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Upcoming Investment Opportunities in Infrastructure

By María Fernanda Farall (Jones Day)

The Brazilian government is in the process of implementing a new set of infrastructure projects pursuant to its Programa de Aceleração do Crescimento (Growth Acceleration Program), which is commonly referred to as PAC. In 2007, President Silva's administration created this program to promote the growth of the Brazilian economy through a series of infrastructure projects pertaining to logistics (e.g., railroads, roads, and ports), energy, water, and housing.

Timing for the launching and promotion of these new projects by the Brazilian government could not be better –with its long-term credit recently being upgraded by Standard and Poor's Rating Service to investment grade status, Brazil is being perceived as a safe place for foreign investment.[1] These projects offer many investment opportunities to foreign investors. Here is an overview of some of them.

Railroads

A high-speed train that would link the cities of Rio de Janeiro, São Paulo, and Campinas is one of the many privatization projects currently under way. While this project has been under consideration for several years, its implementation did not begin until 2007. Specifically, the Brazilian government appointed a consortium led by the British company Halcrow Group, which includes the Brazilian companies Balman Consultores Associados and Sinergia Estudos e Projetos, to conduct a technical feasibility study. This study, which is being coordinated by Banco Nacional de Desenvolvimento Econômico e Social – BNDES, will provide for the preliminary lay-out of the project and will also include an analysis of the potential demand for use of this line, pricing, and other relevant issues. The recommendations resulting from this study are expected to be made public by the end of August.[2] Additional engineering, environmental and legal analysis are expected to be completed during the last quarter of 2008.

Under current plans, the train will run mostly underground and will link the cities of Rio de Janeiro and São Paulo, with stops in the international airports of these cities, as well as in the cities of Volta Redonda, Resende, Taubaté, and São José dos Campos. The Rio de Janeiro-São Paulo section would cover approximately 280 miles. A 63-mile extension to Campinas, that would include a stop at its airport, is under consideration, as well. The total investment for this project is estimated between US$ 9 billion and US$11 billion. The opening of the bidding process is currently being contemplated for the first quarter of 2009. The Brazilian government anticipates that the train will be running by 2014, when Brazil hosts the World Soccer Cup.

A high-speed train that would link the cities of Rio de Janeiro, São Paulo, and Campinas is one of the many privatization projects currently under way.

The expected travel time between Rio de Janeiro and São Paulo would be approximately one and a half hours with an estimated ticket fare of US$60 one way, compared to a six-hour car trip or a 45-minute plane ride for approximately US$100 one way. This line would be the first passenger railroad connecting major cities in Brazil; Rio de Janeiro and São Paulo alone have a combined population of approximately 31 million people. To date, this project has attracted the interest of several foreign investors, including companies from France, Germany and Japan. Last June, the government of Japan sent a delegation led by its Minister of Infrastructure, Transportation and Tourism to Brazil.[3]

Another infrastructure project being considered by the Brazilian government is a 30-year sub-concession by the state-owned company Valec – Engenharia Construções e Ferrovias S.A. for the development and operation of a 972-mile section of the North-South railroad corridor (Ferrovia Norte-Sul) that runs from Palmas, State of Tocantins, to Estrela D'oeste, State of São Paulo. The bidding process for this section is expected to commence early in 2009. Feasibility studies are currently being conducted and will be followed by an analysis and approval of the project by TCU – Tribunal de Contas da União. The

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section that runs from Açailândia to Palmas was given under a 30-year sub-concession to Companhia Vale do Rio Doce for US$837,000,000 last October. When completed, the North-South railroad corridor would go from Belém, State of Pará, to the city of Panomara, connecting the cities of Açailândia, State of Maranhão, Palmas, and Estrela D'oeste.

In an effort to increase trade with Asia, the Brazilian government is also considering participating in the construction of a cross-border 2,400-mile rail line that would link the port of Santos in Paranaguá, Brazil to the port of Antofagasta in Mejillones, Chile. This is an international effort that is also under study by the other South American countries through which the line would run. Given the international scope of this project, timing for its implementation has not yet been defined.

Highways[4]

The Brazilian government started the privatization program for roads in Brazil in 1994. Several concessions were granted during 2007. As a result, 2,537 miles are under 25-year concessions with several international companies, such as Companhia de Concessões Rodoviárias, Triunfo Participações e Investimentos, Empresa Concessionária de Rodovias do Sul S.A., Acciona, and OHL Brasil.

For the second half of 2008, the Brazilian government expects to grant 25-year concessions pertaining to the following roads:

Port	Estimated Investment	Estimated Date for Opening of Bidding Process
Rio Grande	US$91,500,000	July 31, 2008
Itaguaí	US$74,500,000	July 31, 2008
Recife	US$13,900,000	July 31, 2008
Santos	US$78,300,000	August 31, 2008
Rio de Janeiro	US$85,700,000	October 31, 2008
Vitoria	US$1,500,000	October 31, 2008
Fortaleza	US$19,700,000	September 30, 2008
Suape	US$137,900,000	September 30, 2008
Aratu	US$28,000,000	September 30, 2008
São Francisco Do Sul	US$49,000,000	November 30, 2008
Itajaí	US$13,300,000	November 30, 2008
Natal	To be determined	January 31, 2009
Cabedelo	US$60,000,000	January 31, 2009
Salvador	US$6,600,000	January 31, 2009
Paranaguá	US$30,300,000	January 31, 2009
Imbituba	US$2,500,000	January 31, 2009

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- BR-116/324 BA for the section going from MG/BA Border to Salvador, State of Bahia. This stretch of road is 423 miles long and the estimated investment amounts to US$1.2 billion. The approval and publication of the bidding terms, which are currently being reviewed by the TCU, are expected by the end of August.[5] The Brazilian's National Privatization Council has indicated that the concession will be awarded to the bidder that proposes the lowest toll rate, with the maximum rate being set by the government at R$3.15 (US$1.96).[6]
- BR-040 MG/DF for the section going from Juiz de Fora, State of Minas Gerais to Brasília, Federal District. This stretch of road is 582 miles long and the estimated investment amounts to US$1.6 billion.
- BR-116 MG for the section going from RJ/MG Board to MG/BA Border. This stretch of road is 508 miles long and the estimated investment amounts to US$2.3 billion.
- BR-381 MG for the section going from Belo Horizonte, State of Minas Gerais to Governador Valadares, State of Minas Gerais. This stretch of road is 191 miles long. The feasibility study for the privatization of this road is still underway and, thus, the amount of expected investment has not yet been determined.

Technical studies for the privatization of six additional roads are being prepared. It is expected that these roads will be up for privatization in the second half of 2009. These roads are:

- BR-163 MT/MS from Sorriso, State of Matto Grosso to Rondonópolis, State of Matto Grosso (392 miles)
- BR-060 DF/GO from Brasília, Federal District to BR-153 Entry (78 miles)
- BR 153 GO from BR-060 Entry to GO/MG Border (162 miles)
- BR-101 BA from ES/BA Border to BR 324 Entry (492 miles)
- BR-101 ES from RJ/ES Border to ES/BA Board (285 miles)
- BR-470 SC from Navegantes to SC/RS Border (223 miles)

In addition to these projects announced by the Brazilian federal government, some states have also expressed an interest in implementing toll concession programs. For instance, Minas Gerais State is considering putting up for bid 16 tranches amounting to approximately 4,350 miles.[7] It is expected that these new investment opportunities will be announced during the second half of 2008.[8]

Ports

Under its new Port Dredging Program, the Brazilian government expects to put up for bids dredging service contracts for 16 ports from July 2008 through January 2009. The main common issue with theses ports is the lack of sufficient depth to handle large container vessels. There is also an immediate need reduce the ship transit time in these ports.

Brazil's Growth Acceleration Program has created numerous investment opportunities.

The chart shown on page 4, identifies the ports that are part of the program, the estimated investment, and the current estimated date for the opening of the bidding process:[9]

The contracts to be awarded to the successful bidder would be for a 5-year term, renewable for an additional year.

Conclusion

Brazil's Growth Acceleration Program has created numerous investment opportunities. There are other projects under way that are also within the framework of PAC, such as investment in the generation and transmission of energy, which have not been covered in this article. It is expected that foreign investment in Brazil will continue to grow as a result of such investment opportunities. ❑

1 The Brazilian government held a U.S. road show in the cities of Atlanta, San Francisco, and New York during the week of June 23, 2008 to promote these new investment opportunities to U.S. investors.

2 "BNDES divulga em agosto estudo técnico do trem de alta velocidade" [BNDES will release a technical study regarding the high-speed train in August], (June 30, 2008). Available on the Internet at http://www.bndes.gov.br/noticias/2008/not102_08.asp.

3 Id.

4 Source -- Presentation on Federal Road Concessions by Mr. Henrique Amarante da Costa Pinto, Superintendent of Projects of BNDES in Atlanta, Georgia on June 23, 2008 as part of the U.S. Road Show by the Brazilian Government.

5 CND Approves Bidding Process for BR-324, BR-116 Highways in Bahia – Brazil, Business News Americas (July 7, 2008). Available on the Internet at http://www.bnamericas.com.

6 Id.

7 Toll Roads Brazil Special Report - Brazil's Toll Road Concessions: A New Cycle of Opportunities in a More Stable Environment, Fitch Ratings (May 9, 2008).

8 Id.

9 Source -- Presentation on Brazilian Port Dredging Program given by Mr. Fernando Victor C. Carvalho, Sub-Secretary of Ports in Atlanta, Georgia on June 23, 2008 as part of the U.S. Road Show by the Brazilian Government.

Brazilian Competition Authority Blocks an International Transaction for First Time

By Ricardo Inglez de Souza and Marianna Alves Paganini Picanço (Demarest e Almeida Advogados)

On July 23, 2008, the Administrative Council for Economic Defense ("CADE"), the Brazilian competition authority, ordered, unanimously, the unwinding in Brazil of the acquisition by Owens Corning of fiberglass strengtheners manufacturer Compagnie de Saint Gobain. This is the first time in the whole history of CADE that an international transaction has been blocked.

Owens Corning is a company with activities in the glass fiber technology industry and had registered sales of $6.5 billion in 2006. It has operations in 30 countries. Saint Gobain is a French holding, leader of Saint Gobain Group, which operates in the following sectors: flat glass, high-performance materials, construction products, building distribution products and packaging.

The acquisition was closed on February 2007 and it was completed for approximately $640 million following approval by regulatory authorities in Europe and the United States.

The Brazilian Antitrust Act, Law No. 8,884 of 1994 (the "Competition Act"), allows transactions to be submitted prior to or within 15 business days after the execution of the first binding document relating to the deal. Thus, premerger notification is not mandatory as it is in the US.

The transaction was submitted for the approval of CADE in March 2007.

Given that post-submission may jeopardize CADE's analysis and compromise the effectiveness of CADE's final decision, CADE has enacted a regulation to prevent the closing of deals that have higher probability of harming competition. This regulation allows the parties involved in a transaction to execute an agreement with CADE in which certain restrictions are agreed regarding the closing of the deal in order to guarantee its reversibility. This agreement is called Agreement for the Preservation of the Reversibility of the Transaction ("APRO").

