Privatization Methods and Their Impact on Competition: the Brazilian Experience

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Summary

The Brazilian privatization process, which started in 1990, with the Brazilian Denationalization Programme, was marked also by other important legal milestones, the Law of Concessions for Public Services and the Constitutional Reform which, among other things granted equal treatment to foreign capital, on a par with Brazilian capital, both from 1995.

This institutional picture was framed in a general way by the removal of trade restrictions, monetary stability and the deregulation of the economy, followed by the establishment of a new body of regulations and agencies to control the competition, essential function of the new role of the State in the economy. Also to be noted is the need to use privatizations as an instrument to ameliorate the grave problems arising out of the fiscal crisis and public accounts.

The methods used in the Brazilian privatization, some applying to the process as a hole, and some specific to each sector privatized, had a decisive influence on the competitive atmosphere of the privatization process (procedures) itself as well as subsequently. In adopting transparency as basic pressuposition, subsequent efficacy and security were conferred on the privatized companies, as well as on the consumer, the securities market, on potential Brazilian and international investors in the 'mirror-companies', in addition to providing solid elements for economic policy.

Determining factors in raising the income from privatizations, and market competitiveness were: prior restructuring of the sectors to be sold; the system of evaluation carried out by independent consultants; the prevention of monopoly formation in the privatized sectors, either by prohibiting 'cross-overs' (a company cannot participate in another sale in the same sector, limiting it's participation in that market to a maximum percentage) or by the institution of regulatory stipulations; the system of public auctions with 'closed envelopes'.

The need for resources to control public deficits and current accounts made the process of privatization very important to the State, and hasted in the sale of old assets, which were effected without relation to new investments. The State restructured the companies to be privatized, provided hedge and insurance operations, and financed part of the purchases, sometimes through the acceptance of public securities as a form of payment.

In sectors considered strategic, the Government still maintains a participation through the system of shared decisions, either by the ownership of special class shares (golden shares), or by means of partial sales. As a general tendency, however, they are sectors which are increasing subject to more participation by the private sector.

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I- Factors That Contributed to the Brazilian Privatization Process

The debate over privatization models has to deal with the supposed paradox between, on the one hand, the need to ensure a growing supply of products and services of adequate quality, at reasonable prices, on the one hand, and on the other, the necessity of not reducing the attractiveness and profitability of the undertaking to be privatized.

In the case of Brazil, the State owned companies, 40-50 years old, effective and efficient at the start, were not so any longer at the beginning of the 90's, when privatization was started. There existed, therefore, in the act of privatizing, the opportunity of achieving appreciable increases in productivity, and resolving the dilemma of improved service to the consumer and attractiveness for the private investor.

The removal of commercial restrictions, programmed for a gradual reduction in tariffs from 1990 onwards; [the reform in 1994-1998, still in progress, of the 1988 Constitution, trying to make it something more than a Citizen's Constitution, also a Competition Constitution][2]; the stabilization of the currency, a reality after 1994; and the deregulation of the economy, with the end of price control and diverse governmental interventions, followed by the introduction of a modern and flexible re-regulation; all this made possible the Privatization Programme, by creating the conditions necessary for competition between the private agents.

The programme was now possible, essentially because if was necessary. Greater economic efficiency had been foreseen and sought, but it was urgently necessary to privatize to achieve that indispensable reduction in the internal public debt and the procurement of foreign resources.

The National Denationalization Programme (NDP) was edited in 1990, its first acts being in the field of industrial companies in steel, petrochemicals etc., which would be controlled by the "market", with out those difficulties inherent in the public services sector.

A second important milestone was the approval of the Concessions Law in February 1995, proposed originally by Mr. Fernando Henrique Cardoso, Senator at that time, which allowed from that date on the privatization of public services.

Also noteworthy was Constitutional Amendment, Number 6, in 1995, which provided equality of status to foreign capital on a par with Brazilian capital, which thereupon could participate in these privatizations. This completed the necessary legal basis.

The nationalized companies, which had become outdated, had fulfilled their purpose. They had been used to develop Brazilian industry and entrepreneurial activity; to obtain the economy associated with large scale enterprises and to make up for lack of capital necessary for fundamentally important projects; to use the purchasing power of the government for the formation of suppliers, for technological development and for strategic projects. But with the passage of time, and coincident with the reintroduction of the nascent, reborn, democracy, they had become instruments in the hands of

[2] The 1994/1998 constitucional reform, whic intends to allow legislation to increase business competition, at the same time if garantees the basic social rights.

politicians for the promotion of "jobs for the boys", nepotism, and scheming. As internal reactions had produced a distorted solidarity and "union" feeling, efficiency felt, discouragement prevailed and privatization became necessary.

The World Bank handbook on privatization states: "The economic benefits of privatization are maximized when governments make the increase of efficiency their number one objective". In Brazil, however, adjustment of the public accounts conditions government action. It´s the case, for example, of the use of privatization income to reduce the internal debt instead of being used for investment. This real and immediate need seems to delay the general increase in efficiency. However, the reduction in the debt permits a reduction in the interest payments and provides an incentive for investments that will increase productivity. As it is, today, the Brazilian State has negative savings. And the fiscal deficit is still very high, therefore, the use of privatization income to amortize the debt is a movement that leads to greater national productivity.

