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Financing Access to Basic Utilities for All
The Case of Brazil

A Background Paper for the Multi-Stakeholder Consultation in Brazilia
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There is a strong trend toward supplanting public service provision with public-private partnerships (PPPs). PPPs in infrastructure (particularly water supply and electricity) should not be undertaken without a thorough examination of the past performance of PPPs in these sectors and an understanding of the explicit and implicit risks to national, and especially state and local, governments. To this end, pages 1-5 of this paper describe: 1) the ways in which the Government of Brazil (GOB) and the World Bank are promoting PPPs, particularly at subnational levels and 2) some of the risks involved in going forward (e.g., allocation of risks; off-budget liabilities). It

In Brazil, infrastructure spending as a percent of GDP stood at about 3% during 1989-1993, shrunk to less than 1% during 1994-2001, and has since rebounded.[1] The World Bank estimates suggest that, during the 1990s, about half of Brazil's fiscal adjustment was accomplished by compressing public investment in infrastructure.[2] The World Bank also attributes the decline in infrastructure to the 1988 Constitutional mandate to increase social expenditures. Since infrastructure requires large, lumpy investments, there are significant trade-offs between such investment and other government priorities.

During 2004-07, the Government will invest $117 billion in infrastructure projects, representing annual investments of 4% of GDP. Priority state infrastructure projects are identified in the nation's PPA ("Brazil for All" – the national development strategy). The Treasury Department established a Pilot Project in Infrastructure (PPI) which aims to increase the quality and quantity of public investments in infrastructure. If needed, the government is permitting a downward adjustment of up to .15% of GDP in its primary surplus target to accommodate investments in its pilot project in infrastructure (PPI).[3]

[1] In Brazil, total investment in infrastructure projects with private participation skyrocketed from an annual average of less than $1 billion during 1989-1993 to an annual average of $25 billion during 1994-98 and then dropped back to an annual average of $6 billion during 1999-2003. During 1996-2001, the average return for shareholders in infrastructure in Brazil was 3%, compared to 6% in the region, while the cost of capital in Brazil was three percentage points higher than in Argentina and twice as high as in Chile. (Second Programmatic Loan, page 20)

[2] Calderon, Easterly, Serven, "Infrastructure Compression and Public Sector Solvency in Latin America" in Easterly and Serven (eds.) "The Limits of Stabilization—Infrastructure, Public Deficits and Growth in Latin America," 2003..

[3] IMF, "Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies," April 1, 2005.

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The government maintained a large public sector primary surplus of around 4 ¼% of GDP during 2005-06 to ensure a decline in the net public debt to at most 50% of GDP by 2007. This underscores the country's vulnerability to shocks. This vulnerability is deepening as a result of competition with China. There are also warning signs that a prospective downturn, or recession, in the United States could reverberate throughout Latin American and the world.

Vulnerability is exacerbated by the macroeconomic policies promoted by the IMF and World Bank. The institutions rely on short-term deficit (surplus) targets as a measure of liquidity and gross debt. They pay relatively little attention to public assets and net worth. This approach leads to declines in public investment as well as a shift of investment to public-private partnerships (PPPs), where guarantees are off-budget. In their excellent paper, "Fiscal Space for Public Investment: Toward a Human Development Approach," UNDP authors posit that the institutions' fiscal policy framework is of limited relevance developmental (as opposed to the fiduciary) objectives.[4] The authors suggest that the IMF's and World Bank's fiduciary back calculations become less precise and predictable the more an investment serves the public good and provides a development payback.

Aspects of Infrastructure Policy in the World Bank Group's Country Assistance Strategy (CAS) For Brazil

The World Bank's lending program for Brazil totals $1.5 billion per year for five years or $7.5 billion. According to the World Bank's Country Assistance Strategy (CAS) for Brazil, the government has to implement "trigger" policies in order to qualify for this level of borrowing, including:

- Effective reforms for service provision: land, housing, urban services [for example, successful policies for urban land regularization and better designed, targeted housing programs; definition of regulatory framework for water and sanitation provision, and better designed and targeted water and sanitation programs]
- Improved regulatory framework in main infrastructure sectors [for example, strengthened regulatory framework effective in attracting private investments] The Bank's private sector affiliate – the International Finance Corporation (IFC) is in infrastructure.

At present, the Bank's private sector affiliate, the International Finance Corporation, is considering options with commercialized, fiscally independent infrastructure entities…an option that has worked poorly in Brazil to date. A third of the IFC's Brazil portfolio is devoted to infrastructure and logistics.

False Financing Promises of some PPPs. There is an enduring illusion that private investors in electricity and water supply will powerfully supplement public investment. Antonio Estache of the World Bank issued an evaluation of PPPs in Infrastructure from 1994-2004 is (reviewed in Attachment 6) and concluded that 1) poorly structured PPP projects have been pervasive over the past decade and have generated considerable fiscal risks and 2) countries risk giving priority to PPPs at the expense of improving public systems.