In the Owens Corning/Saint Gobain case, due to the high concentration that the transaction could cause in some of the relevant markets in Brazil (over 90% in some cases), CADE and Owens Corning entered into an APRO to prevent the parties from stopping or reducing the production of both Brazilian plants (Rio Claro and Capivari), based on normal levels of production.

There were several manifestations from third parties opposing approval of the transaction, including among others Rodhia Brazil Ltd. and Amiteck Brazil Ltd. Many well-known specialists were retained by the parties and also by interested third parties and hundreds of pages of technical support were filed. Most of them manifested that the relevant geographic market should be defined as national (Brazil), and therefore the transaction would result in the monopolization of the Brazilian market.

The Secretariat of Economic Monitoring ("SEAE") and the Secretariat of Economic Law ("SDE") issued a joint opinion recommending that CADE block the transaction. According to both authorities' opinion, the transaction could not be approved as presented by the parties. Among other reasons, the Secretariats presented the following: (i) high market concentration in some relevant markets; (ii) lack of installed capacity of competitors; (iii) high barriers to market entry; (iv) high possibility of collusion after the deal; and (v) lack of efficiencies.

CADE's Attorney General has issued its opinion contrary to SEAE and SDE. Basically, this opinion recommended the approval of the transaction be conditioned on the divestment of the Capivari plant by Owens Corning, among other measures.

The Federal Attorney Office also issued an opinion, but contrary to CADE's Attorney General, it defended the disapproval of the transaction, due to the possibility of setting up a monopoly and the likely harmful effects on the competition environment.

CADE's decision was unanimous for blocking the transaction. The Reporting Commissioner, Fernando de Magalhães Furlan, was the leading vote. On judgment section held on July 23, 2008, CADE's Commissioners decided, among other measures, that Owens Corning should (i) sell the units acquired in Brazil, including the Capivari plant to a third party; (ii) hire, upon CADE's approval, an independent company to evaluate the assets and conditions of payment; and (iii) hire, upon CADE's approval, an independent company to monitor the selling process and identify potential purchasers. Moreover, CADE's Board, by majority, decided to recommend the evaluation of possible changes in the import taxes to the Foreign Trade Chamber.

This is a very interesting and important precedent because for the first time CADE Board's denied clearance in an international transaction. Obviously, the effects of such decision are limited to the Brazilian portion of the deal. However, this is a strong message to international companies with activities in Brazil to be aware and mindful of the Brazilian merger control system and try to avoid this kind of undesired outcome. ❑

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The Next Bidding Rounds?

By Glenn Faass (Macleod Dixon), Roberto dos Santos Carneiro and
Alexandre Calmon Bittancourt (Veirano Advogados)

Recently, the ANP hosted an event in Rio in honor of a retiring ANP director. Although the well-regarded Newton Monteiro has concluded a lengthy and valued career in the public sector of Brazil's oil and gas industry, it would not normally be remembered in an article. The element that brings his retirement party to the notice of this forum is that several speakers chose to make extensive comments on public policy. Those remarks were clearly out of context, and tend to show us that 8th and 10th bidding round issues are very much in the ANP's focus, but not necessarily within the ANP's grasp, since it was admitted that the ANP requires political support to implement its recommendations.

Two private industry speakers predictably appealed for a resolution of the interrupted 8th round, and for a new bidding round. They mentioned many good reasons for this – the need for Brazil not to disrupt the "pipeline" of exploration results; taking advantage of current high levels of interest in Brazilian upstream; high oil prices; and maintaining Brazil's place and visibility in the budgets and minds of international oil companies, among others. These are valid, but predictable observations (assuming speakers at a retirement party will be addressing federal upstream policy at all).

What was less expected was that the head of ANP would take up this theme. Haroldo Lima, in a rollicking speech, also made extensive comments about the 8th and 10th rounds.

Closing the 8th Round

Mr. Lima stated the ANP directors' view that the suspended 8th round should be re-opened, and then closed without further bidding. Some will recall that a number of blocks were awarded in this round in fall '06, before an injunction granted in Brasilia to a leftwing politician shut down the round shortly after lunch on its first (of two) days. Though the litigation has since been resolved in favor of the ANP, the round remains in limbo. The ANP now apparently wants to close off the 8th round with its current results intact, and to formally award and sign concession contracts with those who made winning bids in the partial round.

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Other Possibilities

The other options are to cancel the 8th round entirely, thereby negating results achieved before suspension. Or alternatively, to complete the round. Since Mr. Lima indicated that the ANP approach is based on legal advice, we infer that the ANP is concerned about liability should it refuse to award blocks to the early successful bidders. It is likely that this also would further tarnish Brazil's reputation for transparent bidding rounds.

Even a more obvious choice is to complete the round. This would also meet some of the demand for a new bidding round, which otherwise will not occur in 2008. However, that option seems never to have been under serious consideration, for reasons as yet unstated. Some connect this with the announcement last year of the Tupi mega-discovery, remembering that immediately afterwards, a significant number of blocks with similar characteristics were withdrawn from the imminent 9th round. It is supposed that the Tupi discovery has increased the perceived value of some remaining 8th round blocks, and that the ANP (or the government, or both) are reluctant to put this added value out to bid on existing fiscal terms.

Future Rounds

Mr. Lima's comments also strongly supported the regular holding of future bidding rounds. In this context, he specifically mentioned the 10th round, but added that some areas (presumably the famous "pre-salt blocks") would be held back.

Many Cooks?

No details or predictions were offered as to the schedule for concluding the 8th round or holding the 10th round. This is because, as Mr. Lima commented, accepting and implementing the ANP recommendation are both decisions for the Minister of Mines & Energy. Strictly speaking, this decision is subject also to the approval of the National Council for Energy Policy. But, in fact, it is widely believed that other senior figures in the government will have a prominent role in answering those questions.

For example, the head of the President's administration, Dilma Roussef, is likely to have a persuasive voice in these policy decisions, both because she occupies a very senior position (approximately that of the French prime minister) and because she is a former Minister of Mines & Energy.

Perhaps it is not accidental that Ms. Roussef recently spoke to the press on related points. A few days earlier,

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she had offered broad support for holding bidding rounds regularly. However, she was not very specific about timing, nor did she offer listeners any reason to believe that the pre-salt blocks would soon become available. In fact, she compared those blocks to a starship, that would not be sold on Volkswagen terms.

Subsequently, Edson Lobão, Minister of Mines and Energy, agreed that bid rounds could be held this year or next year for onshore and offshore areas that are not pre-salt blocks, and he also raised possible changes to the Brazilian upstream legal/fiscal regime to accommodate the pre-salt blocks.

This indicates that both ministers should support creating new "starship terms," i.e. a new Brazilian upstream regime for these highly prospective assets.

What's on the Menu?

Unfortunately, depending on the objectives, that new regime may require legislative (or even constitutional) changes. In fact, the model proposed by Minister Lobão involves a fundamental change, including returning to a state monopoly in respect of the pre-salt blocks through the vehicle of a 100% state-owed company (i.e., not Petrobras), which conduct bids and supervise the exploration and production activities of winning private companies. That would be a challenge, given Brazil's glacial public processes, and also given the fact that the government is approaching lame duck status, without control of the Senate.

Predictions

We are brave enough to predict:

- A pro-forma opening/closing of the 8th round in the second half of 2008:

The only real obstacle is for the bureaucracy to process the ANP recommendation, because very little preparation is required for a non-event.

- A 10th round without pre-salt blocks in the second quarter of 2009:

Normal preparation for a bidding round is an intensive process for the ANP, with many milestones and a lengthy calendar. It is no longer feasible to start and finish that process in 2008, especially given substantial recent turnover in the ranks of the ANP staff.

We are not brave enough to predict when (or even if) the pre-salt blocks will be put on the block. ❑

Economic Notes

Argentina: Revenge is Best Served Cold

By Walter Molano (BCP Securities, LLC)

The brutal standoff with the agriculture sector ended badly for the Kirchners. The opposition snatched victory from the jaws of defeat, thanks to Vice President Julio Cobos, who broke the tie and voted against the measures. Although cabinet ministers and labor leaders were camped outside the congress, ready to celebrate, Vice President Cabos, with a quavering voice and shaking hand, cast the decisive vote at 2 am. There were joyous celebrations in the streets of Buenos Aires, but few people realized that Argentina was on the brink of institutional breakdown. President Kirchner, abetted by her husband, considered tendering her resignation, which would have plunged the country into chaos. The couple rescinded their decision at the final hour. However, investors were wary of being overly optimistic. The Kirchners will not accept defeat calmly. Unfortunately, no one knows how and when they will strike, but retribution is inevitable.

The Kirchners were noticeably silent after their defeat, retreating to their estate in the Province of Santa Cruz. Cristina's reputation was sullied, but Nestor was the one who suffered the most. After gaining control of the Peronists, he now finds his party divided. Eleven senators defected during the showdown.

Governors from the most important provinces were in open opposition, and rivals, such as Duhalde, Schiaretti and Scioli, threatened his leadership of the party. It is clear that Nestor must regroup and develop a new strategy. In the meantime, Cristina will employ a more consensual approach. Nevertheless, she needs to find new sources of income.

Government expenses are soaring, rising at a pace of 40% y/y—thanks to the soaring inflation rate. Fuel subsidies, higher wages and infrastructure costs are digging into the fiscal accounts.

Unfortunately, revenues are increasing at a more moderate pace of 30% y/y. Hence, the government is being left short. The Ministry of the Economy recently pruned transfers to the provinces. Not surprisingly, Mendoza and Buenos Aires suffered the most, given that their governors were in open opposition to the export tariffs. Local analysts believe that the central government's primary surplus dropped to 3.1% of GDP during the first half of the year, and it could fall to 2% of GDP by year end. With very little access to the international capital markets, Argentina has no other choice but to adjust expenses.

As one of the biggest grain producers in the world, Argentina is well positioned to take advantage of the trends that are transforming the global economy.

Therefore, the government needs to respond. Instead of penalizing a single sector, the government should overhaul the tax system in order to take advantage of the windfall that is boosting the economy. Yet, the Kirchners will be out for revenge, and there is a good chance that a stronger currency may be the measure that best fits their needs.

An appreciation of the peso would help stabilize consumer prices, thus reducing expenditures. At the same time, a stronger peso would squeeze profit margins for agro exporters—thus penalizing them for their petulance. This could make peso-denominated instruments some of the most of attractive assets in Argentina.

Fortunately, the end of the agro-crisis allows us to refocus our attention on the country's fundamentals. As one of the biggest grain producers in the world, Argentina is well positioned to take advantage of the trends that are transforming the global economy. This is the reason why industrial production remained strong, expanding 6.9% y/y in May.

