

Challenges for Spanish Investments in the Energy Sector in Latin America

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In Latin America and the Caribbean, the beginning of the 1990's showed a fairly small increase in FDI, yet by 1993 the rate of foreign direct investment was growing at a rate of 30% per year (see Baer and Miles, 2001 for details). There were several factors that account for this new trend. First, the economic policies of the receiving countries, as well as of the source countries impacted on both the size of the flows, as well as the sectors to which they were directed. In particular, the decade saw the maturation of the region both politically, and more importantly, economically in terms of the policies adopted by the member countries. These included changes in macroeconomic policies, as well as structural and legal reforms emphasizing the benefits of the market (see Stein and Daude, 2001). Finally, the privatization of state-run enterprises in the region provided a vehicle for the transfer of capital across the globe.

Yet the start of the new millennium has shocked the pattern established previously. While the 1980's was the "lost decade" for Latin America, the first decade of the millennium could prove to be equally costly for the "mother country" of Spain. In this paper, I explore why the risks of FDI increased in general and proportionately more for Spain, in particular in the energy sector. The next section provides an overview of the major Spanish firms operating in Latin America. It is followed by a discussion of the inherent risks of FDI to the shareholders of the source firms. Evidence on the economic impact of recent privatizations in Latin America is presented and we discuss how these changes may affect the long-term outlook for Spanish investments in energy. The final section provides some concluding remarks.

I. Spanish FDI in the Energy Sector of Latin America

Spanish direct investment in Latin America during the decade of the 90's was especially significant in the energy and public utility sectors. In the privatizations that occurred during the 90's, Spain began its participation tentatively. Initially, other competitors outbid it for the assets of several privatized firms. Later on in the process however, it appears that Spain bid substantially more than its rivals to acquire certain assets. Since the return to an investment depends upon the price paid for the assets, the outcome of these "auctions" is extremely important for shareholder wealth. Therefore, if Spanish acquisition of assets in the region can be characterized by an initial phase of underbidding and then later on of overbidding, then those assets which were acquired during this latter phase could yield a lower rate of return than the other alternatives available that were passed up.

The main Spanish firms in the energy sector in Latin America and the Caribbean are Repsol-YPF, Endesa, Gas Natural, Union Fenosa and Iberdrola. Over the years, these firms have either acquired direct or indirect control of host firms in different segments of the energy sector. Similarly, their degree of involvement has varied across the region's countries. For example, Repsol acquired the Argentine company of Yacimientos Petroliferos Fiscales (YPF) in 1999. In the process, Repsol-YPF became Spain's largest company in terms of revenue, the largest private energy company in Latin America in terms of total assets and one of the world's ten largest oil companies. In Latin America it is involved in the exploration and production of crude oil and natural gas in various countries as well as other energy related businesses. Repsol YPF's oil and gas reserves in Latin America are located in Argentina, Bolivia, Brazil, Colombia, Ecuador, Trinidad and

Tobago and Venezuela. It operates refineries in Argentina and Peru and is involved in the liquefaction of natural gas in Trinidad and Tobago, as well as the distribution of natural gas in Argentina, Brazil, Colombia and Mexico. Finally, in the electricity sector it is engaged in the generation of power in Argentina.

In the area of utilities, Endesa acquired shares in numerous companies throughout the region along with a controlling share (61%) of the electricity group Enersis of Chile (with approximately 10 million customers) with purchases in 1997 of 29% and then in March of 1999 of another 32% stake. It is present in electricity generation in Chile, Argentina, Colombia, Peru, Brazil and the Dominican Republic. Endesa engages in electricity generation and its transportation, distribution and retailing activities in Chile, Argentina, Brazil, Colombia and Peru. It has a share in several electricity companies in these countries, directly or through the Enersis group. Although it is primarily involved in the energy sector, Endesa has also become involved in the telecommunication sector in Chile where it is sole owner of the Chilean wireless telephone company Smartcom.

