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**FINANCING INFRASTRUCTURE FROM  
MULTILATERAL CREDIT AGENCIES**

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# **FINANCING INFRASTRUCTURE FROM MULTILATERAL CREDIT AGENCIES**

## **SUMMARY**

**I – Introduction;**

**II - The role of Multilateral Credit Agencies;**

**III – Privatization in the Sanitation Sector;**

**V - Conclusion**

The Chapter's overview:

## I Introduction

In the chapter, there will be presented the objective of the paper, a scenario of the sanitation sector in Brazil and the limits of the study.

## II The role of Multilateral Credit Agencies

In this chapter a description of the most important agencies for the region will be presented. The topics developed will be, how the agencies have been created, their objectives, purposes, the amounts they generally manage and the main criteria and policies used to select a project to be financed.

## III Privatization

This chapter will be directed to introduce the privatization in the State-Owned-Companies: the context, the experiences in the sanitation sector in other countries than Brazil and, also the plans that have been developed in the sector in that country.

## V Conclusion

The final chapter will bring the conclusion of the studies related to the policies and the actions of the Multilateral Credit Agencies in financing infrastructure.

# INFRASTRUCTURE FINANCING FROM MULTILATERAL CREDIT AGENCIES

## Chapter I Introduction

The main objective of this paper is to evaluate the Multilateral Credit Agencies' path to describe the way those agents operate, specifically in terms of financing infrastructure. It will deal with the policies established by the agencies to the sector and follow the actual results perceived in its work.

Due to the large scope of the subject, some restraints will be established. The first will be the number of agencies analyzed. It will be restricted to the World Bank and its agencies and the Inter-American Development Bank. Those institutions are the biggest investors in the development role in Latin America, mainly in Brazil.

The second limit established will be the sector analyzed. One of the main objectives of the Multilateral Developing Banks is to reduce poverty and promote environmental sustainability. The sector chosen was sanitation, that is very important to develop that aim. In this paper we will refer to sanitation as water and sewage services.

Before describing the multilateral agencies role, a scenario of those services in Brazil will be described in which it will be possible to understand the strategic effect in making all the efforts to develop that segment in the country.

While in 1940, 32% of the countries' population lived in urban areas, in 1991 that amount increased to 75.6%, and in the year 2000 there will be approximately 80%.

We can follow the urban population's increase by the table:

YEAR	1970	1995	1998
Urban Population	55 million	123 million	161.3 million

Source: IBGE

Although several projects were created to develop the sector and the large amount invested, it was not enough to provide the country with levels that meet the international standards. From 1970 to 1998, R\$16.5 billion was invested in sanitation, divided in R\$10.8 billion in water supply and R\$5.7 billion in sewage. It is estimated that an amount of around R\$39.0 billion in investment will be needed to

support the water supply activities in the period of 1999 to 2010. To the sewage activities the amount needed is around R\$20.4 billion.

The benefits to the Brazilian population resulted from the investments in the period of 1995 to 1998 are presented as follows:

- ✓ 25 million people enjoyed the benefits;
- ✓ Direct employment generated around 1,1 million jobs.

Governmental authorities also estimate that for each monetary unit invested in sanitation, the country saves four monetary units in the health system. Furthermore, in 1998, 64% of the hospital and medical internments of children aged 10 years old or less, had been associated to the precariousness of the treated water.

To demonstrate the related services evolution in the period of 1970/1997 in terms of the percentage of population served, the table is presented below:

**Percentage of population served with sanitation services:**

SERVICE	1970	1992	1997
Water Supply	60.0%	73.6%	77.7%
Sewage Collection	20.0%	38.9%	40.8%
Garbage Collection	-	66.6%	76.3%

Source: IBGE

After that overview, we can also see the description of the Sanitation deficit in the country as follows:

**Deficit in Basic Sanitation in 1998 – per region (millions of tons):**

REGION	WATER	SEWAGE
North	30.87	91.09
Northeast	13.93	77.53
Southeast	4.55	24.24
South	5.64	82.59
Center West	17.25	65.91
<b>Brazil</b>	<b>8.89</b>	<b>51.12</b>

Source: SEPURB

Presently, the amount invested in the sector is much reduced, mainly because of the small capability of the state sanitation companies. Their basic statements are presented as follows:

### Financial and Operational Indicators of State Sanitation Companies – 1997;

DATA	AMOUNT
Invoicing	R\$8,0 billions
Total collection	R\$6,9 billions
Total cost of service	R\$7,1 billions
Net revenue	- R\$0,2 billion
Loss index (1995)	45%
Loss index (1998)	40%
Water measurement (1995)	60,8%
Water production	25 millions of m3
Nr. of employees / 1000 water plugging	4,39 (*1)
Nr of direct employment generated 1997	86.167
Nr of indirect employment (estimated)	30.000
Annual average expenditure for employee	R\$32.249,85
Average water tariff	R\$0,90/m3
Nr of water companies with total cost compatible to the direct operational revenue	16

Source: GESPE/CAIXA

(\*1) = the international standard is around 2 employees per 1.000 water services plugging.

### Standards of Efficiency:

STANDARD	BRAZIL	CHILE	ENGLAND
Average tariff	0,66	0,36	0,82
Water service coverage	86	86	100
Percentage of loss	45	29	28
Expenditure with staff	60	ND	38
Nr. of employees / 1000 water plugging	6,5	2,1	1,7
GNP per capita (US\$)	2.930	3.170	18.060
capacity of purchase of water (m3/year)	4.480	8.805	22.024

Source: SEPURB 1995

After evaluating the companies numbers, we can certify the inability of the companies to raise sufficient funds to invest. The tariffs are very high when we compare it to other countries in the region (Chile), and it almost as the same level as European countries (England). The point that we have to focus on is the inefficiency of the companies. The percentage of losses is very high and the reduction of net revenue shows us the inadequacy of the collection system. Despite the fact that other problems exist, if those two cited would be reversed, profits would be generated and then could be invested in the companies activities.

The way that is being found by the federal government to change the condition is stimulating privatization. It is expected that new players from the private sector will be able to modify the situation, cutting inefficiencies, providing real returns in terms of profits and opening the credit lines to the sector again. Nowadays in the sector, there's a revenue evasion of 15%, the fiscal losses are around 42% while the international patterns are, at most, 25%, and invoicement losses are around 37%. Despite that fact, investments will be effectively needed. The new companies will have to invest a large amount of funds to provide the population with the services specified. Investments to modify the standards of living of poor people are the biggest part of the total. Another fact that has to be noticed is the lack of long term funds in the developing countries market, and in the Brazilian market they are not different. In that scenario the country and its agents will have to look for all the compatible funds available and a partnerships with the Multilateral credit agencies can help in that task.

## **Chapter II** The role of Multilateral Credit Agencies

In this chapter a description of the most important multilateral credit agencies for Latin America, especially Brazil, will be presented. The topics developed will be how the agencies were created, their objectives, their purposes, the amounts they generally manage and the main criteria and policies used to select a project to be financed.

The Multilateral Credit Agencies, also known as Multilateral Development Banks (MDB), are autonomous international agencies that finance economic and social development programs in developing countries, using money borrowed in world capital markets or contributed by governments of richer countries. The multilateralism allows consistency and wider acceptance of objectives.

They operate under the policy and operational direction of boards of executive directors and boards of governors, selected by member country governments. Countries voting shares are based on their contributions to help finance Multilateral Development Bank operations.

Multilateral development banks have a dual role as financial intermediaries and development institutions. They must operate financially as banks while maintaining a development perspective. Most of the Banks have both a hard-term and a concessional-term lending window. They generally lend 75% of their funds on market terms, using money borrowed at commercial rates in world capital markets. These borrowings are backed by the capital subscription of their member countries. The Banks lend the other 25% of their funds on highly concessional terms, mainly to the poorest countries, using money contributed by their member country governments or repayments from previous loans.



## **THE WORLD BANK GROUP**

### **THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT**

The International Bank for Reconstruction and Development was created at Bretton Woods in 1944 by victorious countries of World War II who sought to develop a constructive framework for international finance. The Bank began operations on June 25, 1946 and it was referred as the World Bank.

