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# Project Finance
# 2021

Ecuador: Trends & Developments
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# ECUADOR

## Trends and Developments

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### Ecuador in Context

The world has changed dramatically during the last decade. Politically, it has deteriorated almost everywhere, and mounting social unrest, institutional weakness, economic uncertainty and large fiscal deficits are no longer the exclusive traits of undeveloped economies, but can increasingly be seen in jurisdictions that were until recently considered the examples of mature democracies, economic welfare and the overarching prevalence of civil liberties and the rule of law. Indicators used just a few years ago to assess the general business environment of a jurisdiction should be adjusted to the new realities.

Notwithstanding this global climate, aggravated by the COVID-19 pandemic, the last decade has also witnessed many exponential technologies reaching the market and evolving from a concept into unicorn companies. Innovation has been unprecedented, bringing many benefits in terms of health, education, sustainability, social mobility and other global challenges. Political institutions are marching backwards or in circles, at best, while entrepreneurship and market forces are creating a world of abundant opportunities.

Since Ecuador adopted the US dollar as its official currency two decades ago, the economy has remained dissociated from political changes to some extent, particularly those that could otherwise have unleashed inflationary forces. After the 2015 collapse of oil prices, which fed much of the public treasury, an economy that was impacted significantly by government spending has come to rely again on private sector growth and market forces; in the last few years, Ecuador has adopted more investor-friendly policies and laws.

In any case, and in spite of political noise, for the last 20 years Ecuador has maintained (with minor variations) certain key elements relevant to the cost and opportunity of doing business, including an economy that is market-driven for its most part, with state intervention and regulatory pressures in strategic economic sectors, and a relative stability of the essential components of corporate taxes, labour regimes and a dollarised economy that depends increasingly on the need to promote foreign investment and international trade.

Ecuador has developed its infrastructure (energy generation, road, ports, airports, telecom, oil pipelines, etc) significantly over the last two decades, to the point where energy and oil transportation excess capacity have been sold to neighbouring countries. Nonetheless, the country needs to continue investing in order to keep up to speed with increasing demand. In terms of business opportunities, Ecuador has become the next mining exploration frontier, with many major companies setting up local operations. Due to its geographical position and rich biodiversity, it is also a hot spot for green energy projects and power plants. The country is also home to many companies working in the digital space, and applications for financials, fintech and logistics produced in Ecuador can be found throughout the Americas and other parts of the world, so there is an emerging tech sector adding to and diversifying an international trade basket. The current economic downturn and pandemic-related pressures have increased the pace of acquisition of distressed businesses and assets.

If Ecuador had been adjusting some of its policies and legal framework to attract investments over recent years, the trend intensified during 2021, as a new government with a clear investor-friendly agenda took office. President Lasso is an economic liberal who advocates for individual freedom and a market-driven economy, and has made the attraction of private sector investment the highest priority of his government. As such, he is currently promoting legal reforms aimed at reducing the labour cost of doing business (in order to facilitate and stimulate entrepreneurship and job creation), reinforcing tax stability concepts, providing investment-related tax incentives and streamlining all government permits and processes in order to significantly reduce the timeframe and complexity of regulatory hurdles that currently thwart business initiatives. As part of these moves, Ecuador has rejoined ICSID and has started talks with its trade partners in order to revitalise the free trade frameworks.

These positive business climate trends are taking place in Ecuador at a time when neighbouring countries Colombia and Peru are seeing a quick deterioration of their own political health and placing themselves increasingly under the influence of the same authoritarian forces that have so far prevailed in much of the region over the last 15 years or so. It is no surprise that Colombian and Peruvian capitals are now looking to invest in Ecuador, nor that North American and European companies that lost market share to Chinese counterparts are now taking a renewed interest in this jurisdiction. Chinese businesses, for their part, are slowing down activities, partly as a result of the overall deceleration of the Chinese economy growth rate (currently in record lows for decades) and the failure of many Chinese business initiatives abroad, and mostly due to the increasing grip, control and influence of Chinese government officials over the corporate world, distorting with political goals business decisions that should otherwise be driven by market efficiencies.

Against this background, Ecuador is positioning itself as an investment hotspot, and an intensified level of project finance activity can be expected in a number of areas, particularly M&A, infrastructure-related private-public partnerships (PPPs), and energy and resource projects.

