Ecogas - A privatisation

Colombia is strategically located in the middle of the Western hemisphere, on the northern coast of the South American continent. By **Carlos Albarracín**, a partner in the Latin America practice of **Chadbourne & Parke LLP**, and **Mauro Penteado** and **Agustín Cerda**, visiting attorneys at the firm.

Colombia borders both the Caribbean Sea, between Panama and Venezuela, and the Pacific Ocean, between Ecuador and Panama. The country is 1,138,910km^2 in size, similar to that of the states of Texas and California combined. With a population of 45m, Colombia is the third most populous country in Latin America.

The nation is one of the Latin America countries with the most significant energy resources and potential for future development. Its proven oil reserves are estimated at about 1.55bn barrels, the fifth-largest in South America, while its proven natural gas reserves are around 4.35t/cf. Because the vast majority of the country remains unexplored, Colombia's true hydrocarbons potential is still uncertain. Some estimates, however, indicate that its crude oil and natural gas reserves range from 12bn to 47bn barrels and 4.2t/cf to 34t/cf, respectively.

Oil is Colombia's largest foreign exchange earner, representing about a quarter of its total exports, and the country's oil resources play an important role in its public finances. In addition, over the last decades, Colombia has positioned itself as an important supplier of oil to the US. But despite its potential as a major player in the Latin American oil and gas sector, Colombia's oil production has declined steadily since 1999, when Colombia's oil production peaked at 830,000 barrels per day, compared with less than 550,000 barrels per day in 2006. This decline in oil production was a function of a decline in reserves, which, in turn, was attributable to a decrease in investments in the sector.

To address this issue, the Colombian government began implementing a series of policy reforms aimed at deregulating the oil and gas sector and attracting private sector and foreign investment. As part of this initiative, the government introduced new legislation, which converted Ecopetrol from a state agency responsible for developing and implementing Colombia's energy policy to a competitive oil and gas exploration and development company and transferred all of Ecopetrol's policy-making functions to the newly created National Hydrocarbons Agency (AHN).

In addition, the Colombian government amended the rules that governed oil and gas royalties applicable to production activities to replace the 20% flat royalty rate by variable royalty rates ranging from 5%, for low production levels, to 25%, for higher production levels. This resulted in an increase from 10 new wells drilled in 1999 to 56 new wells drilled in 2006.

The Colombian government also implemented policies aimed at promoting the development of the natural gas sector and the use of natural gas as a substitute fuel for industrial and residential consumption. These policies included a plan to attract private sector investment to develop the country's natural gas transportation and distribution infrastructure, which resulted in an increase in natural gas consumption at an average annual rate of 3.8% between 1996 and 2006, when the consumption of natural gas as a fuel source reached about 20.3% of the country's total fuel consumption.

The Ecogas privatisation

As part of its plan to deregulate the oil and gas sector, in 1997 the Colombian government created Empresa Colombiana de Gas ESP (Ecogas) and transferred to it all the natural gas transportation assets, rights and contracts of Ecopetrol, including more than 3,600km of natural gas pipelines. Because of its status as a state-owned company, Ecogas operated under the regulatory regime that applies to governmental agencies and state-owned enterprises, and its management was supervised by the Ministry of Energy. Among the rights and contracts transferred to Ecogas were several BOMT contracts that Ecopetrol had entered into with private companies to

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finance the construction, maintenance and operation of many of the pipelines comprising the Ecogas system.

Ecopetrol used BOMT contracts as a means of financing the construction and operation of new infrastructure, which would have required a substantial capital outlay and technical expertise that Ecopetrol lacked at the time. Under these BOMT contracts, Ecopetrol, and subsequently Ecogas, had the exclusive right to use of all the transportation capacity of the pipelines operated by their third-party contractors. At the end of the contracts' terms, Ecogas had the right to acquire the assets in exchange for a fixed payment. In consideration for the use of pipeline capacity, Ecopetrol paid a service fee to the contractors. Of the 3,600km of natural gas pipeline transferred from Ecopetrol to Ecogas, about 1,800km were operated by third parties under these BOMT contracts.

In early 2005, the Colombian government announced its intention to privatise Ecogas through a programme that included the creation and capitalisation of a new private company that would then acquire the assets, rights and contracts, and assumed some of the liabilities, of Ecogas. The Colombian government launched an international bidding process in which bidders would compete to buy the shares of Transportadora de Gas del Interior (TGI), the new company that would acquire Ecogas's gas transportation business.

As required by Colombian privatisation rules, the bidding process comprised two phases. The first phase was designed to give members of the so-called "solidarity sector" (sector solidario), which included workers and former workers of Ecogas, pension funds and workers' unions, the opportunity to make an investment in TGI by purchasing shares at a discounted price and in instalments. The second phase, which would take place after the consummation of the offer to the solidarity sector, consisted of a bidding process to sell the shares of TGI not subscribed to by the members of the solidarity sector to the highest bidder.

In this phase, interested bidders would offer a per share price for TGI's shares and also a price that TGI would pay for Ecogas's assets, rights and contracts. To qualify for this phase, bidders had to offer a price that exceeded a minimum set by the Colombian government, which was not disclosed to bidders prior to submission of their bids.

The first phase concluded with the acquisition by members of the solidarity sector of 4,073,045 shares of TGI, which represented 5.5% of its capital stock, and the remaining shares were subsequently auctioned among the bidders that qualified for the second phase, which included Promotora de Desarrollo de America Latina SA de CV, Interconexion Electrica SA ESP, Enbridge, International Finance Corporation, Empresa de Energía de Bogotá SA ESP (EBB) and joint venture Prisma-Promigas.

