forecast for 2011 is in the 3.5% to 4.5% range. Therefore, further appreciation of the currency will only make matters worse by favoring imports over exports. This is why the country's economic policymakers should not give in to political temptation by hollowing out the fiscal adjustment. Brazil needs to deeply cut into the bureaucratic fat and frivolous expenses in order to stabilize the economy. Otherwise, this party is going to end with a nasty hangover. ❏

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Investors to Remain Onboard with the Production Sharing Model

By Vanessa Christina Lacerda and Carlota Berault Moreira
(Miguel Neto Advogados Associados)

The most heated debate over current forms of oil exploitation, and which state-owned company should be engaged in it, raises controversial issues, such as the creation of new state-owned companies, taxes and political disputes, strengthening the capitalization of Petrobras and the attraction - or not – of foreign companies.

The possibility to exploit this new national wealth opens up a new age in the history of Brazil, turning it into a major oil producer and exporter, which represents a possible leap in Brazilians' standard of living.

The regulatory framework developed by the government establishes that the pre-salt layer oil will be exploited under a regime whereby the federal government, Petrobras and other oil companies share a contract in a scheme known as production sharing. In the federal government's view, this is the model that best fits. However, under the concession scheme currently in force, exploration areas are granted to concerned companies, which therefore bear all underlying risk during the operations.

Countries that adopt the production sharing system intend to generate more income and maintain management of production. What is key for Brazil in this regard is management, because this scheme poses the risk of the so-called 'Dutch disease': strong exchange rate appreciation resulting from foreign exchange inflows from exports of commodities, such as oil, ultimately leading to deindustrialization. Furthermore, there is also a high risk of having the economy heavily dependent on oil revenues, thus creating tax problems.

Notwithstanding the foregoing, experts say the country will be internationally integrated as a result of adoption of this scheme. In countries under the sharing system, international companies are tapping oil reserves. This model does not prevent the arrival of foreign companies, and any contracts executed shall be enforced and monitored as appropriate.

If the Government's proposal is not amended, Petrobras will become even stronger, as it will take part in all bids and will not be competing against any other parties. Rather, it will enter all concessions holding a guaranteed share of 30%, while other competitors will compete for the remaining 70%.

The Brazilian Congress has started considering the creation of a new state-owned company engaged in managing the wealth from the new pre-salt layer. "Petro-Sal" will play a major role in hiring companies to sell some of the oil assigned to the government. As the new state-owned company will not provide any infrastructure to store, transport and sell oil, this is where oil industry companies come into play. Their services may be contracted by way of an invitation to bid or via Petrobras's direct choice of service providers, which will make it even more attractive. ❑

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What Are the Key Considerations for Executing Transactions in Brazil?

By Carlos R. Asciutti (Ernst & Young)

Executing transactions in Brazil is not without certain challenges. Many are common among emerging markets in general, while others are specific to the Brazilian legal, regulatory, cultural and macroeconomic environment. According to the World Bank's 2011 Doing Business report, Brazil is ranked 127 out of 183 countries with regards to the ease of doing business, trailing many other emerging economies including China, Mexico, and Russia. While great strides have been made in recent years, doing deals and operating businesses in Brazil remains a complex and cumbersome process.

According to the World Bank, Brazil has 15 separate processes for opening a business, which take an average of 120 days to complete. These include paying registration fees, applying for operating permits, and registering employees in Brazil's various social programs. Obtaining construction permits can take even longer, averaging more than 400 days from beginning to end, and involving 18 separate processes. The aggregate impact of these and other expenses define what is known as the "Brazil cost."

Despite the current challenges however, Brazil is one of the most active reformers when it comes to improving the operating environment for businesses. Several pieces of legislation are currently under review that are designed to streamline processes and make Brazil more competitive with leading economies. Nonetheless, spending time and resources to conduct a comprehensive assessment of a transaction's risk exposure are critical to ensure success; and for foreign firms less familiar with the country and its norms, working with advisors that are familiar with the workings of the market is crucial.

Unexpected Environmental and Labor Issues

Dealing with Brazil's labor and environmental regulations can be daunting to newcomers. Brazil's labor laws are complicated, tend to be pro-labor and provide relatively generous payments for termination and retirement. Workers in Brazil generally receive generous European-style benefits such as extended vacation allowances and implied job security. When disputes do occur, they are typically resolved in favor of employees. Additionally, labor unions in Brazil are very strong in certain industries and regions and can sometimes wield substantial influence over the success or failure of a given transaction. Likewise, environmental regulations can add confusion and delay. While recent legislation has attempted to streamline the permitting process, Brazil has tough regulations in place to protect the country's vast natural resources. Investors must allot sufficient time and resources to ensure compliance.

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Executing transactions in Brazil is not without certain challenges. Many are common among emerging markets in general, while others are specific to the Brazilian legal, regulatory, cultural and macroeconomic environment.

Volatile Market Conditions Relative To Developed Economies

While Brazil has made significant progress toward social, political and economic stability over the last decade, certain legacy volatility still remains. Government expenditures are high - last year, Brazil spent approximately 28.2% of its GDP on government expenditures, which was significantly higher than its neighbors, which averaged 22.1%. Inflation risk remains a concern and the government is inclined to react aggressively amid signs that it is rising. Between January and March, the BCB raised the target Selic rate by 100 basis points to 11.75%, and many analysts predict it will move even higher as Brazil fights significant inflationary headwinds over the near and mid-terms. Currency risk is also present - one of the unintended consequences of Brazil's economic success was the effect on Brazil's currency, the real. Between 2009 and 2011, the real gained more than 40% versus the dollar at the expense of the country's growing export sector. In October 2010, the government increased from 2% to 6% its taxes on foreign capital inflows and implemented changes to the currency markets intended to counter speculation.

Distinctive PE Deal Profiles Relative To Developed Economies

Transactions in Brazil are predicated largely upon providing capital funding for compelling growth stories and for industry consolidation. Unlike economies where PE is more established, access to debt financing for acquisitions in Brazil and throughout Latin America is limited. The dynamics of relying primarily on cash as a means of financing lead to smaller deals than in the US, Europe and Asia.