The positive effects of privatization will be reached in a competitive atmosphere. There is no point in substituting a public sector monopoly by a private one. In this regard the State has an important role to play, as at first sight a large part of the privatized sectors, or those in course of privatization are "natural monopolies". To achieve the aim of increased efficiency an institutional and regulatory apparatus that guarantees competition in the privatized sectors is necessary.[*]

In the process, the privatization model is determinative, which means that the methods adopted during the process have a decisive influence on the subsequent degree of competition. International experience has shown that the type of instrument used, the degree of democratization and transparency in the process and the extension of the regulatory boundaries, in the case of public services, have a significant relation to the price level, the quantity of investments and the quality of the product or services subsequent to privatization.

To this circumstance, confirmed in the case of Brazil, has to be added the difficulty of determining which instruments are adequate for each sector. Specific requirements occasion different models, creating difficulties in the negotiations between the State, on the one hand which has to represent the interests of the community, and private enterprise, on the other, seeking the greatest possible profit from the acquisitions. In the Brazilian case the situation is still further compounded by the political contest, very often ideological, understandably complicated in a time of great change in the development model, resulting in an agenda of complex subtle argument.

The Brazilian National Denationalization Programme (NDP) benefited from previous experiences carried out in other countries. It was possible for the Brazilian Government to study such experiences, adapting them to the Brazilian situation, incorporating in our models effective instruments and avoiding the errors that the pioneering countries had committed in the process.

On the other hand, the short time that the NDP has been in existence makes an analysis of the impact of the model on the efficiency of the various sectors difficult. Today, one

[*] This will be achived through regulatory agencies, in the case of public services, and through Competition Defence Agencies, in other sectors.

phase of the process has been completed, and in some sectors, notably those of infrastructure, only recently have these companies started to be privatized.

II – Methods and Aspects of Privatizations

II.1 – Old *versus* new assets

One of the difficulties faced by the BDP is the need to sell existing ('old') assets coincidentally with the need to realize new investments fundamental for growth by private enterprise. The 'available' capital was directed firstly to the purchase of the 'old' assets to satisfy the pressing need to reduce the public and external debt; and also because there was a lack of regulations in Brazilian legislation dealing with competition which would establish clear and dependable rules for the functioning of the markets involved, so as to render acceptable the uncertainties in relation to the return on the investment, with a reduction or transfer of risks to the seller.

This delay in the formation of the new structure led to difficulties in the privatization process during the last four years, that are now overcome. To aggravate further, the Brazilian Privatization Programme was superimposed on several similar international programmes, especially Latin American ones. The result of the conjunction of these factors would be the scarcity of capital in auction of state companies, which depreciated the price of the assets to be privatized and jeopardized the feasibility of the privatization programme itself, delaying new investments.

To face this problem, the Brazilian Government made the rules of the privatization programme more flexible. Initially the BNDES, the federal financial development institution, started financing a large part of the acquisitions. In addition, government securities and other 'public currency' started to be accepted as a part (very often an appreciable part) of the payment. As regards this flexibilization, the importance of the constitutional amendment which removed restrictions on foreign capital, treating it in the same way as Brazilian capital, should be reiterated.

Here an observation regarding the use of public currencies as a form of payment is in place. On the positive side, in reducing the stock of public debt, the acceptance of government securities represents an apparent depreciation of the price of the assets sold, as these securities were bought in the market for a value much lower than their face value, but accepted for their full value in the auctions. As a counter to this, we have the fact that in the auctions, if there are sufficient funds available, competition between the buyers will bring out the real price, in spite of the use of securities with a discount.

There thus arose an absolute need (which was met) of complete mobilization of those interested in the auctions, bringing in not only internal resources, but also external, attracted by the creation of a propritious environment and by putting on road shows in the world's principal financial centers.

As a consequence, in many cases high premiums were achieved in relation to the minimum prices evaluated by independent auditors. Learning by experience in the process led to the use of closed envelopes in the auctions, which represented a big advance, with a significant increase in the final selling price.

II.2 – Evaluation of risk

It could appear that, once a company has been privatized, the inherent risks should be assumed by the new owner, as the free functioning of competitive markets includes the administration of the risks associated with the investments.

It should be noted, however, that there is an important difference between the risks associated with the purchase of an originally state-owned enterprise and one which has been privately owned from the beginning.

In the case of a privatization, an initial risk arises due to the evaluation of the enterprise, of the minimum price and the premium to be paid in the disputation of the auction. It is to be supposed that the minimum evaluation has already deducted the hidden accounting liabilities, and that other business risks have been taken into account in fixing this price. For the seller to obtain a better price, he will assume foreseeable risks in the edict of privatization. The buyer can thus pay more, without assuming these risks, which, if not materializing, will benefit the seller.

