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PPPs and Latin American Infrastructure Markets: Brazil and Chile

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Introduction

The importance of the public-private partnership ("PPP") model for infrastructure development in Latin America has increased dramatically during the last two decades. In recent years, Brazil, Chile, Colombia, Mexico and Peru have been most active in seeking PPP investments. As the first in a series of articles on PPP frameworks in Latin America, we look at Chile and Brazil. In future articles we will discuss the latter three.

Latin America's experience with PPPs has varied greatly from country to country and has revealed certain drawbacks, but the advantages of the PPP model have proven valuable. As a result, PPPs have gained acceptance as a preferred model for constructing, managing and financing major infrastructure projects. When negotiated and managed effectively, PPPs provide a viable way to leverage public resources in a way that can—and has—simultaneously benefited public interests while creating profits for the private-sector.

Chile and Brazil are among the top markets for infrastructure projects in Latin America. Both countries have shown a strong and sustained commitment not only to infrastructure development but to private involvement in such projects. Chile and Brazil are the top scoring countries, respectively, in the 2010 Infrascope index (see chart, "2010 Infrascope Index: Brazil and Chile") due to their relatively effective legal frameworks, favorable political appetite for PPPs, strong economies and the availability of financing for long-term projects.[1] Chile and Brazil have among the lowest rates of project cancellation and distress in the region, and both markets are poised to experience major infrastructure growth in coming years.

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Project Finance and the Equator Principles

During the life cycle of a PPP, the sources of project funding evolve from the construction phase to the operational phase. During the construction phase of a PPP, sponsor equity and bank loans are the primary sources of financing. Bridge loans, subordinated debt and government grants or subsidies may be involved as well. As a project progresses to the operational phase, financing typically transitions to passive investors as long-term bonds replace bank loans and sponsor equity may be bought out by a facilities operator or even by passive third-party investors.[2]

With respect to social and environmental issues, the Equator Principles may apply to projects with value of at least $10 million USD. Launched in 2003, the Equator Principles provide a voluntary framework for assessing and managing environmental and social risks in project finance. At present, 72 adopting financial institutions—four in Brazil, one in Chile and nine in Latin America—and various financial associations, such as the Chilean Banking and Finance Association, have adhered to the Equator Principles. As a result, the Equator Principles are playing an important role in infrastructure project finance.

PPPs in Chile

Infrastructure Opportunities: The Chilean Market

Chile has arguably the most successful infrastructure development track record in Latin America. For years, Chile has welcomed private participation in a variety of sectors and its success with PPPs has helped make Chile a regional leader in infrastructure, particularly in roads, airports and seaports. Chile's Ministry of Public Works ("MOP") has awarded over 50 concessions since 1991, valued at approximately $11.3 billion USD.[3] Roads account for a majority of the total amount invested in PPPs. The MOP has a specialized section dedicated to concessions, la Coordinación de Concesiones, with a staff of around 300.[4]

Under President Michelle Bachelet, the MOP was largely occupied with internal reorganization and regulatory reform. Currently, under President Sebastián Piñera, the MOP has turned its focus back to procuring and implementing projects, and the Piñera administration has encouraged private sector involvement in a variety of areas. In February of 2010, as President Piñera took office, Chile endured a disastrous 8.8 magnitude earthquake that caused an estimated $15-30 billion USD in damage.[5] Some key figures from rebuilding projections:[6]

- electrical power, telecommunications and transportation infrastructure will require significant repair and rebuilding;
- after 24 hospitals were damaged or destroyed, the Chilean government announced in November of 2010 a package of eight new hospitals to be awarded as concessions contracts at an estimated value of $1.4-1.5 billion USD;[7]
- an estimated 1,000 schools require repairs and 40 need to be rebuilt; and
- an estimated 160,000 new homes will be built in 2011.

Combined with preexisting infrastructure goals, the earthquake rebuilding effort will continue to fuel infrastructure projects in various sectors. Just before the earthquake, the MOP announced Chile 2020, a package of major infrastructure projects that would involve new construction and overhauls to Santiago's airport, reservoirs and irrigation canals, shipping and coastal infrastructure, ports, freight rails, power plants and transmission lines and roads.[8] In June of 2010, the MOP announced plans for a four-year $15 billion USD infrastructure program.[9]

Chile has arguably the most successful PPP track record in Latin America, which has helped make Chile a regional leader in infrastructure.