Indeed, he found that the public sector committed 70% of total financing for infrastructure PPPs. Percentages of total financing commitments by the private sector and by development aid represent 22% and 8%, respectively. Public outlays can balloon as they did in Eastern Europe when PPPs in electricity required government subsidies representing 6% to 7% of GDP. The IMF's concern with the off-budget liabilities of PPPs are described in its document "Public-Private Partnerships," 2005.

[4] Rathin Roy, Antoine Heity, Emmanuel Letouze, Paper prepared for the G24 Technical Meeting, Singapore, September 13-14, 2006.

In another study, Estache et al. found that most cross-country studies find no statistically significant difference in efficiency scores between public and private providers.

Where infrastructure PPPs are viable in social as well as economic terms, the risks of applying trade rules to service sectors may outstrip any benefits that the PPP may be able to confer. (See box, below.)

Real and Potential Costs of Investment Treaties

When public-private partnerships (PPPs) are established, they will almost always qualify as a foreign investment under most trade and investment treaties, which have tremendous political, economic and social consequences for national, provincial or local governments. Governments' corporate partners in the PPPs are deeply involved in writing the investment rules of trade agreements by which governments are required to abide. Under such agreements, 1) governments cannot re-assume public service provision, except at great cost; 2) governments lose some rights to regulate; and 3) investors can take their cases to international courts (e.g., the World Bank's International Centre for the Settlement of Investment Disputes (ICSID). Some $30 billion in claims brought by private utility companies against Argentina's government are pending in international courts as a result of the peso devaluation that cut their profits.

Attachment 1 describes the infrastructure dimension of **Brazil's new $601 million Second Programmatic Loan from the World Bank.** While a primary purpose of the loan is to improve the climate for "doing business" in Brazil (see attachment 2), the infrastructure dimension calls for: "a) defining approaches to public-private interactions, b) strengthening the institutional capacity of regulatory agencies to plan and regulate, and c) enforcing laws and regulations consistently and predictably." (p. 38) The World Bank is also strengthening the new Public-Private Partnership Unit of the Ministry of Planning and supporting the government's finalization of the regulatory framework for the water and sanitation sector, even after past attempts at this failed.

Finally, the loan supports the design of better contracts for concessions and improvements in regulatory governance. Public-private partnerships (PPPs) cannot responsibly deliver services to the poor without strong regulation. This is particularly the case since competition is absent in the water sector and parts of the electricity sector which are natural monopolies. However, in order to off-set risk to investors, regulatory frameworks are being established that transfer considerable power to private investors. While initial PPP contracts may provide a reasonable balance of power between public and private sectors, shifts occur when contracts are renegotiated. Because of factors, such as the dive-bidding of many private providers, 41% of electricity contracts and 74% of water and sanitation are renegotiated in a short time-frame (1.6 years for water and sanitation contracts).

In general, PPPs require higher levels of cost recovery from the consumers of utility services than they are used to. In Brazil, the cost recovery will not only cover costs of capital, operations and maintenance, but also environmental fees. However, according to the World Bank, "Because most existing electricity and water subsidies tend to benefit too many people, any serious effort to redirect, reduce or eliminate subsidies is likely to raise the bills paid by a significant part of the population, including among the non-poor. This will be unpopular, despite the potential benefits of putting utilities on a better financial footing, including improved service quality and eased fiscal pressure."[5] High water and electricity fees without subsidies will block access to these services by poor people.

[5] World Bank, "Infrastructure in LA & C: Recent Developments and Key Challenges," 2005, Annex, p. 34.

Subnational governments and service delivery. In Brazil, about 90% of total federal spending is non-discretionary (including wages, transfers to regional governments, interest payments, pensions, and spending on other entitlement social programs). The World Bank pressures the federal government to reform pensions and cut spending in most of these categories. Indeed, cuts in transfers to regional governments are required in order for these governments to become financially self-sustaining and, hence, gain credit ratings that permit access to domestic and international credit markets.[6]

Credit markets require, among other things, a strict no-bail-out policy for state or local governments in trouble. In short, these markets require that the federal government:

- Devolve centrally delivered service to subnational governments
- Cut transfers to subnational governments
- Refrain from "bailing out" over-indebted subnational governments

Brazil and the World Bank require that only the subnational governments that are in compliance with the Law on Fiscal Responsibility (LFR) can borrow for infrastructure. However, that rule is already being broken in Minas Gerais, which meets only two of the five stipulations of the LFR.

Law on Fiscal Responsibility (LFR) of 2000

The law sets a general framework for budgetary planning, execution and reporting applicable to all levels of government and supported by strict sanctions for non-compliance. It imposes ceilings on subnational debt and on payroll spending in relation to revenues, and stipulated strict transparency and reporting requirements for the subnational, as well as the national, governments.