Even with a GDP growth rate of only 7% y/y in 2008, the warrants should pay out 3.17 at the end of next year. This means that the accumulated payout for the next 17 months will be 5.48—versus a current price of 9.75. The problem is that investors will be reticent about jumping too fast onto the Argentine bandwagon. The Kirchners are out for vengeance, and they will take their time playing their hand. Therefore, don't be surprised by the market's lethargic reaction to the good news. We can't forget that revenge is a dish best served cold. ❑

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Colombia: Uribenomics

By Walter Molano (BCP Securities, LLC)

In the land of magical realism, every-day life can be surreal. The rumors and events surrounding the release of the high-value hostages held by the FARC were often hard to believe. Moreover, the timing of the rescue, on the eve of Senator McCain's visit to Colombia and a constitutional showdown with the Supreme Court, could not have been better. Nevertheless, the end of the Betancourt nightmare and the liberation of the North American hostages was a major victory for Colombia. President Uribe's popularity soared to 92%, and it looks like he will soon launch a bid for another term in office, but his economic plan may put the country in harm's way.

Security was the foundation of President Uribe's economic model, locally known as Uribenomics. The sense of greater security engenders an increase in investment, which in turn propels the level of economic activity. In contrast to most of the other countries in the region, exports were not a priority. The real goal of Uribe's economic policy was to tap into the pent up demand of 44 million Colombian consumers who were cowering in fear after two and half decades of civil war. The concept worked well. Gross fixed investment soared 20% y/y, pushing the pace of GDP growth to 7.3% y/y in 2008--the highest level in three decades. Foreign direct investment poured in, allowing the peso to appreciate 20% since the start of 2007. Uribenomics functioned as long as international liquidity was abundant. However, the onset of the global credit crunch is taking its toll on Colombia, and the economy could be in for a painful adjustment.

Despite giddy consumer sentiment, industrial production fell 4.3% y/y in May. Retail sales also dropped 0.4% y/y during the same month. In addition to tighter liquidity conditions, higher inflation is squeezing households. Consumer prices spiked 7.2% y/y in June, forcing the central bank to raise interest rates to 9.75%. This forced local analysts to trim their growth forecasts below 5% for 2008. We expect the Colombian economy to grow 4.6% y/y this year, suggesting a significant slowdown during the second semester. After falling for the last 7 years, and bottoming out at 9.9%, the unemployment rate is rising—reaching 11.8% in June. Local analysts are expecting consumer prices to rise 6.5% y/y in 2008. However, our projections show that this year's inflation rate could top 8% y/y. Nevertheless, the biggest surprise will be in the fiscal accounts. The spike in oil prices was a tremendous boost for the government, since it had such a positive effect on royalties. The consolidated fiscal deficit fell to 1.3% of GDP, against a projected shortfall of 2% of GDP. Unfortunately, the slowdown in the global economy marked the end of the oil rally, and crude prices are falling. This will be bad news for the fiscal accounts, and it will put more stress on the balance of payments, thus marking the end for the country's investment grade aspirations.

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Unlike other countries in the region, which could see the adjustment focus on the external sector, Colombia will be forced to take the entire adjustment on its domestic demand.

President Uribe is well aware of the dangers facing the Colombian economy, and he recently announced measures to confront the deterioration of external conditions. In addition to a reduction in government spending, the president announced new measures to attract more foreign investment. However, the point may be moot. Confidence is not the problem. The real problem is that capital is scarce and dear. The economic woes could soon spell trouble for Colombian financial institutions. Banks went on a lending binge during the last two years. Credit for homes, automobiles and durable goods was abundant. However, tighter monetary policy and reduced access to external lines of credit could leave the banks scrambling. This is the moment when Colombia may have wished to have had more emphasis on exports and trade. Unlike other countries in the region, which could see the adjustment focus on the external sector, Colombia will be forced to take the entire adjustment on its domestic demand. The shortfalls of Uribenomics could make President Uribe's third term in office a less memorable affair. ❑

Modifications and Reforms Made to the Mexican Acquisitions and Service Law

Government Pressure for Lowering Prices and Application of the Mexican Antitrust Law

By Alejandro López-Velarde (López Velarde, Wilson, Abogados, S.C.) and Regina Kuchle (AstraZeneca)

Introduction

As part of a policy towards obtaining better prices for Mexican public entities, the Mexican government amended on July 2, 2008, in the Official Gazette of the Federation (Diario Oficial de la Federación), the Public Acquisitions, Leases and Service Law (Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público--"Acquisitions and Service Law").[1] The principal policies behind the modifications and reforms to the Acquisitions and Service Law include lack of (i) additional financial resources that can be dedicated to the purchase of equipment, products and materials; and (ii) an adequate distribution infrastructure (this is particularly true in sectors such as pharmaceuticals where distribution of drugs and medicines are monopolized by two or three distributors increasing the final price of such products).

The Acquisitions and Service Law is a stringent public policy-based law that cannot be avoided by the public and the private sectors dealing with administrative contracts.[2] This important legal ordinance was recently modified on July 7, 2005 and October 1, 2007, establishing terms and conditions that seem to be against the latest modifications and reforms to be discussed below.

The most important State monopolies and health institutions such as Petroleos Mexicanos ("Pemex"), the Federal Electricity Commission (Comisión Federal de Electricidad--"CFE"), the Mexican Social Security Institute (Instituto Mexicano del Seguro Social--"IMSS"), and the Security and State Workers Social Services Institute (Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado--"ISSTE"), are governed by the Acquisitions and Service Law, whereby government expenditures related to acquisitions, leases, services and public works represent approximately 42% of the federal budget.

Modifications and Reforms to the Acquisitions and Service Law

The Acquisitions and Service Law's modifications and reforms established very broad legal principles. This congressional reform allows the federal executive to address the intricacies of the Acquisitions and Service Law in its Regulation and through general public guidelines to be issued by the Federal Comptroller Bureau (Secretaría de la Función Publica--Known by its Spanish acronym as "SFP"), thereby permitting the executive office to change the current structure of the acquisitions, leases and services to be sold and rendered to the Mexican public sector through creation of a more detailed body of law as long as the executive office does not establish principles, obligations, rights and faculties beyond those authorized by the Congress in the Acquisitions and Service Law.

Pursuant to the amendments to the Acquisitions and Service Law, public entities will be able to request from potential suppliers in the Bidding Guidelines a "Reverse Auction" (Subasta en Reversa) that will be carried out under the following purpose, terms, conditions, and restrictions:

Purpose and Requirements of the Reverse Auction

The amendments aim to obtain the best price condition for the Mexican State.[3] Public entities will need to (i) justify in advance the Reverse Auction; and (ii) obtain an authorization by the SFP.[4] The contract will be awarded to the lowest price bid as long as its corresponding proposal complies *inter alia* with the (i) Acquisitions and Service Law; (ii) Bidding Guidelines; and (iii) best quality and opportunity conditions.[5]

The new possibility to hold a Reverse Auction by public entities could be considered unconstitutional since Article 134 of the Mexican Supreme Law dictates the following:

> *Acquisitions, leases, services and public works, shall be awarded by public bidding after a public bid tender so that reliable proposals can be freely submitted in sealed envelopes, that shall be opened publicly, for purposes of insuring the State of the best available conditions with respect to price, quality, financing, opportunity and any other pertinent circumstances.*[6]

From a careful review of the above-mentioned constitutional mandate it is possible to draw the following interpretation:

(i) The Constitution does not provide the possibility to have two or more tenders at the same time with the

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purpose to obtain the lowest price.

(ii)The Constitution requests one tender for purposes of insuring the State of the best available conditions including quality, financing, opportunity and any other pertinent circumstances on a case-by-case basis and not only the price.

It is important to recall that one of the most important modifications made to the Acquisitions and Service Law on July 7, 2005, was the Lowest Price Rule based on a practical and legal need to allow other kinds of award methodology and not only price consideration.[7] Thus, it was possible to avoid the rigidity of the Acquisitions and Service Law to obtain the best price for the state. This modification allowed the possibility to the public sector to contract for better services even though the same could be more expensive, avoiding the true notion that "if you pay peanuts, you get monkeys."

According to this modification public entities were allowed to account for considerations beyond price in awarding service contracts, including that the lowest price only accounted for 50% of the total award methodology value and establishing the obligation to determine in the Bidding Guidelines the percentage that each of the remaining considerations (e.g., quality, reliability, opportunity, financing, etc.) will be given in accordance with an award methodology to be published by the SFP.[8]

(iii)The Constitution requests a public bid tender so that reliable proposals can be freely submitted in sealed envelopes, that shall be opened publicly, for purposes of insuring the State *inter alia* the best available conditions for price, meaning that the sealed envelopes shall contain the final price and not a marked-up price for the purpose to lower same by potential suppliers losing the confidentiality element and a bidding process whereby final offers are posted by potential suppliers.

(iv) The Constitution establishes the possibility of holding a public bid tender so that reliable proposals can be freely submitted by any individual or corporation that might comply with the equipment, materials, products, public work or service requested by the bidder. Reverse Auctions will require using electronic systems which not all of the potential suppliers have in their offices.

(v) From a practical point of view, awarding administrative contracts based on the Lowest Price Rule has not been the best option for the Mexican State. Some examples are related to public tenders carried out in sectors such as the banking system, construction of highways, sugar mills, among other sectors.

(vi) A governmental policy based on the Lowest Price Rule makes the mistake of not having considered important conditions that might create bad effects in the economy and increase the possibility of generating a predatory pricing scheme.

It is important to recall that one of the most important modifications made to the Acquisitions and Service Law on July 7, 2005, was the Lowest Price Rule based on a practical and legal need to allow other kinds of award methodology and not only price consideration.

Reverse Auction Methodology

The modifications and reforms to the Acquisitions and Service Law lacked the administrative guidelines for their corresponding implementation. The SFP will publish the Reverse Auction Methodology in the Official Gazette of the Federation six months after the publication of the amendments to the Acquisitions and Service Law.[9] Therefore, the full significance of the amendments as to its scope, validity, and understanding will be made clear when the Reverse Auction Methodology is published in the Official Gazette of the Federation.

It will be very interesting to see how the SFP's Methodology warranties open access to any economic agent that wishes to participate in a Reverse Auction; the minimum and maximum auction time; confidentiality; among other provisions.

In a legal system such as the Mexican one, the SFP's Methodology could be subject to constitutional challenge since the constitutional general principles shall be developed by the Mexican congress through the promulgation of congressional laws. Part of the Mexican doctrine considers that these kinds of modifications and reform, through which the Executive Branch and Mexican Congress establish very broad legal principles so that the Federal Executive may establish the term and conditions under which potential suppliers may participate with public entities in the public acquisition, leases and services sector through regulations, are a violation of the Mexican legal system. According to the Constitution, the Mexican President is empowered to provide Regulations for the application and understanding of a Congressional law. However, the president can not use the Regulations or a simple Methodology to legislate, as could be the case with the Acquisitions and Service Law's modifications

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and the Reverse Auction Methodology to be published by the SFP.[10]

In addition to the above-mentioned constitutional challenge, questions about corruption will be in line regarding the discretionary authority provided to public entities through the SFP's Methodology when a contract is granted to a participant whose bid was higher in price, triggering appeal processes against public entities.