Historically, the main source of unplanned costs for PPPs in Chile has been renegotiation. Renegotiation has affected a substantial portion of PPP investments in Chile with changes representing as much as 26% of total PPP investments.[10] Data reflecting renegotiation of PPP contracts in Chile is comparable to regional data and in many cases renegotiations benefit the concessionaire. Nonetheless, renegotiations are often costly for both parties and have potential to cause delays, incentivize corruption and undermine public budgets.

Chile is one of the least corrupt countries in the world and arguably the least corrupt in Latin America, yet a major corruption scandal in 2002 known as "MOP-Gate" forced Chile to halt its PPP programs for several years. Chile's experience with the MOP-Gate scandal highlights the importance of adequate and independent oversight mechanisms in PPP regimes.

Chile's PPP Legal Framework

Enacted in 1991 by Decree No. 164, the Public Works Concession Act (the "Concession Act") permitted the Chilean government to grant concessions for most public works, including roads and airports. Significant modifications were made to the Concession Act in 1996 to clarify key procedures, expand the scope of public works concessions and improve operational aspects of the framework.

In early 2010, Chile again reformed the PPP framework substantially with Law No. 20,410, which introduced limits on renegotiation and strengthened institutional safeguards.[11] Other highlights include provisions for:

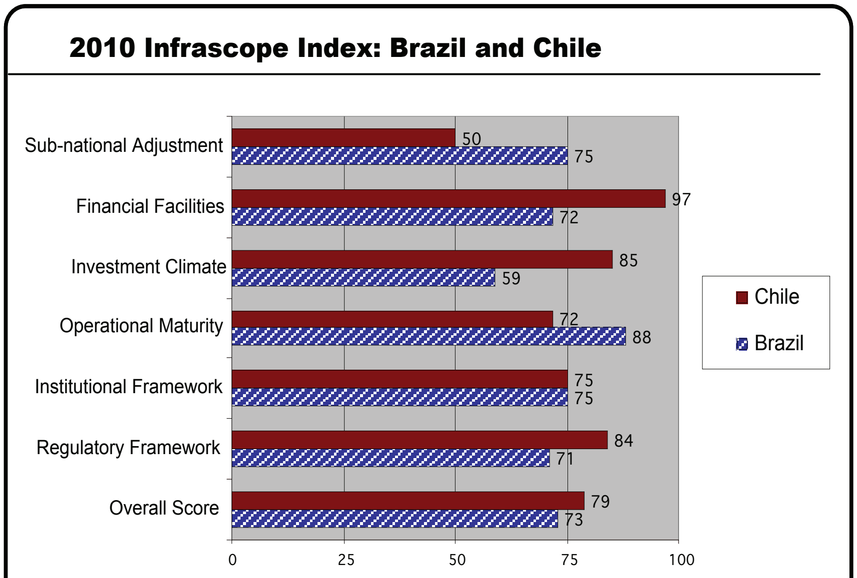
- a Concessions Commission, whose principal role is to advise the MOP on potential infrastructure projects and the appropriate type of concession contract;
- a Technical Panel to hear technical and economic disputes between the MOP and the concession company and issue recommendations as a dispute resolution mechanism prior to arbitration;
- an increased role for the Arbitration Commission, which has the power to decide substantive legal disputes between the concessionaire and the MOP;
- a process concessionaire to apply for compensation if an amendment to works or services is requested by the government that differs from the bidding terms;
- a registry of contractors to be maintained by the MOP as well as a five year prohibition on future concessions for contractors and subcontractors that are found in gross non-compliance a contract; and
- the regulation of fines levied upon concession users that do not pay tolls.

The MOP has the lead role in designing, awarding and administering PPPs in Chile. In cases where the MOP executes a concession contract on behalf of another ministry—for jails or airports, for instance—a committee representing both ministries is appointed. The Ministry of Finance has an important role in counterbalancing the MOP's concession authority with key approval and monitoring powers during various stages of the PPP process, including the bidding conditions, changes to the concession contract, dispute resolution settlements, and others.

Financing PPPs in Chile

Chile offers the best PPP financing conditions in Latin America. Chile scored a nearly perfect 97.2/100 in the financial facilities category of the 2010 Infrascope index while no other Latin American country surpassed 72.2/100. Unlike many other countries in the region, Chile is capable of funding most projects domestically and in local currency.

The World Bank's International Finance Corporation and private banks have been active in financing infrastructure projects in Chile.[12] Pension funds, a major source of liquid assets in Chile, have also been active in infrastructure investments through infrastructure bonds and other instruments.[13] Local banks are increasing their role in project financing but remain reluctant to take on completion risk unless such risk is covered



Source: 2010 *Infrascope*, Economist Intelligence Unit

by a multilateral entity—such as international insurance entities like FSA, MBIA and XL—or a foreign bank.