Attachment 4 identifies the five rules for state compliance with the LFR. A key rule is the 60% threshold for the ratio of personnel costs to net current revenues. All states are in compliance with this target, except for two. Clearly this rule creates significant downward pressure on public sector jobs and wages.

Because the richer states in Brazil have higher debt burdens, the government and the World Bank (as well as the Inter-American Development Bank) may give priority to lending to the poorest states in the North and Northeast. At first glance, it may appear that such a strategy could lessen the gross inequality in, for instance, the water sector.

Piped water connections by population quintiles (1996/97)

Urban – by quintile (percentage)					Rural – by quintile (percentage)				
63	85	90	97	98	7	30	42	48	37

However, saddling the poorer states with significant debt burdens for high risk public-private infrastructure investments may not be prudent. Public services often provide a significant cash flow for governments. In PPPs, private investors require higher returns in risky environments. Moreover, they are increasingly requiring that risks, such as regulatory and exchange rate risks, be transferred to host governments.

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[6] In 2002, prior to the election, the IMF and the Brazilian Finance Ministry agreed to terms of a Stand-by Arrangement that were not disclosed to the public. Leaks revealed that, in early September 2002, the IMF and Brazil agreed to terms which required cutting support for subnational governments by, among other things, a reduction in revenue-sharing with the states and municipalities, termination of revenue earmarking, and promises by the new administration to resist pressures to reopen the debt restructuring agreements between federal and subnational governments. Source: IMF, Brazil—"Request for Stand-by Arrangement," August 30, 2002 (p. 23) and "First Review Under the Stand-by Arrangement and Request for Modification of Performance Criterion," December 4, 2002.

Poor governments should not assume significant levels of contingent fiscal liabilities through guarantees to private investors, e.g., guarantees of the private firm's debt or minimum demand levels.

Aspects of the expansion of the subnational infrastructure programs of the World Bank and Brazil are described as follows:

- Attachment 3 describes the World Bank's Pilot Subnational Development (SND) Program, which was launched on July 1, 2006.

- In Attachment 4, an excerpt from a Bank document, describes the market conditions for subnational development in Brazil. The Bank's subnational development program aims to increase the creditworthiness of state and municipal governments.

  Brazil has 25 States, the Federal District (Brasilia) and over 5,500 municipalities ranging from small rural enclaves to Brazils mega-cities, Rio de Janeiro and Sao Paulo. None of these subnational governments have domestic or foreign currency ratings. There are 267 public water, sanitation and sewerage companies; only two (Sabesp and Sanepar) have local and foreign currency ratings; Sabesp has accessed the local and international capital markets.

- Attachment 5 reviews the criteria for subnational lending in Brazil. There is subnational lending in well-governed states, such as Ceara and Bahia, and the Bank just approved a subnational loan to the state of Minas Gerais. Subnational governments need to comply with the requirements of Brazil's Law on Fiscal Responsibility (LFR). Although both the government of Brazil and the World Bank strongly emphasize that states must comply with the LFR in order to qualify for a subnational loan, the government of Minas Gerais had not met two of the five rules of the FRL. (These rules are in attachment 5.)

Conclusion
Before executing PPPs, governments, especially subnational governments, should disclose proposed public-private contracts for public review and carefully weigh the explicit and implicit allocation of risk (particularly the risk that off-budget guarantees will be called) assumed by the public and private sector, respectively. Governments' ability to bear risk – particularly in the context of Fiscal Responsibility Laws – should be examined in light of the historical experience with PPPs. Finally, the risk allocation should specifically identify how affordable and universal services to the poor will be protected under best and worst case scenarios.

Discussion Questions:

1. How should citizens weigh the trade-offs between investment in social services and investment in infrastructure? To what extent should cuts in wages or pension programs support higher investment in social services or infrastructure?
2. What might a pro-development fiscal framework look like for the infrastructure sectors?
3. What kind of regulatory framework for water and sanitation should the Brazilian Congress adopt?
4. How risky might PPPs be in terms of a) the debt and contingent liabilities assumed by federal and subnational governments? b) the barrier to access to services by poor people as a result of high user fees?
5. Should Brazil strengthen public provision of services or follow the lead of its creditors and establish PPPs to provide services?
6. What are the implications of the rules that prevent the federal government from bailing-out state and local government?