Suppose, for example, a concession associated with a new construction. If the seller assumes the risk of a possible increase in future inflation, the buyer may pay more. Should the increase not occur, the seller benefits.

By these means, some sectors, in specific situations, require the State to assume part of these risks, through its own structure, or through a third party. That is the case of the concession of public services, where the strong regulatory component obliges businessmen to take decisions that they would not take if they had complete freedom of movement, and running risks that do not depend on their process of evaluation.

A good example of this is the Brazilian electricity sector, where the requirement of integrated operation of the system brings risks to the new owners of power plants that do not depend on their decision making process. It is thus fair for the State to assume a part of this risk stemming from its own requirement of a global operation of the electrical system.

It is important to remember that the proprieter should assume the risks deriving from endogenous components of the business process. It should be the responsibility of the State to encourage the adoption of mechanisms to cover uncontrollable risks (such as hedging and insurance operations) and assume, or create funds to cover, those risks deriving from its own decisions.

An important innovation of the Brazilian NDP is in the Concession Law: the edict should include the contract to be signed between buyer and seller, leaving open only the value of the purchase. This definition of mutual obligations, in addition to contributing greatly to the reduction of risks and distortions, found in the post-auction negotiation of contracts in some countries, brought a notable reduction in the length of the process, the buyer assuming soon after the auction.

Finally, we remember that, as an additional result of risk reduction in the privatization process, we have the appreciation in the value of the assets sold, as the forecast of future profitability of the deal increases.

II.3 – Strategic Sales *versus* Pseudo-Privatizations

Another question raised in relation to the modeling of the privatization process relates to the adoption of mechanisms to prevent 'pseudo-privatizations' of sectors or companies. This 'phenomena' has occurred in Brazil in four ways: 1) Partial financing of the purchase by the BNDES, taking shares in guarantee, becoming the buyer in the last resort. In some cases the BNDES buys shares directly to make the deal financially feasible, and sells them later, 2) pension funds linked to nationalized companies buy a substantial part of the company, 3) foreign nationalized companies buy the control of privatized companies and 4) state-owned (as opposed to federal) companies, or pension funds associated with them enter into privatizations of federal companies, or vice-versa.

In this way we have the contradiction that, after the privatization of the company or sector, it continues with greater or lesser state or federal participation. This may annul in part the effect intended by the privatization (for example the more efficient allocation of resources).

The adoption of mechanisms that prevent this process is at present jeopardized, because of the importance of these players as a source of funds for the success of the auctions, in view of the shrinking of available capital stock in the international market after the Asian crisis.

III – Effects of Privatizations

III.1- Efficiency of the companies

In a study published by the Institute for Applied Economic Research (IPEA), by Armando Catelar[3], on the microeconomic effects of privatization, for the periods 1981/91 and 1991/94, it was found that companies are more efficient and profitable with privatization in the following way:

- "for the whole sample, as well as the various sub-samples, sales per employee and net profit present significant growth;
- the improvement in performance is most significant, in statistical and economic terms, in the cases of the sale of control than in minority participation, which is consistent with the idea that together with the change of ownership the incentives for workers and administrators are improved;
- changes were more significant for privatizations in the 90s decade than the 80s, confirming the idea that the impact of privatization on company efficiency are greater when combined with other liberalization measures and austerity;
- the results obtained are quite conclusive as regards job reduction with privatization, showing falls of both the average and the median in the number of employees".

A reservation is that in the majority of cases the Government has prepared the companies for privatization, removing defects, weeding out, streamlining them, total or partially, and delivering them to the auction free of some liabilities and embarrassments that limited them. Sometimes, as in the case of iron and steel, the companies were

[3] 'Microeconomic Impact of Privatization in Brazil', Pesquisa e Planejamento Econômico - IPEA, of /1996, RJ, v.26, nº 3.

privatized after the testing or functioning of new investments that would significantly increase their productivity. In addition, the new economic environment generated a general increase in productivity, including in originally private companies. On the other hand, in this transitional phase, the great concern with the consumer, generated also a reduction in profits, which affected somewhat the result of the privatizations.

In this way, the change in ownership of the capital of companies that operated in infra-structure sectors, among which power, telecommunications, transport and oil/gas, in an environment of growth in competition between companies, of an acceptance of the participation of external capital and the strict control of competition, would lead to, both in the short as in the long term, an increase in the efficiency of the economy as a whole.

The basic premises for the optimization of the positive effects of denationalization of public companies are therefore: the prior establishment of a favorable atmosphere of competitiveness between companies; the definition and transparency of the legal structure upon which the companies should operate, determining the respect for the rights of users, to the increase in quality and productivity and the preservation of the environment; and the reduction of barriers to entry and departure (capital mobility).

Denationalization has static and dynamic effects on the sector. The first relate to the initial organization of the sector, whose variables, particularly relevants are: the number of companies that make it up, different products, cost and price structure, degree of vertical integration with suppliers and levels of investment.

