Bloomberg
Law Reports®

March 19, 2012

Corporate and M&A Law

Mergers & Acquisitions

Negotiated Transactions

Current Issues Involving Latin American Upstream M&A

Contributed by Boyd G. Carano and Alan J. Alexander, Vinson & Elkins

Introduction

Latin America is seeing an upsurge in transactions in the oil and gas industry, including asset purchases, joint ventures and equity acquisitions. Much of this is due to significant discoveries of new oil and gas reserves. The pre-salt discoveries in Brazil are some of the most well-known, with some experts estimating that the Brazilian pre-salt may ultimately be discovered to contain up to 120 billion barrels of recoverable reserves. But other Latin American countries have also realized new successes. Argentina, for example, has been the site of two recent large discoveries by Repsol YPF: an estimated 927 million barrels equivalent of shale oil at the Loma La Lata field in northern Patagonia announced in November 2011, and an estimated 4.5 trillion cubic feet of shale gas in Neuquen province in December 2010. Uruguay is also a country where recent and potentially large discoveries of gas, both offshore and onshore, could lead to the emergence of another hub of upstream activity.

Another factor driving the momentum in upstream M&A activity in Latin America is the privatization or partial privatization of state-owned oil and gas companies that began with Petrobras in Brazil in 1997 and followed with Ecopetrol in Colombia in 2003, when their respective legal monopolies over the hydrocarbon sector were abrogated and some of their shares were sold to the public. In a similar fashion, Repsol acquired Argentina's YPF in 1999. The privatization trend has reversed in recent years, but this has only fueled further M&A activity.

These former state-owned companies are now attracting capital and knowledge for exploration and production activities through joint activities with major independent and other state-owned oil companies. Examples of this trend include Petrobras' joint ventures in the Brazilian pre-salt concessions, and Ecopetrol recently joining with Statoil to announce its first find in the Gulf of Mexico. These examples also illustrate the companies' willingness to expand internationally.

In the medium - to long-term, there is the potential for more partnerships and transactions in countries where state-sanctioned monopolies remain, such as PEMEX in Mexico and PDVSA in Venezuela, if those countries modify their hydrocarbon

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frameworks similarly to Brazil, Colombia and Argentina. To this end, Mexico and the United States reached an accord on the Transboundary Hydrocarbons Agreement, which will allow U.S. companies to partner with PEMEX to develop transboundary reservoirs such as the Western Gap in the Gulf of Mexico.[1]

Although former state-owned companies are major players in their domestic markets, it is not necessarily the case that one must partner with them to do a deal. For example, recent deals in Brazil did not involve Petrobras, including HRT's sale of a 45 percent stake in 21 Amazon blocks to TNK-BP in October 2011 for $1 billion, and Sinopec's acquisition of a 30 percent stake of Galp Energia's deep sea blocks in November 2011 for $5.2 billion.[2]

The size, complexities and nuances of these deals bring to the surface old and new business and legal issues. Interested parties must be careful to address them, or risk encountering difficulties down the road. For example, according to statements issued by BP, the proposed sale of its 60 percent stake in Argentine crude oil producer Pan American Energy to a joint venture comprised of Argentina's Bridas Energy Holdings Ltd. and China's CNOOC recently collapsed after the parties failed to obtain Argentine antitrust approval and Chinese government approval.[3]

This article will discuss a number of issues involved in upstream oil and gas M&A activity in Latin America with a focus on valuation and operational issues, considerations in selecting the form of the transaction, and problems encountered in structuring cross-border transactions. Attention to these matters with the assistance of experienced counsel will help ensure that any proposed transaction progresses smoothly.

Valuation and Operational Issues

Due to the dynamic and changing nature of Latin America's oil and gas industry, both strategic and financial investors must fully understand and address relevant valuation and operational issues in target countries. Careful examination of these issues may significantly affect valuation models.

– Unitization

Although governments typically grant exploration and production rights in square or rectangular geographic blocks, the deposits themselves are not laid out in the same way. In other words, while a grantee may have the right to explore a certain block, the deposit under that block may extend into other blocks. If this is the case, grantees will sometimes be forced to stop all exploration and production activities until a unitization agreement is reached with the holders of the adjacent blocks under which the whole deposit extends.

Problems can also arise when countries change their granting regimes, thus resulting in adjacent concessions governed by both the former and new regimes. Unitization of a deposit could then occur between concessions granted under differing regimes. The result may be a forced change in the concession that is unitized from the old regime to the new regime, which could diminish a grantee's rights.