Attachments:
1. The Infrastructure Dimension of Brazil's Second Programmatic Loan for Sustainable and Equitable Economic Growth ($601.5 billion) from the World Bank

2.. The World Bank's Ratings for "Doing Business" in Brazil

3. The World Bank's Pilot Subnational Development (SND) Program

4. Brazil: Market Conditions for Subnational Development in Brazil

5. Criteria for Subnational Lending in Brazil

6. The Record of Public-Private Partnerships (PPP)

7. Implicit and Explicit Risk Allocation

Attachment 1

The Infrastructure Dimension of Brazil's Second Programmatic Loan for Sustainable and Equitable Economic Growth ($601.5 billion) from the World Bank

This loan, the second in a series of three, was approved in June 2006 and closes at the end of 2007. It supports an agenda that involves passing laws (or constitutional amendments), but also "a) defining approaches to public-private interactions, b) strengthening the institutional capacity of regulatory agencies to plan and regulate, and c) enforcing laws and regulations consistently and predictably." (p. 38)

Infrastructure regulation is seen as not only essential to establishment of public-private partnerships (PPPs), but also to the appropriate enforcement of contracts. In the 1990s, 41% of concession contracts in Brazil were eventually renegotiated, compared to 28% in the Latin America/Caribbean region. Most of them were renegotiated during the initial three years aiming at reviewing tariffs.

PRIOR ACTIONS	KEY NEXT STEPS	MED-TERM ACTION	OUTCOMES
*PPP law approved by Congress *Law on Career Development Plan for Regulators Approved by Congress	Institutional framework for PPP projects consolidated	*Remaining legal bottlenecks overcome in selected sectors e.g. approval of bill regulating the water & sanitation sector *Lei das Agencias approved by Congress	PPP projects approved

Additional and related PRIOR ACTIONS:
*Bankruptcy Law enacted and training program for courts started
*Approval of Antitrust Law by Congress
*Tax exemption for capital goods of exporting firms approved
*Constitutional Amendment No. 45 approved (Sumula Vinculante and Conselho Nacional de Justica)
*Law No. 11.187/2005 approved by Congress

The World Bank's agenda also includes strengthening the new Public-Private Partnership Unit of the Ministry of Planning and the Pilot Project in Infrastructure (PPI) in the Treasury Department which aims to increase the quality and quantity of public investments in infrastructure while respecting fiscal responsibility. This will entail supporting project selection processes and the use of public funds. On the private side, the Bank will support completion of regulation in the water and sanitation sector, design better contracts for concessions, and improvements in regulatory governance. (See loan document, p. 41-42.)

Attachment 2

The World Bank's Ratings for "Doing Business" in Brazil

The rankings show how the Brazilian government's performance stands in relation to the performance of 174 other governments. This rating system has been strongly criticized by the United States Senate for, among other things, promoting violation of labor rights and standards.

Brazil

Population:186,404,913
GNI per capita (US$): 3,460.00

Ease of...	2006 rank	2005 rank	Change in rank
Doing Business	*121*	*122*	*+1*
Starting a Business	115	106	-9
Dealing with Licenses	139	136	-3
Employing Workers	99	101	+2
Registering Property	124	121	-3
Getting Credit	83	76	-7
Protecting Investors	60	58	-2
Paying Taxes	151	149	-2
Trading Across Borders	53	50	-3
Enforcing Contracts	120	117	-3
Closing a Business	135	149	+14

Note: 2005 rankings have been recalculated to reflect changes to the 2006 methodology and the addition of 20 new countries.

Starting a Business (2006)
The challenges of launching a business in are shown below. Included are: the number of steps entrepreneurs can expect to go through to launch, the time it takes on average, and the cost and minimum capital required as a percentage of gross national income (GNI) per capita.

Indicator	Brazil	Region	OECD
Procedures (number)	17	10.2	6.2
Time (days)	152	73.3	16.6
Cost (% of income per capita)	9.9	48.1	5.3
Min. capital (% of income per capita)	0.0	18.1	36.1

Dealing with Licenses (2006)
Shown below are the procedures, time, and costs to build a warehouse in , including obtaining necessary licenses and permits, completing required notifications and inspections, and obtaining utility connections.

Indicator	Brazil	Region	OECD
Procedures (number)	19	15.4	14.0
Time (days)	460	198.7	149.5
Cost (% of income per capita)	179.9	246.2	72.0

Details | Compare All Economies

Employing Workers (2006)

The difficulties that employers in face in hiring and firing workers are shown below. Each index assigns values between 0 and 100, with higher values representing more rigid regulations. The Rigidity of Employment Index is an average of the three indices.

Indicator	Brazil	Region	OECD
Difficulty of Hiring Index	67	34.0	27.0
Rigidity of Hours Index	60	34.8	45.2
Difficulty of Firing Index	0	26.5	27.4
Rigidity of Employment Index	42	31.7	33.3
Hiring cost (% of salary)	37.3	12.5	21.4
Firing costs (weeks of wages)	36.8	59.0	31.3

Details | Compare All Economies

Registering Property (2006)

The ease with which businesses in can secure rights to property is shown below. Included are the number of steps, time, and cost involved in registering property.

Indicator	Brazil	Region	OECD
Procedures (number)	14	6.6	4.7
Time (days)	47	77.4	31.8
Cost (% of property value)	4.0	6.0	4.3

Details | Compare All Economies

Getting Credit (2006)

Measures on credit information sharing and the legal rights of borrowers and lenders in Brazil are shown below. The Legal Rights Index ranges from 0-10, with higher scores indicating that those laws are better designed to expand access to credit. The Credit Information Index measures the scope, access and quality of credit information available through public registries or private bureaus. It ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau.