Increasing Competition for High-Quality Deals

The positive factors that comprise Brazil's deal environment have not gone unnoticed by investors. With new entrants to the market executing significant deals and additional capital raises by veteran investors, many longtime market participants are beginning to express concern about increasing competition for high-quality deal flow driving valuations beyond traditional norms. While Brazil's long-term prospects for continued high growth are promising, in the near term, rising seller expectations, a limited number of clear acquisition candidates and increasing flows of PE capital into the nation could drive valuations further.

Regional Differences Are Inadequately Factored by Investors

Brazil has many regional differences that need to be fully understood and appreciated by investors in order to avoid missteps. While there may exist a tendency to view Brazil as a singular market, Brazil's total area is approximately 8.5 m square kilometers, nearly the size of the continental US. Purchasing patterns, income, demographics and business customs vary significantly among Brazil's many regions, especially between those located in the north and Amazon Basin and those in the more cosmopolitan south. Investors hopeful of simply replicating an existing business model without taking into account these distinctions are likely to be disappointed with their results — many multinationals learn the hard way that addressing the specific characteristics of each region is critical to success. Partnering with local firms or establishing offices with local personnel can go a long way toward bridging the culture gap.

Technology Hurdles

Outdated or nonexistent hardware and application software is common in many smaller and middle market businesses in Brazil, making the collection of information during the due diligence process difficult and creating significant integration issues after a transaction has closed.

When company records are unavailable, benchmarks can often be gleaned from sector sales information provided by the government or market research firms. Barring that, an in-depth and ongoing discussion with target management to produce realistic sales figures, costs and synergies is typically the best way to generate a reliable transaction model.

Lack of Transparency

Substantial challenges can exist with regard to the quality and transparency of financial records for target companies in Brazil, so allowing adequate time and resources for thorough due diligence is critical.

Substantial challenges can exist with regard to the quality and transparency of financial records for target companies in Brazil.

In some companies and industries, maintaining a second set of books is not uncommon, leading to unrecorded revenues and expenses, aggressive revenue recognition policies and inappropriately deferred costs. Especially in many family-owned businesses, records are often unaudited, and in many industries, operating a cash business is the norm. These are all issues that can derail a transaction, highlighting the need for experienced professionals to conduct transaction diligence and assist investors in cutting through the opacity and keep deals on track.

Need for Managerial Talent

One of the key items that PE brings to the table for the middle market companies that represent some of the best opportunities in Brazil is improved corporate governance and professional managerial talent. With a significant percentage of companies spending generations under family control, many are beginning to onboard a team of experienced managers that can take their companies to the next level. Delivering on that promise, however, can be challenging. In many industries, Brazil lacks a deep pool of management talent experienced in operating large private and public companies. The PE firms that will be successful in the Brazilian market over the coming decade will be those that can successfully recruit and retain top-tier operational talent.

Complexity of Brazil's Tax System

Investors in Brazil have traditionally faced stiff headwinds from Brazil's cumbersome tax system. Beginning with the defeat of hyper-inflation in the mid 1990's, Brazil began making substantial changes to its tax statutes that have significantly increased its complexity and accompanying compliance costs. According to the World Bank, with more than nineteen separate taxes,

Transactions in Brazil, Continued on page 16

Transactions in Brazil (from page 15)

Brazil's tax code places a greater regulatory burden on companies than any other system in the world. Brazil's regulations on worldwide income taxation, transfer pricing, the treatment of capital gains on the disposition of assets by nonresidents, anti-tax haven measures, and more recently, thin capitalization rules, provide challenges for businesses operating in the region. Additionally, investors must often deal with a lack of transparency from administrative authorities which can lead to inadvertent noncompliance, as well as heavy cross-checking between federal, state, and local agencies. Since the general statute of limitations on tax collections in Brazil is typically at least five years, risk exposures can persist for a substantial period several years after a transaction has closed. Penalties are generally higher than other countries, ranging from 75% - 150% at the federal level, in addition to market rate interest.

If Brazil is to remain a growing destination for the world's investment capital, reforms that eliminate redundancies and streamline compliance must be addressed. While progress is being made – the country was recently recognized by the OECD for improvements in transparency – change has been slow. It is essential to ensure compliance that companies doing business in Brazil develop and maintain relationships with sophisticated advisors who understand the nuances of Brazil's tax code. ❑

According to the World Bank, with more than nineteen separate taxes, Brazil's tax code places a greater regulatory burden on companies than any other system in the world.

Brazil is Ripe With New Drivers For Growth

By Carlos R. Asciutti (Ernst & Young)

In addition to private consumption, public spending is set to increase over the next several years. Between its two Growth Acceleration Programs, Brazil has set aside more than a trillion dollars for infrastructure projects covering everything from roads to sanitation, housing, hospitals and schools. In all, more than 2,500 projects have been identified, and investments for the World Cup in 2014 and the Summer Olympics in 2016 will necessitate even more investment.

It is against this backdrop that private equity (PE) activity is intensifying. Brazil is a direct beneficiary of many limited partners' intentions to increase their exposure to emerging markets over the next several years. Many of the asset class' largest global investors have already begun increasing their allocations and are expected to scale up their exposure even more. Additionally, increasing involvement by Brazil's public pension funds will provide a natural domestic buyer for capable funds.

New fund-raising efforts in Brazil are evidence of Brazil's heightened profile. Several significant funds have closed in the last several months, and many more are at various stages of the process. Longtime domestic players such as GP Investimentos and Patria are joining relative newcomers such as The Carlyle Group. This fresh capital is actively being put to work — investments are increasing, and PE houses are actively engaging the business community in a dialogue about succession, industry consolidation and the growth opportunities available to them by working in partnership with PE.

Inspiring confidence in PE investors are Brazil's maturing capital markets. Exit routes, once limited to trade sales to multinational firms, have increased significantly in recent years. While still a very viable exit path, Brazil's domestic mergers market now represents a feasible alternative, as cash-rich domestic firms look to consolidate industries and increase their market share. Likewise, Brazil's capital markets have matured in recent years such that initial public offerings are now in many cases the preferred means of securing an exit, and the growing acceptance and competition for cross-border listings provide yet another means of exiting investments that for all practical purposes, did not exist more than a few short years ago. ❑

Minority Shareholding and Antitrust Law in Brazil

By Bruno Werneck and Gustavo Coelho
(Tauil & Chequer Advogados in association with Mayer Brown LLP)

The acquisition of minority shareholding has been subject of analysis by the Brazilian antitrust authorities recently. Transactions involving this kind of acquisition can generate effects that may impact competition in a relevant market, such as: (i) unilateral effects regarding the reduced incentive to compete, due to the interest of one competitor on the profits of its rival and (ii) coordinated effects in connection with the possibility of collusion, by the influence of one competitor over the decisions of the other and exchange of information.