The other large Spanish firms include Gas Natural, an energy services multinational focusing its activity on the supply and distribution of natural gas in which Repsol-YPF owns a 31% stake. It is the main distributor of natural gas in South America, where almost half of its worldwide customers are located. It has a presence in five countries: Argentina, through the distributor Gas Natural BAN; Colombia, with the company Gas Natural ESP; Brazil, through CEG, CEG Rio and Gas Natural SPS; Mexico, where it operates with Gas Natural México; and Puerto Rico, where it manages the company Ecoelectrica. Union Fenosa, whose main business is the supply of energy has a large presence in Mexico where it has gas power plants and generates electricity in

the country and is one of the main independent generators of electricity. It is also present in electricity generation and distribution in Guatemala, Nicaragua, Panama, Colombia, Costa Rica and the Dominican Republic. In these other countries it has controlling stakes in several distribution companies such as Deocsa and Deorsa in Guatemala (85% stake) and Disnorte and Dissur in Nicaragua (79.5% holding). Finally, the Spanish company, Iberdrola, is the leading private electricity producer in Mexico. It is also the leading electricity distribution company in Guatemala through its interest in EEGSA, as well as in the northeast of Brazil where it services 6.8 million customers. Through this nexus of direct or indirect control of the energy sector of much of Latin America, the shareholders of these firms expose themselves to economic and political shocks in the region. It is instructive to see how these affect the financial performance of these companies and to a great extent the well-being of the Spanish economy.

II. The Performance of Spanish FDI in Energy

International diversification of securities held in a portfolio is an important strategy undertaken to reduce risk. This strategy can be partially implemented by holding the securities of a domestic firm that has international operations, i.e., by holding the stocks of multinational firms. These multinationals must themselves be diversified in their international operations. While FDI by US firms are diversified across different regions of the world, in the case of Spain they are disproportionately concentrated in one region, Latin America. Making matters worse, it is estimated that 30% of the revenues of the 26 top Spanish firms come from Latin America (see Casanova, 2002). These firms constitute more than 55% of the stocks traded on the Bolsa de Madrid (IBEX). In terms

of country risk, 10% of the profits of Endesa are estimated to come from Argentina, while for Repsol, 40% of its profits come from this country, where the economy has been severely battered. This heavy exposure to a region and in the case of Repsol-YPF, a specific country, can have a disastrous effect not only on the firm's shareholders, but as such a large entity in the Spanish economy, on Spain itself. To make matters worse, other Spanish firms are large shareholders of some of these energy firms. For example, Santander Central Hispano Group owns a 23.8 % stake in Union Fenosa , while Caja de Ahorros y Pensiones de Barcelona controls over 30% of Gas Natural.

Figures 1-3 show the returns for shares of American Depository Receipts (ADRs) of Repsol, Endesa and Enersis as compared to the returns of companies in their respective industries as represented by the relevant industry index. As we can see, it appears that the Argentine crisis has had a profound effect on the value of the shares of Repsol-YPF and to a lesser extent on those of Endesa. For example, as Figure 1 shows Repsol had been outperforming the AMEX Oil Index throughout the greater part of the 5-year period shown. It continued to do so after Repsol acquired YPF in 1999. Yet we can see that the situation began to change in the middle of 2001 with the Argentine economic crisis. To put the timing in perspective, in March of that year, Domingo Cavallo replaced Ricardo Lopez Murphy as Economy Minister. This had no effect on the crisis and the downward plunge continued after President Fernando de la Rúa's resignation in December 2001. The negative differential in returns accelerated with the news of the devaluation of the peso in January of 2002 and began to stabilize by the end of the year.