The World Bank was established as a new type of an international investment institution to make or guarantee loans for productive reconstruction and development projects, both from its own capital, which would be provided by its member governments, and through the mobilization of private capital. The Bank's share capital was so structured that any risk involved in its operations would be shared by all member governments, roughly in proportion to their economic strength. The Bank, although an intergovernmental organization, relies mainly on the world's capital markets for the bulk of its financial resources.

Other affiliates of the Bank have been established: the International Finance Corporation (IFC), which became operational in 1956, the International Development Association (IDA), which became operational in 1960, and the Multilateral Investment Guarantee Agency (MIGA), in 1988.

### **THE OBJECTIVES**

The Bank's first loans, made in 1947 and amounting to about \$500 million, were for reconstruction in four European countries. The task of reconstruction of war shattered countries was far beyond the existing resources of the Bank, and with the advent of The United States Marshall Plan in 1948, the Bank turned its main efforts to development lending.

Until very recently, the emphasis of World Bank lending was traditionally on basic infrastructure, especially in the sector of transportation and public utilities. The Bank' role was search for ways to support projects designed to increase the

productivity, and hence, the standards of living of the poorest groups of people living in the developing world.

Today, the main function of the Bank is to reduce poverty by promoting sustainable economic growth in the borrowing countries. The aims of its actions are in the fields of investing in people, particularly through basic health and education, and in protecting the environment. They also support and encourage private business development, strengthen the ability of the government to deliver quality services efficiently and transparently, and promote reforms to create a stable macroeconomic environment. Their basic issues focus on social development, mainly governance, as a key element of poverty reduction.

## **THE STRUCTURE**

All powers of the Bank are vested in a Board of Governors, which consists of one Governor appointed by each member country. The Board meets once a year and, in the interim, votes by mail or cable on matters requiring its action. With the exception of certain powers specifically reserved to them by the Articles of Agreement, such as decisions on membership, allocation of net income, and changes in the capital stock, the Governors have delegated their powers to a board of Executive Directors. The Directors perform their duties on a full-time basis at the Bank's headquarters in Washington, DC. The five largest shareholders appoint five of these Directors, and the remaining 15 are elected by the other members.

The Board of Governors has the power to admit new members, and to determine the conditions of their admission. However, the country must join the International Monetary Fund (IMF) which involves signing an agreement accepting rules of international financial conduct.

The subscription of an applicant for membership is fixed after consultation between the Bank and the applicant and approval by the Bank's Board of Governors. In general, it is based on the economic and financial strength of the member and linked to the member's financial participation (called "quota") in the IMF. Upon joining the Bank, a country pays in 10% of its subscription. The remaining 90% is not paid in but may be called by the Bank if it requires the members to meet their obligations, arising out of borrowings or guaranteeing loans.

Individual members' voting power is linked to the size of their subscriptions to the Bank. Each member has 250 votes plus one additional vote for each share of stock held.

Voting by the Executive Directors is also weighted; each Director's Vote is the sum of the voting power of the member country or countries he represents. The Directors choose the President of the Bank who is subject to the decisions of the directors on questions of policy. The President is responsible for the conduct of the Bank business and for the organization, appointment, and dismissal of officers and staff. Only the President proposes loans.

## **THE POLICIES**

Policy is broadly decided by the Executive Directors within the framework of the Bank's Articles of Agreement. The Articles of Agreement are general enough to give the Bank flexibility in its operations so that it can adjust its policies to the realities of a changing world. Normally, a detailed analysis of any policy adjustment is presented by the President of the Bank to the Executive Directors for their consideration and decision.

Individual major shareholders do not have legal veto powers. Nevertheless, because a member's voting power is based on the amount of capital it has subscribed to the Bank, a combination of the largest shareholders (Canada, France, Germany, Japan, the United Kingdom and the United States) could together defeat an issue requiring a simple majority of the votes. In practice, however, consensus, rather than voting, is the normal method of reaching decisions.

Before issuing a loan, the Bank must consider if a proposed loan is likely to impose too great a burden on the economy of a potential borrower. Such a constraint on lending can sometimes be overcome by modifying the scope of the proposed project. The Bank has also adopted the practice of "blending" its assistance, by arranging to provide financial assistance for some projects with conventional Bank loans, and for others with funds on more "concessionary" terms. This practice is limited, however, to countries whose debt service problems make such a practice appropriate. In some cases, "blending" may occur in the financing of a single project.

Concessionary loans impose a relatively light burden on the borrower, either by bearing a very low rate of interest or by being repayable over a very long period, or both.

The Bank may lend to any member country, either for reconstruction or for development, but it has concentrated for over 20 years on development, and most of its loans since 1948 have been made to its poorer member countries rather than to the richer countries. The latter can usually find reasonable alternative sources of funds, and thus would not be eligible for World Bank loans.

The World Bank itself can only provide loans or loan guarantees that receive a borrowing-government guarantee, which significantly limits their utility in private transactions.

## **MONEY ALLOCATION**

Except in special circumstances, a World Bank loan must be for a specific project in a member country, or a territory under the administration of a member.

The project which the loan will assist must be technically and economically sound and of high priority for the economic development of the country. The Bank must be satisfied that the project will be well managed, both during its implementation and after completion. There must be reasonable assurance that the loan will be repaid and the loan must not impose an undue burden on the economy of the borrower. The Bank also ascertains that the prospective borrower cannot obtain loans on reasonable terms from other sources.

The Bank lends either to governments of member countries or to public or private organizations, which can obtain the guarantee of the member government administering the territory where the project to be financed is located. This guarantee requirement is imposed by the Bank's Articles of Agreement. The Bank's loans usually cover part or all of the foreign exchange costs of the proposed project, but in certain circumstances, they may also cover some local currency costs.

Before determining what projects in a particular country should be supported, the Bank seeks to obtain a comprehensive picture of the structure and development prospects of the country's economy. It does so by assessing the country's agricultural, mineral, industrial, and human resources. It looks after basic facilities,

such as transport and electric power, the quality of its public administration and education, its external trade and payments, and its internal finances. Against this background, the Bank discusses with the government the company's development plans for the next few years, and their feasibility and probable effectiveness. This continuous process includes the preparation of periodic reports and frequent contacts with policy makers, government officials, and the financial and business community. Loans must be repaid in fifteen to twenty years, and there is a three to five year grace period before repayment of principal.

## **PROJECT SELECTION**

After a project has been identified, it is appraised by a team of Bank specialists and sometimes by outside consultants hired for the purpose. The team examines in detail the following aspects of the project:

- ✓ Economic, including the demand for the goods or services the project will provide, the extent to which the project will employ domestic resources (including labor) which otherwise would not be utilized, the balance of payments effects of the project, and the relative merits of different ways of producing the goods and services required. A comparative analysis is made of the likely economic costs and benefits;
- ✓ Technical, including examination of the detailed plans for the project's construction and operation, the location, scale, layout, and design of the project, the types of processes and equipments to be used, the timing of the project, and the availability of factors of production and of technical staff. Cost estimates are also examined in detail, and provision for general cost increases and contingency allowances are checked;
- ✓ Institutional, managerial, and organizational, including the availability and training of qualified local management, the possible need for providing outside management or advice in the early stages of the project, the project's staff structure, and the freedom of management from undue external pressures;

- ✓ Procurement and commercial, including all arrangements for buying and selling, both of the material needed during the implementation of the project, and of the inputs required and output expected after its completion. The Bank normally requires international competitive bidding for project construction and equipment because the best interests of the borrowers are usually served by such bidding;
- ✓ Financial, including assessment of the funds needed during project implementation and their source, and of the project's operating costs, revenues, and prospective liquidity after completion. The Bank usually provides a part of the whole of the foreign exchange component only of a project's total cost; arrangements for the provision of the remaining finance are examined.

After the Bank and the borrower agree on all relevant factors, the negotiation of the loan is undertaken. At this stage, any special requirements of the Bank or the borrower are discussed and agreed upon. After completing the negotiations, the loan is presented to the Bank's Executive Directors for their consideration in the form of a President's report. The presentation to the Board includes detailed reports of the country's economy, the technical description of the proposed project, and the detailed legal aspects of the loan agreement. If the Directors approve it, persons empowered to act for the lender and borrower formally sign the loan.

Economic return is a major, but by no means the only factor, the Bank takes into account when analyzing a project. Other factors such as the income redistributive effects of projects which cannot easily be incorporated in the calculation of the rate of return must be taken into account.