Only EEB and Prisma-Promigas submitted bids that exceeded the undisclosed minimum price set by the Colombian government, with EEB submitting the highest bid of about US$1.47bn for 97.91% of TGI's capital stock and Ecogas's assets, rights and contracts.

The Ecogas privatisation process posed numerous challenges. One was that since 50% of Ecogas's pipeline system was operated by third parties under non-assignable BOMT contracts, Ecopetrol remained responsible for the payment of service fees to the contractors following the transfer of such contracts to Ecogas, whereas Ecogas assumed the obligation to reimburse Ecopetrol for such payments going forward.

As a result, the acquirer of the Ecogas business would still be subject to the risk that Ecogas could fail to reimburse Ecopetrol or Ecopetrol could default in its payments under the BOMT contracts and, as a result, the BOMT contracts could be terminated. Another significant challenge was that, given the strategic importance of Ecogas's pipeline system to Colombia, the Ecogas privatisation process was subject to intense political scrutiny and debate, and to litigation.

As a result, the process was disrupted several times by injunctions, investigations and other proceedings brought by various constituencies that opposed the privatisation of Ecogas or found the process objectionable or not transparent. The most notable of such proceedings was an unsuccessful challenge filed by a group of local pension funds as a constitutional action (accion de tutela) aimed at forcing the Colombian government to disclose the minimum price that qualified bidders would have to offer in order for their bids to not be disqualified under the privatisation rules.

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Contractual structure for the privatisation

According to the privatisation programme, TGI and Ecogas entered into several contractual arrangements intended to transfer to TGI all the rights and assets necessary to continue operating the Ecogas business. The principal agreements were:

- An asset transfer agreement pursuant to which Ecogas sold and transferred to TGI substantially all of Ecogas's assets and rights relating to its natural gas transportation business and all governmental licences, permits and authorisation relating to its natural gas transportation business. Under the terms of this agreement, Ecogas would be liable for all obligations and liabilities arising prior to the transfer date, whereas TGI would be liable for all future obligations arising under the assigned contracts and rights. In turn, Ecogas remained liable for all legal proceedings filed before the date of the transfer agreement, except for any legal proceedings related to the imposition or acquisition of rights of way, which would be managed by TGI.

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An indemnity and assumption agreement pursuant to which Ecogas agreed to assume all contingent liabilities of TGI arising from events that occurred prior to the transfer of Ecogas to TGI and to indemnify TGI for any third-party claims and damages related thereto. Ecogas also agreed to indemnify TGI for all liabilities of Ecogas that originated prior to the transfer of Ecogas's business that were not reflected in Ecogas's financial statements up to an amount of about US$4.5m. Under this agreement, TGI is barred from bringing indemnification claims against Ecogas after the third anniversary of the closing of the acquisition. Ecogas agreed to maintain a reserve in the amount of about US$4.5m with respect to certain contingent liabilities of Ecogas.

Acquisition structure and financing

In order to finance the acquisition of the Ecogas business, EEB was granted a bridge loan agreement in the amount of US$1.47bn by ABN AMRO Bank and a group of commercial banks. EEB used the proceeds from the loan to acquire, through certain derivative arrangements, the Colombian pesos necessary for EEB to pay the subscription price of TGI's shares and for TGI to pay the acquisition price of Ecogas's assets and contracts. The acquisition closed in February 2006.

The bridge loan was then partly assigned to TGI and refinanced through two bond issues, an offering of US$750m by TGI International (a special purpose financing vehicle formed by TGI) and one of US$610m by EEB International (a special purpose financing vehicle formed by EEB). The TGI offering was consummated in September 2007 and the EEB offering in October 2007.

The initial purchasers of the TGI and EEB notes were affiliates of ABN AMRO and the offerings were jointly led by ABN AMRO, Calyon, Mizuho International and BBVA. The refinancing of the debt incurred by EEB through these two bond offerings posed several challenges:

EEB operates certain businesses (primarily electricity transmission) directly but that also has significant investments in and derives significant revenues from two companies operated by third parties in which EEB has equity investments (Emgesa and Codensa). This required the inclusion in the EEB offering document of detailed historical operating and financial information (including separate management's discussion and analysis (MD&A) sections) and regulatory discussions of Emgesa's electricity generation business and Codensa's electricity distribution business.

Second, in May 2007, the Colombian Central Bank imposed new reserve requirements applicable to cross-border financing transactions by Colombian companies. While the bridge financing was consummated prior to the imposition of the new reserve requirements, the refinancing of the acquisition financing through the bond offerings would have subjected the transaction to the new reserve requirements. In consultation with the Colombian Central Bank and Ministry of Finance, the parties to the transaction designed a structure to minimise the effects of such new reserve requirements through the creation of off-shore financing vehicles that would issue notes guaranteed by the Colombian companies (EEB and TGI) and then use the proceeds from the offering to acquire from the lenders under the bridge loan a participation in the loans originally made to EEB and partially transferred to TGI.

Then, upon purchase of the participation by the offshore vehicle, the terms of the bridge loan would be restructured to match the terms of the new notes, so that payments would flow through the acquisition financing up to the offshore vehicle to pay debt service under the notes.

Because Ecogas was a state-owned company, it was not required to maintain accounting records and prepare financial statements in accordance with Colombian GAAP and its accounts were not required to be audited by independent auditors. As a result, the preparation of the disclosure materials for the TGI offering had to be made concurrently with the audits to three years of accounting records of Ecogas, which required a special authorisation from the Colombian government and numerous special procedures that added complexity to the financial statements and the disclosures in the offering materials.

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