In the case of Endesa, we can see that as compared to the Dow Jones Utility Index the company tracked the index quite well up until it gained majority control of Enersis in

March 1999. At this time, we see that it dipped below the index for several months but rebounded during the early months of 2000, and then again began to drop below the index up until the present. In other words, as compared to other possible investments, Endesa has tended to underperform as the new millennium began. Figure 3 shows the performance of shares of Enersis against the DJ Utility. As can be seen from this graph, it does not appear that Endesa's controlling stake in the firm had any notable impact on improving the firm's performance versus other utility companies in the index since its returns continued to be lower than those of other firms in the index. It is important to realize that with globalization, Spanish firms are competing in the same capital market as US firms, i.e., the capital markets are international. Consequently, they are held to the same standards as those of investments emanating from companies based in other parts of the world. Finally, we can look at the performance of Union Fenosa, Gas Natural and Iberdrola securities in the Bolsa de Madrid. As Figures 4-6 show the security prices of all three companies suffered as a result of the Argentine crisis even though for Union Fenosa and Iberdrola their exposure in Argentina was minimal as compared to Repsol-YPF. This shows the ripple effect on shareholder value from country-specific shocks in the region. Therefore, it is important that we explore the issue of risk more closely.

III. Risks of Spanish FDI in Energy

There are several risks for FDI by Spanish firms in general and for energy firms and therefore, some of the largest Spanish firms, in particular. All investments, whether domestic or foreign carry some degree of risk. In the case of FDI, they are compounded by country and exchange rate risk. In the case of country risk, I include such factors as

the macroeconomic environment of the host country, the country's regulatory environment, institutions including the bureaucracy and the quality of the legal system. Other factors include political instability and the degree of corruption in the host country that can act as a tax on corporate earnings.

In addition, given any of these characteristics FDI will be affected by foreign exchange risk generated not only by the monetary and exchange rate policies adopted in the host country, but also by those in the country of origin and in the case of Spain, by the European Central Bank. General shocks to the world economy also contribute to risk. For example, in the case of Spanish firms in the energy sector not only do they have to be concerned with the macroeconomic policies of the host countries that can lead to devaluations of the host country's currency, but also by the monetary policy of the European Central Bank that can affect the euro and therefore, their earnings and the value of profits remitted from their investments in the region.

The case of Repsol-YPF in Argentina during the economic crises provides an interesting example of how host governments react towards foreign firms following some adverse economic shock. On January 9th, 2002, the government of Argentina passed Law no. 25.561 entitled "Law of Public Emergency and Reform of Currency Exchange Regulations," derogating the currency conversion regime of one Argentine peso to one US dollar, and decreed a change in price regulations (Law no. 24.076) by converting tariffs previously charged in dollars directly into pesos, and forbidding their adjustment based on the US Producer Price Index. In addition, on February 3rd, 2002, Decree Law no. 214/02 was promulgated, establishing that the Argentine economy be totally "pesified." Lastly, on February 12th, 2002, Decree Law 310/2002 governing exports was

passed, developing article 6 of Law 25.561, that imposed a 20% tax on crude oil exports and a 5% tax on refined oil products. In June 2002, there were agreements signed between the government and the oil sector that led to reductions of some of the original taxes and regulations such as the law permitting the availability of only 70% of foreign currency from exports.

Yet other regulations, such as the one limiting crude oil exports to 36% of production were imposed with a promise to lift this restriction as soon as “short-supply” problems had been resolved. The economic objective of this policy was to reduce the domestic price of oil paid by Argentines, and thereby gain their political support. This policy amounted to a transfer of income from the shareholders of Repsol to the citizens of Argentina. All these policies taken by the Argentine government reduced the profitability of Repsol-YPF and therefore, their shareholders’ wealth. They provide an example of some of the obstacles and inherent risks faced by firms investing in developing countries with a tendency of enacting populist policies whenever an economic crises ensues. Latin America has historically seen its share of these types of regimes.

More generally, there are other long-term risks involved for Spanish investments in energy in Latin America. A recent study by Ugaz and Waddams Price (2002) for the World Institute for Development Economics Research (WIDER) examined how consumers in Latin America were impacted by the privatization of public utilities. This study concentrated on the experiences of four countries: Chile, Argentina, Bolivia and Peru. These countries’ experiences with privatization were compared with those of Spain and the UK. The distributional impact of reforms in these countries depended upon two main factors. The first was on how access to services changed after privatization. More

specifically, privatized firms generally increased investments in order to expand services and networks to customers after the privatization, i.e., better geographic coverage was provided. This obviously has a positive effect on the well being of those consumers who were previously excluded from access to the services of the utility firm. The second factor is based on how prices for these services changed as a result of privatization. For example, after privatization the price structure facing rural and urban customers, or residential and industrial changed. If prices increased to a specific group, *ceteris paribus*, then they were made worse off.