### Project Finance Landscape

It is believed, with good reason, that the development of the mining sector will be one of the key drivers of the Ecuadorian economy going forward, as will be further described below. In addition, the government has announced its objective to significantly increase oil production, which has remained stagnant during the last 15 years as a result of a failed policy consisting of the taking over by state-owned companies of the property and control of the oil sector, while displacing the private sector to the role of services provider. The government will now shift operation, control and risk to the private sector.

Another area of strategic interest is clean energy and renewables, ports and roads infrastructure, and PPP models for maintaining, revamping and operating state-owned hydropower plants as well as for building and operating new power plants that are much needed in order to cope with increasing energy demands, particularly as some large mining exploration projects move to the development phase within the next few years.

There are also small hydropower plants – both built and operating and still in the works – permitted under a private self-generating regime, that benefit from a business model that allows the surplus to be injected into the national grid at pre-established PPP tariffs. The government plans to reinforce this business model in line with its vision of enhancing the legal standing of the private sector in the development of strategic infrastructure.

Going back to mining, there are several projects that have released pre-feasibility studies and are fast moving into final economic assessment that might be looking to secure funding for the development phase during 2022. Lumina's Cangrejos and Condor projects are good examples, as is SolGold's Cascabel Project, which alone may deliver more than USD5 billion in copper and gold exports. Needless to say, the development of these and other large-scale mining projects has already triggered many initiatives in a number of other industries that need to secure readiness within the supply chain, including energy, drilling services, construction, logistics, environmental, lodging and catering, to name a few.

These developments offer very promising project finance opportunities in the near future. In fact, there have already been a couple of innovative project finance transactions in the resource sector under the streaming modality – ie, Orion's financing of Lundin's FDN gold project, now in production, and the Franco Nevada Corporation NSR Financing Agreement of SolGold's Cascabel Project. In particular, the NSR financing, which closed in September 2020, served as proof of concept regarding the application of royalty-related financing to exploration projects in Ecuador, a project phase typically limited to equity fundraisings.

### Contractual and Tax Issues

Streaming and off-take agreements (forward purchase model or anticipated payment facility) in the resource sector may enjoy a favourable tax treatment in Ecuador (as discussed below); based on existing laws and regulations, case law has qualified certain transactions that do not take necessarily the form of interest bearing loans as debt instruments, such as the securitisation of accounts receivable, the purchase of bonds, or the acquisition of a right over the production or proceeds of a company. This is certainly highly nuanced terrain, and very careful and detailed consideration should be given to the specific terms and conditions of each financing operation in order to assess whether it qualifies as a debt instrument for Ecuadorian tax purposes.

Regarding PPP project finance, Ecuadorian laws are generally in line with the typical project finance requirements, including:

- managing the project through a special purpose vehicle (ie, a project company), segregating the project assets from the assets of other project sponsors;
- lender step-in rights;
- financial covenants, intercreditor principles and subordination rules;
- security agreements, including pledges, liens and security trust structures over project company shares, assets and project revenue; and
- where security over the project agreements is part of the finance agreement package, PPPs would typically require government consent for the assignment of the project agreement.

In addition, PPP projects and investment projects in general may secure stability and certain tax incentives through investment agreements with the government, which typically also include international arbitration as the dispute resolution mechanism, as the ordinary judicial system does not have the sophistication or reliability to deal with this type of dispute. Investment agreements are also the key document in developing the project company and the project sponsor's rights, addressing such critical aspects as termination provisions, government authorisations, force majeure, limitation of liability, liquidated damages and risk allocation rules.

Let us give an overview of the tax treatment of debt instruments.

The payment of capital and interest is generally tax exempt, subject to certain regulatory limits and requirements.

All credit transactions are subject to maximum interest rates set by the Ecuadorean Central Bank (ECB) from time to time. While from a contractual perspective interest obligations may be agreed upon at higher rates, interest payments in excess of the regulatory threshold shall be subject to 25% income tax withholding (WTH), in addition to 5% capital outflow tax (ISD). Unless the creditor accepts the WTH and is able to use it as a tax credit in his or her own jurisdiction, WTH and ISD would have to be grossed up and would not be tax deductible for the debtor.