Medium and Small Corporations

The amendments are designated to allow and encourage the participation of medium and small size corporations.[11]

Use of Electronic Media

The modifications aim to encourage the use of electronic media for Reverse Auctions and further resolutions taken during the bidding process. Public entities shall be previously authorized by the SFP to carry out tenders under this system while participants have the choice to do so through the electronic system or personally. Contracts will be able to be executed when the system is in place and approved by SFP.[12]

Reverse Auctions and Application of the Antitrust Law

The Reverse Auction modifications made in the Acquisitions and Service Law might create several anticompetitive problems. The general rules applicable to competition in a bidding process are the following:

Public Calls and Bidding Guidelines

The Acquisitions and Service Law dictates that public entities shall establish in the public calls and bidding guidelines free access to any economic agent that wishes to participate in a public tender taking into consideration principles such as transparency, impartiality, clarity, precise terms and in general equal conditions without guiding the bidding process in favor of a specific potential supplier or dictating restrictions to competition and free participation.[13]

Administrative Contracts

Any contract or agreement to be granted by a public entity shall be done in accordance with the Antitrust Law.[14]

Price Fixing and Cartels

It is not desirable to hold Reverse Auctions in economic sectors where there are few suppliers since it will be vulnerable to collusion and cartel problems.[15] For example in the pharmaceutical industry there are two or three mayor distributors bidding with health institutions such as IMSS and ISSSTE. In the upstream and downstream sectors of the oil and gas industry there are not enough suppliers of certain equipment and materials used by only Pemex, the state company.

In other countries collusion problems have been detected. In fact, potential suppliers have been scouting prices in public tenders, creating distortions in future tenders and in the economic sector itself.

Rig Bids on Contracts

The possibility to establish, rig or coordinate bids or to abstain from submitting proposals in competitive bidding or bidding in public calls.[16]

The full significance of the amendments will be understood when the Reverse Auction Methodology is published.

Boycott

The agreement between several economic agents or an invitation extended to them to exert pressure on a certain customer or supplier, for the purpose of dissuading it from a certain practice, to retaliate or force it to act in a certain manner.[17]

Predatory Pricing

The intention to sell to the public sector products, materials and equipment or render services to a lower price than its normal cost.[18] Bidders will not be able to determine if the potential suppliers are quoting predatory prices.

Exclusive Discounts

The granting of special discounts to the public sector by the potential suppliers with the requirement of not to use, acquire, sell, or supply the goods and services of another economic agent.[19]

Cross Subsidies

The use of profits obtained from the sale and commercialization of a product or rendering of a service with the purpose to funding the losses of another product or services.[20]

Technology Availability

If the technology is not available to any potential economic agent who whishes to participate in a Reverse Auction, the amendments to the Acquisitions and Service Law will be, by their own terms, discriminatory, impeding access to economic agents that do not have the electronic system available for bidding. Thus, it will be a violation

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not only to the spirit of the Antitrust Law, but also the Constitution in its Article 134 since one of its main elements is to hold public bid tenders whereby anybody may participate, insuring the State the best available conditions in the market. Again, the Acquisitions and Service Law was recently modified and added on October 1, 2007, for the purpose of including express prohibition to discriminatory and anticompetitive terms and conditions established by public entities during public tender processes. In fact, public entities must at all times avoid requirements and establish terms and conditions with the purpose or effect of limiting the competition process and free access by and among potential suppliers.[21]

Reverse Auction Methodology

It will be very important that the Reverse Auction Methodology to be published by the SFP contains terms and conditions aiming to avoid the above-mentioned anticompetitive acts. If any public entity can only grant an award to an individual or corporation with access to electronic systems, the Methodology will be void *ad initio* for violations to the Constitution and the free access to the markets established in the Antitrust Law.[22] Stated in another way, there is not any provision in the Mexican legal system that requires an economic agent to buy an electronic system and hire the corresponding technicians in order to have the opportunity to participate in the Mexican market.

International Treaties

It is our understanding that Reverse Auctions shall not be applicable to commercial partners whose countries have executed international agreements that contain terms and conditions different than this Reverse Auction proceeding based on the following considerations:

a. A treaty such as the North American Free Trade Agreement ("NAFTA") is considered national law throughout Mexico.[23] The Constitution dictates that "the Mexican Constitution, the Laws of the Congress of the Union which emanate therefrom, and all treaties . . . shall be the Supreme Law throughout the Union."[24] The laws of the Congress of the Union which emanate therefrom are known in Mexico as Leyes Reglamentarias (Regulatory Laws) such as the Acquisitions and Service Law. Regulatory Laws are laws that develop constitutional rules in order to have a better understanding and application of the Mexican paramount law. Treaties and the immediately preceding federal Regulatory Laws are rooted in the same hierarchical order. The question of the hierarchy of law, in which a court would be obligated to follow subsequent federal legislation that may contradict a treaty or executive agreement, might be answered differently by the United States and Mexico. In the United States, if Congress approves legislation contrary to binding international agreements and the measures become law, the legislation is binding on United States courts despite the international agreement according to the last in time rule.[25] In Mexico, however, if Congress approves the legislation, the legislation will not derogate a treaty since Congress does not have the power to derogate Mexican international commitments.[26] In fact, Article 72 Section (f) of the Mexican Constitution dictates that:

"[I]n the interpretation, change, or repeal of laws or decrees, the same procedure shall be followed as that established for their enactment."

The Mexican government has made an important effort to provide better price conditions for its public entities.

The U.S. doctrine that a treaty and federal law are of equivalent hierarchy, and that the last in time rule governs, does not apply in Mexico.[27] As a result, in Mexico, the courts would rule that the treaty prevails, despite subsequent contradictory legislation. In addition, in Mexico, it is difficult to believe treaties can derogate congressional laws because only the Senate can approve treaties.[28] Thus, the hierarchical order of treaties and the potential conflict with Mexican federal laws are questions that have yet to be resolved by Mexican federal courts and the Supreme Court to establish clearer rules of application.

b. Reverse Auctions are not regulated in international treaties executed by Mexico.
c. The Acquisitions and Service Law dictates that its application shall be without prejudice to Treaty provisions.[29]

Conclusion

The Mexican government has made an important effort to provide better price conditions for its public entities. Nevertheless, the modifications made to the Acquisitions and Service Law shall be in full compliance with the (i) Constitution; and (ii) Antitrust Law.

The Constitution establishes the possibility to hold public tenders in order of obtaining the best price, quality, financing, opportunity and any other pertinent circumstances for the Mexican State. Nevertheless, this constitutional mandate of obtaining the best products, materials, equipment and services maximizing public

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resources shall be carried out by public entities without affecting competition in any economic sector allowing at all time free access in the market to any economic agent.

The international experience has evidenced that Reverse Auctions have created problems related to corruption, collusion among competitors and fraud, among other unlawful acts.

The full significance of the amendments as to their scope, validity, and understanding will be made clear when the Reverse Auction Methodology is published by the SFP whereby any term, condition, faculty or authority granted to public entities that goes beyond what is established in the Acquisitions and Service Law will be subjected to constitutional challenge. ❑

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1 See Public Acquisitions, Leases and Service Law (Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público), pub'd in the Official Gazette of the Federation (Diario Oficial de la Federación-"D.O") July 2, 2008.
2 Id. Art. 1.
3 Id. Art. 2 (VIII).
4 Id. Art. 28.
5 Reverse Auctions will begin after having filed and opened up the economic proposals. Id. Art. 36 Bis (III).
6 Based on the above-mentioned constitutional mandate the Acquisitions and Service Law also dictates that a public bid tender must be carried out with the purpose of obtaining the best available conditions described in the Constitution. Id. Art. 27.
7 Id. Art. 36 (III).
8 Id.
9 That is to say; the Methodology has to be published no later than January 3, 2009. Id. Art. Second Transitory.
10 See Political Constitution of the United Mexican States (Constitución Política de los Estados Unidos Mexicanos) [hereinafter cited as "Constitution"], pub in D.O. Feb. 5, 1917, art. 89 (I).
11 See Acquisitions and Service Law, arts. 28, 42.
12 Id. Arts. 26, 27, 29 (II)(III), 31(XVIII), 45, 51, 56.
13 Id. Art. 36.
14 As a general rule, contracts between private parties and the Mexican Government or its public entities for acquisitions, leases, services and public works are awarded through a public bidding process, commonly referred to as "Public Calls." Public Calls may be domestic and/or international. They must be simultaneously published in a special section of the Official Gazette of the Federation. Id. Art. 34.
15 Fixing prices is defined by the Antitrust Law as the possibility to lower, raise, fix or manipulate the sale or purchase price of goods or services at which they are supplied or demanded on the market, or the exchange of information which has the same purpose or effect. See Federal Competition law (Ley Federal de Competencia Económica) [hereinafter cited as the "Antitrust Law"], pub'd in D.O. Dic. 24, 1992, art. 9 (I).
16 Id. Art. 9 (IV).
17 Id. Art. 10 (VI).
18 Before the modifications made to the Antitrust Law on June 28, 2006, predatory pricing was included in the general anticompetitive definition which considers the possibility of engaging in any act that unduly impairs or impedes competition and free participation in the production, processing, distribution and marketing of goods and services. Nevertheless, the Mexican Supreme Court declared as unconstitutional this provision ruling that it violates the legality and certainty principles pursuant to Article 16 of the Constitution, given that its wording did not identify particularly any action or practice that should be considered as relative monopolistic practice sanctioned by the Antitrust Law.
19 Id. Art. 10 (VIII).
20 Id. Art. 10 (IX).
21 See Acquisitions and Service Law, art. 31.
22 See Constitution, art. 134; Antitrust Law arts. 1-3, 9, 10.
23 See James F. Smith, Confronting Differences in the United States and Mexican legal Systems in the Era of NAFTA, 1 U.S. Mex. L.J. 85, 96 (1993) (noting that "Article 133 of the Mexican constitution is a near literal translation of the Supremacy Clause of the United States Constitution").
24 See Constitution, art. 133.
25 See Jordan J. Paust. Self Executing Treaties, 82 AM. J. Int'l L. 760, 767 (1988).
26 See Constitution, arts. 89, 76, 133.
27 Id. Art. 133.
28 Id. Art. 72(f).
29 See Acquisitions and Service Law, art. 4. Controversies resulting from the interpretation or application of the Acquisitions and Service Law or contracts signed that are based on it, shall be resolved by the federal courts. Arbitration clauses may only be agreed to in contracts with respect to those controversies specified by the SFP through general rules, on prior consultation with the Ministry of Economy. These provisions are without prejudice to treaty provisions. Id. Art. 15.