The dynamic effects refer to the organization of the sector over time. In this regard, the prevention of predatory practices and the control of variables such as barriers to the entry and departure of companies, vertical concentration and dynamic price competition, are indispensable for the maintenance of a competitive sector.

III.2- The Search for the Maximization of Positive Effects

The guidelines of economic policy in the majority of developed and developing nations, coming from the Washington Agreement, today much debated, envisage measures for the liberalization of the economy and a new redefinition of the role of the State. The precepts revised in the Federal Constitution of 1988 and the dictates of social-democracy, led the Brazilian Government to implement a process of deregulation, privatization and re-regulation, where State presence is not discarded but modernized.

Unlike some international experiences where the processes followed the line: denationalization – restructuring-regulation, in Brazil the sequence has been as follows:

denationalization - restructuring - regulation - denationalization
(conception) (operation)

One of the forces inducing the process of change in Brazil has been denationalization, in parallel with the institution of regulatory boundaries (regulatory agencies) with the function of promoting the maximization of the benefits of the process for the whole economy.

It is essential to understand in the concession process that it is not always possible to establish competition in an economic sector or in its segments. As Coopers & Lybrand, the principal company contracted for the Project of Restructuring of the Brazilian Electrical Sector, have stated, "One of the basic concerns of the Government is that the sector is as efficient as possible. Experience shows that where activities can be organized sensibly and on a competitive basis, the competitiveness brings more favorable results than the regulating of monopolies ... This is not only a question of what can be accomplished in theory, but one which requires a recognition of the tension between the advantages of competition, on the one hand, and the probable losses of large-scale economy, of scope or coordination.... Regulation is necessary to control the monopolies and to ensure that there is no abuse of power, but it is necessary also as a promoter and moderator of competitiveness ..."

IV – Trade off: Mechanisms for the Defense of Competition *versus* the Needs of Large Scale Operation.

All this process of restructuring, re-regulation and denationalization has been orientated by the search for efficiency, micro and macro-economic, necessary for adequately serving the needs of the internal market (today 92% of the Product), in addition to entering with Brazilian goods in the competitive world market. On one hand, efficiencies relative to the State, by means of the valorization of its basis prerogatives, in detriment to its business function, the creation of conditions for the improvement of infra-structure, optimization of outgoings with a reduction in the cost/benefit relationship, the increase in internal income. On the other, efficiencies are relative to the competitiveness of companies, to technological advances, to employment, to savings and private investment, among others.

Measurement of the level of competitiveness of companies passes through the market test where gains in productivity and quality need large investments in research and development. The production of capital intensive goods needs to be on a large scale to be feasible.

In this sense, the split formed in the public service companies of telecommunications and electrical power, for example, during the pre-privatization restructuring, reduced their capacity to operate on a significant scale in production and in the market. The companies, formerly parts of the Telebrás and Eletrobrás systems, today operate independently and suffering the competition of others.

After the year 2000 the entry of new companies will be permitted, to operate in the various regions of Brazil, parallel to the public service concessions, competing freely and without the restrictions imposed on the former relative to territorial and sectorial limitations. They will be the so-called 'mirror companies'.

State monopolies, therefore, have been eliminated and a system created which allows the private sector to operate competitively in the exploitation of key sectors: power, telecommunications and transport.

Within these sectors, there are stages still considered to be 'natural monopolies', where the participation of a second company is not feasible, for example the

commercialization of energy (transmission to the final consumer). The private company with a concession for this activity will be strictly supervised by the regulatory agency until the introduction of a competitive regime becomes possible due to technological advances.

In those sectors not considered 'natural monopolies', for example power generation, privatization has brought market rules with beneficial effects for consumers and that given the interaction necessary with the monopolies, are also subject to tariff regulation to prevent any possible abuses of monopoly power, and to ease the tensions between productive and distributive efficiency and introduce mechanisms to promote dynamic efficiency.

The principles of competition are present in the whole process of restructuring, both in the tradeables as in the non-tradeables sectors.

The iron and steel sector had its environment altered by the privatizations in the period 1991/95, as up to then the participation of the State was immense, and it was slowly losing its capacity to invest. The new structuring given by the private sector resulted in fusions, take-overs, reciprocal participations, in other words, vertical and horizontal integration, which has been a constant source of concern to the Brazilian anti-trust agency.

It is considered preferable for the economy to have a pro-competitive market system, with no barriers to entry and no discrimination as regards the origin of capital, rather than the maintenance of monopolies, oligolopolies or artificial protections established in the name of the power to compete in international markets.

On the other hand, a removal of restrictions without equal treatment, an exclusive preoccupation with the consumer, the inadequate capital formation in Brazil, all require special attention, to return to sustainable growth, with a progressive improvement in the standard of living. In other words, without producers there are no consumers.