With the growing enforcement of the Law 8,884/94 (the "Antitrust Law") and the constant improvement of the legal framework, the Brazilian antitrust authorities now start to turn their attention to transactions involving acquisition of minority participation. The main issues in connection with this context are: (I) whether acquisitions of minority participation should be filed before the Brazilian antitrust system (SBDC) for antitrust clearance and (ii) whether the decision-making agency (CADE) should use structural and behavioral remedies for such transactions. Both issues are discussed below.

Brief Background

The Antitrust Law defines a "concentration act" as any act or transaction that may limit or otherwise restrain free competition, or that would result in one party gaining "control" of a relevant market of products or services. Any such transactions must be submitted for merger review by the SBDC if the turnover in Brazil in the last financial year, by at least one of the economic groups to which one of the parties of the transaction belongs, is higher than BRL 400 million, or if the transaction results in a concentration of at least 20 percent of market share.

Therefore, it is important to understand whether acquisition of a minority position may harm competition or result in the control of relevant markets, thereby requiring that the transaction be submitted for merger review. It is also important for companies to know if minority participation could create - for antitrust purposes - a new economic group (this definition might cause the filing of more transactions that originally would not meet any threshold for antitrust review) or if it simply would be a regular investment of a company in another without competitive concerns.

It is important to understand whether acquisition of a minority position may harm competition or result in the control of relevant markets, thereby requiring that the transaction be submitted for merger review.

Relevant Influence

The concept of relevant influence has been addressed in the past by CADE case law. Notwithstanding the control of a company by the majority shareholder, minority shareholding can also cause some influence in the company and, therefore, may affect competition. CADE set some parameters to identify the relevant influence of a minority shareholder, such as: (i) the opportunity to elect members of the board of directors and board of officers, (ii) fragmented shares among the shareholders, (iii) the possibility for the minority shareholder to exercise effective and continued influence, (iv) the existence of shareholders' agreements that grants decision-making powers to the minority shareholder in connection with specific matters, (v) existence of a contractual relationship and (vi) provisions that allow the minority shareholder to participate actively in the company decisions.

Going one step further, Commissioner Carlos Emmanuel Joppert Ragazzo recently declared that the absence of relevant influence of a minority shareholder means that the referred entities are not part of the same economic group. However, the Commissioner stated that the absence of relevant influence is not enough to discharge anticompetitive concerns.

Antitrust Law in Brazil, Continued on page 18

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Antitrust Law in Brazil (from page 17)

Recent Case Law and Remedies

Despite the fact that CADE previously analyzed some cases involving minority participation and the applicability of the Antitrust Law, the April 7, 2010, decision regarding a concentration act in the telecom sector is now generally considered the leading case on the issue. (It should be noted that all antitrust cases involving the telecom sector must be submitted for analysis of the National Telecommunications Agency (ANATEL). ANATEL issues a non-binding opinion in order to assist CADE for the final administrative decision. Thus, all references to the SBDC regarding the telecom sector should also include ANATEL as an extraordinary member of the Brazilian antitrust system).

In that decision, the SBDC analyzed the indirect acquisition of minority shares issued by Telecom Italia S.p.A. (Telecom Italia) by Telefónica SA (Telefónica), two major players in the telecommunication market, a transaction that would result in Telefónica's indirect participation of 10.9 percent in Telecom Italia shares.

The SBDC's main concern was the competition between Vivo, controlled by Telefónica, and Tim, controlled by Telecom Italia, two of the largest companies in the mobile service market. Specifically, the SBDC was concerned that Telefónica's influence over Telecom Italia could restrict competition between these two companies.

In its judgment of the case, CADE provided some new guidance for identifying the relevant influence and its potential to harm the competition. According to the relevant precedent, a minority shareholder's participation can be (i) active participation, when the shareholder has the control or the possibility of relevant influence over the company or (ii) passive participation, when the shareholder does not have the control or possibility of relevant influence over the company. Passive participation means the shareholder simply benefits from the company's profits as a regular investment, but does not exercise control.

The remedies imposed by CADE in the recent transaction involving the telecom sector serve as a guideline for future minority share acquisition transactions.

Considering Telefónica's acquisition of Telecom Italia shares, CADE decided that even passive participation could give to the minority shareholder possible access to essential information. CADE determined that passive participation should also be divided into two types: passive participation with the possibility to access relevant information and passive participation without this possibility. With the first type, there would be concern about the anticompetitive effects of the minority shareholding, once the exchange of relevant information between the companies would be possible. With the second type, however, the anticompetitive concern could be discharged once it becomes dear that the exchange of information is not possible.

In order to clarify the factors to be considered in a minor shareholding acquisition, the SBDC has identified market characteristics that will be subject to heightened scrutiny, such as: (i) concentration of market shares and number of players, (ii) barriers to entry, (iii) interaction and cooperation among the competitors, (iv) regular growth of demand, (v) homogeneity of products, (vi) reduced innovation, (vii) lack of information transparency for consumers regarding prices and market conditions, (viii) possible access by one competitor to information of its rivals, (ix) lack of market regulation and (x) low investments on marketing by the players. When the market has these characteristics, the minority participation has more potential to affect competition, even if the relevant influence is not possible. As a result, the possibility and the advantages of information exchange or coordinated actions also depend on the conditions of the market and not only on the corporate relations between the companies.

Against this backdrop, the acquisition of minority shares of Telecom Italia by Telco was approved by CADE, but was conditioned on some requirements set by a Performance Commitment Agreement. The Performance Commitment Agreement (Termo de Compromisso de Desempenho - TCD) is an agreement that CADE enters into with the parties in order to set forth some conditions (remedies) to approve a transaction (please note that the Performance Commitment Agreement is executed by virtue of the final decision by CADE). These remedies were set basically to ensure (i) the passive participation or, in other words, the minority shareholding without the possibility of relevant influence, (ii) the elimination of inter10cking directorates and (iii) the creation of "Chinese walls." The last two remedies are especially relevant, because they aim to prevent the companies from influencing the decisions of each other and from exchanging information between them, which emphasizes CADE's concern about the possibility of collusion and coordinated actions between the companies. Hence, the Performance Commitment Agreement sets forth behavioral remedies and partial structural remedies regarding interlocking directorates.