Brazil is currently facing this exact prospect. At the moment, Brazil has either granted or is considering granting exploration and production rights under four different regimes: (1) traditional concessions; (2) pre-salt production-sharing contracts; (3) direct production-sharing grants to Petrobras; and (4) previously granted direct concession-like grants to Petrobras. Unitizing blocks across any of these four regimes will be complicated, as these regimes have material disparities in the rights and privileges afforded to interest holders.

– Local Content Requirements

A few Latin American countries, particularly Brazil, have required grantees of new exploration and production blocks to commit to the use of an ever increasing percentage of goods and services from local sources. Unfortunately, the local goods and services sectors may not be sufficiently developed to meet the needs of large upstream investments. Historical recordkeeping has also been problematic. In Brazil, fines for lack of compliance with local content requirements range from 60 percent to 100 percent of the value of the goods or services that should have been supplied locally.

– Government Intervention

Another significant valuation and operational issue is governmental intervention. Governmental intervention in Latin American exploration and production activities has recently taken three principal forms: compulsory relationships with state-owned entities, changing royalty regimes, and governmental mandates.

Due to their complex nature and varied goals, dealing with state-owned entities as partners can present challenges. The Brazilian government has placed increasing responsibilities on Petrobras–which is already subject to considerable budgetary and work commitments to existing partners. These responsibilities are likely to increase further as Brazil requires Petrobras to be the operator and a 30 percent investor in all new pre-salt contracts. Conceivably, Petrobras may find it necessary to prioritize certain development activities over others, potentially to the detriment of certain partners.

Latin American countries have also been known to intervene in current contracts to alter the terms of the contracts in favor of the government or the national oil company. Nationalization is the most extreme case of such intervention. In May 2006, Bolivia nationalized all oil and gas reserves, forcing Repsol YPF, Petrobras, BP and Total to renegotiate their investments in Bolivia. Beginning in 2004, Venezuela increased the government's stake from 40 percent to 60 percent in all oil fields managed by foreign companies, and installed PDVSA as the operator. Some companies agreed, but ExxonMobil and ConocoPhillips refused and forced arbitration upon PDVSA and the government of Venezuela.[4] In a less dramatic case, some legislators in Brazil are considering whether to propose a law increasing certain royalties under certain contracts. Most recently, Argentina has applied pressure to YPF at the provincial and national level, accusing YPF of underinvestment in exploration and production activities and collusion with other oil companies to charge transport companies a higher wholesale rate for diesel than the retail rate. Re-nationalization of YPF is presently seen as a remote risk, but provincial governments have threatened to withdraw YPF's concessions and the national government has left price caps in place.[5] It is these forms of direct governmental intervention that are of greatest concern during the operational period of an upstream oil and gas venture, and hence parties should consider, among other contingencies, the viability of an investment under altered concession terms or operational arrangements.

Finally, governments sometimes mandate that investors direct their activities towards certain political or other objectives. For example, the Brazilian oil and gas regulator, ANP, has recently conditioned the approval of certain development activities on pre-salt plays in some blocks upon the concessionaires devoting more effort to the development of post-salt plays in such blocks.

Occasionally, political mandates can present positive opportunities. This happened in Peru when the government pressed PetroPeru to lower fuel costs, resulting in deals with Braskem and Repsol to develop downstream facilities in southern Peru, as well as government investment to further pipeline projects and gas distribution network expansions. All of this will require upstream development in the Camisea blocks (and perhaps elsewhere) to supply these facilities.[6] While governmental intervention does not always have negative effects on operations, it is an ever-present concern during the operational period and must be considered by any prudent investor in Latin American upstream activities.

Given the long operational timeline of upstream projects, it is impossible to predict all of the operational issues that a project could confront. Varying unitization regimes, local content requirements and governmental intervention are three of the more concerning operational issues. Understanding the nuances of a government's posture (such as historical, political and legal antecedents) and its attitude towards private investors can provide some insight into the likelihood of facing these issues in a country where a transaction is contemplated.

Considerations in Selecting the Form of the Transaction

When an investor has come to understand the valuation and operational issues of a potential transaction, it must then carefully consider the form of the transaction. Threshold questions in Latin American upstream oil and gas transactions include the acquirer's level of control and involvement, government approvals, third-party rights and compliance with confidentiality restrictions. How these questions are resolved affects whether the transaction will be structured as an acquisition or disposition of: (1) interests in oil and gas deposits, or (2) entities that are formed to carry out exploration and production activities relating to such deposits.