Foreign investments in Chile are governed by the Central Bank Act and the Foreign Investment Statute, Decree Law 600 of 1974. Among other things, the Foreign Investment Statute provides for non-discriminatory treatment of foreign investors and rights of access to financial markets. Under these laws, profits may be freely remitted abroad at any time at the discretion of each investor. The Foreign Investment Statute provides that capital invested thereunder may not be repatriated earlier than one year from the time the investment is made, but the Central Bank Act has no such restriction.

Since the financial crisis of 2008, new large-scale infrastructure projects in Chile have been on hold while certain aspects of financial structuring in the post-crisis environment remain uncertain. Additionally, the financial crisis caused the demise of the "monoline model," the traditional approach of selling an internationally wrapped bond to pension funds to finance projects. In some cases monolines have been replaced by syndicated loans and, for mature projects, Chilean-peso denominated bonds but whether or not such instruments can fill the entire monoline void is still uncertain.

Brazil

Infrastructure Opportunities: The Brazilian Market

Brazil offers a massive and advanced market for infrastructure development. On top of a rapidly growing economy, the World Cup in 2014 and the Summer Olympics in 2016 are fueling demand for infrastructure in Brazil. During a visit to Brasilia, at a CEO Business Summit, President Obama emphasized these opportunities and remarked that American companies "stand ready" to take part in this stage of Brazil's growth.[14] Around the same time, the U.S. Export-Import Bank authorized $3 billion USD in financing to Brazil, including a $1 billion commitment to infrastructure projects.[15]

The Brazilian Development Bank ("BNDES") forecasts needs for investment in infrastructure of $380 billion reais ($243 million USD) between 2011 and 2014.[16] Energy infrastructure leads the way with an estimated 36.6% of that figure while other major growth sectors include telecommunications (18.8%), rail (15.9%), roads (13.3%), sanitation (10.7%) and ports (4.7%).[17]

Brazil's infrastructure—inadequate by international standards—lags behind the size and sophistication of its economy, leaving huge growth potential in the gap. Brazil is particularly behind in roads, ports and airports. Other sectors that demand investment right now include electricity, railways, urban mass transit, water and sanitation, telecommunications and health care.

Brazil's investment in infrastructure was just 2.1% of GDP between 2006 and 2009.[18] Before leaving office, the Lula administration announced two Growth Acceleration Programs (the "PACs") for investments of over $312 billion USD and another $560 billion USD during a second phase in infrastructure, energy and social development through 2014. A principal objective of the PACs is to remedy Brazil's flagging infrastructure development.

Brazil's PPP Legal Framework

Brazil welcomed private participation in infrastructure in the mid 1990s with a series of constitutional amendments and legislative projects. Reacting to deficiencies in public infrastructure, which had been the exclusive domain of the government for decades, the purpose of the reforms was to encourage private investment in order to improve and develop critical infrastructure for the country. The original concessions framework, which revolved around the Concessions Law of 1995, Law 8,987/95 (the "Concessions Law"), proved inadequate for the consistent procurement of financing for certain large-scale projects.

The most important PPP law in Brazil is Law 11,079/04, the Federal Public-Private Partnerships Law (the "Federal PPP Law"), which modified and complemented the already existing Concessions Law. Though the Federal PPP Law builds on and replaces parts of the Concessions Law, all PPPs remain subject to the Concessions Law insofar as applicable. Brazil's Federal PPP Law established general rules for the bidding and contracting of PPPs while creating two new types of concessions:

- Sponsored Concessions are for public utilities or construction projects and, unlike concessions under the Concessions Law, they authorize the state to subsidize a concessionaire's revenues.
- Administrative Concessions, which are technically not concessions, are long-term service contracts for the construction and operation of infrastructure facilities paid by the state. Under this model, end-user charges are not

an option, as in the case of prisons or sewage treatment plants.

The Federal PPP Law established a minimum value of $20M reais ($12.6 million USD) for projects and a term between 5 and 35 years. Step-in rights are permitted under the Federal PPP Law, and the state has the power to pay consideration directly to lenders under a PPP agreement. Other important authorities created by the Federal PPP Law include the ability to guarantee payment obligations and provide performance based compensation to concessionaires.

The Federal PPP Law authorizes arbitration of disputes between private and public entities, but such arbitration must be conducted in Brazil and in Portuguese. A signatory to the New York Convention and the Panama Convention, Brazil will enforce any foreign arbitral award or court decision provided it does not offend its sovereignty or undermine public policy, defined as disturbing public order and good morals.