The low level of capital formation in Brazil requires not only the consolidation of stability but also a series of reforms and measures that guarantee the attractiveness of new investments and the necessary formation of capital for them. The negative savings of the State can be made positive by Fiscal Reform. Company growth can be ensured by reinvestment of profits, at present low, but which will grow under the new regime. And family savings will be ensured by the new attitude to life, and the new Social Security model, based on the private sector. It cannot be thought that foreign capital will resolve our present deficiency. It is unlikely to exceed $25 billion p.a., and it even appears to be probable that this figure will be reduced in future. In addition, it initially is destined basically for the purchase of existing assets, not realizing new undertakings, being used to build up external reserves. In the following year profits are remitted, and these values should reach $10 billion p.a. It becomes here absolutely necessary that the regulatory agencies, in the case of public services, and agencies such as CADE and SDE, do not act exclusively in the interest of consumers, but that they seek an equilibrium between the producer and the consumer, so that companies are permitted to grow, reinvesting healthy profits in an atmosphere of lawful competition.

It should further be remembered that Brazil cannot stand another round of tariff reductions, nor a valuation of the Real. The buyers in the privatization auctions would be deluded if this were to happen. Principally the overseas investors, who know that their countries preach indiscriminate removal of restrictions merely as diversionary rhetoric, and have not practiced, and do not now, practice it. In addition, they defend and promote their producers to care for their consumers in a structured way.

The flexibility and dynamism of companies operating in the market confers on them a capacity to formulate strategy, that may have the goal of achieving market power and that associated with large scale operations, which keeps them competitive. The decision should come from the market itself.

The Brazilian System of the Defense of Competition emphasizes the need for a pro-competitive structure and a strict regulation of conduct to ensure economic well being in the competition formulation **structure – conduct – performance.** In this formulation, the where structure refers to the number of competitors, the organization of production and distribution, the barriers to entry, among other things; conduct refers to the competition strategies of each company using instruments such as price, advertising, innovation and investments; and performance refers to the quest for allocative efficiency, technical progress and full use of resources.

V – Conclusions and a Sketch of Replies to Questions

There are two cases among the privatized companies; those that operate public services subordinated to the Concessions Law and those that operate with industrial products, in general, traded on the international market. In the former including telecommunications, electrical power, oil, and probably transport, control of the efficiency of the markets in the post-privatization period is achieved by means of the operation of regulatory agencies. In the others, this control is achieved by the Brazilian System for the Defense of Competition (SBDC)[4], acting in an antitrust sense in Brazil.

The regulatory agencies organize, supervise and regulate the operation of services within their jurisdiction, and as regards the aspect of competition, look after questions of conduct. The structure remains under the supervision of CADE, SDE and SEAE.

The SBDC, through specific legislation promoting free initiative, forestalls and checks abuses of economic power, both in conduct and in the construction of oligopolistic and monopolistic structures, acting over the whole economy, including private companies and those that operate within a concessionary regime.

This picture of the regulatory and antitrust agencies, defines the new role of the State in a post-privatized economy, in other words, a pro-market profile re-regulation, where the constitutional determinations of the defense of competition, of the rights of consumers and of the social role of companies must be respected.

The security of this environment is tied up with the transparency of the denationalization process, in view of the necessity of the economic agents to trust in the

[4] Includes the Administrative Council for Economic Defense (CADE), The Secretariat of Economic Law of the Ministry of Justice (SDE) and the Secretariat of Economic Supervision of the Ministry of Finance.

independence and competence of the new players in the market and the regulatory power of the State.

Action taken by the Brazilian Government, defined by the Brazilian Denationalization Programme, by the restructuring of the sectors to be sold, by the evaluations carried out by third parties, by the prevention of the formation of monopolies in the privatization auctions, by the prohibition of 'cross-overs' (a company cannot participate in another sale in the same sector), by the institution of regulations and by the public auctions, have been essential to raise the level of competition in the markets.

The transparency and legality of the privatization process were essential for its subsequent effectiveness, in giving security to the companies in their subsequent development, to consumers, to the securities market, to potential investors, Brazilian and foreign, to state action and to economic policy.

Excessive participation of foreign nationalized companies in the auctions, the initial lack of obligation towards the new assets (necessary investment) when selling the 'old' assets, the acceptance and utilization of 'rotten currencies' for example, are being re-thought so that the State does not transmit only the benefit, but includes also some of the obligation in its sales.

The 'modus operandi' of the Brazilian privatization process established by the Brazilian Denationalization Programme, already described, tries to reach solutions for questions relative to restrictions on capital for investment, to the fiscal deficit, to the need for technological contributions, to transparency and to the establishment of a competitive atmosphere that results in increased quality and low prices to consumers on the one hand, and capacity of companies to compete internationally on the other. In some specific cases the State has decided to continue participating in recently privatized companies through partial sales and the possession of special classes of shares (golden shares).

The continuation of the participation of the State in privatized companies, through ownership of the special class shares, are intended to introduce a government perspective into the operation of companies. In this case the golden shares are not intended to have an effect on competition.