– Acquirer's Level of Control and Involvement

When the business deal involves a joint venture, negotiations regarding the acquirer's level of control and involvement can be protracted because these issues are fundamental to such transactions. Recent Latin American oil and gas transactions have taken two principal forms: asset investments and equity investments in asset holders. This distinction is important, particularly in joint venture transactions. First, asset joint venture investors' rights are relatively consistent across transactions; such investors obtain a tangible asset interest and, in many cases, a seat on the operating committee. However, with joint venture equity sales, marked variability exists in acquirers' rights. Some acquirers successfully negotiate strong voting rights, veto rights and/or operating committee proxy rights, while others obtain few voting and veto rights and no voice at the operating committee. In addition, investors often prefer asset transactions due to the relative legal strength of an asset interest versus the contractual rights obtained in a shareholder agreement, which are potentially less robust. For example, Statoil's sale of 40 percent of its interest in its Peregrino field in Brazil to Sinochem for $3.07 billion was an asset transaction designed, according to Statoil's May 2010 announcement, to "partner with Sinochem Group in the further development and operations of the large Peregrino field."[7] Thus, both parties will share in the risks, rewards and operations of the assets. HRT's sale to TNK-BP followed similar lines. In contrast, Sinopec's recent investments in Petrogal Brasil and Repsol Brasil were structured as equity investments with complicated shareholders' arrangements.[8]

Finally, if one of the parties to the transaction is a publicly-traded company, the ability to book reserves may differ between an asset sale and an equity sale. While the ability to book reserves will depend on the securities laws of the country where the company is listed, generally speaking, if a company purchases a concession or an interest in a concession, it may be able to book the reserves or the amount of reserves corresponding to its interest in the concession. However, in an equity deal, the investor may need to purchase a majority stake in order to book the reserves.

– **Government Approval**

Government approval generally means host government approval in the country where the oil and gas assets are located, but it can also mean government approval of one of the parties entering into the transaction if that party is a state-owned or national oil company. Asset transactions typically require government approval of the host government, which can create roadblocks. Consider the following examples. First, the HRT and TNK-BP deal became subject to government approval in Brazil when it was announced. Second, the BP-Devon deal faced headwinds in March 2010 when the company was seeking Brazilian government approval, due to BP's issues in the Gulf of Mexico. Finally, Sinopec's investments in Petrogal Brasil and Repsol Brasil were likewise subject to Chinese government approval.

While it is generally clear that asset transactions always require host government approval, it is less clear on the equity side (unless the equity transactions involve minority stakes, in which case they are generally considered not to require government approval). Unfortunately, change of control provisions that trigger governmental approval requirements in exploration and production right-granting agreements are often quite vague (although, Brazil's new premerger antitrust review and approval requirements are likely to apply in control transactions).

Transactions in Latin America involving Chinese state-owned oil companies, including CNOOC, Sinopec, and Sinochem (which are aggressive players in Latin American upstream oil and gas deals, especially in Brazil), will require approval for virtually all deals due to the regulatory registration and approval process mandated for all outbound Chinese capital. Approval of the outbound capital flow is required first from China's National Development and Reform Commission and then from the Chinese Ministry of Commerce. After those approvals are obtained for the outbound capital, the investment must be registered with the State Administration of Foreign Exchanges. This process may add time to a transaction involving Chinese counterparties.[9]

– **Third-Party Rights**

In many of the recent upstream transactions in Brazil, sellers have sold partial interests in blocks that are also partially owned by third parties. In most such cases, these third parties have approval and/or rights of first offer or refusal in the interests being sold. Unfortunately, the triggers for these third-party rights are often vaguely addressed, causing some legal uncertainty. One disadvantage to asset transactions is that they are typically subject to these kinds of third-party rights (whereas equity transactions are not). However, many joint operating agreements have "package sale" exceptions that effectively block third-party rights so long as the specific asset being sold constitutes less than a certain percentage of the value of the overall transaction.

Third-party rights will likely be an issue in future transactions in Latin America because governments are further strengthening their national oil companies in the wake of new large discoveries. Petrobras, for example, has indicated that it is likely to exercise its third party rights in many such cases.

Buyers in upstream Latin American M&A transactions should be cautious in signing agreements until they have some level of assurance that they are going to receive what they intend to purchase and, in a transaction involving multiple assets, an acceptable arrangement if third-party purchase rights are exercised on some but not all of the portfolio. Thus, as part of the due diligence process, buyers should carefully scrutinize transaction documents for third-party rights, and if they find any, they should investigate them thoroughly.

– **Confidentiality Restrictions**

A final transactional form issue worth keeping in mind in upstream ventures in Latin America is the existence and content of confidentiality restrictions. Confidentiality restrictions typically apply in two contexts: disclosures to potential purchasers and post-transaction operational disclosures. Nearly all granting agreements provide an exception for disclosure to bona fide potential asset purchasers and to actual asset purchasers. Often, neither granting agreements nor joint operating agreements are clear regarding disclosures to potential equity purchasers.