The results of the study showed that access has improved in all countries after privatization. In particular, for Bolivia there is evidence that the connection rate for the poor increased faster than for other groups across all utilities. A similar pattern emerges in Peru. In Chile, service coverage increased for most income groups, increasing most for electricity coverage amongst the lower income deciles. Yet for pre-existing customers, the evidence showed consumer welfare losses associated with the increase in fixed charges in all the countries studied, with heavier losses being incurred by the poor from price changes. Combining the two effects, we find a mixed picture of who gained from privatization based on the different income groups. For example, the poor benefited from access but were adversely affected by price, while for other income groups, benefit and cost varied across the services. These findings are extremely important for firms investing in energy and utilities since it highlights the political risks generated by the current incentives towards increases in government regulation or even the nationalization of Spanish firms in these industries. Given the strong pressures for governments to cross-subsidize more powerful political groups by limiting the ability of firms to charge the

appropriate price, e.g., by the use of price controls, shareholders must be wary of their firm's investments in these politically volatile countries.

IV. Conclusions

This paper has presented an overview of Spanish foreign direct investments in Latin America, and in the energy sector in particular. By emphasizing how the capital markets have reacted to these investment, it appears that they have not been completely successful. As the Argentine crisis has shown, there are inherent risks to these investments when deteriorating economic conditions lead host governments to enact policies that are not market-friendly. These policies reduce the profitability of these firms and therefore, their shareholder's value. Recent research has shown that the distributional impact of privatization is mixed, with some income groups benefiting and others made worse-off. Since many Spanish investments came about due to the privatization of state-owned enterprises, one must be vigilant to a swing in attitudes towards greater regulation of these firms by Latin American governments aiming to quell political dissatisfaction.

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Repsol YPF vs. AMEX Oil Index



