

Private Participation in Infrastructure – The Legal and Regulatory Frameworks in the Case of Brazil¹

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1. Introduction

Since the early nineties, Brazil has gone through an extensive process of privatization involving sectors such as steel, petrochemicals, energy, telecommunications, highways, railroads, gas, and water supply. This process was one of the most comprehensive outside the transition economies world, and is comparable only to Great Britain's privatization process during the Thatcher Administration.

This text tries to provide a brief description and evaluation of the Brazilian experience with privatization in infrastructure focusing on its legal and regulatory frameworks. In order to do that, I will refer to a set of topics that are often present in the international literature on Private Participation in Infrastructure (PPI), such as network expansion, quality improvement, competition, fiscal issues, allocation of risks, economic equilibrium of contracts, and *ex-ante* evaluation of efficiency gains. My objective is to define where Brazil stands when it comes to each of these topics and, when appropriate, to point out how the legal and regulatory frameworks in Brazil deal with each of them.

Although outside the mainstream debate on the matter, I would also like to draw some attention to the need of an adequate government planning or coordination

¹ Text presented at the Expert Meeting organized under the auspices of the OECD Investment Committee "International Investor Participation in Infrastructure: Lesson for Governments", Paris, 3 March 2006.

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capacity to manage a PPI program and to make it consistent with public sector investments.

It is needless to say that the responsibility for the following opinions is only of the authors and that these opinions may not reflect other officials' views on the subject.

2. The legal framework for privatization in Brazil

The institutional, legal and regulatory framework for privatization has been put in place since the early nineties. Along with Constitutional amendments, it was necessary to pass in Congress several statutes. One of them was the National Privatization Program⁴, which established the guidelines to implement the privatization procedures at the Federal level of Government. Other important statutes include the Act that lays down standards on concession contracts and on bidding procedures to award concessions⁵; and the Act that sets up standards on concessions that involve payment of subsidies to private partners⁶.

Several other statutes were also passed to create specific rules to conduct the privatization process in each economic sector, to create the regulatory agencies, and to set the guidelines that direct these agencies' activities.⁷

3. Comparing Public and Private Provision of Services – Ex ante evaluation of efficiency gains

It is widely known that lower government costs of capital create a tendency towards public sector direct implementation of projects. This makes it necessary to

⁴ The latest version of this Program is the Federal Act 9.491 of 1997. The first version dates from 1990.

⁵ Federal Act 8.987 of 1995.

⁶ Federal Act 11.079 of 2004.

⁷ Among others, Federal Act 10.233/01 on the transports sector, 9.427/96 on the energy sector, 9.478, on the petroleum sector, 9.472/97 on the telecommunications sector.

evaluate in each case if the efficiency gains brought in by private participation prevail over the higher costs of capital faced by private partners.

In Brazil, the costs of public works undertaken by the Government is much higher than the costs of the same works contracted by the private sector due to various sorts of inefficiencies such as poor procurement mechanisms, low management capacity and difficulties to comply with agreed payment schedules.⁸ This creates room for efficiency gains by private partners, and a strong proclivity towards PPI when heavy investments in construction are involved.

Notwithstanding this proclivity, it is still worth comparing, on a case-by-case basis, the efficiency gains to be obtained by private participation against some shortcomings and difficulties involved in privatization. However, due to a lack of adequate historical information on the costs faced by the public sector, and on the costs of privatized services (not all regulatory agencies release adequate information on privatized services) we still face difficulties in comparing the costs of public and private provision of services.

It would be desirable to eventually develop a sort of Public Sector Comparator (PSC) suited to the Brazilian case that would allow *ex ante* evaluation of contracting out projects.

4. Competition

The Federal Constitution⁹ and the Concessions Federal Act¹⁰ require concessions to be awarded under competitive bidding procedures. Therefore,

⁸ For evidence on that see the Annex H of Report on the Financial Evaluation (Relatório de Avaliação Financeira) made by the Brazilian Ministry of Planning, the IFC – International Finance Corporation and BNDES, the Brazilian Development Bank, which is a result of a comparison between the costs of public works in the road sector in Brazil (using for that end the SICRO, which is a system employed by DNIT, the National Department of Transports Infrastructure to price motor road public works) and the costs of the same works when done by a private organization under market conditions. This comparison was done by Dynatest, a local engineering consultancy firm. A Portuguese version of the Report on the Financial Evaluation is published at <http://www.pppbr116.org/docs.html>.