Potentially even more problematic is the fact that strict interpretations of confidentiality exceptions may permit disclosure to potential equity purchasers, but prohibit disclosures to such persons in the post-transactional operational stage. Furthermore, disclosure of geophysical and geological data is typically subject to additional and more burdensome confidentiality restrictions with data providers.

Problems Encountered in Structuring Cross-Border Transactions

While the focus in an upstream transaction will usually be on transactional and operational issues, holding structures are an important consideration in Latin American transactions because they directly affect applicable taxation and the protections afforded under bilateral investment treaties. Holding structures depend significantly on the country in which the entity (that will purchase oil and gas assets or join with another entity in a joint venture) is chartered. Often, careful tax planning will result in the formation of a holding company in a particular jurisdiction to carry out investment activities either within or outside of the jurisdiction.

Tax Issues

Tax issues can be broken down into two major categories: double taxation treaties and capital gains tax. The purpose of double taxation treaties is to prevent an entity from being taxed in both its home jurisdiction and the jurisdiction in which it realizes income. Double taxation treaties are typically bilateral and the terms will vary from treaty to treaty. Historically, Latin American countries have not had many double taxation treaties, but that has changed in recent years. Many investors in Colombia use either Panama or Spain holding companies, while many investors in Brazil use Netherlands holding companies or sometimes Austria or Luxembourg holding companies. It is important to note that some double taxation treaties deny their benefits to holding companies formed in jurisdictions solely to take advantage of that jurisdiction's double taxation treaty (i.e., by means of economic substance requirements).

Many Latin American countries also impose sizeable capital gains taxes on direct entity sales. This is an important valuation issue for sellers and for buyers that contemplate an exit at some point in the future. In many cases, these taxes can be eliminated by structuring sales at the foreign company level. However, Colombia is considering imposing indirect capital gains taxes and Brazil has the power in some cases to recharacterize indirect sales as direct sales. Underlying all tax issues in Latin America is the issue of indeterminate enforcement regimes. Thus, the assistance of good local and international counsel with substantial experience in structuring cross-border Latin American transactions is fundamental to avoiding any tax pitfalls.

– Bilateral Investment Treaties

Bilateral investment treaties can provide protections against expropriation, discrimination and unfair treatment of companies from one country investing in another country. Latin American countries have an uneven history of entering into and honoring bilateral investment treaties. For example, Brazil has none in force, while many other Latin American countries have such treaties with Spain. The key issue regarding bilateral investment treaties is shopping for a convenient treaty for the transaction in question. Unlike double taxation treaties, bilateral investment treaties do not require economic substance. Thus, a Japanese company could form a holding company in Spain to serve as its investment vehicle to invest in an upstream transaction in Colombia. This would avail the Japanese company of the protections and benefits of the bilateral investment treaty between Spain and Colombia. Notably, bilateral investment treaties that were passed before the North American Free Trade Agreement tend to offer better protections for investors than those that were passed post-NAFTA.

Conclusion

These issues (and others, such as expanding environmental regulations and enforcement, sometimes-daunting labor law liabilities, and elaborate local tax architectures) should be evaluated in light of the potential rewards these transactions can bring.

It is evident that the oil and gas industry in Latin America is poised to grow, especially in Brazil, Colombia and Argentina. Uruguay could emerge as a new player in natural gas, and political changes could present opportunities for upstream investment in Mexico and Venezuela. To participate successfully in these opportunities, investors should begin by looking to the experience and knowledge of others who have navigated Latin America's distinctive business and legal environments, and select their advisors accordingly.

Boyd Carano is Managing Partner of the Palo Alto office of Vinson & Elkins LLP and a member of the Energy Transactions & Projects Practice Group. Boyd led the firm's representation of HRT O&G Exploração e Produção de Petróleo Ltda. in its sale to TNK-BP of concession rights in Brazil covering 48,500 square kilometers for $1 billion (plus contingent payments of as much as $5 billion). He also represented Sinopec International in its US$7.1 billion investment in Repsol Brasil, S.A and Statoil on its US$3.1 billion sale of an interest in the Peregrino oilfield in Brazil to Sinochem. He can be contacted at bcarano@velaw.com.

Alan Alexander is an associate in the Houston office of Vinson & Elkins. Alan's practice focuses on transactions and projects in the energy industry. From 2005-2006, Alan was a Rotary International Ambassadorial Scholar at the Instituto Tecnológico y de Estudios Superiores de Monterrey – EGADE where he received his M.B.A. In addition, Alan has extensive professional experience in Latin America. He is fluent in Spanish and can be contacted at aalexander@velaw.com.

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[9] *See* Star Zhang, Li Ge, Ji Yan & David Blumenal, The Regulatory Aspects of Outbound Investment by Chinese Companies, The China Dealmaker (June, 2010).