The Federal Government detained golden shares in the Companhia Vale do Rio Doce with the intention of preserving for itself strategic aspects of the planning and decision-making of the company and the Brazilian economy itself. It ensured for the Union the right to enforce the maintenance of the CVRD's principal economic activity, restricting alienation or termination of any stage involving the production and sale of iron ore, in other words, the mine/rail transport/ port system, and to prevent any change in the location of the head office of the company.

Consequently the strategic decision-making nucleus of the company, independently of equity holdings, includes the participation of the Union which, in accordance with Brazilian legislation, retains the ownership of the mineral resources of the subsoil in Brazil, the company merely having the mining rights.

This model chosen for the CVRD, with a modern administration, of shared control makes it possible for strategic investors – companies and professionals with experience and tradition in the fields where the company operates – such as its partners, to accumulate to it know-how and capital. It has also allowed a transition process to take place from a state to a private company, with fewer upsets and more long-term commitment.

It should be noted that the golden shares limit the participation of competitors and customers in the controlling nucleus of the privatized company, which fact favors competition by preventing horizontal and vertical integration.

The golden shares in the possession of the Union could cause, as a negative effect, a reduction in the amount received for the sale, as there would be restrictions on the total control of the company. Such a fact did not occur, because the amount reached at the auction exceeded the originally foreseen premium. On the other hand the complete pulverization of the company shares would reduce the volume of resources by making unfeasible any type of participation in its control.

Partial privatizations were introduced for several motives, one being the lack of proportion between the needs of direct investment and the real possibilities of public financing, given the fiscal restrictions of the State and the urgency of introducing a competitive regime in sectors until then thought of as 'natural monopolies', such as the whole process of electrical energy generation.

Partial privatization can generate, secondly, a problem in common with golden shares, a reduction in the sale value of the remaining part of the shares in control of the State, in view of the fact that investors interested in the control of the company will not participate in the auction. The position of the first partners, partial controllers, may prove an obstacle to the valorization of the shares in the hands of the State. In the absence therefore of any justifiable strategic interest on the part of the State in participating in the company, the sale, in view of the value to be received, should be total.

Constitutional restrictions[5] on the exploitation and production of petroleum delimit the authorized model and concession for such activity, which was regulated by Law no. 9478/97 (the Petroleum Law) stating that *'the Union may allow state or private companies, constituted according to Brazilian law and with head office and administration inside Brazilian territory, to undertake activities of prospection and production of petroleum and natural gas in Brazil, by means of concession contracts, preceded by tender....'*.

In this model, according to prior government studies, privatization will occur by means of the entry of new companies into the sector through new concessions and through the partial sale of the patrimony of the state company Petrobrás. It should be a partial privatization that would allow the necessary investments to be effected and the transition to be secure and orderly.

[5] Articles 176 and 177 of the Federal Constitution of 1988 state that 'the prospecting and production of petroleum, natural gas and fluid hydrocarbonates existing in Brazilian territory belong to the Federal Union'.

This law envisages the participation of private companies or consortia in petroleum refining, in the processing of natural gas and in the transport of petroleum, its derivatives and natural gas, through authorization from the National Petroleum Agency, coincidentally with the operation of Petrobrás.

Petrobrás cannot have any privilege from the State that distorts, in its favour, its capacity to compete. At the same time it was authorized to effect partnerships with private enterprise, which prohibits it from receiving any government incentives. This is in conflict with the constitutional precept of equal treatment.

As regards the exploitation of petroleum/gas, the NPA realized on 14 August last an international tender for the contracting of specialized consultancy in the promotion of block tenders, where activities of prospection, development and production of petroleum and natural gas would be carried out, in Brazilian territory.

As regards electrical energy, the new model envisages total competition in the area of generation, whose concession will be granted by means of public tender, establishing total competition between state and private company.

In relation to distribution and commercialization, the breaking of the monopoly for cargo above a certain size was established, through which free access would be permitted to any supplier, once again establishing competition between state and private company. This leaves the consumers with cargo below a certain size, representing more than half of the total, whose prices will be regulated by ANEEL.

The agency however establishes maximum prices for reference and stimulates the progressive reduction in prices, by means of encouragement to the concessionary. In this case there is no monopoly in the area of the concession.

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ANNEX I

History of the Brazilian Denationalization Programme

In 1990, the Brazilian Denationalization Programme was created, after it was observed that the old model of economic growth, based on the active participation of the State as entrepreneur, had exhausted itself. The fiscal crisis of the 80s undermined the capacity to invest in state companies, jeopardizing the expansion of supply compatible with the evolution of demand. The expedient of using tariff containment as an instrument of inflation control made the financial result of these companies even worse, and contributed to restricting still further their capacity for future expansion.

This situation, allied to a growing need for gains in productivity to introduce Brazil into the international market, had as its logical result, the fact that a new model of economic development, in which private enterprise would assume the entrepreneurial function was adopted, while the State took over for itself the responsibility of supervising and regulating the economic system.

In the first phase of the Programme (1990/1994) predominantly industrial companies were denationalized, concentrated in the iron and steel, petrochemicals, and fertilizer sectors. During this period, privatization currencies were used on a large scale (sundry credits on the Federal Government), and restrictions on external capital were significant.

