

TermoFortaleza CCGT

Luke McLeod-Roberts

18/04/2006

The landslide victory of Luiz Inácio Lula da Silva in the 2002 Brazilian presidential election, with more than 60 per cent of the vote, was a surprise to many investors and sent shockwaves through the energy market, concerned about fiscal irresponsibility and populist policies

The prospects for the TermoFortaleza CCGT plant in northeast Brazil, which secured equity shareholders just two months before Lula was elected, might have seemed uncertain as a result.

But in fact under the PT (Workers' Party) government, fiscal policy has been as, if not more, conservative than under that of the previous administration of Fernando Henrique Cardoso and the Brazilian financial sector has boomed.

It is the regulatory framework which has been most unpredictable and frustrating for the sponsors - something on which the PT cannot be said to be breaking any new ground.

The Project

Over 90 per cent of Brazil's energy comes from hydroelectric plants, this would appear to make perfect sense in a country with an extensive river network and high rainfall.

But parts of Brazil - particularly the interior of the impoverished northeastern region - are also prone to prolonged periods of drought, at which times the rivers dry up and the lights go off.

In response to a particularly bad energy crisis in 2001, the federal government launched an emergency programme, the Thermolectric Priority Programme (Programa Prioritário de Termelétricidade) (PPT), with the intention of diversifying the energy mix beyond hydro.

Thermal plants were fast-tracked under the programme, what the sponsors were billed to get in return: long-term supply and power purchase agreements at fixed tariffs.

The projects were concentrated in northeastern states such as Bahia, Pernambuco and Ceará, 59 projects obtained initial authorisation, of which 10 moved ahead into commercial operation.

TermoFortaleza, a 310.7MW CCGT plant located in an industrial complex close to Ceará's capital - Fortaleza - was one of such projects.

The equity was originally put up by Endesa of Spain (100 per cent-owned by Endesa Internacional (EI)) and Enersis (a Chilean firm 65 per cent owned by EI), that together formed the SPV Central Geradora Termelétrica Fortaleza (CGTF). Following a reorganisation, since 2005 the sole equity partner is Endesa Brasil.

Mitsui was the main EPC contractor, with Kawasaki carrying out certain aspects of the project, which used 2xGT11N2 Alstom gas turbines.

Power is sold under a 20-year PPA to the state company Companhia Energética do Ceará (COELCE) on a fixed tariff basis, the growing strength of the Real, the Brazilian currency, means that it is split between USD and Reais on a 60:40 basis.

While a similar structure (80:20) was inked on a 20-year GSA with Petrobrás via state company Cegás.

But the agreements were not as watertight as they initially looked and as the next section explains, a series of legal changes meant that financing on the project was severely delayed.

And since the sponsors were contractually obliged to have the plant ready by the end of 2003, they had to go ahead and build it regardless, using balance sheet financing first and securing debt later.

Legal and institutional obstacles

The warning bells first rang for CGTF when the federal government began changing executive-level officials in the top regulatory agencies and energy companies.

The replacement of the top-dogs at ANEEL and Eletrobrás with PT cronies was heavily criticised by the anti-PT dominated national press, which interpreted these and other such moves as a creeping absorption of the state apparatus by the government.

This immediately created problems for the project, as the main financier, IFC, was reluctant to proceed in negotiations with the borrower until the outcome of the changes was clear.

But the real problems started in 2004, when ANEEL ruled that restrictions were to be imposed on the output which the newly-tendered northeastern power projects were allowed to sell.

This was in direct contravention of the PPAs which had been set up with local energy companies and made financing 'virtually impossible', according to Jose Virgilio Enei, partner at Machado Meyer which acted for the banks on the deal, explaining that this was an emergency response to Petrobrás' inability to meet its supply obligations:

'ANEEL used the expression that it was as if a "hydro plant was built on a dry river", - a strange choice of words, given that these new gas plants were originally conceived of as a way of reducing dependency on dry rivers.

ANEEL's unilateral action led to protracted discussions between the Ministry of Energy, Petrobrás, ANEEL and the project developers and there was the risk that the PPAs might be cancelled altogether.

One year later, a settlement was reached under which Petrobrás agreed to provide energy from other assets under its control to meet the generation shortfall and alleviate the energy needs of the northeast.

The deal expires at the beginning of 2007, by which time it is expected that an extensive pipeline network will be in place, making gas available to the region from the states of Rio Grande do Norte, Rio de Janeiro and from Bolivia.

'If not, then the agreement will have to be extended,' said Enei.

The other major hurdle which the project encountered was of a more socio-political nature. Given that most of Brazil's power needs come from hydro, the inclusion of thermal capacity into the mix was bound to push up prices for consumers.

When TermoFortaleza's offtaker, state utility COELCE, revised tariffs in 2005, the 30 per cent jump was beyond what most consumers could feasibly manage to pay, as well as being inconsistent with tariff rises being introduced by other utilities at the same time.

Discussions between the offtaker, legal bodies and consumer protection groups ended with an agreement that a portion of the increase would be deferred over the 2007-2012 period, reducing the initial increase to 23 per cent.

This was still not ideal for consumers, but a more acceptable arrangement, which meant that neither COELCE nor

TermoFortaleza would lose overall revenues.