## **FUND RAISING AND COSTS**

The IBRD sells AAA rated bonds and other debt securities to pension funds, insurance companies, corporations, other banks and individuals. This rating helps the Bank in its mission of borrowing funds to be invested in developing countries. It always tries to keep its lending rate as low as possible to be compatible with the maintenance of a sound financial position, on which its own ability to raise money in the capital market depends.

Since the largest sources of the Bank's loans are the capital markets on which it sells its obligations, the cost of funds in these markets is the principle determining factor in setting the interest rates the Bank charges its borrowers. Adjustments in the Bank's lending rate, either up or down, reflect the changing costs of the money the Bank raises. These adjustments are applicable only to the rate charged on loans made subsequent to an adjustment. The Bank also contracts loans in different currencies, depending on the funds available in their statements. The loans must be paid in the currencies and in the proportion they were disbursed. Sometimes, the Bank also provides the currency swaps to their clients in order to give them better conditions for the repayment.

## **AUDITING**

An Audit Committee, currently made up of six Executive Directors, was established in 1970. The Committee is responsible, under its terms of reference, for the nomination to the Board of Executive Directors of an independent accountants firm to conduct the annual audits of the accounts of the Bank, IDA, and IFC. A few of the firm's duties are to check the adequacy and sufficiency of the Bank's internal audit and operations evaluations, to discuss with the independent accountants the scope of their examination ,and to review the Financial Statements and the accountants' Report. The Committee also consults with the accountants on the most effective system of internal controls over the Bank's expenditures. The Bank's accountants have traditionally been chosen from private, independent, and internationally established firms of accountants, and this will continue to be the practice. The Financial statements and the accountants' Report are reviewed by the executive Directors before submission to the Board of Governors.

## **FINANCIAL POSITIONS**

The World Bank, in the Fiscal Year 2000, raised US\$15,8 billion in international debt capital markets. That money was lent on the IBRD and the IDA operations.

The IBRD new lending commitments to the Fiscal Year 2000 declined from US\$22,182 billion to US\$10,919 billion, because of several member countries

emerged from the financial crisis. At the end of the FY00, there were US\$13,332 billion disbursed in the period and the outstanding IBRD loans amounting to US\$120,104 billion.

The table below shows the data related to the cofinancing and Trust Funds operations contracted:

**COFINANCING AND TRUST FUNDS: (US\$billion)**

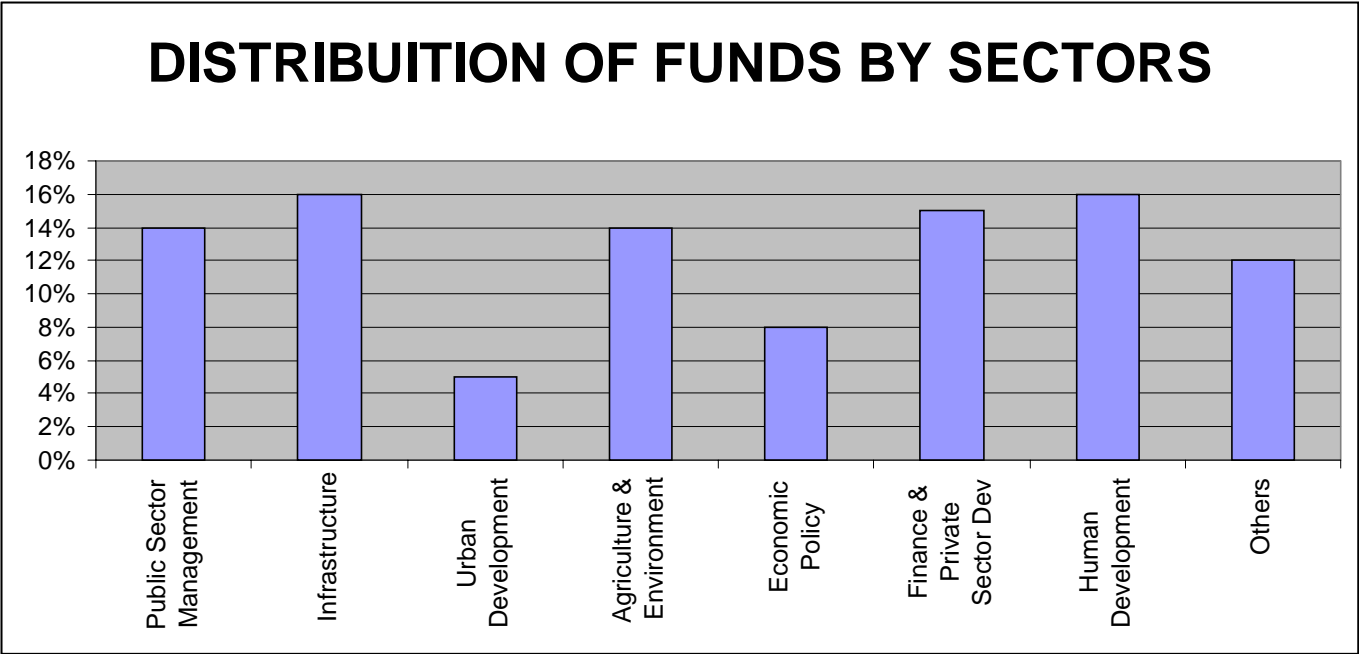
OPERATION	FY 2000	FY 1999
Cofinancing	9,341	11,350
Cofinancing / World Bank lending	61,1%	39,1%
Trust Fund Contributions ratio	1,769	1,568
Trust Fund Disbursements	1,659	1,333

SOURCE: World Bank Annual Report

Loans to Brazil, Colombia and Mexico accounted for a large part of new commitments in Latin American and Caribbean region.

The IBRD support in fiscal 2.000 focused on strengthening the financial sector (\$1,6 billion), improving public sector management (\$1,5 billion), and meeting infrastructure needs (\$1,8 billion), including transportation, telecommunications and Water Supply.

The distribution of the resources were as follows:





## **THE AFFILIATES**

### **INTERNATIONAL FINANCE CORPORATION - IFC**

The International Finance Corporation (IFC) is the World Bank affiliate for private sector financing. It was established in 1956 in response to pressure from developing countries to create a new United Nations fund as an alternative channel for foreign aid. Membership in the Bank is a requirement for membership in IFC.

### **THE OBJECTIVES**

The purpose of IFC is to further economic development by encouraging the growth of productive private enterprises in member countries, particularly in the less developed areas. Thus, the IFC supplements the activities of the International Bank for Reconstruction and Development.

In carrying out this purpose, the IFC:

- ✓ assists, in association with private investors, in financing the establishment, improvement and expansion of productive private enterprises which would contribute to the development of its member countries. Those investments are contracted without guarantee of repayment by the member government, in cases where sufficient private capital is not available on reasonable terms;
- ✓ seeks to bring together investment opportunities, domestic and foreign private capital, and experienced management;
- ✓ stimulates and helps create conditions to guide the flow of private capital, domestic and foreign, into productive investments in member countries.

### **THE STRUCTURE**

All of the powers of the IFC are vested in the Board of Governors. Each member country appoints a representative to the Board. The Board holds several meetings during the year in order to decide the guidelines and the principle measures to be acted by the IFC. In the meetings, each member has two hundred fifty votes plus one

additional vote for each share of stock held. All matters are decided by a majority of the votes cast.

The Board of Governors may delegate to the Board of Directors authority to exercise any of its powers, except to:

- ✓ admit new members and determine the conditions of their admission;
- ✓ increase or decrease the capital stock;
- ✓ suspend a member;
- ✓ decide appeals from interpretations of the General Terms of Agreement;
- ✓ make arrangements to cooperate with other international organizations;
- ✓ decide to permanently suspend the operations of the IFC and to distribute its assets;
- ✓ declare dividends;
- ✓ amend the General Terms of Agreement.

The Board of Directors is responsible for the conduct of the general operations of the IFC. They are appointed by a member of the Bank who is also a member of the IFC. A quorum for any meeting of the Board of Directors is the majority of the Directors exercising not less than one half of the total voting power.

The President of the Bank is the Chairman of IFC's Board of Directors, but he does not have a vote, except a deciding one in case of a tie vote. The President of IFC is appointed by the Board of Directors on the recommendation of the Chairman. The president is the chief of the operating staff of the IFC.