In the period 1995/96, the programme enters a new phase. The Brazilian Denationalization Council (CND) was created, an organ directly connected to the President of the Republic, and composed of various economy ministers. The Brazilian Denationalization Fund was also created (FND), an accounting fund where the shares of companies included in the Denationalization Programme are deposited, and which is administered by the Brazilian Bank for Economic and Social Development (BNDES). Included on the privatization agenda were concessions of public services, such as the electrical energy, telecommunications and road and rail transport areas. Another important decision during this phase was the inclusion of the Companhia Vale do Rio Doce in the portfolio of the FND. Other characteristics of this period were the start of privatizations at the state, as opposed to Federal, level, the reduction in the use of 'rotten currencies' in payment, and less discrimination against the participation of overseas investors in the purchase of the ex-state companies.

The year 1997 was distinguished by the sale of the CVRD, one of the largest mining companies in the world, which constitutes a milestone in the Brazilian privatization programme, due to the polemic about its strategic importance for the country and the advisability of selling a profitable and undoubtedly efficient company. With this sale, privatization of industrial companies was practically exhausted, and the attentions of the CND turned to public service concessions and to the support of state privatization programmes. The graph below, which illustrates the break-down by sector of the privatizations already effected, shows how the PND concentrated, up to 1997, on predominantly industrial sectors:

Graph 1:

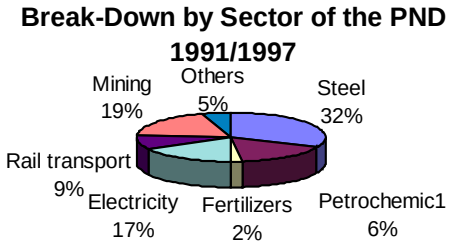

Table 1

Result of the Brazilian Denationalization Programme (PND)

Period	Privatized Companies (Nº)	Income from Sale ($ million)	Income from Sale Total ($ million)	Total Income from Sale (%)
1991/1992	18	49	4,015	1.2
1993/1994	15	1,590	4,593	34.6
1995	8	327	1,003	32.6
1996	11	3,057	4,080	74.9
1997	4	4,073	4,265	95.5
Total	**56**	**9,096**	**17,956**	**50.6**

Source: Brazilian Bank for Economic and Social Development (BNDES)

Finalization of the sale of the Federal Rail Network (RFFSA), the sale of Centrais Elétricas do Rio de Janeiro (CERJ), of Espírito Santo Centrais Elétricas S.A. (Escelsa), and Cia. de Eletricidade do Estado da Bahia (COELBA); and the auctions for the sale of shares of Cia. Riograndense de Telecomunicações (CRT) and of Centrais Elétricas de Minas Gerais (CEMIG) were other important events of the year. In the telecommunications sector, the privatization programme was started by the call for tenders for the Band B mobile phone concession. In addition, the privatization of the Banco Meridional do Brasil SA started privatizations in the financial sector. Table 1 presents the results of the PND in the period 1991/1997.

It should be observed that in the years 1996 and 1997 total sales receipts corresponded approximately to double the yearly average of the first four years and to four times the value for the year 1995. In terms of the number of companies sold, this falls from 8 and 11 in 1995 and 1996 respectively to 4 in 1997, the result of the impulse given to process to concentrate on large, high value companies.

In the eighth year of the PND, it still remains to complete privatizations in the electrical sectors, considered some of the most profitable, to advance in the area of concessions in the field of highways and ports, and to consolidate the state and municipal privatization programmes.

In addition the first signals are being sent that in the event of a second term for President Fernando Henrique Cardoso, sales of other State companies will be appraised.

For 1998/99, the BNDES envisages the privatization of state banks, ports, underground and/or metrô railway lines, and state energy and basic sanitation companies, among others.

Table 2 and graph 2 show the results of privatizations in the period 1991/1997:

Table 2

Yearly Results of the PND for the period 1991/1997 and 1998

Year	Nº of Companies	$ million		
		Income from Sales ($ million)	Debt Transferred ($ million)	Total Income ($ million)
1991	4	1,614	374	1,988
1992	14	2,41	982	3,383
1993	6	2,627	1,561	4,188
1994	9	1,966	349	2,315
1995	8	1,003	625	1,628
1996	11	4,080	669	4,747
1997	4	4,265	3,559	7,826
1998*	12	-	-	22,058
Total	56	17,956	8,119	48,1335

*Refers only to the Telebrás auction
Source: BNDES

ANNEX II

Initial Legal Regulatory Framework in Brazil (Re-regulation)

The structuring of the legal framework in Brazil is governed by several articles of the Federal Constitution of 1998, which confers on the State the attribute of a standardizing and regulating agent of economic activity (essential function of the new role of the State in the economy), and the rendering of public services is the responsibility of the Public Authorities, either directly or under a regime of concession or permission. Law number 8.987/95, which deals with the regime of concession and permission for the rendering of public services and Law number 9.074/95, which deals with the granting and extending of concessions and permissions complement the constitutional provisions on the subject. The legal foundations define public utility services rendered under a public regime, through concessions and permissions, and those rendered under a private regime, which complies with the constitutional principals of economic activity, where 'full, free and just competition should prevail' .