Recent Changes in Mexican Law May Affect Loan Sales, Securitizations

By Leonora Olmedo Beltrán (Strasburger & Forastieri, S.C.) and John E. Rogers (Strasburger & Price LLP)

In February 2008 the Mexican Law Regulating Credit Information Companies (the "CIC Law"), called the Ley para Regular las Sociedades de Información Crediticia, was amended in several respects[1]. One of the more significant changes was the introduction of Article 27 Bis into the CIC Law,[2] whereby significant new obligations are imposed on financial institutions and other lenders who are users ("Users")[3] of the services of Mexican credit bureaus, called Sociedades de Información Crediticia (Credit Information Companies or "CICs"), in connection with sales or assignments of loans or extensions of credit, including credit card receivables, to individuals or companies ("Customers") who are reported as clientes (defined below) under the CIC Law. The new obligations introduced by Article 27 Bis should be taken into account by any lenders planning to sell loans made to or receivables owing by any such Customer, whether in negotiated sales to other financial institutions or as part of the securitization of a portfolio of loans or receivables. Such lenders should insist on requiring the purchasers or assignees of such loans or receivables to agree to take all steps necessary to avoid the difficulties which may arise under Article 27 Bis.

It should be emphasized that although the largest number of Customers subject to reporting to CICs are individuals, the obligations established by Article 27 Bis will affect the sale or assignment of loans and receivables owing by many corporate borrowers as well. Article 2 of the CIC Law defines "*cliente*" as "any individual or entity that requests information from, or as to whom or which a request for information is made to, a Company [i.e. a CIC]". The Mexican affiliate of Dun & Bradstreet is a CIC which specializes in the reporting of the credit histories of corporate Customers, but other CICs also report on corporate Customers even where the vast majority of their Users' reported Customers are individuals.

The new Article 27 Bis provides that, if a User sells or assigns to any other person (an "Assignee") loans or receivables that were previously reported to any CIC, such User must inform the CIC thereof within 20 business days after the relevant Customer is required, under applicable law, to be so notified. The User must also inform the CIC of the name, address and tax registration number of the Assignee and any other information about the Assignee necessary to sufficiently identify it. If the Assignee is also a User, it will then become obligated to perform the duties as to credit reporting that are imposed on Users under the CIC Law. Such duties include those of reporting to the CIC any late payments or defaults by the related Customers and being responsible for dealing with complaints by such Customers – for example, complaints filed by Customers with the National Commission for the Defense of Financial Institution Customers (the *Comisión Nacional para la Defensa de los Usuarios de las Instituciones Financieras* or "Condusef") claiming, for example, that the reports filed with a CIC were incorrect in some way, damaging the credit status of a Customer.

Even though the largest number of Customers subject to reporting to CICs are individuals, the obligations established by Article 27 Bis will affect the sale or assignment of loans and receivables owing by many corporate borrowers as well.

If, however, the Assignee is not a User, the selling or assigning User will continue to be obligated to perform such duties, which will mean that such User will continue to have to report to the CIC any information as to the status of the relevant Customers' loans or receivables, even though after the sale or assignment such information will be in the possession of the Assignee and not normally disclosed by it to the assigning User; such disclosure may even be prohibited by bank secrecy laws. If the assigning User has agreed to act as the servicer of the credits, for example in a securitization of mortgage loans under a servicing agreement with the special purpose trust or other entity (the "Issuer") which has acquired the loans and issued mortgage-backed securities based thereon, this obligation may not be particularly onerous. As servicer

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of the mortgage loans, the assigning User may continue to receive sufficient information on their payment status to be able to continue performing its obligations under the CIC Law.

On the other hand, if the assigning User intends to make a complete break with the loans or receivables, and does not wish to act as servicer with respect to them after they have been assigned, it must ensure that the Assignee is a User or immediately takes the steps necessary to become a User. In the contract governing the sale or assignment of the loans or receivables, the assigning User should insist on the Assignee either representing and warranting that it is already a User or agreeing that it will promptly become a User, and on indemnifying the assigning User from and against any liabilities or claims that may arise in the event that the Assignee fails to become a User or fails to comply with its obligations as a User under the CIC Law. In light of the adverse consequences to the assigning User of the Assignee not becoming a User, the assigning User may even wish to make it a condition precedent to closing the sale or assignment that the Assignee shall have become a registered User with each applicable CIC.

In a loan or credit card securitization transaction, where the assigning User is expected to act as servicer of the loans or receivables, there is the question of how to deal with the backup servicer situation. In other words, if the Issuer has not become a User because it is relying on the assigning User to act as servicer of the loans or receivables and continue to be the responsible User with respect thereto, but investors wish to provide for the possibility of a backup servicer to address the risk of servicer default or insolvency, such investors may need to ensure that any backup servicer will be a User in order to qualify to so act. The alternative is for the Issuer to become a User, but this is normally not the kind of role that Issuers, which typically do not have the staff required to carry out such functions, would be suited to assume.

Litigation may be brought to challenge the constitutionality of the new Article 27 Bis, on various grounds, including that it imposes an undue burden on selling Users, that there is no time limitation established for compliance and that it creates undue uncertainty as to the effect of contractual obligations. It is not clear whether such claims will succeed, and unless and until Article 27 Bis is ruled unconstitutional by the Mexican courts, the parties to loan sales or assignment transactions are best advised to comply. Going forward, the parties to loan sales or assignments should keep Article 27 Bis in mind in negotiating their contractual obligations where the loans or receivables are reported to any CIC. ❑

In light of the adverse consequences to the assigning User of the Assignee not becoming a User, the assigning User may even wish to make it a condition precedent to closing the sale or assignment that the Assignee shall have become a registered User with each applicable CIC.

1 Published in the *Diario Oficial de la Federación* on February 1, 2008.

2 Article 2 of the CIC Law, as amended, defines a "User" as any financial institution, commercial entity or multiple-purpose financial entity (*sociedad financiera de objeto múltiple* or SOFOM) which uses the services of a CIC.

3 Article 5 of the CIC Law provides that a disclosure between a User and a CIC of credit information does not violate bank secrecy, but it is not clear whether a disclosure of such information to a User by a non-User institution bound by bank secrecy would violate the secrecy restrictions under Article 117 of the Credit Institutions Law. Although the February 2008 amendments refer extensively to the situation of a non-User having credit information on Customers, they do not include any change in Article 5 of the CIC Law that would help to clarify this point.

Mexican REITS and Real Estate Investments of Pension Funds

By Bernardo Ramírez (Chevez, Ruiz, Zamarripa y Cia., S.C.)

Although currently the steep real estate crisis has reduced or eliminated the interest for further investments in the US, in other countries this financial crisis does not seem to have identical effects and real estate developments continue; probably at a more paused step, but still with certain dynamism. Probably the reason is that demand for real estate is still present in countries such as Mexico and economic conditions appear favorable for this type of investment.

In this context, the tax effects derived from real estate investments in Mexico, as well as the recent changes to the available investment figures is still of relevance.

Foreign Pension Fund Investments

Over the past few years, Mexico has experienced a significant increase of foreign investment in real estate, specifically in real estate development for office, commercial and industrial rental purposes. These investments have attracted the attention of investment vehicles where foreign pension funds participate, mostly US.

As a general principle, non-residents directly owning immovable property located in Mexico are subject to Mexican income tax on the lease income, as well as on any capital gain arising from the sale of immovable property, or from the sale of shares which value derives mainly from immovable property located within the country, regardless if the entity is a Mexican resident or not.

Under Mexican law[1], pension funds are not subject to Mexican income tax on interest, capital gains and lease income derived from their investments, provided such funds are: the effective beneficiaries of the income; non taxable entities in their home country, and comply with a number of formal requirements before the Mexican tax authorities. The capital gain exemption also covers the sale of shares issued which value derives mainly from immovable property located in Mexico.

The above is only applicable if the immovable property has been subject to a lease for at least one year before the capital gain is obtained.

Additionally, when pension funds participate as shareholders in an entity that obtains at least 90% of its income from the sale or leasing of immovable property, or from the sale of shares which value derives mainly from immovable property, such entities would be exempt from corporate income tax in the percentage that pension funds hold of such entities' capital stock.

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On the other hand, beginning 2008 a new alternative minimum tax to the income tax has been enacted in substitution of the asset tax formerly in force. This new flat tax (IETU tax) is imposed on a broader base than income tax, limiting certain deductions (i.e. interest payable, royalties and wages) but applying a lower rate[2]. This new flat tax is only payable whenever it exceeds the ordinary income tax. The Flat Tax Law also provides[3] that Mexican resident entities in which pension funds participate, that are to some extent exempt of income tax, will also be exempt of flat tax in the same proportion.

The Mexican tax regime applicable to foreign pension funds investing in Mexico continues to promote participation in the Mexican real estate market.

These tax advantages are unique in the Mexican Income Tax Law and have been a significant driver for foreign pension funds to actively participate in the real estate market in Mexico, where they have partnered with Mexican land owners to build developments and entered into long term lease agreements providing for a reasonably safe investment return for the pension funds.

Mexican REITS

In fiscal year 2004, a tax incentive was introduced granting a special regime for operations undertaken through a Mexican trust ("fideicomiso") which had as its main purpose the purchase or construction of real estate destined to leasing activities or to the acquisition of rights to receive rental income, or to the granting of mortgage financing to such ends. Commonly these real estate investment trusts are known as FIBRAS.

As background, Mexican trusts are contracts that lack legal personality entered into between a settlor who contributes assets into the trust to achieve a certain objective, and where a beneficiary of the assets of the trust is appointed. The beneficiary may be the settlor himself or a third party. In order to undertake the purpose of the trust, there is a legal transfer of property into a third party to the contract, the trustee agent, this has to be a financial entity, commonly a bank.

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This regime has been modified over the past years trying to accommodate the practical application of these investment vehicles and to ultimately create a market through the Mexican Stock Exchange of participation titles issued by such trusts. Unfortunately, the current provisions[4] are not yet able to provide the required flexibility and legal certainty to encourage investors to participate in the market with this kind of vehicles.

However, tax and financial authorities as well as other players in the market are still interested in making the required legal and regulatory changes to make sure that investors participate through this investment vehicle.

Under current legislation the advantages derived from this investment vehicle are as follows:

1. Income tax imposed over gains derived from the contribution of real estate, by the settlor into the trust may be differed until the sale of the certificates issued in exchange of the contribution.
2. There is no obligation to make advanced income tax payments on monthly basis, but rather to determine a tax result for the fiscal year.
3. Foreign pension funds are exempt of income tax on distributions made from the trust, as well as on capital gains derived from the transfer of the certificates they may hold, in the same line as if they were investing in a Mexican resident real estate entity.
4. There is a basis step-up of real estate contributed into the trust, thus allowing a larger depreciation deduction to determine the trust's taxable income.
5. Mexican resident individuals, and non-resident investors that sell certificates they own representing their investment in the trust are not subject to income tax, nor flat tax on the disposition, provided it is executed through the Mexican Stock Exchange.

In order for a trust to qualify for these benefits, there are a number of requisites that must be met, the main ones being:

1. At least 70% of the trust's net-worth has to be invested in real estate, or in rights to receive rental income. The excess has to be invested in government bonds or shares of investment entities devoted to hold publicly-traded debt.

This requisite poses a practical problem, as it lacks definition as to when the 70/30% ratio has to be measured. Since the value of real estate may fluctuate during the year as well as the value of investments held, there should be a close of the year period to measure and clear definition as to which real estate value to consider (tax cost basis, appraisal value at closing, or any other formula).

