

Spotlight on Brazil: Brazil Launches New PPP Projects

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About the Author...



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Abstract

In this article the author discusses the recently enacted PPP Law in Brazil and explains how it offers the opportunity to stimulate lagging private investment in social and infrastructure projects in that country. He concludes that while the new law and regulatory framework for PPPs and reforms of the concession regime may be helpful, in the final analysis, private investors will need assurances that: (1) the regulatory institutions are adequately staffed and managed by competent professionals: and (2) the rules of the game for dispute resolution will be consistently applied and enforced.

Introduction

In 2000, I was invited to speak at a conference in Brazil on the subject of private sector participation in the financing of Brazil’s infrastructure. At that time Brazil was beginning to attract private capital to finance its burgeoning infrastructure requirements. At that conference, I made the following observation about Brazil’s experiences with private sector investment in infrastructure and the difficulties in securing financing for such projects under its concession law (Law No. 8,987 of 1995):

“My overriding theme, to the extent there is one, is that because of the uncertainties and complexities of transactions in Brazil, it will be difficult to obtain financing on non-recourse, project finance basis, and that, in many, cases it will be necessary to rely on significant sponsor support and credit enhancements to close major infrastructure deals in this country. However, in spite of these uncertainties, the outlook for limited or non-recourse project finance in the Brazilian market is quite promising. The legal and regulatory issues which have often slowed the pace of investment in some of the key sectors are being forthrightly addressed by the authorities, and the current economic and political stability of the country appears to be assuaging the anxieties of investors following the Asian flu.”

At that time, I was cautiously optimistic about Brazil’s experiment with private concessions and investment in infrastructure. The Brazilian government of Fernando Henrique Cardoso had privatized several major electricity distributors, significant private investment had been carried out in several large toll roads, and major private power plants were about to be financed by multilateral banks and private lenders. But there were clouds on the horizon. Unfortunately, the wave

of new investment soon gave way to doubts about the capacity of the regulatory infrastructure to manage relations between the public sector and the newly privatized companies. Rio Light, the electricity distributor that had been acquired by Electricité de France and AES ran into difficulties implementing rate increases resulting in street protests and political controversy at both the state and federal levels. The governors in several states took action to bar higher tolls on a recently privatized road concession and, in one case ordered tolls reduced by 50%.

Meanwhile, on the legal front, the enforceability of arbitration awards against the public sector were being questioned; the constitutionality of many of the privatizations was challenged with many of these disputes meandering aimlessly in the state and federal courts. These political uncertainties drove many foreign investors to exit Brazil, or at least to refrain from further investments there. Finally, provisions in the existing concession law severely restricted the ability of the government to offer subsidies or guarantees to private concessions, thereby limiting the financial options for developing viable public-private partnerships.

In 2002 Brazil's newly elected President Luiz Inacio Lula da Silva committed his government to carry forward privatization, but promised new legislation to provide a better framework for public private partnerships. It took nearly three years to enact the new PPP law (Law No. 11,079 of December 2004), which sets the stage for a new round of privatizations and private sector investment in infrastructure. Similar changes were introduced at the state and municipal level of government. In this article, we highlight some of the main features of these legislative changes and offer some comments on its likely impact on investment in infrastructure in Brazil.

New Budgetary Authority

The new PPP Law provides new statutory authority for the government to make direct financial contributions in the form of guarantees or subsidies to private concessions. There are two types of concessions authorized in the new law:

- *Sponsored Concession* which is a public services or public works concession under which the private concessionaire is entitled to both a tariff to be paid by end users and financial contribution from the government or government entity.
- *Administrative Concession* where the private entity provides services to the public entity or partner. The government entity makes a payment on basis of the services received from the private partner.

Conventional concessions that do not receive any government guarantees or financial support will still be governed by the old concession law. However, it is unclear whether the innovations introduced in the new PPP law regarding lender security interests will be extended to the old concession law.

Risk Sharing and Security

Under the old concession law, the lenders were often confused about their security interests in the concession. First, the right of the lenders to step-in and run the concession to avoid or remedy a default by the concessionaire was not openly recognized under the law, and the lenders were required to seek clarifications about their security interests through direct agreements and explanatory letters from the conceding authority. Secondly, the concession contracts did not give lenders the right to participate in any administrative proceedings involving readjustments in the terms of the concession. Finally, the law did not acknowledge the right of the lenders to control the special project company (SPC) or to receive compensation amounts in the event of early

termination of the concession. These issues were left to be negotiated case-by-case in consents executed between the lenders, the government and the borrower. The new PPP law openly recognizes the lenders' right to intervene in the concession, control the SPC and receive any termination payments-changes. These changes should help reassure lenders and developers when new infrastructure deals enter the market in search of long-term financing.