Indicator	Brazil	Region	OECD
Legal Rights Index	2	4.5	6.3
Credit Information Index	5	3.4	5.0
Public registry coverage (% adults)	9.2	7.0	8.4
Private bureau coverage (% adults)	43.0	27.9	60.8

Details | Compare All Economies

Protecting Investors (2006)

The indicators below describe three dimensions of investor protection: transparency of transactions (Extent of Disclosure Index), liability for self-dealing (Extent of Director Liability Index), shareholders' ability to sue officers and directors for misconduct (Ease of Shareholder Suits Index) and Strength of Investor Protection Index. The indexes vary between 0 and 10, with higher values indicating greater disclosure, greater liability of directors, greater powers of shareholders to challenge the transaction, and better investor protection.

Indicator	Brazil	Region	OECD
Disclosure Index	5	4.3	6.3
Director Liability Index	7	5.1	5.0
Shareholder Suits Index	4	5.8	6.6
Investor Protection Index	5.3	5.1	6.0

Details | Compare All Economies

Paying Taxes (2006)

The data below shows the tax that a medium-size company in must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes. These measures include the number of payments an entrepreneur must make; the number of hours spent preparing, filing, and paying; and the percentage of their profits they must pay in taxes.

Indicator	Brazil	Region	OECD
Payments (number)	23	41.3	15.3
Time (hours)	2,600	430.5	202.9
Total tax rate (% profit)	71.7	49.1	47.8

Details | Compare All Economies

Trading Across Borders (2006)

The costs and procedures involved in importing and exporting a standardized shipment of goods in Brazil are detailed under this topic. Every official procedure involved is recorded - starting from the final contractual agreement between the two parties, and ending with the delivery of the goods.

Indicator	Brazil	Region	OECD
Documents for export (number)	7	7.3	4.8
Time for export (days)	18	22.2	10.5
Cost to export (US$ per container)	895	1,068	811
Documents for import (number)	6	9.5	5.9
Time for import (days)	24	27.9	12.2
Cost to import (US$ per container)	1,145	1,226	883

Details | Compare All Economies

Enforcing Contracts (2006)

The ease or difficulty of enforcing commercial contracts in is measured below. This is determined by following the evolution of a payment dispute and tracking the time, cost, and number of procedures involved from the moment a plaintiff files the lawsuit until actual payment.

Indicator	Brazil	Region	OECD
Procedures (number)	42	39.3	22.2
Time (days)	616	641.9	351.2
Cost (% of debt)	15.5	23.4	11.2

Details | Compare All Economies

Closing a Business (2006)

The time and cost required to resolve bankruptcies in is shown below. The data identifies weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process. The recovery rate, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm, is also shown.

Indicator	Brazil	Region	OECD
Time (years)	4.0	2.6	1.4
Cost (% of estate)	12.0	13.6	7.1
Recovery rate (cents on the dollar)	12.1	25.7	74.0

Attachment 3

BRAZIL: MARKET CONDITIONS FOR SUBNATIONAL DEVELOPMENT

(Source: World Bank, IFC, MIGA, "Subnational Development Program," January 4, 2006)

D. Investment Needs

- In 1999-2001, Brazil invested 2.1% of GDP in infrastructure
- The Government will invest $117 billion in infrastructure projects over 2004-07, representing annual investments of 4% of GDP.

B. Market Segmentation and Creditworthiness

1. Local Governments

- Brazil has 25 States, the Federal District (Brasilia) and over 5,500 municipalities ranging from small rural envlaves to Brazils mega-cities, Rio de Janeiro and Sao Paulo
- None of the subnational governments have domestic or foreign currency ratings

2. Public Utilities

- There are 267 public water, sanitation and sewerage companies; only Sabesp and Sanepar have local and foreign currency ratings; Sabesp has accessed the local and international capital markets
- Of the public sector electric utilities, Cemig, Cesp, and Copel have local currency ratings and have accessed the domestic capital market. Cemig and Copel have foreign currency ratings and have accessed the international capital market.
- 12 public utilities trade in the Brazilian Stock Exchange

3. Development Finance Institutions (DFIs)

- Caixa Economica Federal (CAIXA) and Banco Nacional de Desinvolvimento Economico e Social (BNDES) have local and foreign currency ratings
- In 2004, BNDES and CAIXA combined had an outstanding loan portfolio of approximately $30 billion, of which 31% was disbursed for infrastructure projects
- Banco da Amazonia S.A. and Banco do Nordeste do Brasil have local currency credit ratings
- Municipal development funds, such as Desenbahia, Banco de Desenvolvimento de Minas Gerais, Servicio Social Autonomo Parannacidade do not have local currency ratings

C. Commercial Bank Loans

- Local governments do not have access to medium or long-term financing from commercial banks
- Funding for infrastructure projects is provided mainly through redistribution of federal funds by BNDES, CAIXA, state banks and municipal development funds
- CAIXA is funding federal, state and local governments at rates between 8-122%; approximately 40% of the loans have maturities ranging between 5 to 15 years and 30 percent have maturities over 15 years.
- In June 2005, Cemig secured loans in the Brazilian commercial bank market for R1.5 billion, with a total tenor of 8 years.

