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States lead in public private partnerships

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Overview

Although Brazil passed legislation to establish a legal framework for public private partnerships in 2004, the federal government has failed to move ahead with any projects. But the states of Sao Paulo and Minas Gerais have taken the lead in developing a workable model already applied in toll-road and municipal transport projects, with a pipeline that includes prisons, higher education and water treatment.

This model reduces risks for private investors by creating mechanisms to guarantee contracts will survive political transitions. The model also protects the states through service agreements guaranteeing that projects will be completed and maintained. Other states governed by opposition parties are watching Sao Paulo and Minas closely and are likely to move ahead with their own PPP programmes to attract much-needed investment.

Context

The states of Minas Gerais and Sao Paulo are taking the lead in the development of PPPs.

But the programme lacks leadership on the federal level

> **Mauricio Endo**, Director, KPMG Global Infrastructure Group

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Brazil's PPP legislation is a step forward
> **Isabel Franco**, Partner, Demarest and Almeida Attorneys

Wrap

Despite the failure on the federal level, PPPs are likely to play a growing role in the development of new infrastructure projects.

Context

In recent years, Brazil has received only a fraction of the investment needed to maintain and expand infrastructure. The country's [roads](#), [ports](#) and railroads have failed to keep pace with growing demand from the export sector, increasing the cost of doing business. The lack of investment in these sectors is not a result of an absence of funds. Billions of dollars have been raised in private equity funding in recent years, with a primary focus on infrastructure investment.

Rather, the lack of investment is due to the limited number of projects structured to receive private investment. The PPP legislation passed in 2004 was designed to facilitate the entry of private investment into infrastructure projects. The federal government has failed to take advantage of PPP mechanisms, in part because of ideological resistance to private investment from within the administration but also because of the challenges in structuring these investments. The PPP model developed by the states of Sao Paulo and Minas Gerais is likely to be replicated in other states and perhaps, eventually, at federal level.

The model includes strong guarantees that the private investor will receive those payments from the government. Another key feature is service quality requirements to ensure that investments in road expansion and maintenance are made. Providing guarantees for the investor is seen as essential to limit the risk of contracts being broken by future state administrations. For the state, the quality control mechanisms seek to avoid past problems of companies receiving payment for public works that were not completed.

Trailblazing road and subway projects

Minas Gerais, which has the country's third-largest economy, recently concluded its first PPP for the MG 050 highway. According to the contract, the winning contractor - Equipav - will spend R\$645 million (\$337.7 million) on the concession over 25 years. Some of the income generated by the project will come from monthly payments made by the state government and the remainder from tolls.

The state of Sao Paulo has moved ahead with its first PPP, too. It is now in the process of finalizing several other PPP projects. The first project was Line Four of the Sao Paulo subway system. The MetroQuatro consortium - which includes the Brazilian toll road management company Companhia de Concessões Rodoviárias (CCR), the Banif Primus Infra-Estrutura Fund, RATP Developpement S.A., which operates the Paris Metro, and Benito Roggio Transporte, which is operator of the Buenos Aires Metro - won the tender to manage the line.

For details on the structuring of both these projects, including the arm's length arrangements underpinning the private investors' revenue streams and the quality control provisions, click [here](#).

Future plans

The state of Minas is currently structuring two other PPP projects, including one that will manage state penitentiaries and another that will improve the state university campus. If these projects can be successfully structured, PPPs could expand into areas other than infrastructure and into sectors that do not have clearly defined revenues from user fees. Because PPPs in sectors without defined user fees are more complex, a longer lead time will be needed to bring them to the market.

Sao Paulo is in the final stages of developing a PPP to expand Sabesp's Alto Tiete water treatment system by 50 per cent. Bidding was suspended last year by the state audit court after several companies requested revisions to the rules. Other projects on the table include the expansion of the Congonhas airport, a new train line between the city of Sao Paulo and satellite cities of Santo Andre, Sao Bernardo and Sao Caetano and an express train to the international airport in Guarulhos.