2. Real estate conveyed into the trust must be rented out and it is not sold before a 4 year term has elapsed. If a piece of real estate is sold before the 4 year term elapsed, said asset would not enjoy the benefits derived for this kind of investment vehicles.

There is also a lack of clarity on how to apportion the loss of benefit within a trust that holds assets that were kept for more than 4 years and others that were not.

3. The trust has to issue participation certificates in exchange for the assets (real estate, cash, others) conveyed into the trust, and such certificates have to be placed in the Mexican Stock Exchange. As of today, the lack of clarity in some of the provisions as well as the adverse effects still associated to this figure have prevented any public placement of these certificates.

Tax and financial authorities as well as other players in the market are still interested in making the required legal and regulatory changes to make sure that investors participate through this investment vehicle.

Alternatively, it is possible to set up a private FIBRA, in which the certificates owned by a group of at least 10 investors, that are unrelated parties amongst them, and in which none of them holds more than 20% of the certificates. A private FIBRA may also be set up if at least 80% of the certificates are owned by foreign pension funds or investment funds in which pension funds participate.

4. At least 95% of the trust tax result has to be distributed to the certificate holders on a yearly basis, based upon the previous year's profits.

This requirement is probably the least appealing feature of this investment vehicle, from an income tax perspective, as it forces the beneficiaries of the trust to anticipate the income tax effect on the profit (foreign pension funds are exempt while all others are subject to taxation in Mexico) and there is no incentive created to re-invest the profits on a tax free basis in the trust to continue participating in further asset acquisitions.

In addition to these requisites and the considerations commented on each of them, there are a number of other issues that have to be considered and that in practice have prevented a successful application of these investment vehicles, amongst which the following may be highlighted:

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Mexican REITS (from page 19)

1. There is not enough clarity in the tax provision in force as to whether the flat tax exemption that applies for pension funds investing in real estate entities extends to their participation in FIBRAS on the profits generated through the trust.
2. There is a local tax imposed on the acquisition of real estate, which is applicable in most of the municipalities of Mexico. Normally this tax ranges between 2% and 5%, and is imposed on income from most forms of alienation of real estate.

There is a wide variety on the scope covered by these local taxes, and in most cases the contribution into the trust of the real estate is taxed and also tax is levied on the transfer of the certificates. Only a few states have started contemplating changes to local legislation to provide for a relief, but so far these taxes have represented the main obstacle to implementing these investment vehicles.

3. There are a number of technical adjustments to be made to the provisions that regulate FIBRAS, but probably these necessary adjustments are less significant when compared with the rest of the issues and problems commented above.

In Summary

The Mexican tax regime applicable to foreign pension funds investing in Mexico continues to promote participation in the Mexican real estate market, and those features have contributed to delay the adverse effects of the crisis within the US real estate market.

Although it is plausible trying to develop, through FIBRAS, a market of publicly traded instruments, with rented real estate as underlying assets, there are still significant hurdles to overcome. On the other hand, there is a clear interest of the appropriate parties to make the necessary adjustments to legislation to create an incentive for the market participants to take advantage of these vehicles. Hopefully these adjustments will be ready by the time there is a more favorable international climate to continue investing in the real estate market in Mexico. ❑

1. Article 179 Mexican Income Tax Law
2. For year 2008 the applicable rate is 16.5%, 17% for 2009 and 17.5% from 2010 forward.
3. Art. 4 section V IETU Law
4. Articles 223, 224, 224-A of the Mexican Income Tax Law and miscellaneous resolution rule I.3.20.2

Venezuelan Legal and Business Developments

By Vera De Brito de Gyarfas (Travieso Evans Arria Rengel & Paz)

Energy

The Constitutional Chamber of the Supreme Court of Justice accepted for its consideration a petition for nullification of articles 22, 33, 34, 35, 36 and 37 of the Organic Hydrocarbons Law filed in January 2008 which provide for the establishment of mixed companies in hydrocarbon activities. The petition also claims that the act pursuant to which the National Assembly approved the format of contract for incorporation of the mixed companies by Corporación Venezolana de Petróleo (CVP) and private companies is unconstitutional. A decision is expected by the middle of August.

PDVSA announced the buy back of bonds of Petrozuata no longer existing, which are still in the market, as well as the payment of US$ 200 million in private debt contracted with a group of banks including Credit Suisse, BNP Paribas and Societé Generale. PDVSA and Petrobras signed two preliminary agreements according to which Venezuela commits to provide LNG to Brazil from the first and second liquefaction trains of the Gran Mariscal de Ayacucho project, currently under construction in Güiria.

Reportedly, three areas of the Orinoco Oil Basin (Carabobo 1, 2 and 3) will be subject to a bidding round which will be the first after the entering into effect of the Organic Hydrocarbons Law. Each project is expected to include an upgrader to convert the 9° API crude into syncrude.

Basic Industries

The Decree with Rank, Value and Force of Organic Law of Organization of Cement Producing Companies was published in the Official Gazette of June 18, 2008 for purposes of reserving to the State the industry of cement production and ordering the transformation of Cemex Venezuela, S.A.C.A., Holcim Venezuela, C.A. and C.A. Fábrica Nacional de Cementos S.A.C.A. (Grupo Lafarge de Venezuela) in State-owned companies with a State participation of at least 60%.

Exchange Control

"Temporary Guidelines to Facilitate the Obtaining of Authorizations for Acquisition of Foreign Currency for Imports of Capital Goods, Inputs and Raw Material by the Companies that Form the Productive and Transforming Sector of the Country" were issued as per Presidential Decree published in the Official Gazette of June 23, 2008. These guidelines will apply to entities registered with the RUSAD as of June 11, 2008 and for requests for acquisition of foreign currency up to US$ 50,000. CADIVI will issue a resolution to regulate these guidelines and reduce the applicable time periods, and the Ministry of the Popular Power for Finance will issue a resolution defining the capital goods, inputs and raw materials that will be subject to these guidelines.

A joint resolution of the Ministries of the Popular Power for Finance, Basic Industries and Commerce, Agriculture and Lands and Food established that the local market does not have an adequate and sufficient production of certain products in order to facilitate the granting of foreign exchange by CADIVI. The list of products is mainly made up of milk (in different presentations), eggs, beans and various types of seeds.

Finance

Mr. Alí Rodríguez, former President of PDVSA, Minister of Energy and Mines and representative of Venezuela before OPEC, was appointed Minister of Finance as per Presidential Decree published in the Official Gazette of June 16, 2008.

As per Resolution N° 062-2008 published in the Official Gazette of June 6, 2008, the National Securities Commission issued the new Regulations for Filing, Negotiation and Sale of Securities in the Caracas Stock Exchange, C.A.

A Resolution of the Venezuelan Central Bank, published in the Official Gazette of June 10, 2008 established that the former and new group of bills and coins will circulate simultaneously at least until December 31, 2008.

The Superintendence of Banks and other Financial Institutions issued Resolution N° 129-08 published in the Official Gazette of June 13, 2008, which establishes rules to regulate the minimum aspects that must be contained in credit card agreements, as well as the method and formula for calculating interest. Said resolution was issued in order to comply with the decision handed down on July 10, 2007 by the Constitutional Chamber of the Supreme Court of Justice and includes the following aspects, among others: (i) information that must be readily available to the public regarding the product (credit card), including the name and characteristics of the credit card franchiser; (ii) minimum information that must be contained in the credit card agreements; (iii) The standard credit card agreement for each bank or financial institution must be approved by the Superintendence of Banks; (iv) any charges made by persons other than the card holder shall

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be borne by the issuer of the card, unless it can prove the guilt of the card holder in the act; (v) information that must be included directly on the card, i.e., current photo of the card holder; (vi) minimum information that must be included in monthly card statements; and (vii) formula to calculate interest.

The National Securities Commission issued the Norms on Brokerage and Stock Intermediation Activities as per publication in the Official Gazette of June 19, 2008.

Taxation

As per Presidential Decree published in the Official Gazette of June 12, 2008, the Tax on Financial Transactions applicable to Legal Entities and Economic Entities without Legal Identity was repealed with effect as from June 12, 2008.

On June 27, 2008, the Constitutional Chamber of the Supreme Court of Justice published Decision N° 980 which contains a new clarification of article 31 of the Income Tax Law related to the determination of net profit of employees for purposes of calculation of the income tax. The original decision establishes that for purposes of calculation of net profit of employees the taxable base shall only be the "normal salary." This new clarification indicates that the criterion of the normal salary established by the original decision will apply for the 2008 tax year, not the 2007 tax year. The Supreme Court of Justice further indicates that "normal salary" is the one defined in the second paragraph of article 133 of the Organic Labor Law which states that "For the purposes of this Law, normal salary is considered to be the remuneration earned by the worker in a regular or permanent manner, for the rendering of his/her services. Therefore, items of an incidental nature, those derived from seniority payments, and those that this Law considers do not have a salary nature, are not in the nature of salary."

Temporary Guidelines to Facilitate the Obtaining of Foreign Currency were issued.

The SENIAT issued an Administrative Ruling dated June 16, 2008, informing that the average interest rate for loans, set by the Venezuelan Central Bank for May 2008 was 25.97%, in order to calculate late payment charges caused by tax debts, which are determined at 1.2 times said rate.

Labor

The new Law of the "Instituto Nacional de Cooperación Educativa (INCE)", was published in the Official Gazette of June 23, 2008. Said law is in force since its

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publication in the Official Gazette and it repealed the laws on the subject published in 1959 and 1970. The new law changes the name of the Institute to "Instituto Nacional de Capacitación y Educación Socialista (INCES)", and includes indigenous communities and citizens with penalty of imprisonment as participants in the education programs offered by the Institute in addition to the apprenticeships, in which case the age range was modified and now includes teenagers that are between 14 and 17 years old.

The new law establishes that not only persons or companies dedicated to industrial or commercial activities have to contribute to the Instituto Nacional de Capacitación y Educación Socialista (INCES)" but also every association engaged in consulting and services in general, which has 5 or more employees. Non-profit organizations are exempt from paying the contribution referred to in the law as long as they carry out the values and principles of the social, participative and communal economy. According to the law, the contribution paid by the employer must be equivalent to 2% of the normal salaries paid to the employees and each employee must contribute with 1/2% of the amount received as profit sharing. The employer will have to withhold the amounts corresponding to the contributions made by the employees and then pay them to the Institute. The number of apprentices that employers should hire will be determined by the regulations to the law, which should be issued in a period of 180 days following the publication of the same. Meanwhile, the number of apprentices hired should not be less than 3% or more than 5% of the total number of employees, as long as this total is greater than 15 employees.

Environment

The Law on Forests and Forestry Management (Ley de Bosques y Gestión Forestal - LDB) was published in the Official Gazette of June 5, 2008. This law substantially modifies the legal regime applicable to the handling and exploitation of public and private forests. Its most significant provisions include the modification of the permitting process, as well as tax rules requesting the payment of new royalties for exploitation rights granted by the government. In addition, this new law sets forth monetary and criminal sanctions for the activities capable of degrading forest areas (up to 10 years of imprisonment and 10,000 Tax Units). The LDB partially repealed the Forest Law on Soils and Waters with respect to the handling of forestry resources and Decree 1770 about competence between the Executive and the Municipal powers. ❑

The Venezuelan Oil and Gas Sector – Are there still Opportunities in the Era of Petronationalism?