Source: BigCharts.com

Figure 1

Endesa vs. DJ Utility Index



Source: BigCharts.com

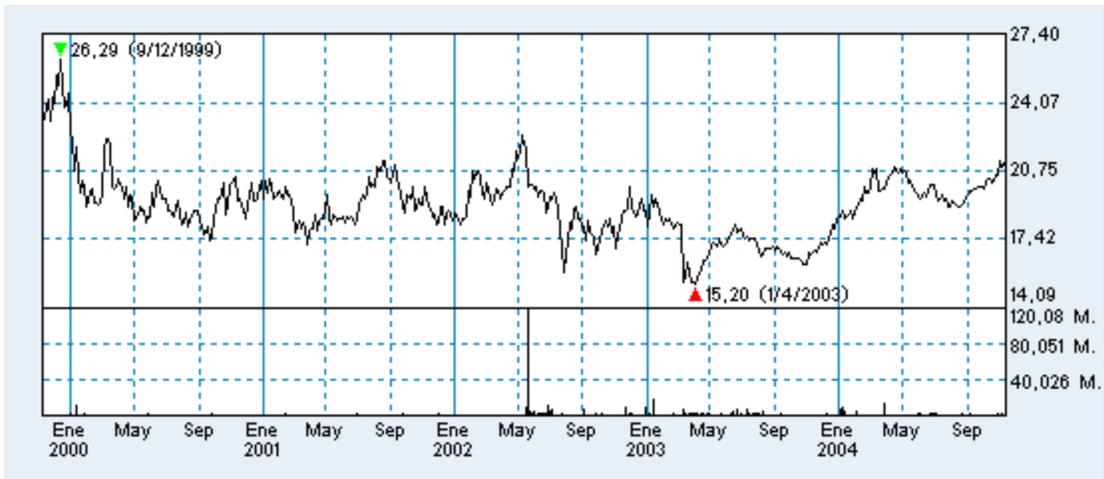
Figure 2

Enersis vs. DJ Utility Index



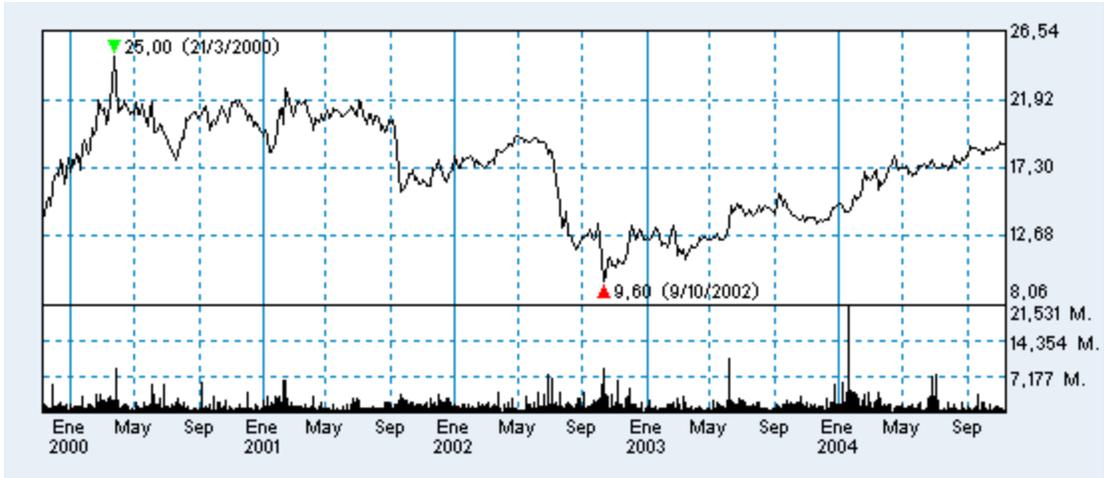
Source: BigCharts.

Figure 3



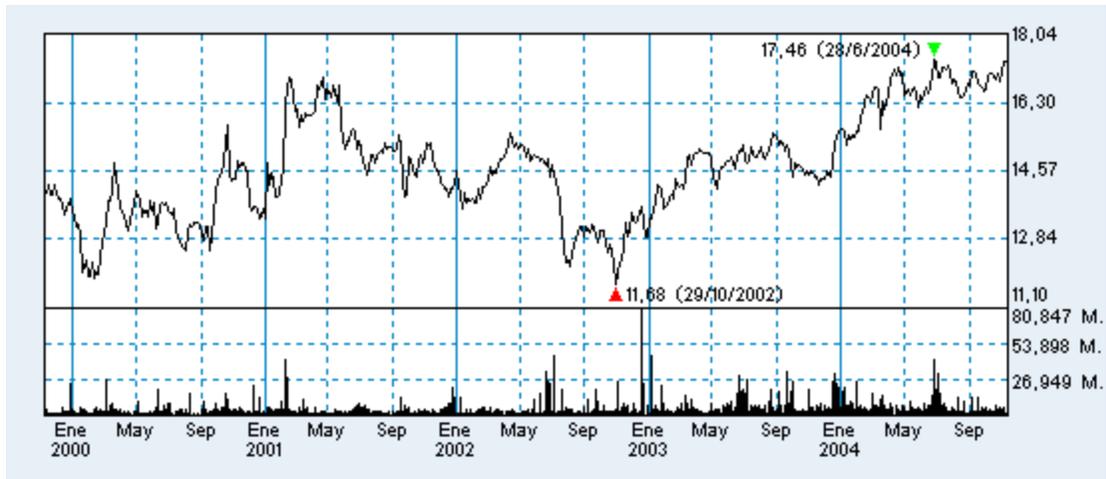
Source: Bolsa de Madrid

Figure 4: Gas Natural



Source: Bolsa de Madrid

Figure 5: Union Fenosa



Source: Bolsa de Madrid

http://www.bolsamadrid.es/ing/contenido.asp?menu=2&enlace=/ing/empresas/empresas_rv.htm

Figure 6: Iberdrola