## **MONEY ALLOCATION**

The IFC may make investments of its funds in productive private enterprises in the territories of its members. They can also make investments of its funds in such form (s) as it deems appropriate in the circumstances.

IFC typically limits its financing to 25% of the total project cost (debt and equity). IFC's need for project and country diversification precludes allocating much more financing for a single project.

The IFC offers three broad and complementary services. The IFC's traditional and largest activity is project finance. Using its own funds IFC provides both loans and equity finance to private sector projects that meet the IFC's appraisal criteria, but which cannot get financing from other sources on reasonable terms. The IFC

also offer quasi-equity and financial risk management products. It is important to point out that, although the IFC lends on market terms, it does not compete with, but rather complements private capital.

Some more details on the IFC products are described as follows:

- ✓ Loans: Loans are the IFC's largest product. The IFC provides fixed and variable rate loans in any of the leading currencies. These loans typically have maturities of 8 to 12 years, with grace periods and repayment schedules determined on a case-by-case basis in accordance with the borrower's cash flow needs. If warranted by the project, the IFC provides longer term loans and longer grace periods;
- ✓ Equity: The IFC's equity investments are based on project needs and anticipated returns. The IFC usually maintains equity investments for a period of 8 to 15 years and is considered a long-term investor. The IFC's preferred objective is to sell its shares through the domestic stock market;
- ✓ Quasi-Equity: The IFC provides a full range of quasi-equity finance, including convertible debentures, subordinated loans, loans with warrants and other instruments. These products are provided, whenever necessary, to ensure that a project is soundly funded.;
- ✓ Since 1990, the IFC has been offering financial products to its clients to allow them to better manage their financial risks. These products include currency and interest rate swaps, options, forward contracts and other derivative products;

The IFC has also the power to:

- ✓ invest funds that are not needed in its financing operations. The IFC choose the obligations that better fit their needs;
- ✓ invest funds it holds by it for pension or similar purposes in marketable securities;
- ✓ guarantee securities in which it has invested in order to facilitate their sale;
- ✓ buy and sell securities it has issued, guaranteed or invested in;
- ✓ exercise any other powers incidental to its business as is necessary or desirable in pursuing its ends.

## ADVISORY SERVICE

Advisory services are provided for a wide range of activities including project assistance, privatization and restructuring, capital markets development, foreign investment advice, and small and medium business development.

- ✓ **Project Assistance:** The Corporation's project assistance services include financial as well as industry-specific issues, from the structuring and packaging of financial plans to engineering and technical advice. This includes markets, technical and feasibility studies, project preparation and implementation, partnership arrangements, locating appropriate technology and sources of funding, and providing financial and operational assistance.
- ✓ **Privatization Advisory Services:** the IFC has been actively promoting privatization as a policy instrument to promote private sector development in its member countries. The IFC has extensive experience in advising governments and government agencies on privatization of state-owned enterprises , structuring Build-Operate-and-Transfer (BOT) projects, public sector reform and financial restructuring.
- ✓ **Capital Markets Development:** IFC advises governments on fiscal, legal and regulatory matters and on the institutional structure required to develop a market-oriented financial sector. IFC has provided advice on the design and development of the general legislative environment, including basic company law, which is a prerequisite to capital market activities. IFC also offers technical assistance in establishing a regulatory framework for banking and non-banking financial institutions, including supervisory and enforcement entities and mechanisms.
- ✓ **FIAS - Foreign Investment Advisory Service:** operated jointly with IBRD it assists developing countries with how to attract larger amounts of foreign direct investment. FIAS advises governments on foreign investment laws, policies, regulations and procedures; organizes the framework and institutions needed to promote and regulate foreign direct investment; and develops investment promotion strategies to attract foreign capital, technology and managerial expertise.
- ✓ **TATF - Technical Assistance Trust Funds Program:** technical assistance to promote private sector growth in developing countries. Through TATF, the

IFC hires consultants to conduct a broad range of technical assistance activities, from helping entrepreneurs develop project proposals to assisting with private sector institution-building.

## **THE POLICIES**

The operations of the IFC are conducted in accordance with the following rules:

- ✓ the IFC does not undertake any financing for which, in its opinion, sufficient private capital could be obtained on reasonable terms;
- ✓ the IFC does not finance an enterprise in the territories of any member if the member objects to such financing;
- ✓ the IFC imposes no conditions where the proceeds of any of its financing must be spent in the territories of any particular country;
- ✓ the IFC does not assume responsibility for managing any enterprise in which it has invested and does not exercise voting rights for such purpose or for any other purpose which, in its opinion, properly is within the scope of managerial control;
- ✓ the IFC undertakes its financing on terms and conditions which it considers appropriate, taking into account the requirements of the enterprise, the risks being undertaken by the IFC and the terms and conditions normally obtained by private investors for similar financing;
- ✓ the IFC seeks to recycle its funds by selling its investments to private investors whenever it can appropriately do so on satisfactory terms;
- ✓ the IFC seeks to maintain a reasonable diversity in its investments;
- ✓ The IFC, at its discretion, may waive any of the privileges and immunities conferred to any of its loans.

## **PROJECT SELECTION**

A company or entrepreneur, foreign or domestic, seeking to establish a new venture or expand an existing enterprise can approach the IFC directly. After the

initial contacts and a preliminary review, the IFC will request a detailed feasibility study or business plan to determine whether or not to appraise the project.

To be eligible for IFC financing, projects must be potentially profitable for investors, as well as being economically sound. All IFC projects must also comply with stringent environmental guidelines. The IFC finances projects in many different industries-agribusiness, financial services, mining, manufacturing, tourism, power, and telecommunication, to name a few. It can finance the expansion or modernization of established companies or the start-up of new enterprises. It can also finance local companies, joint ventures with foreign investors, and companies with some government ownership, provided that these run on a commercial basis.

## **FUND RAISING**

The IFC may borrow resources to fund its operations. IFC raises funds from institutional investors through underwriting arrangements for public offerings or the private placement of shares, debentures, and other corporate securities. The triple A rating allows it to access the global financial markets on the most favorable terms. Before making a public sale of its obligations in the markets of a member, the IFC must have to obtain the approval of that member and of the member in whose currency the obligations are to be denominated

The IFC raises additional funds from foreign commercial banks through its loan participation program. It helps individual corporations from emerging markets to tap the international capital markets.

## **FINANCIAL POSITIONS**

In fiscal year 2000, the IFC approved new investments for its own account totaling \$3,5 billion, representing 259 projects, compared with \$3,5 billion in FY99 and its 255 projects. The IFC approved loan participation (B-Loans) in the amount of \$2,3 billion in 45 projects, compared with \$1,8 billion in 39 projects in FY99.

The distribution of funds were 76% in loans, totaling \$8,3 billion, encompassing “greenfield” projects, expansions, and modernizations. Ninety one percent of the IFC loans were denominated in US dollar.

Since FY99, the IFC has offered local currency loan products to certain clients, provided the Corporation was able to hedge its local currency exposure through mechanisms such as cross-currency swaps or forward contracts.

The equity and quasi-equity accounted for 24% of the IFC disbursed investment portfolio at FY2000. The IFC equity investments are typically in the form of common or preferred stock and are usually denominated in the currency of the country in which the investment is made.

## **INTERNATIONAL DEVELOPMENT ASSOCIATION – IDA**

The International Development Association (IDA) is an intergovernmental agency, an affiliate of the World Bank, through which the Bank makes concessionary loans (called “credits” to distinguish them from Bank loans on conventional terms) to the poorest countries for sound, productive, high priority economic development projects. The IDA was established in 1960 to provide concessional funding to poorer countries.

### **THE OBJECTIVES**

The basic reason for setting up a concessionary lending affiliate of the World Bank was that some developing countries were too poor even to service their new debt on “conventional” World Bank terms. The IDA provide not only loans but technical assistance, and policy advice. The IDA credits account for about one-fourth of all Bank lending.

### **THE STRUCTURE**

Any member country of the World Bank may join IDA. The Agency members are divided into two categories: “Part I” countries – relatively developed or high income members and “Part II” countries, the poorer, or relatively less developed members. Each Part I country pays its entire subscription in convertible currency, all of which may be used in lending. Each Part II country pays only one-tenth of its subscription in convertible funds; the remaining nine tenths is paid in the member’s own currency and may not be used for lending without the member’s consent. All additional subscriptions are paid in the members’ own currency as well.