By Larry B. Pascal (Haynes and Boone, LLP, Dallas)
and Ramon A. Azpurua (Squire, Sanders, & Dempsey, S.C., Caracas)

(Editor's Note: This is Part 2 of a two-part series on the Venezuela oil and gas sector.)

Conversion from Operating Agreements to Jointly Owned Enterprises ("Empresas Mixtas")

Implementing its strategy of obtaining full national sovereignty over natural energy reserves (Plan Soberanía Plena), in 2005 the Venezuelan government announced that the thirty-two (32) oil fields that were in production under operating agreements entered by PDVSA during the three rounds of the oil liberalization program in the 1990s, would be required to convert to jointly owned enterprise contemplated under the new 2001 Hydrocarbons Organic Law.[1]

In April 2006, the Law for the Regularization of Private Participation in Primary Activities under the Hydrocarbons Organic Law[2] was enacted. This legislation declared the termination of the existing operating agreements, the obligation to convert to the new form of jointly owned enterprise to comply with the Hydrocarbons Organic Law, and the prohibition of any new contract for the granting of rights to private parties in the exploration, production, storage, and initial transportation activities in connection with liquid hydrocarbons or in any production related benefit, except in the form of a minority investor in a jointly owned enterprise. According to this law, the Republic of Venezuela directly, or by means of a company 100% owned by it, shall resume the activities performed under the operating agreements, notwithstanding the possibility to incorporate jointly owned enterprises to that effect.

In January 2007, PDVSA took control of the thirty-two (32) oil fields, of which thirty (30) were converted to the new form of enterprise and two (2) were terminated with PDVSA taking over. Under this program, PDVSA, through it subsidiary, Corporación Venezolana del Petróleo ("CVP"), controls the majority stake in all the projects.[3]

The remaining two (2) operating ventures that elected not to convert to the new form of enterprise were those belonging to Jusepin and Dacion fields controlled by Total/BP and ENI, respectively. PDVSA, through CVP, entered into an agreement with the companies Total Oil and Gas and BP Venezuela Holdings to terminate all rights, shares, or claims related to the terminated operating agreement corresponding to the Jusepín Field in the Monagas State. In contrast, in November 2006, ENI initiated an arbitration proceeding against Venezuela before the International Centre for Settlement of Investment Dispute ("ICSID") after the unilateral termination by PDVSA of the operating service agreement in the Dacion area.[4] Later in February 2008, ENI reached a settlement with Venezuela. Under the terms of the settlement agreement, ENI will receive compensation in cash based on the net book value of the asset.[5]

Conversion of Orinoco Belt Association Agreements and Profit Sharing Agreements to Jointly Owned Enterprises (Empresas Mixtas)

In early 2006, the Venezuelan government announced the mandatory conversion of the Orinoco Belt association agreements and risk profit sharing agreements into jointly owned enterprises. PDVSA entered into those agreements during the oil liberalization program of the 1990s.

The royalty payments, established by Article 41 of the 1943 Hydrocarbons Law, that apply to the four association agreements were reinstated at the 16 2/3% rate. Moreover, the statute allows the National Executive to temporarily reduce royalty rates for active projects whose degree of maturity calls for such measure. The statute further allows the National Executive to increase the lowered tax to the original rate when, according to its judgment, the conditions that prompted the reduction no longer apply. The National Executive had established royalty payments applicable to the four association agreements at the minimum level of 1%. In September 2004, the MENPET proposed that royalty payments were reinstated at the 16 2/3% rate. The reinstatement was subsequently implemented, and the measure was then accepted by the majority of the foreign private companies involved in the associations.

Later in 2006, the Income Tax Law was reformed to eliminate the exceptions to the applicability of the 50% income tax rate. The Income Tax Law imposes a 50% income tax rate on companies performing hydrocarbon exploita-

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tion and related activities such as refining and transportation or the purchase or acquisition of hydrocarbon and its derivatives for exportation purposes. However, before the 2006 reform, companies formed under association agreements, pursuant to the former Organic Law that Reserves the Industry and Marketing of Hydrocarbons to the State,[6] had a maximum applicable tax rate of 34%.

Pursuant to Presidential Law Decree N° 5,200 for the Conversion of the Orinoco Belt Association Agreements and Oil Risk Profit Sharing Agreements into Jointly Owned Enterprises[7] and to conform to the Hydrocarbons Organic Law, the Orinoco Belt Association Agreements (Petrozuata, S.A., Sincrudos de Oriente, S.A., Sincor, S.A., Petrolera Cerro Negro, S.A., and Petrolera Hamaca, C.A.)[8] and the oil risk profit sharing agreements (Golfo de Paria Oeste, Golfo de Paria Este, and La Ceiba blocks) had to be converted into entities in which the CVP or other PDVSA affiliates hold an equity participation of at least 60%. Orifuels Sinovensa, an association agreement company consisting of PDVSA´s affiliate, Bitumenes del Orinoco, S.A. ("Bitor"), China National Petroleum Corporation, and Petrochina Fuel, also had to convert to jointly owned enterprise.

A four-month term was granted to the private parties in the agreements to negotiate the terms and conditions for new jointly owned enterprises with the Republic. If the parties did not reach an agreement within the four-month term, then PDVSA would take over the operations.[9] In addition, the law provides that the infrastructure, transportation, and upgrading services belonging to the strategic associations would be of open access and would not otherwise be restricted per the guidelines to be enacted by the MENPET.

In October 2007, legislation concerning the effects of the conversion from association agreements and risk profit sharing agreements to jointly owned enterprises was enacted.[10] Under the new law, all association and risk profit sharing agreements that converted to the new form of enterprise were terminated at the moment the corresponding transferring presidential decree was published. According to the law, all rights and assets corresponding to such agreements that belonged to private companies that did not reach an agreement to convert to the new form, were transferred to the newly incorporated jointly owned enterprise. In those cases where none of the private parties reached an agreement to convert, all rights and assets corresponding to such agreements were transferred under the reversion principle to the PDVSA affiliate in charge of the negotiation. The agreements that did not convert were terminated as of the publication of this law.

PDVSA took control of three (3) of the four (4) Orinoco Belt association agreements and two (2) of three (3) risk profit sharing agreements.[11]

Although Chevron, Statoil, Total, ENI, and BP agreed to the handover, ExxonMobil and ConocoPhillips chose to reject the terms of the new joint ventures. ConocoPhillips participated in the Petrozuata (50.1%) Association, the Ameriven (40%) Association, the Golfo de Paria Este risk profit sharing agreement, and the Golfo de Paria Oeste risk profit sharing agreement. ConocoPhillips was the only private participant in the Petrozuata Association. ExxonMobil participated in the Cerro Negro association and the La Ceiba risk profit sharing agreement, along with Petro-Canada. By October 2007, ConocoPhillips, ExxonMobil, the Overseas Private Investment Corporation ("OPIC"), and Petro-Canada were unable to reach an agreement with PDVSA's affiliate, CVP. Consequently, PDVSA officially announced that it was taking over the operations of Petrozuata, later renamed Petroanzoátegui, and La Ceiba field.

In September 2007, ExxonMobil announced that it filed an arbitration claim with the ICSID against the Government of Venezuela.[12] In February 2008, a United States federal court issued temporary injunctive relief sought by ExxonMobil, freezing US$ 300 million worth of PDVSA's assets.[13] Subsequent court orders in London, the Netherlands, and the Dutch Antilles froze up to US$ 12 billion of PDVSA's assets in those jurisdictions. ExxonMobil claimed the injunctions were necessary to ensure payment if it prevails in the arbitration.[14]

In contrast, Venezuela's Minister of Energy and Petroleum (who also serves as PDVSA's chairman) characterized Exxon's legal actions as "judicial terrorism," and declared the multi-billion dollar freeze of PDVSA's assets as totally "outside the parameters of the arbitration."[15] President Chávez, upset with the temporary injunctions, threatened to withhold oil exports to the United States. Later, Venezuela's Minister of Energy and Petroleum, called for ExxonMobil to drop its hostile judicial actions in the United States, Dutch, and British courts against PDVSA, and return to the framework of international arbitration. The British judge reversed the temporary injunction in March and ordered Exxon Mobil to pay court costs.[16]

In November 2007,[17] ConocoPhillips also announced that it was considering filing a request for international arbitration for compensation for oil operations seized by Venezuela. The arbitration claim was finally registered in December 2007.[18]

Other Jointly Owned Enterprizes

In June 2007, the incorporation of the jointly owned enterprise Petrozumano was announced, whereby PDVSA will hold a 60% interest and CNPC Venezuela B.V. will hold the remaining 40%. The company was later incorporated in November 2007.[19] The company was assigned the operations of the fields Zumano in the States of Anzoátegui and Monagas.

In addition, the incorporation of the jointly owned enterprise Petrolera Bielovenezolana, S.A.[20] was authorized in December 2007. CVP holds a 60% interest and the Association of Producing Companies Belorusneft holds the

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remaining 40%. The company was assigned the operations of the fields Guara Este in the Anzoátegui State and Block 10 Lago Medio in the Zulia State.

Finally, in January 2008, the incorporation of the jointly owned enterprise Petrolera Indovenezolana, S.A. was authorized. CVP holds a 60% interest and the Indian Ongc Videsh Ltd. holds the remaining 40%.[21] The company was assigned the operations of the fields San Cristobal in the States of Anzoátegui and Guárico.

Supply Agreements

Venezuela has entered into various supply agreements with Argentina, Uruguay, Cuba, and certain other Caribbean nations. In March 2007, during the First South American Energy Summit, PDVSA and Petroecuador extended an agreement reached between Venezuela and Ecuador earlier in February 2007 by entering into a gasoline purchase-sale agreement. Petroecuador will furnish PDVSA with a monthly gasoline supply during a one-year term, subject to monthly adjustments in volume of a maximum of 100,000 bpd. In return, the Venezuelan state oil company will supply the same amount of refined oil to Ecuador.[22]

In November 2007, PDVSA and the China National United Oil Corporation ("Chinaoil") entered into an agreement for the supply of fuel oil to the Chinese market. On that same date, Venezuela entered into an agreement to supply China with 500,000 bpd of crude oil and oil-products starting in 2010, increasing to 1 million bpd by 2011 or 2012 (in 2007, Venezuela supplied approximately 350,000 bpd to China).

Amendment of the Hydrocarbons Organic Law

In May 2006 (later republished in August 2006), the 2001 Hydrocarbons Organic Law was partially amended.[23] Article 2, which assigned gaseous hydrocarbons regulation to the Gaseous Hydrocarbons Organic Law, now provides that the exploitation of gas reserves associated to crude oil will be governed by the Organic Hydrocarbon Law (this provision was already included in the 1999 Gas Hydrocarbon Law).

