

Investment in Brazilian Power Sector: challenges and opportunities

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Brazil is now in the process of recovery from one of its worst economic recessions since 1929, and from its biggest political scandal, both of them mainly caused by corruption scandals. Nonetheless, several changes are being implemented and discussed to allow resumption of economic activity and foreign investment in the country. Not only due to the new expected outlook for the Brazilian power sector, but also due to the difficult financial situation of important players in the sector whose assets are for sale, the Brazilian power sector currently presents good investment opportunities. This article will present some of these opportunities, but, as we are not Alice thinking of Brazil as a wonderland, also deal with some of the challenges to be overcome by the investors.

It is undeniable that, after Dilma Rousseff's impeachment, a new phase has started for Brazil, and for the power sector. The team built by new president Michel Temer is mainly composed by well known professionals of the power sector, what was viewed by the market as a strong indication that the changes will lead to a more investment-friendly regulatory framework. For instance, the economy has been giving signs of recovery (for example, the recent decrease of SELIC rate by Brazilian Central Bank to 14% - first decrease in the past 4 years) and important reforms and legal matters are under discussion in the congress to enhance foreign investments in the country .

In this context, and despite the current and temporary surplus of energy contracted by distribution concessionaires, as soon as economy resumes to the level it had before the crisis, power demand will obviously increase. In addition, considering the projected increase for Brazilian GDP's in the following years, there will be a continuous need for new installed capacity and its associated transmission and distribution infrastructure. Based on the ten-year energy expansion plan disclosed by federal government in the end of 2015, the current installed capacity of Brazilian power system is of 160GW, and by 2024 the Government expects an increase of 46,447MW, part of which is already contracted and under implementation. On transmission lines there is also an expected development up to 2024 by an increment of 85,782km of new lines.

The installed capacity increase will be composed mainly by the expansion of solar, wind, biomass and even nuclear sources, but hydro will continue to be the main source in the Brazilian matrix and thermo will still have a system security role. Solar is planned to increase seven times and represent 3% of total installed capacity; wind will increase five times, jumping from the current 6% to 12%; biomass that currently has no significant portion is expected to represent 9% by 2024. According to planned, by 2030, non-hydro renewable sources will represent 40% of Brazilian power mix.

To meet such expected growth, the government has been using the already traditional and tested auction schemes for generation and transmission assets, but now with more attractive return rates and more realistic conditions. For instance, after revising the parameters initially proposed, the transmission auction scheduled to the end of October has increased the annual maximum revenue in around 10.2%, with a total estimated amount of R\$2.3 billion

However, there are challenges to be overcome by the investor willing to invest on greenfield projects and here are some of them: (i) restrictions on acquisition of rural properties by Brazilian companies controlled by foreigners and the uncertainties created by an opinion from the Brazilian General Attorney's Office; (ii) environmental licenses may be very difficult and time consuming, sometimes resulting in the non-viability of the project (even though there is a project of law being analyzed by the congress aiming to simplify the environmental licensing process and a pretty new law provides for longer construction periods for projects sold in auctions); and (iii) labor laws are still very protective of the employees, although there is no tenure on the job. At last, but not least, there is a latent need for tax, political, labor and social security reforms, but some of them are already under discussion in the Congress.

Private investors willing to swim such challenging waters may also want to keep an eye on several different assets that are being sold, in different stages of construction and operation, mainly by companies that are facing liquidity issues or even going through court-supervised reorganization. There are also different opportunities in transmission, distribution and generation projects whose construction works have been delayed and are unlikely to be finalized according to the schedule initially approved by ANEEL.

The issues surrounding Petrobras's crisis, the enactment of Brazilian Clean Company Act (or anti-corruption law) and other recent political scandals are also bringing investment opportunities in the power sector. The construction companies involved in the "car-wash operation" launched by Brazilian Federal Police are selling different assets in the sector trying to remedy a severe financial crisis, mainly due to the difficulties on obtaining financing.

On transmission, there are also M&A opportunities. The most challenging one is related to the assets owned by Abengoa Group, which is currently under court-supervised reorganization, and owns relevant concessionaires in the sector. A specific law is being passed to enable the sale of the concessionaires with more attractive concession conditions.

On generation, there are also auctions to be organized by state-owned companies to sell existing generation plants in the States of Paraná, São Paulo, Santa Catarina and Minas Gerais, such as power plants Jaguará, São Roque, Miranda and São Simão.

In the distribution area, the government is promoting the sale of distribution assets currently owned by Centrais Elétricas Brasileiras S.A. – Eletrobras. This sale is seen as a unique opportunity for Eletrobras to rebalance its financial statement. Up to now, seven power distribution concessionaries of Eletrobras are expected to be privatized and sold in 2016 (Celg) and as of 2017 (the other distribution companies). New legislation is being passed to make the sale faster and to help Eletrobras's financial situation to be under control. In addition, important distribution companies were sold in 2016, contributing to the consolidation of important groups in the distribution sector.

The corruption scandals and the efficient way that Brazilian authorities are reacting to them are also changing the way business and deals are being done in Brazil. Both national and international companies with subsidiaries or branches here are implementing robust compliance programs and acquisition deals are granting special attention to earn out conditions, price holdbacks and special indemnities. Regardless of the deal's structure, M&A transactions must be preceded by a thorough due diligence especially of actual and potential liabilities in the tax, labor, compliance and environmental areas.

As a consequence of so many challenges and opportunities, Brazilian power market currently seems to attract those with bigger appetite for risk and long term viewers that, as us, believe that after the storm Brazil will be stronger and "cleaner" than ever before.