D. Domestic Bond Market

- Local governments have not accessed the bond market since the 1990s
- Five public utilities have debentures trading in the BOVESPA
- In February 2005, Copel issued a R400 million, 4-year bond, at 115% of the average daily CDI rate, with amortization beginning in 2007

Attachment 4

The World Bank's
Pilot Subnational Development (SND) Program

The Bank loaned $2.8 billion to subnational infrastructure projects in fiscal year 2005, but the Bank's Articles of Agreement have prevented it from lending directly to subnational entities. The Articles stipulate that national governments must provide a sovereign guarantee or its equivalent for a subnational loan. Many national governments do not favor the provision of sovereign guarantees as desirable or feasible.

The Bank views the limitations in its subnational lending as a major obstacle to establishing public-private partnerships (PPPs), especially for infrastructure. It also prevents the Bank from deepening its work in decentralization, even though the Bank spent $5 billion to support decentralization reforms in FYs 2004-05.

2003 Pilot Program. In 2003, as an experiment in lending to subnationals without sovereign guarantees, the Bank Group established the IFC Municipal Fund offering $100 million in financial support to subnational entities, which catalyzed $570 million in investments.

2006 Pilot Program. On July 1, 2006, a larger, three-year (FY07-09), $800 million subnational development (SND) program was launched to scaled up this initiative and offer guarantees and loans (mostly in local currency) to focus on three types of entities, which to provide or finance services: local governments, public utilities and development finance institutions. The SND program may have a fund for technical assistance to which donors would be expected to contribute. Alternatively, the assistance may be administered through the Public-Private Infrastructure Advisory Facility (PPIAF), a multi-donor consortium housed at the World Bank.

The IFC will bear the entire risk for the SND program.

Governance. To administer the program, the World Bank and the IFC established a joint department. The head of the SND Unit reports to the Bank Vice President for Infrastructure and the IFC Vice President for Industries. Projects will be approved by the IFC's Board of Executive Directors. A future option involves the World Bank's establish a subnational development institution run by its own management and staff.

Ultimately, the Bank may create a new legal entity, such as IDA, devoted to subnational lending in order to skirt the legal problem posed by its Articles of Agreement. This option is viewed as more feasible than amending the Bank's Articles of Agreement.

The program follows the IFC procedure which entails seeking consent for subnational lending from the national government on a no-objection basis before the loan proposal goes to the Board of Executive Directors for approval.

SND Among donors and creditors. Each of the development banks has the capacity to lend to sub-sovereigns, including the African Development Bank, the EBRD, the European Investment Bank, the Asian Development Bank (as of August 2005) and the Inter-American Development Bank (as of March 2006). Many bilateral agencies also have this capacity, including USAID's Development Credit Authority, Germany's KfW, and Agence Francaise de Developpement (AFD).

SND services:
Technical Assistance:
- Capacity and policy development
- Upstream market development
- Project facilitation

Financial Support:
- Leverage local private financial markets
- Use of guarantees and derivatives*
- Loans (local currency)

Utility Eligibility. To qualify for financing from the SND program, public utilities would need to operate on commercial principles, independently of support from the national government.

Creditworthiness. The World Bank views its engagement with subnational entities as helping to enhance their credit ratings, so that they can borrow on domestic and foreign capital markets. In order to achieve this goal, subnational entities must become financially autonomous by raising sufficient taxes and fees (e.g., user fees for basic services) and diminishing reliance on central governments in order to cover their expenses. The Bank promotes Fiscal Responsibility Laws governing subnational debt that requires subnational entities to balance their budgets. In order to achieve balance, many subnational entities (as with central governments) have increasing levels of contingent (off-budget) liabilities.

Client Countries. The program is aimed at middle-income countries. Indeed, the World Bank has produced in-depth analysis of the potential for SND in Brazil, China, India, Mexico, Poland, Russia and South Africa. However, it will not exclude low-income countries. Technical assistance in qualifying for SND program financing would be provided in the form of grants. The program anticipates providing 40-50 grants per year during FY07-09 to help subnational entities improve fiscal performance and financial management.

India. India has a three tier government structure comprising the center, 28 states and about 2700 urban local bodies, of which only 50 are creditworthy enough to access domestic capital markets. Expenditures on core services account for 12% of subnational GDP, of which only 62% are covered by "own revenue" sources.