Payments and Guarantees by the Government

Unquestionably, the authority of the government to participate financially in the concession through direct payments and guarantees is the most significant improvement of the new PPP law. Like its UK counterpart, the Brazilian charge or payment may be variable and subject to performance guidelines. It can be made by means of cash payments, assignment of tax credits, or other government rights of payment. Guarantees can be extended through special funds, guarantees from third parties, multilateral agencies or securitized pools of assets.

In February 2006, Brazil formally launched a \$1.55 billion PPP Guarantee Fund that will serve to backstop the government payment obligations under the PPP concessions. The establishment and authorization of this fund is the final piece of legislation needed to implement the PPP Law. The funds assets consist of the shares in state-owned companies including about \$500m in Bank of Brazil shares, \$650m in PNA da Vale do Rio Doce shares and \$ 389m in Eletrobras notes.

A new wave of privatizations

Recent reports confirm that several projects are being readied for financing under the new scheme at both the state and federal levels:

- BR 116/324 Road duplication project between Bahia and Minas Gerais with the IFC involved in the financing
- MG-050 370 km concession highway in the state of Minas Gerais linking Belo Horizonte and Sao Paulo (\$293 million investment)
- Sao Paulo Metro 4 line. (\$1.26 billion investment) to be financed by the state government, Japan Bank for International Cooperation, the World Bank (\$922 million) and a private investor (\$340 million)
- Rio de Janeiro by pass (\$233 million investment).

These announced biddings are attracting interest from many international and Brazilian investor groups such as OHL of Spain, CCR of Brazil, Dragados of Spain, and Bombardier of Canada. Certainly, this level of investor interest should reassure the Brazilian authorities and generate more PPP projects.

Comment

Although I am greatly encouraged about the changes about to take place in the PPP sector in Brazil, I cannot avoid expressing a word of caution to potential investors. First, the new law will be implemented by public agencies that are notoriously weak. Staff upgrading and enhanced training must keep pace with the reforms in the broader legal framework. As noted by the UK's HM Treasury:¹

¹ "PFI: Meeting the Investment Challenge", HM Treasury (Jul 2003)

“Strong procurement skills are vital for delivering quality investments on time and in a way that secures value for money for the public sector...PFI requires relevant expertise- like other large and complex procurements- because it involves long-term options appraisal, significant use of specialist advisers and what can be complex negotiations reflecting Government’s approach to risk sharing”

PPP concessions cannot be efficiently implemented as a true partnership if government officials are untutored in all facets of the financing, management and operation of the private concessions. Moreover, dispute settlement will remain problematic and could become a roadblock to higher levels of investment if the government does not establish improved adjudicatory procedures for handling the inevitable controversies that will arise between the public sector and private concessionaires. Because the Brazilian courts are notoriously slow and inefficient, investors will be leery of relying on the Brazilian court system to resolve legal conflicts.

Finally, it will be important to develop standardized legal documents to facilitate the drafting and negotiation of financing and concession contracts. As noted again in the UK, the high transaction costs (lawyers and advisors) in putting together PPP financing packages were a serious problem that adversely affected the earlier PPP projects. In Brazil, the standardization of project and financing agreements should therefore be given a high priority with the assistance of BNDES, the national development bank.

The size of the guarantee fund also has been questioned. Will it be large enough to provide sufficient comfort to potential lenders? In the early stages of the program, this might not be a problem. But once the program is more fully developed the fund will probably need further infusions of capital to support its contingent claims.

These potential concerns will probably not prevent the program from getting started. However, experience from Brazil’s earlier flirtation with privatization in the 90s should warn us of the danger of institutional complacency. Failure to address these problems in a meaningful way could come to jeopardize its success at a time when the country will desperately need the additional levels of investment. Like their earlier counterparts, PPP concessions are not a panacea to private investment in infrastructure. To succeed they will need to operate in a well-organized and structured regulatory framework where the rules of the game are transparent and predictable. Investors will therefore be looking carefully at Brazil as it implements its new concession regime.