As a consequence of the reform, under article 33, the Venezuelan National Assembly has to approve not only the terms and conditions for the incorporation of the jointly owned enterprises, but also any subsequent modification to those terms and conditions (after hearing the favorable opinion of the MENPET and the Energy and Mines Commission of the Assembly). The new article 33 adds that the jointly owned enterprises will be governed by the Hydrocarbons Organic Law and in particular by the terms and conditions contained in the accord enacted by the National Assembly authorizing the incorporation of the same.

The option to reduce royalties to 16 2/3% in the Orinoco Belt bitumen projects was ruled out, and two (2) new taxes were implemented: the tax on extraction and the tax on exportation registry. The tax on extraction is equal to one-third (1/3) of the value of all liquid hydrocarbons extracted from any reservoir (calculated using the same base to calculate the royalty paid in cash),[24] payable on a monthly basis together with the royalty, by the operating company extracting such hydrocarbons.[25] The tax on exportation registry is equal to 0.1% of the value of all hydrocarbons exported calculated on the selling price.

Special Contribution on Extraordinary Oil Prices in the International Oil Market

In April 2008, the Law for the Special Contribution on Extraordinary Oil Prices in the International Oil Market was enacted by the National Assembly.[26] The special contribution will take effect when the crude oil price rises above US$ 70 per barrel, based on the Brent crude reference price. The amount of the contribution per barrel will be equal to 50% of the difference between the referenced averaged monthly price and the maximum price of US$ 70 per barrel, and will increase to 60% when the price reaches US$ 100 per barrel or more. The special contribution is to be paid to the Fondo de Desarrollo Nacional ("National Development Fund" - "FONDEN")[27] by those companies which export crude or refined oil or oil products.[28] According to the law, these companies will have the right to discount from their total exports the volume of any imports of these products to Venezuela.

Conclusion

Venezuela has leveraged its large hydrocarbons sector to assert a stronger economic and geopolitical role in Latin America and the Caribbean than many US observers even a few years ago thought possible. The sheer volume of Energy Cooperation and Integration Agreements entered into with countries in Latin America and the Caribbean speaks to this development. Such agreements are one indication that although the United States remains Venezuela's large export market, Venezuela is working to diversify its dependence on any single market. However, notwithstanding the heated rhetoric exchanged between Washington and Caracas,[29] the countries still have an economic relationship of mutual dependence and it is not clear that the current high oil prices have altered this fundamental reality.

Nevertheless, both private investors and Venezuela face important challenges. For private investors, Venezuela has some of the riches reserves in the Western hemisphere and in this era of declining supplies and reserves, its potential and allure cannot be easily ignored. However, as evidenced by recent unilateral changes to drilling contracts, such opportunities also present greater risks in the form of juridical instability. Investors have reacted in different manners to this difficult environment – many, perhaps mindful of the long-term implications, have elected to accept their inferior, subordinated role and less attractive commercial terms, thereby selecting the pragmatic route, while others have decided to fight and withdraw from the

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country, rather than accept the new, unilaterally imposed terms. However, while many private investors have elected to stay, many are delaying new investments in the country, a development that could have profound implications for Venezuela, particularly if the price of oil drops.

By the same token, Venezuela too faces challenges. Arguably, a more polarized society than before, Venezuela has benefited from the dramatic rise in oil prices, thereby offsetting inefficiencies. However, some analysts contend that production still has not returned to pre-strike levels. In addition, Venezuela has courted national oil companies, particularly from countries that enjoy good relations with Caracas, to effectively replace some of the diminished private investment, but it is unclear whether these companies possess the technical, financial, and operating acumen to function outside their home markets (with the possible exception of Petrobras). Moreover, its national oil company, PDVSA is carrying out more non-energy roles, such as housing and food distribution, and it runs the risk of distraction from its core competency and managerial overload. Finally, PDVSA once enjoyed the reputation within Latin America as the finest national oil company in terms of managerial and technical competency, and it is not clear that it has been able to fully replace its dismissed personnel. In short, like many emerging markets, Venezuela poses that classic risk-reward conundrum and yet neither private investors nor Washington can afford to ignore it. ❑

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1 Earlier, in April 2005, the Venezuelan Tax Administration Authority (Servicio Nacional Integrado de Administración Aduanera y Tributaria - SENIAT) announced a change of interpretation on the applicable tax rate to the income obtained by the contractor-operators operating the thirty-two (32) oil fields that were in production under operating agreements. Under the new interpretation SENIAT taxed the income of the contractor-operator with the 50% tax rate applicable, according to the Income Tax Law, to companies performing hydrocarbon exploitation and related activities. Until then the contractor-operators was regarded as a services provider the operating agreements and, therefore, the applicable tax rate was 34% (corporate tax rate). The change of interpretation was then based on the grounds that it was inappropriate to consider as "service contracts" those agreements in which the party called to "render the service" was also liable for the investment of risk capital or, at least, without any assurance of recovery. In addition, article 22 of the Organic Hydrocarbons Law defines operating companies as those dedicated to the performance of primary activities, such as the exploration in search for hydrocarbons, the extraction of hydrocarbons in their natural state, gathering, transportation and storage.

2 Ley de Regularización de la Participación Privada en las Actividades Primarias Previstas en el Decreto N°1,510, con Fuerza de Ley de Hidrocarburos published in the Official Gazette N° 38,419, dated April 18, 2006.

3 See the 2008 Supplement to the Latin American Matthew Bender Energy Law and Transactions for a chart illustrating the terminated operating agreements, the 21 new jointly owned enterprises, and their share participation.

4 See Eni Dación B.V. v. Bolivarian Republic of Venezuela, (ICSID Case N° ARB/07/4), pertaining to hydrocarbon rights, filed on February 6, 2007.

5 See http://www.energy-business-review.com/article_news.asp?guid=3A5BD392-6C93-44D7-9DC5-5068901E98B7 Eni said to be seeking to improve co-operation through the development of new initiatives, especially in the oil-rich Orinoco Oil Belt region of the country.

6 The exception ruled out from the Income Tax Law also included companies formed through the national interest contracts provided for in the Constitution, for the execution of vertically integrated projects oriented to the exploration, refining, industrialization, emulsification, transportation and commercialization of petroleum and extra-heavy crude, such as bitumen; and companies created and domiciled in Venezuela to perform integrated commercial activities related to the production and emulsification of natural bitumen.

7 Decreto con rango, valor y fuerza de Ley de Migración a Empresas Mixtas de los Convenios de Asociación de la Faja Petrolífera del Orinoco; así como de los Convenios de Exploración a Riesgo y Ganancias Compartidas, published in the Official Gazette N° 38,632, dated February 26, 2007.

8 The four association agreements for the improvement of extra-heavy crude in the Orinoco Oil Belt produced some 660 mbpd of extra-heavy crude, resulting in a production of almost 600 mbpd of improved crude. See http://www.pdvsa.com

9 According to the Decree, the process and negotiation for the transfer of activities had to be completed by April 30, 2007 and the process and negotiation for the conversion had to be completed by June 26, 2007. The terms and conditions were subject to the approval of the Venezuelan National Assembly.

10 Ley sobre los Efectos del Proceso de Migración a Empresas Mixtas de los Convenios de Asociación de la Faja Petrolífera del Orinoco, así como de los Convenios de Exploración a Riesgo y Ganancias Compartidas published in the Official Gazette N° 38,785 dated October 08, 2007.

11 Please see the 2008 Supplement to Matthew Bender Energy Law and Transactions for a chart showing the terminated agreements, the new jointly owned enterprises, and its share participation.

12 See Mobil Corporation and others v. Bolivarian Republic of Venezuela, (ICSID Case N° ARB/07/27), registered on October 10, 2007.

13 See also "Exxon's Wrathful Tiger Takes on Hugo Chavez," The Economist, February 16, 2008.

14 See http://www.venezuelanalysis.com/news/3179

15 Idem. Energy and Petroleum Minister Rafael Ramirez contended that ExxonMobil's former assets in Venezuela were worth less than $1 billion, contrary to the company's multi-billion dollar claim.

16 See http://english.eluniversal.com/2008/03/20/en_eco_art_exxon-pdvsa-battle-e_20A1448123.shtml

17 See http://www.reuters.com/article/marketsNews/idLTAN0139317320071101?rpc=44

18 See ConocoPhillips Company and others v. Bolivarian Republic of Venezuela, (ICSID Case N° ARB/07/30), registered on December 13, 2007.

19 See Decree Nº 5,670 authorizing the incorporation of the jointly owned enterprises Petrozumano, S.A., published in the Official Gazette N° 38,801, dated November 1, 2007; Presidential Transferring Decree N° 5,672 transferring the right to operate in the corresponding area to the jointly owned enterprise Petrozu-

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mano, S.A., published in the Official Gazette N° 38,807, dated November 9, 2007.
20 See Decree Nº 5,842 authorizing the incorporation of the jointly owned enterprises Petrolera Bielovenezolana, S.A., published in the Official Gazette N° 38,830, dated December 12, 2007; Presidential Transferring Decree N° 5,787 transferring the right to operate in the corresponding area to the jointly owned enterprise Petrolera Bielovenezolana, S.A., published in the Official Gazette N° 38,840, dated December 28, 2007.
21 See Decree Nº 5,873 authorizing the incorporation of the jointly owned enterprise Petrolera Indovenezolana, S.A., published in the Official Gazette N° 38,874, dated February 20, 2008.
22 See http://www.abn.info.ve/go_news5.php?articulo=89390&lee=17.
23 Ley de Reforma Parcial del Decreto N° 1,510 con Fuerza de Ley Orgánica de Hicrocarburos published in the Official Gazette N° 38,443, dated May 24, 2006, reprinted for material mistake in the Official Gazette N° 38,493, dated August 4, 2006.
24 The basis used to calculate the royalties in cash is the price of the corresponding hydrocarbons volumes measured at the production field at the market value or a convened value, or absent such values, at a fiscal value fixed by the liquidator.
25 When calculating this tax, the taxpayer has the right to deduct royalty amounts paid, including additional royalties being paid as special advantage. The taxpayer has also the right to deduct from the extraction tax, any amount paid for any special advantage annuity, but only in periods subsequent to the payment of such annuity.
26 Ley de Contribución Especial sobre Precios Extraordinarios del Mercado Internacional de Hidrocarburos published in the Official Gazette N° 38,910, dated April 15, 2008.
27 Back in 2005 the Law of the Venezuelan Central Bank ("BCV") was amended (Official Gazette N° 38,232, dated July 20, 2005) to provide for the incorporation of a national fund (later incorporated as the FONDEN). According to the BCV Law, after discounting operating and investment expenses, PDVSA must transfer any remaining amount to this fund. The Fund will be used to finance education and health programs; to improve the profile and amount of the public debt and to attend strategic situations. The Fund was initially incorporated with a US$ 6,000 contribution from the BCV.
28 In addition, any contributions made to the FONDEN under the Venezuelan Central Bank Law will be deductible.
29 For a recent article that examines the relationship between Washington and Caracas and the triumphs and setbacks of the Chavez Administration, see Daniel Wilkinson, "Chavez's Fix," by The Nation, March 10, 2008.