Brazil. Brazil has 25 states and over 5,500 municipalities. None of the subnational governments have domestic or foreign currency ratings. There are 267 public water, sanitation and sewerage companies, only 2 (Sabesp and Sanepar) have local and foreign currency ratings. Of the public sector electric utilities, three (Cemig, Cesp, and Copel) have local currency ratings and have accessed the domestic capital market. Two (Cemig and Copel) have foreign currency ratings and have accessed the international capital markets.

Philippines. Among 1,600 Local Government Units (LGU) which consist of four levels (provinces, cities, municipalities, and barangays), 435 LGUs have preliminary credit ratings of which 19 have final credit ratings from Local Government Units Guarantee Corporation (LGUGC).

Attachment 5

BRAZIL: CRITERIA FOR SUBNATIONAL LENDING

(Source: World Bank, Country Assistance Strategy (CAS) Progress Report for fiscal years 2004-07, May 8, 2006, p. 11)

Some criteria for lending to **states**:

- Fiscal health. Strong fiscal and financial performance, as evidenced by compliance with the Fiscal Responsibility Law and debt rescheduling agreements with the federal government. Relevant projects must be included in the state's PPA ("Brazil for All" – the national development strategy) and budgeted.
- Commitment to reform. "States must have demonstrated a commitment to a clear, unambiguous and unchanging reform agenda, elaborated clearly in the PPA, and the proposed project must play a clear and unambiguous role in achieving the core development objectives of the state."
- Public sector management impact. The state must have demonstrated commitment to building public sector institutional capacity and public sector expenditure efficiency and transparency and the proposed project should help address those objectives.
- Sustainable growth impact. Priority would be given to those projects which have a direct impact on sustainable growth, preferably in the context of regional development.
- Poverty levels and the impact of the proposed interventions.

Additional criteria for lending to **municipalities**:

- Clustering. In response to government request and to ensure economies of scope in preparation and supervision, all municipal projects would be clustered in a consortia or regional package. The legal (and financial, if relevant) structure for the clustering arrangement should be clear.
- Strategic intervention. Bank engagement must focus on competitiveness and growth of the municipality, and on improving fiscal performance, municipal management and economically-critical issues, such as land management. Specific investments must be embedded in, and supportive of, these higher-level objectives.
- Lending in local currency is to be done whenever appropriate and whenever agreed upon by the municipality and federal government.

Subnational lending in well-governed states, such as Ceara and Bahia. SNGs need to comply with the requirements of Brazil's Law on Social Responsibility. The richer states of the South and Southeast are most severely indebted, whereas the poorer states of the North and Northeast have greater capacity to borrow. Bank just approved a subnational loan to the state of Minas Gerais that had not met two of the five rules within the FRL.

Attachment 6

Public-Private Partnerships: The Record

In identifying the risks involved in PPPs, the IMF reached a conclusion that: *"First and foremost, the decision whether to undertake a project, and the choice between traditional public investment and a PPP to implement it, should be based on technically sound value-for-money comparisons. It is particularly important to avoid a possible bias in favor of PPPs simply because they involve private finance, and in some cases generate a revenue stream for the government."*[7]

World Bank infrastructure specialist Antonio Estache evaluated infrastructure PPPs during 1994 to 2004 and concluded that 1) poorly structured PPP projects have been pervasive over the past decade and have generated considerable fiscal risks and 2) countries risk giving priority to PPPs at the expense of improving systems for public investment.[8] Findings of this study follow:

Volume of Investment. Between 1984 and 2002, the level of investment in PPPs in key sectors is as follow: energy ($242 billion), telecom ($332 billion), transport ($129 billion) and water/sewerage ($39 billion).[9]

Who Invests? Governments are primarily financing the shift of their own power to the private sector since they provided 70% of total financing for infrastructure PPPs. Percentages of total financing commitments (not contributions) by the private sector and by development aid represent 22% and 8%, respectively.

Fiscal Jeopardy. Despite the fact that increased revenue is touted as one of its main justifications for PPPs, there is actually a risk of fiscal deterioration. This is the case since private firms have become more risk averse, especially in Africa and, as a result, they have increasingly insisted on guarantees and financial supports that ensure profitability, minimize capital outlays, and greatly increase the fiscal exposure of government.

In Eastern Europe, more costs than benefits accrued to taxpayers and consumers. Although there was an average increase in electricity prices of 16% between 2000 and 2002, "…the combination of high losses, non-payment of bills, and below-cost recovery tariffs added up to a fiscal cost of, on average, 7.5% of GDP at the end of the 1990s." Through additional cost recovery, costs dropped to 5.9% of GDP by the end of 2002.

Finally, it found:
******Impact on the poor.* "…efficiency gains were achieved at the cost of an increase in the burden imposed on the lowest income groups connected."
*"*Cream-skimming* in the design of reforms has often left rural and suburban areas out of the service obligations." When the private sector engages in "cream-skimming," it serves the paying customers and leaves the rest. He predicts, "Cream-skimming is likely to be much more common from now on."
**Corruption.* Low middle and low-income countries have seen corruption increase.
**Reporting.* For now, there are no internationally agreed fiscal accounting and reporting standards for PPPs, which exacerbates risks.