In order to guarantee the enforcement of the decision, ANATEL and CADE agreed to monitor the business of the parties in Brazil, including decisions from the board of directors and officers, market reports, independent auditing and in locus inspection. The competitors agreed to provide relevant information to both agencies in connection with their businesses in Brazil.

Next Steps

According to CADE precedent, transactions involving the acquisition of minority shares in various businesses are common but nonetheless subject to the Antitrust Law. The remedies imposed by CADE in the recent transaction involving the telecom sector serve as a guideline for future minority share acquisition transactions. As illustrated by the telecom transaction, the antitrust authorities may subject the parties to significant monitoring obligations (and costs), and restrict the powers of the shareholders, in order to protect competition. ❑

Franchise Agreement

By Luciana Valera Menegatti (Miguel Neto Advogados Associados)

The franchise agreement was originally developed in the United States, and is currently widely used. Franchising caught on especially after the Second World War as an alternative for expansion of business enterprises whose products had great acceptance by consumers and good market results. It is now regarded as an effective market expansion tool.

In Brazil, franchise agreements are regulated by Federal Law No. 8955/94, which defines the franchise agreement as "the pact through which the franchisor grants the franchisee the right to use a trademark or patent, as well as exclusive or semi-exclusive sale of products or rendering of services, and eventually the right to use the implementation and administration technology related to the business or production system developed or held by the franchisor compensated by direct or indirect payment without, however, establishing any labor relationship".

Whenever interest in granting franchises arises, the franchisor must provide all prospects with the "Circular de Franquia", a document written in clear and accessible language that must, as per all applicable law, display information such as franchisor's brief background, its corporate structure, address and full or legal name and that of all the companies directly related therein, detailed description of the franchise, general description of the business and tasks to be performed by the franchisee, description of the "ideal franchisee" considering previous experience, education level and other mandatory or preferred assets and information regarding initial investment and compensation.

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This document must be delivered by franchisor to the prospective franchisee at least ten days before the execution of the agreement or pre-franchise agreement, and also before the payment of any fees by the franchisee, or the former will be liable for returning all amounts paid plus damages.

The franchise agreement will be considered valid and effective if executed into a private document, as long as it is bared to and signed by two witnesses.

Exclusivity or preference of action in a given territory may be provided to the franchisee, as could commission in sales and authorization to render services outside of the designated territory and for exports.

According to general agreements law, the franchise agreement may be terminated by running its course, agreement between the parties, or resolution through event of default.

In a nutshell, the subject of the agreement mentioned herein is the use of the brand and know-how, given that as much as the franchisee must duly comply with its obligations, so must the franchisor provide consulting, means of production and marketing, thus achieving net gains for all parties.

The franchise business has a socioeconomic function all over the world, especially in developing countries, by helping the development of various economic sectors and introducing new forms of product marketing and sales, among other benefits, namely widespread generation of jobs.

This business has grown steadily in recent years, even more so in Brazil, which is currently one of the greatest franchising countries in the world in various segments. ❏

Mexico to Award Up to 20 Oil Blocks

By Reuters

The number of oil fields operated by private companies in Mexico will jump by the end of 2012 as state oil monopoly Pemex speeds up the unwinding of a seven-decade ban on private investment, a top executive said.

Pemex PEMX.UL, which will award three oil field operating contracts to private companies this summer at a historic auction, may kick off a second auction as soon as June, Carlos Morales, the head of Pemex's oil production arm, said at the recent Reuters Latin America Investment Summit.

Two further auctions, including an offer of prized exploration acreage in the deep waters of the Gulf of Mexico, will follow soon afterward, he said.

"By the end of next year .... we think we should have more than 20 areas in total already awarded," Morales said.

Mexico loosened its restrictions on foreign investment in the oil and gas sector in late 2008 as the world's No. 7 oil producer grappled with a plunge in crude output.

Pemex is now permitted to hire private companies to operate oil fields on its behalf in return for fees and although the company has stopped the fall in Mexican oil output on its own, it will still expand opportunities for private companies.

Mexico hopes to lift oil production to 2.6 million barrels per day by the end of this year and then to 2.7 million bpd by 2012 as it develops new discoveries such as Ayatsil.

Pemex currently produces approximately 2.55 million bpd and is a top supplier of crude to the United States.

Private companies could contribute up to 25,000 bpd to Mexico's total output by 2012, Morales said.

New Rigs

Pemex is also set to hire dozens more drilling rigs as it seeks to sustain output from aging oil fields including the giant Cantarell deposit, as well as develop new discoveries such as Ayatsil.

"Right now we're working with about 54 marine rigs and another 120 land units," Morales said. "This year we will probably get to about 80 (marine rigs) and on land ... it's probable that we hire about 15 more, although this is still being studied."

The number of rigs operating in Mexico fell sharply last year as Pemex switched strategies at its controversial Chicontepec project, which was heavily criticized by regulators for being potentially unprofitable and for falling short of ambitious production targets. ❏

Mexico Exchange Lists First REIT After Delays

By Patrick Rucker (Reuters)

Mexico's stock exchange listed the country's first real estate investment trust last month, allowing investors to make big bets on the local property market.

The sale of shares in the first real estate investment trust (REIT) in Mexico came after years of frustration that saw the current deal stumble last month before finally reaching investors.

If Mexico's REITs prove to be successful, the securities could give local property markets a big capital injection.

Fibra UNO (FUNO11.MX), the maiden REIT named for its acronym in Spanish, was rebuffed in February by investors unwilling to pay the asking price, but the deal was retooled and listed on the local exchange on Thursday.

"Mexico is taking on a new life, becoming more dynamic," Luis Tellez, head of the Mexican Stock Exchange (BOLSAA.MX), told Reuters shortly after the security was listed.

Mexico financial markets are not as vibrant as those in Brazil where REITs have deep roots but Tellez said this week's REIT listing was a sign of things to come.