All the powers of the IDA are vested in the Board of Governors, that are indicated by the member countries. The Board holds several meetings during the year in order to decide the guidelines and the principle measures to be enacted by the Corporation. In the meetings, each member shall have two hundred fifty votes



plus one additional vote for each share of stock held. All matter are decided by a majority of the votes cast.

The Board of Directors is responsible for the conduct of the general operations of the agency. A quorum for any meeting of the Board of Directors shall be a majority of the Directors exercising not less than one-half of the total voting power.

The Articles of Agreement make the Board of Governors responsible for determining the disposition of net income, "having due regard to provision for reserves and contingencies."

The Bank lends to its poorer member countries through its own concessionary affiliate, the International Development Association (IDA), at no interest, charging instead, an 0.75% a year service charge on sums disbursed to cover the IDA's administrative costs, with repayment spread over a period of 40 years, following a 10 year grace period. Other sources of concessionary finance include loans and grants available under certain developed countries' aid programs, and from some other international and regional development agencies, as well as loans from the Bank's "Third Window".

Those projects in a "blend" country, which are funded on the Bank's concessionary terms through the IDA, are in no sense less "sound" than those funded on conventional terms. The same rigorous appraisal and performance criteria are applied. "Blending" is undertaken (subject to the availability of the IDA and the Third Window funds) on the basis of the Bank's overall assessment of a country's debt service burden, with the aim of lightening this burden where justified.

The Third Window is an additional source of Bank financing, and the loans financed by it are on terms intermediate between the standard terms of the Bank and the highly concessional terms of IDA. The third window is subsidized by an Interest Subsidy Fund, whose resources are supplied by the Bank's richer members on a voluntary basis. The Fund will supplement interest payments due to the Bank from borrowers by paying the Bank semiannually an amount equal to 4% a year of the outstanding principle of Third Window loans. The difference between the 4% paid by the Fund and the Bank's standard interest rate will be paid by the Fund and the Bank's standard interest rate will be paid by the borrowers.

## **MONEY ALLOCATION**

Governmental, public or private entities in the developing world can borrow from the IDA. However, in practice, all IDA “credits” have been made to governments. Therefore, IDA credits have been limited to the poorest member countries.

The terms of concessionary loans impose a relatively light burden on a borrower, either by bearing a very low rate of interest or by being repayable over a long period of years, or both.

## **THE POLICIES**

The World Bank and IDA assessments of the economy of a country asking for finance sometimes reveal practices which could seriously affect the country’s economic prospects or its ability to make effective use of external financial assistance. In such circumstances, it is the Bank’s policy to recommend, before lending, that the potential borrower institute measures designed to improve the performance of its economy. The Bank does not insist that all remedial measures which appear necessary be completed before any loans are made. Nevertheless, it does require concrete evidence that the potential borrower is taking positive measures to remedy deficiencies in its policies. Given such evidence, the Bank is usually willing to provide finance with the execution of the necessary reforms.

## **PROJECT SELECTION**

The IDA uses the same process as IBDR.

## **FUND RAISING**

The IDA's funds have been obtained from five sources: members' initial subscriptions, periodic "replenishments" provided by its richer members, special contributions made by some members, transfers of income from the World Bank, and the IDA's own accumulated net income.

Initial subscriptions alone were never envisioned as the sole source of IDA lending funds. From the beginning it was expected that the IDA would have to obtain funds from governments from time to time, to enable it to continue operations.

Under its Articles of Agreement, the IDA is authorized to issue and guarantee securities. Thus, there is nothing to prevent the IDA from selling interest-free bonds to subscribers who might wish to help promote its activities, but this has not been thought practical.

## **FINANCIAL POSITIONS**

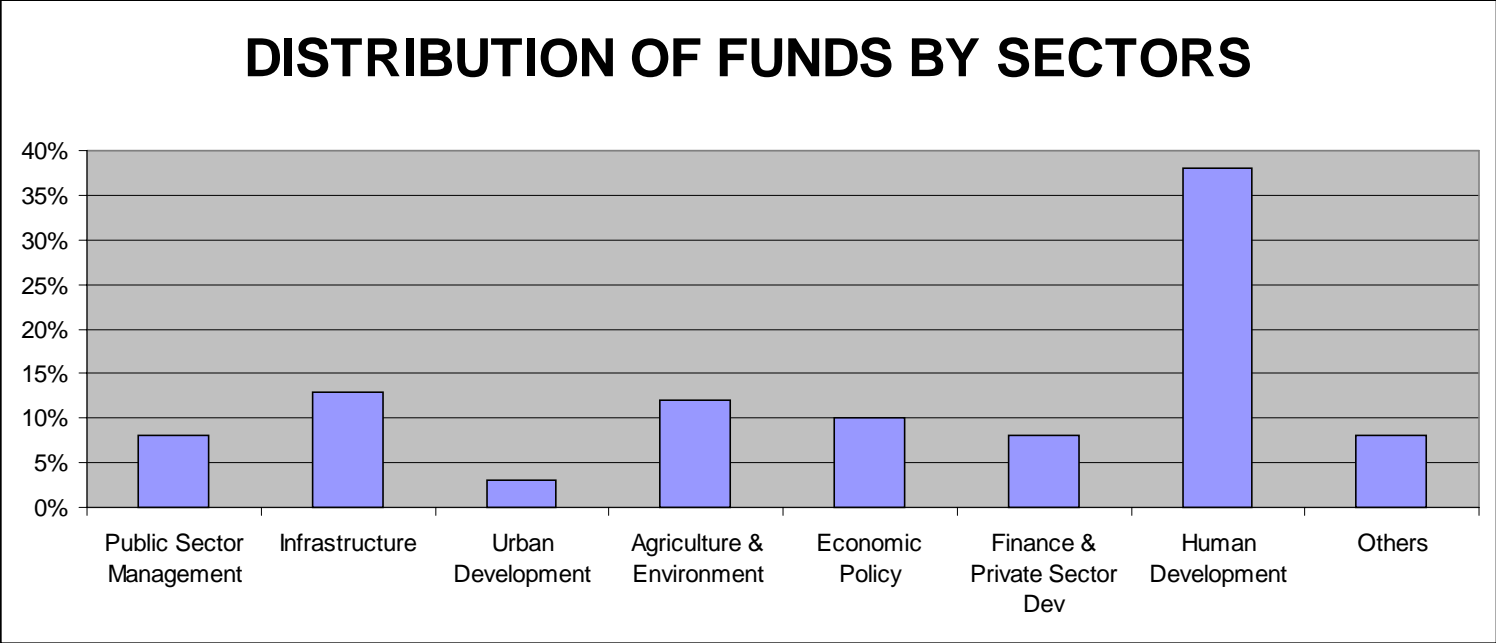
The World Bank, in the Fiscal Year 2000, raised US\$15,8 billion in international debt capital markets. That money was lent to the IBRD and the IDA operations.

The IDA's new lending commitments to the Fiscal Year 2000 declined from US\$6,813 billion to US\$4,358 billion, on behalf of several member countries emerged from the financial crisis. At the end of the FY00, there were US\$5,177 billion disbursed in the period and the IBRD loans outstanding amount up to US\$86,643 billion.

The size of new IDA operations averaged under US\$35 million in fiscal 2000, compared to US\$55 million for 1990 to 1999. The lower volume focused on effective use of resources.

Support to Human development, including education, health, nutrition, and social protection was the most important focus of IDA lending.

The distribution of the resources were as follows:



## **THE MULTILATERAL INVESTMENT GUARANTEE AGENCY – MIGA**

The Multilateral Investment Guarantee Agency was created in 1988. its best efforts are to fill a perceived gap in an investment insurance market unwilling to provide political risk insurance to the extent required by private investors. Membership in the MIGA is open to all members of the World Bank and to Switzerland.

### **THE OBJECTIVES**

The objective of the MIGA is to encourage the flow of investments for productive purposes among member countries and in particular to developing member countries, thus supplementing the activities of the International Bank for Reconstruction and Development, the International Finance Corporation and other international development finance institutions.

The Agency may cooperate with, and seek to complement the operations of national entities of members and regional entities whose capital is owned by members which carry out activities similar to those of the MIGA. They must follow a view that allows the maximizing both of the efficiency of their respective services and their contribution to increased flows of foreign investment. To this end, the Agency may enter into arrangements with such entities on the details of such cooperation, including in particular the modalities of reinsurance and coinsurance.