The importance of the PPP model for infrastructure development in Latin America has increased dramatically during the last two decades.

At the same time, the Brazilian government was authorized to create a PPP trust fund (the "FGP"). While the FGP does not guarantee project risk, it was authorized and funded to insure the private sector with respect to the government's financial obligations. Along with authorities to issue guarantees of payment, the FGP provides the Brazilian government greater latitude to attract financing for and carry out PPP projects.

One problem encountered under the Federal PPP Law is a provision that allows the state to make payments to a concessionaire only when services are made available. Partial availability of services enables partial payments, but this issue can be a major barrier, especially for capital intensive projects. Certain workaround options have come forth, such as sequential project phases that allow the government to participate in the project risk along with the private sector at an early stage.

Fewer projects have been implemented under the Federal PPP Law than originally expected. While the PPP regime allows the state greater flexibility, government officials have been reluctant to execute projects, partly due to concerns for the political risk of such actions. Ideological resistance to the notion of private investment in public infrastructure and the complexity of structuring projects are additional factors. As Brazilian officials become more comfortable with the PPP regime and Brazil's demand for infrastructure continues to grow, it is likely the Brazilian government will start leveraging its PPP authorities more assertively.

Due in part to the slow pace of infrastructure development at the federal level, Brazilian states took initiative in establishing PPP frameworks and implementing projects. In 2003, Minas Gerais became the first Brazilian state to pass a PPP law. Shortly thereafter, Bahia, Ceará, Goias, Rio Grande do Sul, Santa Catarina and São Paulo followed suit. Minas Gerais and São Paulo have led the way among states in large-scale infrastructure projects.

Financing PPPs in Brazil

Like Chile, Brazil offers deep capital markets, domestic players with infrastructure experience and local-currency financing options. BNDES is the primary source of funding for infrastructure projects in Brazil. In 2009, infrastructure projects comprised 36% of BNDES's total disbursements at $48.7 billion reais ($31.1 billion USD), an increase of 38.6% from 2008.[19]

Other sources of project funding have included multilateral and development banks, export credit institutions, institutional investors such as pension funds, private banks and other government controlled banks such as Banco do Brasil and Banco do Nordeste do Brasil. Local sponsor capital is typically provided by infrastructure funds (BR Partners, BRZ and Infrabrasil) major oil companies (Petrobras and OGX) and development conglomerates (AG, Camargo and Odebrecht). Chinese investment in Brazil has grown rapidly, reaching about $17 billion USD in 2010, and is likely to continue as a major source of infrastructure funding.[20]

Since the economic crisis in 2008 dampened appetite for risk among international investors for construction and development projects, project bonds have an expanded role in project finance in Brazil. Project bonds are increasingly used during the construction phase, which has historically been funded by bank loans.

Research by Morgan Stanley revealed that the most profitable areas in terms of average return on investment were toll roads (29%), industrials (28%) and oil service companies (25%).[21] Auto parts, metals, media and utilities also performed well. The least profitable sectors included ports, building materials, airlines and energy/logistics. In contrast with the higher levels of private participation in transportation and water infrastructure in Brazil, state-owned enterprises have maintained a dominant position in the electricity industry.

Observations

PPPs provide an efficient method of project delivery that balances the interest and risks of public and private parties. In spite of the proven versatility of PPPs, the success of these projects depends on their proper structuring and an adequate institutional and regulatory framework. The Brazilian government's recent plans to re-launch its $33.1 billion real ($21.1 billion USD) Rio-São Paulo-Campinas bullet train tender in two stages, after a tender to build and operate the high-speed rail line failed to attract any bidders, is a sign that the size and visibility of a project are not the only keys to success. Carefully designed, high quality projects and solid procurement track records also matter when selecting a jurisdiction to bid on a specific project.

Meanwhile, the economic, political and legal stability experienced in Chile during the last two decades have made MOP programs among the most attractive in the region. However, some investors need time to become comfortable with the recent reforms to the Chilean PPP framework and the post-crisis financial landscape. Challenges remain in the social and political arena with respect to the suitability of procuring social infrastructure through PPPs in certain areas, such as hospitals.

PPPs offer diverse risk sharing mechanisms that allow them to be suitable for greenfield and brownfield projects alike. Where performance and incentives for improvement and expansion support efficiencies, the provision of the service and maintenance reach higher levels than those usually found in the public sector. Both Brazil and Chile enjoy a diverse portfolio of projects, strong local partners, attractive commercial terms and government support for PPPs that have positioned them to attract significant interest and investment from international sponsors and the financial community.

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