"We are not at the level of Brazil but we are much more dynamic than we were," he said.

The REIT sold roughly $300 million worth of shares with about a third bought by foreigners and the rest by domestic investors. The February book was roughly split between foreign and domestic investors.

Mexico's stock exchange listed the country's first real estate investment trust, allowing investors to make big bets on the local property market.

Investors took hold of 43.7 percent of the trust - or 185,385,543 shares valued at 19.5 Mexican pesos each.

The fund will hold a basket of 16 properties located in several states across the country.

REITs are seen as an efficient way to inject capital into property markets because they spread the risk and costs of long-term building projects across many tradeable shares.

Mexico's 15 private pensions and their $115 billion in assets are likely to continue to be a source of funding for REIT investments.

REIT and RE-REIT

The local advisors behind the deal, Protego Asesores, went back to the drawing board after the first offer was rejected and eventually enticed investors with a 10 percent discount.

The property owners also agreed to swap some of their properties for equity in the REIT rather than get paid in cash, as another way to smooth the deal, Protego Asesores said.

Turmoil in North Africa and the earthquake in Japan made this a difficult time for the deal but the advisors wanted to conclude it quickly to put an end to 18-months of work.

"We've always said that the real estate market in Mexico cannot grow as it should without investment from the private market," said Augusto Arellano, director of Protego Asesores. ❑

Indo-LatAm Trade and Investment on the Upswing But Obstacles Still Exist

By Sumeet Chugani (Diaz Reus & Targ, LLP)

Trade between India and Latin America could exceed $30 billion by 2012. Given Latin America's abundant natural resources, as well as India's liberalizing markets and growing domestic demand for commodities, bilateral trade between these regions has immense potential for growth. Unlike China's sprouting trade relationship with Latin America, India's unique political dynamics and trade policies impose barriers to an open trade relationship. However, India's recent lowering of tariffs and other trade barriers, and its growing number of trade pacts with Latin American countries, has begun a trend that can potentially boost the flow of goods and services between these regions.

Currently, India's average tariff on Latin American agricultural goods is about 65 percent - more than five times China's level. Similarly, Latin America places tariffs on Indian exports, reaching as high as 9.8 percent for manufactured products. Again, this is well above the average of 4-6% imposed by developed nations in the Organization for Economic Cooperation & Development. Due to the distance between the regions, transportation costs have stood as another major impediment to Latin American trade with India. Unlike China, India has not created a direct shipping service to Latin America – requiring goods to travel to Latin America via Singapore or Europe.

Witnessing the growth of a beneficial Indo-LatAm trade relationship, the Indian government continues to boost this bilateral trade relationship through the signing of multiple regional Trade Agreements and trade pacts. For example, India and Chile are in discussions to execute a broad trade pact calling for the exchange of over 10,000 categories of goods between the regions. India and Mexico also continue to expand their relationship through the extension of their Bilateral Investment Promotion and Protection Agreement. Moreover, India is currently a member of Mercosur, a trading bloc with Latin American nations such as Argentina, Brazil, Paraguay, and Uruguay. The Indian Government, with a continuing view to promote economic cooperation between the regions, has also set up Joint Commissions with important trading allies in Latin America.

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Despite the current "obstacles" to trade between the two regions, India-based corporations and entrepreneurs are actively pursuing their economic goals in Latin America. Thousands of Indian companies have looked to Latin America as a vital region to expand on their global footprint. These corporations also see Latin America as a means for satiating their need for commodities and energy sources. Seeing Latin America as a "new" gold mine, Indian companies specializing in information technology, pharmaceutical manufacturing, energy and mining have also set up operations in Latin America. For example, Tata Consultancy Services Ltd., India's largest software service exporter, currently employs over 7,500 Indian professionals in Uruguay, Argentina, Chile, Ecuador and Mexico. The company expects its Latin American sales to double to upwards of $1 billion within the next three years. Jindal Steel & Power Ltd. has already spent more than $3 billion to further develop and expand its iron-ore mining operations in Latin America. As well, Tech Mahindra's Chief Executive Sanjay Kalra has repeatedly stated his firm's strong interest in acquiring Latin American companies in the near future.

Given Latin America's abundant natural resources, as well as India's liberalizing markets and growing domestic demand for commodities, bilateral trade between these regions has immense potential for growth.

This is just the beginning. India eyes Latin America as the next frontier for growth and expansion. For example, Ashok Leyland, a leading Indian commercial vehicles manufacturer, recently announced the company's strong desire to pursue new opportunities in Latin America. India's entrance into the Latin American market will present some obvious challenges. Different languages and cultures, along with a myriad of complex tax regulations, trade laws, and political dynamics will pose risks to uninformed Indians entering the region. Those savvy players that adequately balance risk and reward will undeniably benefit from this upsurge of Indo-Latin American trade and investment. ❑

Is China Stepping Up Trade with Latin America Too Quickly?

By Knowledge@Wharton (Wharton School of the University of Pennsylvania)

During the past two decades, China's unstoppable growth and its voracious appetite for raw materials have made Latin America one of its favorite locations for sourcing raw materials and a preferred destination for making its foreign investments. The recent confirmation that China has become -- after only the U.S. -- the second-largest economy in the world, overtaking Japan, comes at a time when China is showing interest in realizing the old dream of building an alternative route across Colombia to compete against the Panama Canal. This ambitious project would bring together the two coasts of Colombia – Atlantic and Pacific – by means of a railway, creating what some call a "dry canal."

Although this project has yet to materialize, it is a good example of the growing interest that China has in Latin America. In 2010 alone, through a series of about 20 acquisitions and corporate stock purchases in such sectors as oil, energy, steel, telecommunications and autos, China's investments in Latin America – especially in Argentina, Brazil, Peru, Chile and Mexico – exceeded US$30 billion, more than the cumulative value in previous years.

How have things gotten to this point? China's emergence as one of the main engines of global growth can be explained in good measure by its strong effort to pursue the production and exportation of manufactured goods, notes Alejandro Micco, professor of economics at the University of Chile. These products include the latest technologies and devices in such sectors as appliances, automobiles, motorcycles and industrial machinery. "During the 1970s, Japan played that role, and now it is China," he says. "Korea replaced Japan, and now China has replaced Korea as the leader."