### **THE STRUCTURE**

All the powers of the MIGA are vested in the Council of Governors. The council is composed of a Governor and one Alternate appointed by each member country in a manner it desires. No alternate may vote except in the absence of its principle. The council selects one of the Governors as Chairman.

The council holds an annual meeting and as many other meetings as the council considers necessary or called by the Board. The Board calls meetings of the council whenever requested to do so by five members or by members having 25% of the total voting power.

. The Council may delegate to the Board of Directors the exercise of any of its power, except to:

- ✓ admit new members and determine the conditions of their admission;
- ✓ suspend a member;
- ✓ decide on any increase or decrease in the capital;
- ✓ increase the limit of the aggregate amount of contingent liabilities;
- ✓ designate a member as a developing member country;
- ✓ classify a new member as belonging to Category One or Category Two for pursuant voting purposes;
- ✓ determine the compensation of Directors and their alternates;
- ✓ cease operations and liquidate the Agency;
- ✓ distribute Assets to members upon liquidation and;
- ✓ amend the conventions, its Annexes and Schedules.

The board is responsible for the general operations of the MIGA and has to take any action required or permitted by its convention to ensure their mission.

The agency should have, at least 12 directors. The number of directors may be adjusted by the Council to take changes in membership into account. The Council determines the term of office of the Directors and they generally meet at the call of its Chairman.

The president conducts the ordinary business of the Agency. He/she is responsible for the organization, appointment and dismissal of the staff. He/she is appointed by the Board on the nomination of its Chairman.

Each Director is entitled to cast the number of votes of the members whose votes counted towards his election.

The President, under the direction of the Board decides on the payment of claims to a holder of a guarantee in accordance with the contract of guarantee and such policies as the board may adopt.

## **THE POLICIES**

The Agency may guarantee eligible investments against a loss resulting from one or more of the following types of risk:

- ✓ Currency transfer: any introduction attributable to the restrictions of the host government on the transfer outside the host country of its currency into a freely

usable currency or another currency acceptable to the holder of the guarantee. This includes a failure of the host government to act within a reasonable period of time on an application by the holder for transfers;

- ✓ Expropriation and Similar Measures: any legislative or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of its ownership or control of, or a substantial benefit from, its investment, with the exception of non-discriminatory measures of general application, which governments normally take for the purpose of regulating economic activity in their territories;
- ✓ Breach of Contract: any repudiation or breach by the host government of a contract with the holder of a guarantee, when the holder does not have recourse to a judicial or arbitral forum to determine the claim of repudiation or breach or a decision by such forum is prescribed in the contracts of guarantee pursuant to the Agency's regulations or such a decision cannot be enforced;
- ✓ War and Civil Disturbance: any military or civil disturbance in any territory of the host country to which this convention shall be applicable.

Eligible investments shall include equity interests, including medium or long-term loans made or guaranteed by holders of equity in the concerned enterprise and such forms of direct investment as may be determined by the Board.

## **MONEY ALLOCATION**

New investment contributions associated with the expansion, modernization, or financial restructuring of existing projects are also eligible, as are acquisitions that involve privatization of state-owned enterprises. New investments are those that have neither been made nor irrevocably committed on the date of submission to the MIGA of a Preliminary Application for Guarantee signed by the investor.

The MIGA insures investments in a wide range of industries. Types of foreign investments that can be covered include equity, shareholder loans, and shareholder loan guaranties, provided the loans that have a minimum maturity of three years. Other forms of investment, such as technical assistance and management contracts, and franchising and licensing agreements, may also be eligible for MIGA guarantees.

The terms and conditions of each contract of guarantee are determined by the Agency subject to the rules and the regulations issued by the Board, regarding that the Agency can not cover the total loss of the guaranteed investment. Contracts of guarantee are then, approved by the president, under the direction of the board.

To serve its objective, the Agency shall:

- ✓ issue guarantees, including coinsurance and reinsurance, against non-commercial risks in respect of investments in a member country which flow from other member countries;
- ✓ carry out appropriate complementary activities to promote the flow of investments to and among developing member countries;
- ✓ exercise such other incidental powers as shall be necessary to desirable in the furtherance of its objective.

Unless determined by special majority of the council, the aggregate amount of contingent liabilities which may be assumed by the MIGA cannot exceed one hundred and fifty percent of the amount of the Agency's unimpaired subscribed capital and its reserves plus such portion of its reinsurance cover as the Board may determine. The board generally reviews, from time to time, the risk profile of the Agency's portfolio in the light of its experience with claims, degree of risk diversification, reinsurance cover and other relevant factors with a view to ascertaining whether changes in the maximum aggregate amount of contingent liabilities should be recommended to the council. The maximum amount determined by the council shall not under any circumstances exceed five times the amount of the Agency's unimpaired subscribed capital, its reserves and such portion of its reinsurance cover as may be deemed appropriate.

Contracts of guarantee shall require holders of guarantees to seek, before a payment is made by the Agency, such administrative remedies as may be appropriate under the circumstances, provided that they are readily available to them under the laws of the host country. Such contracts may require the lapse of certain reasonable periods between the occurrence of events giving rise to claims and payments of claims.



## PROJECT SELECTION

In keeping with MIGA's objective of promoting economic growth and development, investment projects must be financially and economically viable, environmentally sound, consistent with the labor standards and other development objectives of the host country.

The MIGA will undertake an environmental screening of each investment to determine the appropriate extent and type of environmental assessment required. The MIGA will classify the proposed investment into one of three categories depending on: the type, location, sensitivity, and scale of the project; and the nature and magnitude of its potential environmental impacts.

- ✓ Category A: A proposed investment will be classified as Category A if the project is likely to have significant adverse environmental impacts that are sensitive, diverse, or unprecedented. Environmental assessment for a Category A project examines the project's potential negative and positive environmental impacts, compares them with those of feasible alternatives and recommends any measures needed to prevent, minimize, mitigate, or compensate for adverse impacts and improve environmental performance.
- ✓ Category B: A proposed investment will be classified as Category B if the project's potential adverse environmental impacts on human populations or environmentally important areas are less adverse than those of Category A projects. The scope of environmental assessment for a Category B project may vary from project to project but it is narrower than that of a Category A project. It examines the project's potential negative and positive environmental impacts and recommends any measures needed to prevent, minimize, mitigate, or compensate for adverse impacts and improve environmental performance.
- ✓ Category C: A proposed investment will be classified as Category C if the project is likely to have minimal or no adverse environmental impacts. Beyond screening, no further environmental assessment action is required for a Category C project.

## **FINANCIAL POSITIONS**

Fifty three guarantee contracts were issued in the fiscal year 2000, totaling \$1,605 million in coverage. The new projects facilitated investments in 26 developing countries. After cancellations and replacements of \$916 million, gross exposure increased by 19% from \$3,7 billion to \$4,4 billion.

New coverage of more than \$257 million was provided for projects under the Cooperative Underwriting Program (CUP) up from \$115 million in fiscal 1999.

Gross premium income and fees increased by \$9,7 million to \$42,6 million. Net premium income amounted to \$29,5 million.

Coverage of infrastructure projects grew at the fastest rate in the portfolio, rising from 19% at the fiscal 1999 to 29% at the end of fiscal 2000.

# **INTER-AMERICAN DEVELOPMENT BANK - IDB**

## **THE BANK**

In 1959, the first of the regional development banks, the Inter-American Development Bank (IDB), was established as a response to the desire of countries in the Western Hemisphere for an international financial institution that would be more regionally sensitive and would improve United States' relations with the region. The goal was to counter the perceived marginalization of the region by the Bretton Woods institutions in which voting power was heavily weighted in favor of the industrial countries.

In the very beginning, only members of the Organization of American States (OAS) were eligible for membership. However, since 1970, the IDB started to accept new nonborrowing countries, and that has changed the percentage of voting power. Today, there are 46 shareholder countries, 26 which are borrowing countries. After several changes, the IDB Articles of Agreement stipulate that the voting power of the Borrowing Member Countries (BMCs) cannot fall below 50.005% of the total.

