

Step-in rights: a solution for investments in the electric energy sector?

The crisis Brazil now faces creates a complex situation: the need for increased economic capacity and infrastructure development but also increased public expenditure. Towards solving this dilemma, the Brazilian Law of Concessions (Law No. 8,987, of February 13, 1995) offers possibilities not evident at first sight.

Project finance is a financing mechanism by which lenders rely on cash flow and assets from a project as primary sources of payment and as security on the invested capital. The mechanism enables dilution of project risk and transfers the position of project main investor from the government to the private sector.

In this context, Article 27-A of the Law of Concessions (introduced by Law No. 13,097, of January 19, 2015) allows lenders and guarantors the right to take control or temporary administration of the concessionaire to promote its financial restructuring and to ensure the continuity of services. This "step in right" of Anglo-Saxon origin has not been much explored in Brazil until now.

The ability to take control or temporary administration is particularly relevant in project finance transactions where it may not serve the lender's interest to foreclose the collateral involved in the transaction. The reason is that, typically, the company's assets are worth less if sold separately than the debt incurred to acquire them. More interesting to the creditor is the continuity of the enterprise, enabling cash flow to compensate invested capital.

The Brazilian electric energy sector is an example of a regulatory environment that is favorable for structuring projects by means of project finance¹, being able to attract both public and private capital. The main factors that contribute to the success of the project finance model in this sector are:

- (i) the sector requires large upfront capital expenditures while the cash flow is predictable and stable, enabling considerable increase in financial leverage;
- (ii) energy generation and transmission is based on assets that are physically identifiable and therefore can be economically and legally segregated through a Special Purpose Company (abbreviated "SPE" in Portuguese); and
- (iii) existence of a stable regulatory environment.

Project finance and step-in rights complement each other in the Brazilian electric energy sector. Step-in can be effective in two different ways: it may lead to transfer of corporate control on a provisional basis for creditor-led reorganization or assignment of control as collateral.

The first form of step-in is foreseen in Article 9 of Normative Resolution No. 484, of April 17, 2012, which allows for the assumption of corporate control of the company by creditors for financial restructuring and to ensure the continuity of the provision of electric energy services.

The second form of step-in is foreseen in Article 5 of Normative Resolution No. 532, of January 14, 2013, which allows the shareholders of concessionaires and licensees of electric energy generation companies to offer shares as security.

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¹ Law No. 10,848 of March 15, 2004, known as the sector's "regulatory framework", regulated by Decree No. 5,163 of July 30, 2004.

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Article 5 of Resolution No. 532 states that the implementation of a step-in clause depends on the prior consent of the National Electric Energy Agency (abbreviated "Aneel" in Portuguese). The question is posed, however, as to whether it would be possible to obtain the necessary final authorization when contracting the transaction without awaiting default for its request. The question is important because obtaining the authorization in theory would encourage potential financiers to agree to disburse the funds, which otherwise would not happen should they have to wait default.

A positive answer should be given to this question. Concluding otherwise would undermine the intent of Article 27-A of Law of Concessions, which aims to attract funds to the Brazilian infrastructure sector. Moreover, the prior authorization procedure to be followed is that of Resolution No. 532. This regime is compatible with the prior authorization being obtained at the time of the disbursement of the funds by the financiers. The effectiveness of the authorization obtained would be conditional upon default on the principal and interest to be paid to the creditors.

Project finance, thus, can be said to be a boost to the electric energy sector. Its favorable effects can be further increased should step-in rights be taken advantage of.

It is our hope that the step-in solution be adopted in future electric energy transmission and generation contracts in Brazil, including those related to what, according to Aneel, shall be "the biggest electric energy transmission auction in history", to take place in February 2016.

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