Meanwhile, the state is receiving unsolicited PPP proposals from the private sector. These projects are likely to play a greater role in future PPP project developments because they cost less for the government but tend to address deficiencies in infrastructure that impact company operations.

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Isabel Franco, senior partner at Demarest and Almeida Attorneys in Sao Paulo.

The PPP law will be an important tool to bring new investment to Brazil's infrastructure sector, which is in desperate need of capital. On the federal level, PPPs have been slow to start because the government underestimated the time it would take to structure these projects, but states are taking the lead, meaning that more and more investments are likely to be forthcoming.

One improvement of the new legislation is the creation of mechanisms to reduce the risks for private investors when committing to long-term projects. The mechanisms are necessary to guarantee that contracts are followed, regardless of which political party is in power. These guarantees also facilitate project finance mechanisms, which had a more limited reach under the previous legislation.

Another advance in the legislation are the guarantees that projects will be concluded. In the past, payments for an infrastructure project could be made before its completion; now the private partner can receive compensation only after completion of the project has been verified by an independent auditor. These mechanisms significantly reduce the risk of fraud.

There is also growing interest from private companies, which are increasingly developing their own PPP proposals and presenting them to state and federal governments. These projects range from bridges, private roads and ports to services provided to governments. Many are being developed by companies seeking to resolve infrastructure deficiencies that impact on their operations. While these projects are required by law to go through a public tender offer process, companies that invest in feasibility studies will be compensated even if they do not win the concession to operate the project.

Even though the federal government has been slow to launch PPPs, given the interest from the private sector the new law will achieve its goal of increasing investment in infrastructure.

Mauricio Endo, Director of KPMG Global Infrastructure and Projects Group

The federal government did a great job developing the PPP legislation and paid careful attention to the regulatory framework established by the law. Unfortunately, PPP projects on the federal level have had a hard time getting off the ground. One problem is that they pass through many different ministries and need to be approved by many people.

These issues could be resolved if the programme had a leader. The lack of leadership has been clear with the BR 116 highway project, which was supposed to come to the market in the second half of 2006 but was suspended because of concerns about returns.

The reality is that although the administration has evolved, there are people in government who think the private sector will exploit the process. When the BR 116 project was up for review in May, cabinet members asked to see the model once again, and it now seems unlikely that the BR 116 PPP will get off the ground this year.

Unlike the federal government, the state of Sao Paulo has advanced quickly and we should see several new projects this year. The team set up by the previous governor (defeated presidential candidate Geraldo Alckmin) has remained in place under the new governor (the former mayor of Sao Paulo Jose Serra). This is a very competent team of professionals which has created a framework to streamline the development of new PPPs. Sao Paulo has really done its homework. It will have the most successful PPP programme in Brazil.

Wrap

Despite their limited number, the PPP projects that have been launched are important, primarily because they are making costly infrastructure projects possible. No less significant is the fact that these projects are moving ahead in states controlled by the opposition PSDB party. Other states governed by opposition parties, such as Rio Grande do Sul and Goias, are looking to the model to develop PPPs. The state of Bahia, too, has made headway towards developing its own PPP programme; however, with the recent political transition, it is possible that planned projects will be postponed or abandoned.

The PPPs in Minas Gerais are of particular interest because it is likely that Aécio Neves, the current governor, will be the next president of Brazil, given his popularity and his political pedigree (the grandson of Tancredo Neves). In the event of a Neves presidency, the PPP model developed in Minas Gerais would almost certainly be replicated on the federal level.

The PPP legislation is poised to be one more instance of the private sector stepping in to fill the void left by the federal government's inability to act. The focus so far has been on infrastructure projects, but as the programme matures, PPP will expand into new areas, including services. The development of PPP proposals by the private sector will not only facilitate investments in infrastructure but also cater to the needs of the private sector.

Next tests

- Structuring of the penitentiary project in the state of Minas Gerais
- Development of other projects without user fees
- Smooth resolution of any problems related to delays in completion of Line Four of the Sao Paulo subway
- Completion of the structuring of the BR116 highway in the state of Bahia