Interest payments within the ECB rate limits are not subject to WTH or ISD. The ECB maximum referential interest rate set for October 2021 is 7.74%. There are other regulatory and process requirements for these exemptions to apply, including that the terms of the loan should not require repayment of the principal within six months from the capital disbursement, and that certain regulatory registrations need to be performed.

Credit transactions amongst related parties are subject to thin capitalisation rules, such that the maximum annual interest payment may not exceed 20% of the debtor's EBITDA. Interest payments in excess of this threshold will not be tax deductible for the debtor and will be subject to WTH and ISD.

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**Tobar ZVS** is a full-service firm for corporate clients in Ecuador. With over 25 years of experience, the firm offers a client-centric approach, seeking to understand clients' industries and particular business objectives. Tobar ZVS is the exclusive member of TerraLex in Ecuador, a global legal network with a presence in more than 150 jurisdictions. The firm acts for diverse foreign and local clients working within the construction, infrastructure, mining, pharmaceuticals, media, food and beverage, and energy and natural resources sectors, among others. Recent transactional work includes acting as lead counsel to SolGold in the closing of a NSR financing agreement for its Cascabel mining project. Other recent clients include Luminex Group, China Road and Bridge Corporation and Flower Investment Capital Fund. The firm also advises long-term clients such as The Coca-Cola Company, Sony Pictures and The Walt Disney Company on all their Ecuadorian legal matters.

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**Bernardo Tobar** is the founding and managing partner of Tobar ZVS. He has 30 years' experience as a practising attorney, including four years as a CEO of one of the largest private infrastructure companies in the resource industry in Ecuador. He advises investors and corporate clients in cross-border, multi-jurisdictional transactions, integrating legal and business perspectives to meet their strategic goals. His key areas of practice include M&A, private equity, financing, corporate structuring, investment protection and risk management. As managing partner, Bernardo also focuses on innovation, and is constantly looking for ways to improve the client experience by leveraging technology in service delivery models. His recent work includes acting as lead counsel for SolGold on its project financing and structuring for the development of the Cascabel mining project; he also led the team representing Flower Investment Capital Fund on two acquisitions, and advised long-standing client Luminex on the restructuring of its holding company in Ecuador.

**Alvaro Sevilla** is a partner and leads the Antitrust and Competition team at Tobar ZVS; he is also a key member of the corporate team, advising on the structure of legal vehicles for businesses, commercial contracting, M&A and project financing. He mainly acts for clients in sectors such as healthcare, food and beverages, technology-based businesses, advertising, the flower and agriculture industry, trade mark management, communications, entertainment and sports. Alvaro's recent work includes guiding Univercells on its project for the execution of a medical facility of biosimilars in Ecuador, acting for Deerpath Fund on a financing agreement in Ecuador, and providing regulatory advice to The Walt Disney Company regarding its new streaming service. In addition, he has continued to provide routine legal advice to clients such as The Coca-Cola Company and Ecuatexxis, particularly in relation to the pandemic. Other key clients include Essity, SolGold and Luminex.

**Cesar Zumarraga** is a partner at Tobar ZVS, and heads the Natural Resources, Energy and Infrastructure team. He has prolific experience across all matters relating to the energy and mining sectors, at local, national, and international levels. Most recently, Cesar acted for a range of international corporations with interests in Ecuador's thriving mining sector, on matters including dispute resolution, development and operations agreements, acquisitions and regulatory issues. He also leads all legal matters for Lumina regarding their Cangrejos project, and for Aurania on the Ciudades Perdidas project. Cesar is a member of the International Bar Association, the Rocky Mountain Mineral Law Foundation and the Prospector and Developers Association of Canada.

**Juan Fernando Larrea** is head of the Environmental and Sustainability team at Tobar ZVS. He joined the firm as an associate in 2009 and was promoted to partner in 2021. He has been instrumental in the growth of the firm's energy and mining team and client portfolio, which has seen the firm advising on major mining and infrastructure projects in Ecuador. He plays a key role in advising clients on environmental regulation and compliance. Recent work highlights include assisting SolGold on several matters regarding its Cascabel project, and acting for Lumina Gold on its Cangrejos project. Other key clients include Aurania Resources, Condormining Coroporation and Minera Mesaloma.

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