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[7] http://www.servicesforall.org/html/Privatization/Summary_public_private.html

[8] A. Estache, "PPI partnerships vs PPI divorces in LDCs, World Bank and ECARES (Universite Libre de Bruxelles," October 2004.
[9] NEPAD's "Short-Term Infrastructure Plan" compares the volume of infrastructure investments in African PPPs ($14 billion) with the volume in Latin American PPPs ($237 billion) during the period 1990-1998.

*****_Collusion._ In another study by Benitez and Estache, "How Concentrated are Global Infrastructure Markets?" the authors found that infrastructure projects were highly political, in part, due to the degree of concentration of corporate investors, which can pose the risk of collusion. [10] They found that concentration was present in 20% of their sample, while presumed concentration was found in an additional 30% of the sample. The authors explore the need for a supranational competition or regulatory agency.

Since the water sector and parts of the electricity sector are "natural monopolies," strong regulation is needed to protect and benefit consumers. However, transnational corporations often capture regulators, especially in low-income countries. In the water sector, key companies are French: Suez (Ondeo), Veolia Environment (formerly Vivendi), and SAUR and German: RwE (which owns Thames Water and American Water Works).

*****_Efficiency._ In Estache et al., the authors conclude that "Infrastructure performance and reform in developing and transition economies: evidence from a survey of productivity measures," the authors find that, for utilities, ownership often does not matter as much as sometimes argued. ***Most cross-country studies find no statistically significant difference in efficiency scores between public and private providers.***

[10] D. Benitez and A. Estache, "How Concentrated are Global Infrastructure Markets?," World Bank, February 2005.

Implicit and Explicit Risk Allocation

In a World Bank Institute book, "Granting and Renegotiating Infrastructure Concessions: Doing it Right," J. Luis Gausch states that in Latin America, 41% electricity, transportation, and water and sanitation contracts are renegotiated. In the water and sanitation area, 74% of contracts are renegotiated within 1.6 years. He contends that the renegotiations adversely affected users and contribute to the negative perception of PPPs. That is, the interests of consumers are compromised when renegotiations change factors such as tariffs, investment plans and levels, exclusivity rights, guarantees, lump-sum payments or annual fees, coverage targets, service standards, and concession periods. (Standard scheduled tariff adjustments and periodic tariff reviews do not count as renegotiation.)

The incidence of renegotiation is much higher when the regulatory framework is imbedded in a decree or in a contract rather than imbedded in law. The World Bank required decrees and regularly imbeds regulation in contracts. The risks involved in PPPs or concession contracts include the following:

1. Design or development risk
2. Revenue risk, such as changes in tariffs and changes in demand
3. Financial Risk due to changes in interest rates or exchange rates (e.g., devaluation of local currency; fluctuations)
4. Unexpected event risk, such as "acts of God" and changes in law (e.g., taxes, environmental standards)
5. Performance risk, such as a political event (e.g., expropriation)
6. Environmental risk.

With regard to financial risk, many PPPs have foundered when the value of a domestic currency falls in relation to the dollar, the amount of the dollar-denominated corporate debt and the cost of imports balloon. Currency risk was a major factor causing the collapse of corporate contracts for water and electricity provision in Manila and Buenos Aires, among others. In June 2005, Suez withdrew from its contract to supply water and sanitation services to Buenos Aires after a long-simmering dispute dating back to the 2001 Argentine economic crisis, when the government froze utility tariffs and converted them from U.S. dollars into pesos, making contracts held by Suez and other companies unprofitable.

Recipe for Trouble. World Bank researchers Ehrhardt and Irwin,[11] assert that many private infrastructure projects combine the following ingredients:

- Regulation that subjects the private company to considerable risk;
- A government or regulator that is reluctant to see the company go bankrupt; and
- High leverage on the part of the company (that is, a high value of debtholders' claims on a company as a fraction of the value of the firm).

They conclude that "the combination is a recipe for trouble" since the true allocation of risk is different from the apparent allocation as set forth in laws, regulations, concessions, licenses and government. This is due to the fact that, when the government or regulator refuses to allow a company to go bankrupt, taxpayers or customers provide an implicit guarantee of the firm's debt, the cost of which increases with the firm's leverage and the extent to which regulation transfers risk to the company. They conclude that the best solution is for the government to make bankruptcy politically acceptable and, short of that, the government should restrict leverage, reduce the power of regulation or both.

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[11] David Ehrhardt and Timothy Irwin, "Avoiding Customer and Taxpayer Bailouts in Private Infrastructure Projects: Policy Toward Leverage, Risk Allocation, and Bankruptcy," World Bank Policy Research Working Paper 3274, April 2004.