A key step for China came in 2001, when the country joined the World Trade Organization, notes Daniel Morales, macroeconomics analyst at the APOYO consulting firm in Peru, which provides financial and business advice. "This move enabled China to take advantage of Latin America as a destination for its manufactured goods and as an important source of supply for primary products," Morales notes. During this period, China undertook a series of measures that opened up trade with the region, in part by reducing its own average tariff from almost 20% in 2000 to 10% in 2009.

As a result of such efforts, China is now one of the chief trading partners of Peru, Chile, Brazil, Argentina, Uruguay and other countries in the region, according to Morales. These countries have used this opportunity to export large volumes of commodities to China, including copper, iron, tin, zinc, petroleum and soy products.

In 2009, the economies of Latin America exported more than US$40 billion worth of goods to China, a huge increase from the US$4 billion in shipments of raw materials they made in 1999, notes Morales. He cites the data in a report by the Inter-American Development Bank (IDB), titled "Ten years after the Take-off: Taking Stock of China- Latin America and the Caribbean Economic Relations."

In 2009, the economies of Latin America exported more than US$40 billion worth of goods to China, a huge increase from the US$4 billion in shipments of raw materials they made in 1999.

Although trade with China has experienced spectacular growth, contributing significant revenue streams to the region, Diego Sánchez, professor of Latin American economics at the University of London, points out that the region has specialized in supplying primary products to China. "This involves risks for the region; it could remain mired in this position with little possibility for acquiring new technology and diversifying its basket of exports," he says.

An Unequal Trade Balance

Germano Glufke, professor at the Getulio Vargas Foundation in Brazil, agrees that it is quite possible that much of Latin America will remain merely a provider of commodities for the Chinese market. The problem with this sort of trade, says Glufke, is that "it reduces the region's potential for being part of the value chain of that Asian country, something that has boosted the recent expansion of some Latin American countries, such as Brazil."

Roberto Durán, professor of political science at the Catholic University of Chile, also warns that trade relations between China and Latin America are moving at various speeds in different countries. "Until now, the most helpless countries, such as the Central American nations, have had almost no trade relations with China. In contrast, Chinese trade with Brazil, Argentina, Chile and Peru has been much more considerable". It is easy to conclude that this is all about unequal and discriminatory trade ties, since the Central

Knowledge@Wharton (http://knowledge.wharton.upenn.edu), the online research and business analysis journal of the Wharton School of the University of Pennsylvania. Republished with permission.

American nations are smaller and less competitive."

Brazil, Chile, Argentina and Peru are the largest beneficiaries of the favorable trade relationship with China, notes Morales, since those four countries represent almost 90% of the region's total exports to China. "This scenario can be explained by the large contribution of raw materials to their exports," says Morales. "That creates a gap between the trade balances of these countries and those of the other Latin American countries that trade with China."

One factor working in favor of China and against Latin America is that Chinese exports of manufactured goods to the region have grown much more than the region's shipments of raw materials to Asia, notes Morales. In 2009, Latin American commodity exports to China totaled US$40 billion, while the total for Chinese shipments of manufactured goods to Latin America was almost twice as high, at US$78 billion.

"Some countries in the region, such as Mexico and Costa Rica, have a great trade deficit with the Asian giant [China], since these countries export very little to China and import huge volumes of manufactured goods," notes Sanchez.

Glufke warns that various sectors of Latin American industry have been negatively affected by the unstoppable expansion of Chinese competitors. "This has forced some manufacturers in the region to shut down." For example, in some countries of Central America and the Caribbean, many companies in the textile industry have lost their competitiveness because of the onslaught of Chinese products.

The Particular Case of Brazil

For now, Brazil – rather than Central America -- is the source of greatest concern for analysts. According to Reuters news agency, Dilma Rousseff, the new president of Brazil, recently said that China's undervalued currency, the yuan, is one of the greatest dangers for her country's economic health. She added that a wave of cheap imports from China has affected the trade balance of Brazil, leading to the loss of thousands of jobs in Brazil's manufacturing sector.

Afonso Fleury, professor of engineering at the University of São Paulo, says that although China's currency is artificially undervalued in the Brazilian market, this has not affected trade ties between China and Brazil -- despite pressure imposed by Brazilian business leaders, who want to create barriers to Chinese products. Since that approach has proven quite ineffective, notes Fleury, Brazilian businesses have now decided to change their tactics for counteracting the onslaught of Chinese products. "A recent study by the National Confederation of Brazilian Industry revealed that 67% of all companies – two-thirds of local companies – have changed their strategies regarding articles that are "made in China," and are now focusing on improving the design of their own products and investing more in their quality." As a result, "Most Brazilian firms today are escaping [the full impact of] Chinese competition."

According to Fleury, this strategy is also working because the Brazilian market is in a healthy process of expansion. But he warns that there could be new problems down the road if Brazil's growth rate declines, and if competition with Chinese products becomes even more extreme.

A Continuing Opportunity

Although the trade balance is now more favorable for China than for Latin America, Micco stresses that trade with China was especially beneficial for Latin America during the global economic crisis of 2008, when it helped the region recover quickly from the economic disaster. "China managed to emerge quickly from the havoc created by the crisis, becoming an even stronger buyer of Latin American raw materials, which reinforced its trade with the region." Micco adds that while the price of copper fell to very low levels after the crisis erupted, copper recovered within months thanks to growing demand from China. That fact, in turn, had a positive impact on exports of copper from Chile and Peru. "The same thing happened with soy beans, when shipments of that foodstuff from Argentina and Paraguay to China bounced back in little time."

For now, Brazil – rather than Central America -- is the source of greatest concern for analysts.

China continues to be an economic growth opportunity for Latin America, according to Osvaldo Rosales, director of the commerce division of the Economic Commission for Latin America and the Caribbean (ECLAC), one of five regional commissions of the United Nations. According to that organization, Chinese salaries rose by between 20% and 25% in 2010, opening up new trading opportunities for the region, especially for those countries that export primary products to China. "These shipments from [Latin America] will remain stable, and they have good prospects for growth in the future."