⁹ Article 175 of the Federal Constitution.

competition for the market is a legal requirement when it comes to awarding concessions in Brazil. Furthermore, the Concessions Act establishes that, except in the case of economic impossibility, concessions should be awarded under arrangements that allow competition in the market¹¹.

It is well known that, in cases where it does not make economic sense to have competition, the regulatory agencies should implement some sort of yardstick regulation. In Brazil, although the legal framework generally gives regulatory agencies the power to do so, most of them have not yet developed the technical expertise to implement yardstick regulation satisfactorily. For instance, most concessions contracts and public utilities regulations provide for the application of price cap mechanisms. However, most regulatory agencies were not yet capable of adequately establishing how to calculate efficiency gains to impact tariffs (the so called factor “X” in the price cap formula).

5. Private sector investment in infrastructure, network expansion and quality improvement

Regarding the quality of services, there is evidence that wherever PPI was introduced users were satisfied with services’ quality. In many sectors, though, there are complains about high tariffs, especially in sectors, such as public highways, where services were usually funded by taxes, before privatization.

Except in some segments of the energy sector (such as transmission lines) and in the telecommunications sector, in which privatizations were followed by high investments to expand telephone wire line network and to develop new services (such as wireless telephone, or high speed lines), privatized companies and services providers were not capable to match the desirable level of investment, and, thus, were not able to substitute adequately public sector investment. The result was that service expansion,

¹⁰ Article 14 of the Federal Act 8.987/95.

¹¹ Article 16 of the Federal Act 8.987/95.

with the exceptions just mention, lagged behind. In some sectors, such as water supply and sanitation, this was to some extent due to inadequate legal and institutional frameworks.

Until 2005, the payment of subsidies to private concessionaires required legislative authorization. For this reason, during the 1990's and the first years of this decade, the privatization programs at the Federal and the State levels focused on implementing financially self-sustaining projects, which in some sectors account for very limited portions of the network. For an instance, in the road sector self-sustaining projects encompass less than 10% of the network. This circumstance has certainly limited the capacity to transfer projects to the private sector.

It is true though that in some sectors statutes have created cross-subsidy mechanisms such as the tax on telecommunications services to finance universal access to the services (FUNTEL). However, because of fiscal constraints, the resources accrued by these taxes were rarely fully spent on the programs they were originally designed to fund. The energy sector is a noteworthy exception. In this sector, the 2001 electricity shortage led to disbursements to acquire electricity and to finance investments in thermoelectric power plants.

6. Fiscal issues

One of the arguments for privatizations was that they would reduce the need to mobilize public resources for investments, and thus release resources for other government priorities. This argument happened to be particularly important in cases where the capacity of the public sector, either to raise savings or to borrow, in order to mobilize resources for investment, was limited. This was the case of Brazil, where an already high public debt constrained the access to medium and long term financing, and the need to generate sizable primary surpluses in the public sector accounts left few resources available to fund investment.

In order to keep the public debt in check, privatization proceeds were extensively used to extinguish debt. There is nowadays a recognition that privatizations, on the whole, had a positive effect on public finances either because of reduced needs of investment outlays, and therefore lower borrowing requirements, or because of efficiency gains and higher collection of taxes.

I already mentioned that in the case of concessions, the fiscal constraints also hampered privatizations that involved some sort of subsidies to the private partner, and that before 2005 concessions that required government payments to private partners could only be awarded after legislative branch authorization.

7. The New Federal Act on Public-Private Partnerships (PPP)

The New PPP Act of December 2004 created new modalities of concessions which allow for government disbursements to the concessionaire and eliminated the need of legislative authorization for government financial commitments to private partners.¹²

To guarantee the fiscal sustainability of the PPP Program and to control the Government commitments to projects (limits on the amount of subsidies, contingent liabilities and overall debt), the Federal PPP Act established some requirements and limits. It also granted specific agencies the power to enforce the standards and rules on this matter.