To organize, supervise and regulate, therefore, the rendering of services under a public regime, specific regulatory agencies were created, and to regulate those services carried out under a private regime, as well as the whole economic environment, the Brazilian System for the Defense of Competition was already in existence and structured, and composed of three organs, the Administrative Council for Economic Defense (CADE), an independent autarchy, the Secretariat of Economic Law (SDE), of the Ministry of Justice and the Secretariat for Economic Supervision, of the Finance Ministry.

The principal characteristic of any initial legislation is the creation of a regulatory agency. Those created, under the legislation cited below have contributed to the fact that the sale of public companies was preceded by the establishment of sets of rules, objectives and limits of action favorable to the investments. Clear rules stimulate the interest of both Brazilian and foreign private groups in being granted concessions or permissions for the exploitation of electrical energy, telecommunications and petroleum, and establish parameters to guide government policy for the sector, with its goals and objectives.

Economic literature and international experience identify two models for the functioning of the regulatory agencies: specific or multisectorial/general. In the first case the objective of the agency is restricted to a given natural monopoly, or monopolies that are highly correlated. In the second, the same agency may be responsible for more than one monopoly (air, rail, road and sea transport, for example). The model more frequently adopted internationally is that of specific regulatory agencies.

Sectorial agencies use the method of market mechanism substitution and have as their object allocative efficiency (primordial goal of the defense of competition), such as the universalization of services, regional integration, conformity between long-term strategy and social exigencies, among other things.

In Brazil, the federal regulatory agencies already created, and those under study, possess specific legal competence, with functioning further restricted to a determined industries sectors. Some states of the Union, such as Minas Gerais and Rio Grande do Sul, have created multisectorial regulatory agencies, in view of the still low number of state public services conceded and permitted.

The state agencies will act in a complementary sense, through agreements with specific federal agencies, in the supervision and regulation of services conceded or permitted to the private sector.

Basic Juridical Ordering of the Regulatory Agencies:

Agencies	Aneel	Anatel	ANP
Law	**9,427**	**9,472**	**9,478**
Date	26/12/96	16/07/97	06/08/97
Decree	**2,335**	**2,338**	**2,455**
Date	06/10/97	07/10/97	14/01/98

Source: Legislation

The regulatory structure of the electrical sector was defined by Law number 9.427/96 which instituted the National Agency for Electrical Energy (Aneel), an autarchy under special regime connected to the Ministry for Mines and Energy possessing the following objective: "*to regulate, and supervise the production, transmission distribution and commercialization of electrical energy, in conformity with the policies and directives of the federal government* ".

The telecommunications sector was regulated by Law number 9.472/97 which dealt with the organization of the sector and created the National Telecommunications Agency (Anatel), an autarchy under special regime connected to the Ministry of Communications, whose objective is "*to adopt the necessary measures to satisfy public needs and to develop Brazilian telecommunications, while operating with independence, impartiality, legality, impersonality and publicity* ".

In the case of petroleum and gas, Law number 9.478/97 deals with the national energy policy and activities relative to the petroleum monopoly, instituting the National Energy Policy Council and creating the National Petroleum Agency (ANP), an autarchy under special regime connected to the Ministry of Mines and Energy, with the objective of "*promoting the regulation, the contracting and the supervision of economic activities within the petroleum industry* ".

Autarchies are "*autonomous administrative entities, created by specific law, with a juridical personality in internal Public Law, own patrimony and specific state attributions* ". A special autarchy is defined as " *every autarchy where the instituting law confers specific privileges and increases its autonomy relative to normal autarchies, without infringing constitutional precepts pertinent to these entities of public personality* ".

Their establishment as autarchies gave to the agencies a juridical independence fundamental for them to fulfil their legal attributions. Such independence, however, is not unlimited and unrestricted. The agencies celebrate previously negotiated management contracts with the Ministries to which they are connected. These contracts are the instruments for the control of the administrative functioning of the autarchies, for the evaluation of performance and the submission of accounts.

The laws that created the agencies and their specific regulations established also mechanisms for the resolution of divergencies between the conceding power and the concessionaries.

The Law of Concessions defined two fundamental attributions of the conceding power: the regulation of the conceded service and the permanent supervision of its operation. Specifically, the attributions of the conceding power are:

- Regulate the service and supervise permanently its operation;
- Declare the assets envisaged in this law a public necessity or utility;
- Apply the regulatory contractual penalties;
- To strive to give the best possible quality service;
- Stimulate competitiveness and improvement in quality, productivity, preservation and conservation of the environment;
- Stimulate the formation of user associations for the defense of interests relative to the service; and

- Intervene in the rendering of the service, extinguish the concession, ratify readjustments and undertake tariff revision.