What's more, over the next three years China's domestic consumption will increase by about US$9.5 billion; that is to say, by US$3 billion more than consumption will increase in the United States, according to Morales, citing the IDB report. In his view, Latin America must continue to nurture its bilateral relationship with China, so that its exports to that country continue to be vigorous while strengthening employment in the region.

Strategic Moves

One of the strategic steps that Latin America can take in this direction, notes Morales, is to invest more resources in the development of its agribusiness exports. In his view, such products still have room to grow in a sustained way. "Peru is one of the Latin American countries that have shown the most progress in taking advantage of this opportunity. Starting in 2010, Peru has had a free-trade agreement with China that will gradually permit its agribusiness exports

Stepping Up Trade, Continued on page 26

Stepping Up Trade (from page 25)

– such as mangos, grapes and citrus fruits – to enter the Chinese market tariff-free following gradual reductions over a period of eight years." Chile also has a free-trade agreement with China. For its part, Costa Rica signed such a treaty last April, but it is awaiting ratification by the Costa Rican congress.

It is equally important for Latin American multinationals to explore their potential in the Chinese market by investing their assets there, notes Glufke. These could be made through acquisitions of companies or by devoting their own funds to constructing plants in China. "There are some good examples of companies that have made these steps and have become success stories, such as WEG, the Brazilian producer and distributor of electric motors, and Gruma, the Mexican tortilla producer."

Nevertheless, Glufke recognizes that a significant number of Latin American businesspeople are uneasy about investing in China because of the very sizable cultural differences between the two markets, and the differences in the Chinese business, legal and political systems.

In an effort to overcome these barriers, Diego Guevara, professor of economics at the Autonomous University of Colombia, suggests these steps: Promote international ties with China by devoting more economic and cultural assets to that country "and then establishing strategic alliances in the fields of science and technology. Certainly, this sort of technology transfer would provide greater added value for the products that the [Latin American] region exports [to China]." ❏

VENEZUELA

PDVSA and Venezuela- Marching to the Beat of the Oil Drums

By Alejandro Arreaza, Juan C. Cruz, Alejandro Grisanti and Donato Guarino (Barclays Capital)

Fiscal Voracity

The recovery in oil prices and the devaluation of the currency in 2010 were not sufficient to drive an improvement in the accounts of PDVSA (Petróleos de Venezuela, S.A.). The government extracted most of the additional revenues and the benefits from cost reduction, confirming the significant fiscal pressure on the company. This extraction of resources limits the company's capacity to invest, which is causing a production decline that, coupled with increased consumption in a highly subsidized domestic market, has reduced the volumes exported.

According to preliminary figures presented by the Ministry of Energy to the National Assembly, despite the increase in the Venezuelan oil basket by 27.5% from USD/b 57.0 in 2009 to USD/b 72.7 in 2010, PDVSA's net profits actually declined 30.5%, from USD 4.5bn to USD 3.1bn, as a result of higher fiscal contributions which rose 35.0%, from USD 24.6bn to USD 33.2bn, siphoning off 80% of the increase in gross profits.

Ironically, PDVSA's greater fiscal contribution has not been accompanied by a significant improvement in Venezuela's fiscal balance. Preliminary figures presented by the Central Bank show that the government registered a deficit of 3.8% of GDP, declining just 1.6 percentage points from 2009. Meanwhile, the Ministry of Finance reported that the total public sector accumulated a deficit of 4.3% of GDP through the third quarter of 2010, and we estimate 6.9% of GDP for the full year. This is not a consequence of a major fiscal expansion by the central government, which actually registered a contraction of 3.5% of GDP, but of the increasing diversion of resources from the "formal" public sector to parallel agencies (mainly Fonden and the Chinese Fund), which are responsible for a greater portion of the government expenditures that are not incorporated in official public sector statistics.

The national treasury figures show that oil revenues for the central government were just VEB60.8bn (USD 14.1bn), less than half of what PDVSA reports as a fiscal contribution. Most of the remaining amount went to the quasi-fiscal funds, which we expect to remain the depositaries of the oil windfall in order to finance off-budget expenditures ahead of the 2012 presidential elections and, at the same time, help the government avoid transfers to regional authorities. Therefore, we do not expect a significant improvement in official public sector statistics, which we feel are becoming less reflective of the real performance of the country's finances.

Given the lack of transparency in the management of the quasi-fiscal funds, estimates of true public sector finances are difficult. We intend to undertake a deeper

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analysis in future publications. In the meantime, we will focus on PDVSA's financial condition.

PDVSA Should Not Have A Cash Flow Issue

The market's perception (and we agree) is that over time, it has become increasingly difficult to separate PDVSA and the sovereign. However, the assumption has been that there is little or no flexibility in PDVSA's social contributions and transfers to Fonden, regardless of oil prices. We argue that the market gives little credit to Venezuela and PDVSA for making adjustments when oil revenues have decreased significantly.

The extraction of resources from PDVSA has been pro-cyclical, fluctuating with oil prices. In 2009, when oil price fell, PDVSA reduced its fiscal contributions by USD 11bn (76%); it increased them again in 2010 as cash flow recovered. But the increase in cash flow has not been accompanied by an uptick in capital investment. Despite the recovery in oil prices, preliminary figures suggest that investment continued to fall in 2010, leading to a production decline of an average 2.89mn bpd, down 280k bpd from 2009 and 507k bpd since 2008. This decrease in production cost PDVSA USD 13.5bn in unreceived revenues in 2010. For the government, this implied a loss of USD 4.0bn just in royalties, partly explaining why, despite the greater fiscal pressure on PDVSA, total fiscal contributions remain at USD 9.0bn below the level in 2007, when the average oil price was USD/b 7.0 lower than in 2010.

Nevertheless, the current environment is extremely supportive of the fundamental picture. Using 3Q10 audited financial statements as a proxy for 4Q10 EBITDAX, we estimate that for 2010, PDVSA generated approximately $28bn in EBITDAX. Ignoring the effects of working capital and pro forma for newly issued debt (we calculate WACD at 6.8%), we estimate net cash flow prior to government transfers and financing transactions at $10.5bn, net of capex of $12bn and debt service of $3.05bn.

Considering the support that the oil market is giving to PDVSA, we assess two issues of considerable importance: 1) the potential risks associated with contingent liabilities that could jeopardize the cash flow, and, 2) the company's recovery value.