The board of directors is the Bank's highest authority on which member countries are represented. Governors are usually Ministers of Finance, Presidents of Central Banks or officers of comparable rank. The Board of Governors has delegated many of its operational powers to the Board of Executive Directors, which is responsible for the conduct of the Bank's operation. The chairman of the Board is the President of the Bank, but the Bank is not a shareholder of the corporation.

The Bank has an authorized capital of US\$101.5 billion at which US\$100.9 is already subscribed. The Bank's debt is AAA rated by the three major rating services in the United States, and is accorded equivalent status in the other major capital markets, mainly, Europe and Japan.

## **THE OBJECTIVES**

The IDB was entrusted with two basic tasks: financing investment projects and providing technical assistance. It can also be said that the purpose of the Bank shall

be to contribute to the acceleration of the process of economic development of the member countries, individually and collectively.

The blue print for the Bank recommended that it should fund not only productive projects in the traditional sense but also social projects. It proposed to enable the regional bank to finance local projects. It was also envisioned that the Bank should support the process of planning and project preparation by providing technical assistance to define priorities, prepare adequate projects, and inform borrowers about the various steps, conditions and commitments required. Because of its regional origin and operational focus, the Bank can inspire and guide rather than impose policy reforms.

## **THE STRUCTURE AND THE INSTRUMENTS**

The IDB is unique among all multilateral banks in having a built in concessional window, The Fund for Special Operations (FSO). The creation of FSO, predominantly for the region's poorest borrowing members, was simultaneous with the creation of IDB and is an integral part of its juridical structure (the other development banks had their concessional facilities created after the banks themselves, and operate as legally separate entities).

The FSO depends exclusively on government contributions except for some income derived from liquid investments and interest payments. Accordingly to Article IV of IDB agreements, "it can make loans on terms and conditions appropriate for dealing with special circumstances arising in specific countries or with specific projects".

The terms of contributions to the soft window have varied. Initially, all contributions to FSO resources, including those from Latin American countries, were made in national currencies; in turn, those currencies were used mainly in conjunction with FSO loans to the countries that contributed them. The terms for borrowing under the FSO had initially stipulated servicing in local currencies. Two important policy changes were introduced in the early 1970's in connection with concessional lending; priority was given to low income countries, and repayment in local currencies ended. Lower interest rates and longer grace and amortization

periods were established bringing FSO terms closer to those offered by WORLD BANK IDA.

IDB uses in its operations funds raised in the world's capital markets and the money collected from the country members. The resources collected are invested directly by the Bank in projects that support the cost of those funds and the additional spread embedded.

IDB also has a small window, the Intermediate Finance Facility (IFF), that lends at intermediate terms to the hard and soft window by using the Bank's net income to subsidize the cost of borrowing countries' regular loans. It was created in 1983 with an initial appropriation of \$61 million in convertible currencies from the general reserve of the fund, for a period of twenty years. It has been made available only to Group C and D countries to subsidize a maximum of five percentage points on ordinary capital loans.

IDB used to have quite small and limited programs to provide loans or equity to private projects without a government guarantee or to make guarantees for funding for private sector projects. In 1984, the IDB created a small affiliate, the Inter-American Investment Corporation (IIC), which makes loans without government repayment guarantees to stimulate growth of private sector firms. It complements the Bank's priority for small and medium-sized companies.

The IIC's initial subscribed capital stock was \$200 million, and it began with a \$210 million loan from the Bank. The corporation raises funds from the markets though its borrowing capacity has been limited by the tight debt-to-equity guidelines set out in its charter. IIC operations take the form of loans, equity investment or guarantees. It can invest in new companies or the expansion, modernization restructuring, or privatization of existing ones. However it has a limit of \$10 million per operation. The IIC has mobilized funds directly and indirectly. For every dollar invested by the IIC, \$4 was provided by other sources.

The IDB Private Sector Department began operations on January 01, 1995. Its objective is to promote private investment in basic infrastructure and public utility services (Greenfield projects, rehabilitation and expansion programs). It has limited resources; project finance operations or on corporate finance basis. The target of this sector is to provide up to 5% of IDB's total loans. It has a catalytic role that they

can mobilize over \$5 in investments from other sources to each \$1,00 of IDB funds, what supported US\$3 billion of investments in 1999.

The IDB in its private-sector operations, including the guarantee program has two limitations:

- 1) no more than 5% of the IDB's estimated annual lending program may be allocated to finance projects in the private sector without government guarantees, and,
- 2) the IDB's share of any individual project may not exceed 25% of total cost or the equivalent of \$75 million, whichever is less.

The IDB Private Sector Department has as instruments the A loans, the B loans and the Financial Instruments Guarantee. The A loans are those contracted using the Bank's own funds. It has a limit of US\$75 million or 25% of the total project cost, except in smaller economies, where 40% is often accepted. Typically it has 10 to 15 years maturity but the real limit is up to 20 years. In terms of costs the borrowers are charged in market terms. The B loans are the ones that are cofinanced by banks and institutional investors. Those agents assume integral risk on their parcel of the loan. In that trade, IDB is the lead lender and the lender of record. Another member in that syndication is the Arranger Placement Agent that acts on IDB's behalf. We also have the Financial Instruments of Guarantee. When those operations are contracted, IDB provides credit and political risk guarantees on part of the total amount raised in the market. The guarantee is valid only in the borrowers domestic capital market and has a limit of up to 25% of its total cost, limited to US\$75 million.

Another small affiliate, the Enterprise for the Americas Multilateral Investment Fund (MIF) provides grant financing for activities designed to expand marginal groups' participation in the economy and finance micro-enterprises in Latin America. The MIF was created in 1992 to promote investment reforms and stimulate private sector development.

The IDB has also administered funds provided under special conditions. The first trust fund, the Social Progress Trust Fund (SPTF) was created by the US in 1961 in the context of the alliance for Progress.

## **MONEY ALLOCATION**

In carrying out its mission, the Bank has mobilized financing for projects that represent a total investment of \$240 billion on annual basis.

In the past, the Bank lendings emphasized the productive sectors of agriculture and industry, the physical infrastructure sectors of energy and transportation, the social sectors of energy and transportation, the social sectors of environmental and public health, education and urban development. Current lending priorities include poverty reduction, social equity, modernization, integration, and environment.

In order to guide access to resources from the Bank, BMC were grouped into four categories known as A, B, C and D, according their level of development. However some adjustments and political compromises were made in order to accommodate particular exigencies.

Group A, which comprises Argentina, Brazil, Mexico and Venezuela held 36.84% of voting power until 1993 and absorbed 55% of total lending in the period of 1961 – 1993.

Group B, which comprises Chile, Colombia, and Peru, holds 7.92% of the voting power. This group has received 19% of the Bank's total lending.

Group C consists of Bahamas, Barbados, Costa Rica, Jamaica, Trinidad and Tobago and Uruguai. They have 3.18% of the voting power and have received 8% of total lending.

Group D countries are the poorest, least developed BMC – Belize, Bolivia, The Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Nicaragua, Panama, Paraguay and Surinam. They have 5.82% of the voting power and have received nearly a quarter of all resources.

The Bank plays different roles in different countries. Its impact as a development institution has been more significant in the small BMC. The bigger countries in the region have stronger institutional capabilities and a broader skills base and they have historically had easier access to alternative sources of funds for their public sector investment programs. The impact of IDB funding is not only quantitative but also qualitative.

The strategic bias toward the less developed BMC has been implemented via concessional loans and greater shares of nonreimbursable technical assistance. Policies also allow preferential treatment in the relative share of funds granted by the bank for the total cost of a project.

## **THE POLICIES**

The Bank has always worked with allocation guidelines for each country grouping. Nine indicators were used as yardsticks of development: GNP, GNP per capita, population, annual rate of population growth, share of investment in GNP, rate of growth of per capita GNP, life expectancy at birth, infant mortality rates and literacy rates.

At the Seventh Replenishment, the Bank limited loans to Group A countries and Group B countries to 65% over the 1990-1993 period, in order to ensure sufficient financing for the less developed countries. This agreement was maintained for the Eighth Replenishment and it is still valid. In addition, all FSO resources are to be allocated over the period to the five poorest Group D countries.

Since its inception, the IDB has functioned largely as an agency for financing public sector projects. However, its Articles of Agreement allows the Bank to make loans to private firms without government guarantees. To date, this has not been a major outlet for IDB activity. Private sector projects used to carry out guarantees from the government. That's one of the policies that has been changing over time.