The PPP Act created a council formed by the Minister of Planning, the Minister of Finance, and the Chief of Staff of the Presidency, to manage the Federal PPP program, especially its relation with the budget. The PPP Act made the approval of each project by the abovementioned council conditional upon studies about its impact on the overall

¹² In the case of Brazil, the term PPP refers only to concessions where the Government pays for part or the whole of the service provided by the concessionaire. The Brazilian legal concept of PPP encompasses traditional concessions in which the Government pays some sort of subsidy to the concessionaire or contracts, such as the British PFI contracts, in which the Government is the one that pays for the provision of the services.

public debt and on current expenses. As it was not possible to define in the PPP Act the accounting standards and rules relating to commitments under PPP, the Act gave the National Treasury the power of issuing the regulation on this issue.

Moreover, the PPP Act determines a limit for subsidy payments under PPP contracts. Each level of Government (federal, state and local) cannot have expenses concerning PPP projects in excess of 1% of its annual net current revenues¹³. To control the fulfillment of this obligation, all levels of Government are required to provide studies on this matter, with forecasts of expenses generated by PPP contracts in the current year and in the ten succeeding years. States and municipalities have to send information on their PPP contracts to the National Treasury, which will be responsible to verify the actual compliance with the statutory limit.

If the Federal Government reaches its limit in a given year or if the forecasts show that it will violate its limit in the next ten years, it will not be authorized to sign new PPP contracts until it complies with the due limit.¹⁴ The sub national Government which is in violation of the limits will not be able to receive guaranties from the Federal Government for its borrowing from multilateral institutions as the World Bank and the IDB, or to receive any sort of voluntary transfer from the Federal Government.¹⁵

PPP legislation also contains provisions to minimize the risks of default on government obligations to private concessionaires. This is achieved through a private trust fund named FGP (Fundo Garantidor de Parcerias Público-Privadas). The fund functions as a backstop facility that will guarantee government's financial commitments under PPP contracts. The PPP Act contains a provision that limits the amount of public resources to be transferred to the fund to R\$ 6 billion, approximately US\$ 2.8 billion.¹⁶ The bylaws of the Fund were approved in February of 2006 and assets in the value of R\$ 4.2 billion, approximately US\$ 2.0 billion, were already transferred to the Fund.

¹³ Article 22 and 28 of the Federal Act 11.079/04.

¹⁴ Article 22 of the Federal Act 11.079/04.

¹⁵ Article 28 of the Federal Act 11.079/04.

¹⁶ Article 16 of the Federal Act 11.079/04.

The PPP Act also creates the possibility of the Government contracting private, domestic or international, (monolines) insurance companies or multilateral organizations to provide payment insurance to mitigate risks related to government payments.¹⁷

We expect that in the long run the new PPP Act, as it allows for the introduction of subsidies in concession contracts, will contribute to significantly increase private participation in infrastructure development. The Federal Government and some States are presently working on the first PPP projects. There are three State projects with invitations for bidders already out: a highway in the State of Minas Gerais¹⁸, a subway line in the State of São Paulo, and a submarine wastewater pipeline in the State of Bahia. The first Federal Government project will be a highway in the Northeastern region of the country.¹⁹ The invitation for bidders will be out this year.

8. Transferring of risks, tariffs and the economic equilibrium of contracts

The Brazilian Concessions and PPP laws allow the Government to transfer to private partners the responsibility of designing, financing, constructing and operating public assets.

In the concessions awarded in the 1990's, there was a lot of concern over transferring to the private sector the responsibility of designing the project. In the highway sector, for instance, the contract documents included provisions not only on the kind of material and technology to be used in the rehabilitation or construction of roads, but also on the timing of each investment. The rigidity of the investment plans led to many renegotiations, which were and still are one of the main downsides of the first Federal highway concessions.

¹⁷ Article 8 of the Federal Act 11.079/04.

¹⁸ The project documents are at http://www.ppp.mg.gov.br/projppp_mg050.htm .

¹⁹ The project documents, including the feasibility studies are all available at <http://www.pppbr116.org/docs.html>.

In several sectors, concessions have evolved to contractual arrangements that focus mainly on outputs. They specify the desirable level of performance (quality, reliability, safety etc.) and transfer to the private partner the choice of means (technology, materials, etc.) to achieve it.