These two issues - ANEEL's ruling and the row over an appropriate tariff - significantly slowed down the project and meant that the debt was not secured until two years after the project began operating - at the end of 2005.

Financing

When the project was first developed, the large component of US-indexed financing, together with the lack of liquidity in the local market meant that the sponsors approached the IFC, among other multilateral lending agencies and international commercial banks, for the debt facilities.

An agreement was reached with the IFC and at the beginning of 2004 the parties were two weeks away from signing, when the ANEEL ruling came and the project was put on hold.

Adolfo Garcia, Head of Project and Structured Finance at Endesa, commented upon the 'supportive' stance of the IFC during the regulatory negotiations mentioned above, pointing out that the partners managed to come to a commercial agreement on the debt in the middle of 2005, with syndication taking place in November of that year.

The IFC acted as sole MLA on the US\$130m debt facility split between:

- US\$55.5m A-loan
- US\$67.5m B-loan syndicated on a best effort basis to: Banco Santander US\$ 28m, BBVA US\$24.5m and Caixa Geral US\$15m
- A US\$7m subordinated C-loan.

The A-loan was priced at LIBOR plus 250bp and the B loan, was priced at LIBOR plus 225bp. This was the 'lowest price in the Brazilian market in the last five years,' according to Garcia, 'at the start of negotiations pricing was slightly above 400bp.' Negotiations were initially entered into with 6 banks as part of the syndication process. Amortisation on the C-loan starts just after the B-loan.

Tenors are 12, 10 and 14 years respectively, there is a 6-month DSRA and no MRA.

Conclusion

TermoFortaleza was plagued with a number of obstacles, as this case study has shown, the most serious one being ANEEL's ruling with respect to generation capacity, which risked destroying the PPA and the financing agreements.

But for Garcia, these were just the tip of the iceberg:

'The [energy] sector is overregulated by ANEEL, which is prone to enter into the tariff system and change it....If there is a new government in October, there could be new changes, there's a lack of stability.'

'The tax system is extremely complex - you really need experts on board. There's a strong presence of public companies... a lack of clarity on rules when dealing with environment, tax issues, registration permits, everything!'

The regulatory risk can make potential investors luke-warm about getting involved:

'We are being conservative, we see Brazil as one of our targeted markets, but we are being shy,' he added.

But these problems are not inherent to the project itself, which if anything, can be seen as a success story in the context, said Enei:

'I think at the end of the day TermoFortaleza was able to resolve those issues. This shows that regulatory risk in Brazil can be addressed and overcome with hard work and people who believe in the project and want to move ahead.'

The developers managed to commission the project in record time and since then it has been operating successfully,

generating a steady revenue stream, as well as delivering much needed power to the local region.

This, together with the low financial risk in the Brazilian market and the substantial scope for new generation, are factors which are likely to keep up the level of interest of foreign investors in energy projects there.

Interest is one thing, gaining contracts is of course another. And as December's wave of tenders for new power projects revealed, the current model favours state-owned companies over the private sector.

It remains to be seen whether next month's auction will follow the same pattern.

The project at a glance

Project Name	TermoFortaleza
Location	Ceará, Brazil
Description	311MW gas-fired plant
Borrower	Central Geradora Termelétrica Fortaleza (CGTF)
Operator	CGTF
EPC Contractor	Mitsui
EPC Sub Contract 1	Kawasaki
Equipment	2xGT11N2 Alstom gas turbines
Project Duration	20-year
PPA	20- year fixed tariff with Companhia Energética do Ceará USD/Reais 60:40
GSA	20-year fixed price with Petrobrás via state company Cegás USD/Reais 80:20
Total Project Value	US\$225m
Total equity	US\$95m
Total senior debt	US\$130m
Senior debt breakdown	IFC US\$55.5m A-loan US\$67.5m B-loan Banco Santander US\$ 28m BBVA US\$24.5m Caixa Geral US\$15m
Senior debt pricing	A loan LIBOR plus 250bp B loan LIBOR plus 225bp
Debt:equity ratio	60:40
Export credit agency support	None
Mandated lead arrangers	IFC - loan subordinated on best effort basis, not underwriter
Participant banks	IFC (MLA/bookrunner) B- Loan syndicated on best effort basis to: Banco Santander Central Hispano Banco Bilbao Vizcaya Argentaria Caixa Geral de Depositos
Subordinated debt	US\$7m
Subordinated debt pricing	Deeply subordinated, starts amortisation just after B-loan
Tenor	A-loan:12 B-loan: 10 C-loan: 14 years
Control account details (DSRA, MRA)	6-month DSRA No MRA
Insurance	Commercial cover, no political cover
Major project risks	Overregulated market Lack of legal continuity Lack of clarity on rules
Legal adviser to sponsor	Davis Polk Villemor Amaral (local)
Financial adviser to sponsor	None
Technical adviser to sponsor	None
Legal adviser to banks	Linklaters Machado Meyer (local)
Financial adviser to banks	None
Technical adviser to banks	Sargent & Lundy

Thank you for printing this article from IJGlobal.

As the leading online publication serving the infrastructure investment market, IJGlobal is read daily by decision-makers within investment banks, international law firms, advisory firms, institutional investors and governments.

If you have been given this article by a subscriber, you can contact us through www.ijglobal.com/sign-in, or call our London office on +44 (0)20 7779 8870 to discuss our subscription options.