Exxon, Conoco, and Other Issues

One uncertainty that hangs over PDVSA's credit story is related to the nationalization program that commenced in 2006. While the government has made nationalizations in most sectors of the economy, from cement and food to oil service and petrochemical companies, the most relevant nationalizations in terms of size and potential liabilities remain the oil projects of the Orinoco basin.

The Exxon Case

- In February 2007, Venezuela issued a decree effectively declaring that all heavy crude JVs in the Orinoco were to be majority owned by Venezuela in a proportion of no less of 60% of total ownership. Exxon and the government (partners in the Cerro Negro venture) failed to reach an agreement regarding compensation within the specified timeframe, and on May 1, 2007, PDVSA assumed control of the operation and expropriated 41.7% of ownership in the project that was until then owned by Exxon (PDVSA also owned 41.7%, and the rest was owned by Veba OEL). At the time of the expropriation, the project reported total daily production of 84.4mbpd of extra heavy crude and 73.6mbpd of synthetic crude. As of March 31, 2007, Cerro Negro reported total assets of $1.2bn.

We think that these claims are unlikely to result in additional financial debt for PDVSA but could lead to a transfer of fields or production to the expropriated parties.

- As a result of the nationalization and failure to reach an agreement on compensation, Exxon filed a request for arbitration with the International Centre for Settlement of Investment Disputes (ICSID) and another arbitration case against PDVSA with the International Chamber of Commerce (ICC) for breach of contract. According to Exxon's filings, a hearing with ICSID is scheduled for Q1 2012. In 2008, Exxon obtained a judgment against PDVSA and was able to freeze international assets worth $12bn (reversed shortly after). At the time of the nationalization, Exxon accounted for its exposure to Cerro Negro at $750mn.
- On November 22, 2010, Venezuela's oil minister, Rafael Ramirez, indicated that Exxon had agreed to reduce its claim against PDVSA regarding Cerro Negro from $12bn to $7bn and said that a final decision on the arbitration could be expected "in 2011 or in 2012".

The Conoco Case

- Conoco and PDVSA were partners in two of the joint ventures in the Orinoco River; Petrozuata (50.1% owned by Conoco/49.9% PDVSA) and Hamaca (40% owned by Conoco and 30% owned by PDVSA). Petrozuata had operating capacity of 104mbpd and Hamaca 120mbpd.
- Following the nationalization of Petrozuata and Hamaca and without having reached an agreement

Marching to the Beat, Continued on page 28

Marching to the Beat (from page 27)

regarding compensation, Conoco also filed arbitration cases against Venezuela with the ICSID and ICC, but unlike Exxon, Conoco did not break talks with the government and left the door open for negotiation.

- In 2007, Conoco wrote down its Venezuelan assets by $4.5bn. While there is no official number attached to Conoco's claims against the republic, Minister Ramirez has indicated in the past that Conoco was seeking $20bn in compensation.

What Is The Potential Liability For PDVSA?

It is difficult to estimate what PDVSA and the expropriated parties will end up agreeing to as a result of the nationalization of Petrozuata, Hamaca, and Cerro Negro. Our analysis relies on the reported net book value of assets as a floor and considers the recoupment value of lost production a strong possibility in the negotiation of claims against PDVSA.

In 2007, when Petrozuata and Hamaca were nationalized, Conoco Phillips wrote down its Venezuelan assets by $4,588mn, including $1,295mn in intangibles. Backing out the intangible portion and taking into account Petrozuata's reported assets at net book value, we estimate the value of Hamaca to Conoco at $1,279mn (similar to Petrozuata). A combination of the two would result in an approximately $2.63bn net book value of fixed assets. Applying the same exercise to Cerro Negro results in a net book value claim for Exxon of $748mn.

Estimating lost cash flow to the expropriated operators leads to a different result from a liability perspective. Taking into account Petrozuata's production of 104mbpd (half of which was Conoco's) and Hamaca's 120mbpd (of which Conoco's share was 48mbpd) and applying the average margin over the four-year average price for the Venezuelan basket (net of royalties) results in roughly $6.3bn of lost EBITDA for Conoco. The same exercise for Exxon results in lost EBITDA of $2.9bn.

Combining the net book value of fixed assets and lost cash flow for the expropriated operators, we estimate that total compensation for Conoco could reach a maximum of USD 9.0bn and for Exxon could reach USD 3.7bn, for a total contingent liability of USD 12.6 bn.

In theory, the expropriated operators (Exxon and Conoco) could request the value of their investments in fixed assets (upgraders, pipelines, terminals, etc.) plus compensation for lost profits. Ultimately, compensation will be the result of negotiation between the parties, and it is possible that payment could be in the form of production areas in the Orinoco (barrels of oil) rather than in cash. Venezuela has the largest oil reserves in the world, and after the nationalization, authorities established and defined a legal framework for the oil business. In our opinion, for these reasons, companies such as Chevron decided to participate in the last round of auctions for the Carabobo and Junin fields in 2010, just three years after nationalization. As such, we think that these claims are unlikely to result in additional financial debt for PDVSA but could lead to a transfer of fields or production to the expropriated parties. ❑

Latin American Law & Business Report 2010 Cumulative Subject Index

Anticorruption

Antitrust / Competition Law

Arbitration

Audits

Banking

Bankruptcy

Capital Markets

Controlled Foreign Corporations (CFC)

Corporate Governance

Country Overviews

Customs / Tariffs

Economic Forecasts / Economic Developments

Electronic Data / Internet

Environment

Financing / Financial Sector

Foreign Exchange / Currency

Foreign Investment / Investment Environment

Franchise Agreements

Global Financial Crisis and Recovery

Holding Companies

Indexes

Industry Sectors

Infrastructure

Intellectual Property

Interviews

Judicial Rulings

Labor and Pension Reform

Leasing

Legal / Regulatory Reform

Litigation

Mergers and Acquisitions

Nationalization

Oil, Gas and Natural Resources

Operating Structures

Political Developments

Private Equity

Procurement

Public-Private Partnerships

Real Estate

Securities / Shareholder Rights

Taxation

Trade / Trade Agreements

Venture Capital / Venture Equity

Cumulative Country Summary 2010

Argentina

Brazil

Chile

Colombia

Costa Rica

Mexico

Uruguay

Venezuela