The legal frameworks on concessions and PPP allow basically any sort of risk allocation.²⁰ Risk allocation is done on a project-by-project basis and contracts are the main instrument to allocate risks. The challenge obviously is to find the most efficient allocation of risks in each sector and project.

The Concessions and PPP laws entitle private partners to the maintenance of the contract economic equilibrium. This economic equilibrium is generally preserved by contractual revisions and renegotiations, which take place in a planned manner every 2 to 5 years, subject to sector peculiarities. There is also the possibility of an extraordinary contract revision should unforeseen events that deeply change the original equilibrium of the contract arise.

To deal with inflation, contracts also establish annual tariff adjustments using sector-specific formulae. Most recently, the Ministry of Finance has issued a recommendation to all Federal Government agencies to use the official general consumer price index (IPCA) in tariff adjustments.²¹

It is worthwhile mentioning that the Brazilian courts have been instrumental to guaranteeing the rights of private concessionaires set by law and contracts. For instance, in one member States that went through a process of highway privatization, the new Administration was against privatization and tried to hinder the process by reducing tariffs or impeding tolling. The matter went to the Judiciary, which first issued an injunction that suspended all investment obligations of the private partner until its

²⁰ Cf.: article 10 of Federal Act 8.987/95 and article 5, item III, of the Federal Act 11.079/04.

²¹ Cf: *A REGULAÇÃO E O COMPORTAMENTO DOS PREÇOS ADMINISTRADOS*, technical note issued in December 2005, by SEAE – Secretaria de Acompanhamento Econômico, an agency of the Brazilian Ministry of Finance. The note is published at http://www.seae.fazenda.gov.br/central_documentos/notas_imprensa/2005-1/p_adm_pub_20051228-a_regulacao-e-comportamento-precos-admi.pdf.

final decision. The final decision was in favor of the private partner and established the right to a proportional reduction of the private partners' investment obligations to match the tariffs price defined by the State Administration.

Another important precedent took place recently in the Telecommunications sector. In 2003, the Federal Government attempted to change the contractual index to adjust the tariffs charged by wire line carriers. The carriers took the matter to the regulatory agency (ANATEL), which upheld the index agreed upon by the parties. Afterwards, the matter went to the Courts, which confirmed the agency's decision. These Judicial rulings created important precedents regarding the prevalence of the economic equilibrium embedded in concession contracts.

9. Planning and regulation

Except in the telecommunications sector, in which specific regulatory framework and agency were created before privatizations, in most sectors privatization took place before the creation of the respective regulatory agency and the legal and regulatory framework to control the privatized business.

Although privatizations in some sectors made private investment responsible for a relevant share of the much-needed investments, in most sectors public investment is still very important. In this regard, a typical Brazilian problem is that the overall capacity of ministries to plan and coordinate public investment with private investment has been reduced after the privatization process.

Many senior officers of the agencies in charge of the sector planning and development of the sectors left to work for the privatized companies. In some sectors, the capacity of sector planning and project development was located in the formerly public-owned companies. As there was no specific strategy preceding the privatizations process to keep the personnel within the Government, the Government lost the mentioned capacities. Furthermore, regulatory agencies were endowed with resources

to attract civil servants from the ministries. As a result, during the early stages of privatization some of the best experts of many ministers were transferred to the regulatory agencies.

Even in sectors where privatization was preceded by the creation of a specific legal framework, there was generally no public body in charge of making private participation and public investment in infrastructure consistent. Neither was there any public body in charge of assuring that essential investments that did not attract the private sector would be carried out by the public sector.

In order to implement the privatization process in the face of opposition stemming from civil servants, the power to award concessions was transferred to the regulatory agencies, although the best practices on this matter is to separate the function of promoting privatization processes (which is a Government function) from the regulatory function (which requires an independent regulator). The outcome was that regulatory agencies became responsible for planning concessions and the Government remained responsible for planning public investment. This framework was afterwards found rather weak.

The result of the combination of a weak planning and public investment capacity with a framework that does not adequately allocate responsibilities for the overall coordination of investments is well known in the energy sector where a major shortage of electricity supply occurred in 2001. In the energy sector, the power to award concessions has already been transferred back to the Government. Besides, a specific public body was created to provide technical assistance for the planning of concessions and public investment.