The bank is addressing the implications of increased lending to the private sector on its portfolio quality. This includes a revision of the mandate of its affiliate, the Inter-American Investment Corporation (IIC).

Privatization and deregulation of member countries economies are encouraged by IDB. It searches for the Public Sector's reduction and its consequent financial equilibrium. In the process, the Bank provide for the Long term financing while reforms continue. As a result of the process it is expected that the Country rating will improve.



## **PROJECT SELECTION**

IDB uses the criteria below to select the projects to be financed:

- ✓ adequate regulatory environment;
- ✓ investment's positive development impact in terms of:
  - improving the standards of service;
  - obtaining efficiency gains;
  - increasing coverage;
  - getting an environmental impact.
- ✓ catalytic role:
  - mobilize private investment and credit.
- ✓ strong project fundamentals.

In the last part of the analyses it becomes more focused on the technical aspects as follows:

- ✓ Analysis of Project Fundamentals:
  - well defined investment objectives;
- ✓ reputable project sponsors; knowledge & experience;
  - adequacy capitalized project company;
  - sound feasibility studies;
  - proven technology and equipment;
  - reliable contractors and operators;
  - sound documentation.

## **FUND RAISING AND GUARANTEE**

It was already mentioned that the Bank's debt is AAA rated by the three major rating services in the United States, and is accorded equivalent status in the other major capital markets. That condition is warranted by its preferred creditor status. That status, in practical terms means:

- ✓ preferred access to foreign exchange in the event of country foreign exchange shortage;

- ✓ IDB loans have never been included in a general country debt rescheduling as part of the London Club;
- ✓ IDB has never been subjected to mandatory new money obligations under a general debt rescheduling;
- ✓ there have been no write-offs of any IDB loans during its entire 40 year operating history;
- ✓ Bank regulators provide exemption from automatic country risk provisioning, when applicable.

The IDB's preferred creditor status is granted:

- ✓ De jure: exemption from withholding taxes;
- ✓ De facto: preferred creditor status;
- ✓ by member governments of IDB & recognized by other creditors;
- ✓ embodied in practice;
- ✓ consistent recognition.

We can also affirm that it is based on IDB's role as a multilateral development agency and some particular reasons such as:

- ✓ IDB works with the BMC private sector in the most difficult conditions;
- ✓ continues lending in good times and bad ones;
- ✓ acts as a catalyst to bring in private investors and restore confidence in an economy.
- ✓ enlightened self interest of governments & other creditors.

## **RECENT REPORTS**

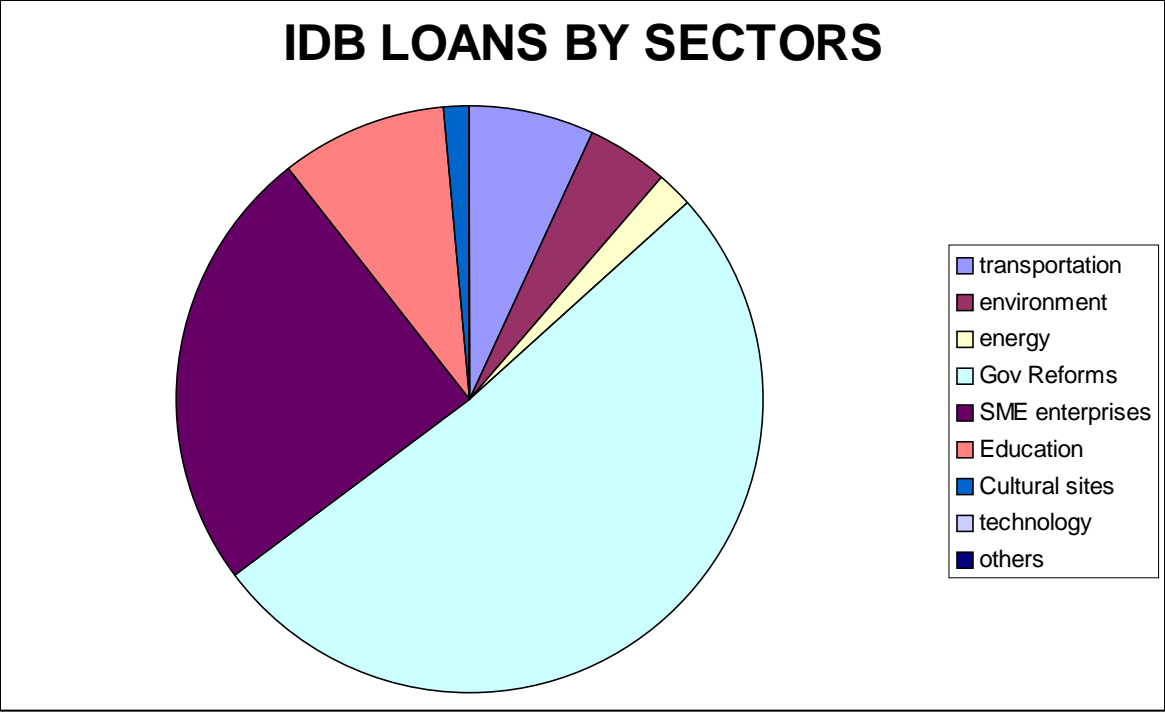
In 1999, IDB approved 13 loans to Brazil. One Loan Guarantee, two Technical Cooperation Operations and five MIF financing. On a cumulative basis, the Bank has made 273 loans and Guarantees a total of \$21,931 million and disbursements have totaled \$14,589 million. The 1999 loans are listed below:

- ✓ Social Sector Reform and Social Protection Program (\$2,2 billion);
- ✓ Global Credit Program for Small and Medium Sized Enterprises (\$1,2 billion);

- ✓ Support for Administrative and fiscal Management of Municipalities (\$300 million);
- ✓ Secondary Education Improvement and Expansion “Escola Jovem” (\$250 million);
- ✓ Tietê River Cleanup Project, Stage II (\$200 million);
- ✓ Professionalization of Nursing Personnel (\$185 million);
- ✓ Bahia Highway Corridor Integration Program (\$146 million);
- ✓ Guarantee Facility Proposal (\$100 million);
- ✓ Ecovias dos Imigrantes Toll Road Project (\$75 million);
- ✓ Preservation of Urban Historical and cultural sites (\$62,5 million);
- ✓ Anhanguera – Bandeirantes Toll Road (\$95,9 million);
- ✓ Ecotourism Development in the Amazon Region (\$11 million);
- ✓ Capacitação Solidária: Training of At-Risk Youth (\$10 million);
- ✓ Linha Amarela Toll Road – Section IV (\$20 million);
- ✓ Development of Renewable Energy Markets (\$0,9 million grant);
- ✓ Equity Investment Fund for Technology Based Industries (\$3 million);
- ✓ Business Models for Private Provision of Renewable Energy (\$2,2 million grant);
- ✓ Alternative Dispute Resolution Methods (\$1,6 million grant);
- ✓ Labor dispute Negotiation and Mediation (0,8 million grant);
- ✓ Consumer Protection in the Public Utility Sector (0,8 million grant).

It can be noticed that there were no projects financed that deals with the Sanitation Project.

The chart below describes the distribution of funds by sectors.



## **Chapter III Privatization in the Sanitation Sector**

### **THE PRIVATIZATION PROCESS**

Infrastructure services were generally believed to be public goods with governments being responsible for providing them. But insufficient investments, growing pressures on government budgets, and a general concern about inefficient service provision resulted in a complete turnaround of this situation in many developing countries. After World War II, in an attempt to modernize and industrialize, several governments took the lead role in the economy. They intervened by creating State-Owned Enterprises (SOEs) in leading sectors. That process was financed by borrowing heavily from abroad. This debt, which financed inefficient SOEs and budget deficits was not productively invested and did not create the means to repay debt.

Economic infrastructure, such as telecommunications, power, transportation, and municipal services, are necessary for economic growth, but too often governments are unable to supply its needed levels. The State-Owned-Enterprises that generally manage those processes have a tendency to be inefficient and unproductive. The fact they are under constant political pressure affect the way the companies are managed. Political pressure often results in setting prices of goods and services below their true costs, especially in the utility sectors, such as gas, electricity and water. As a result, required maintenance and new investment suffers, service to customers deteriorates, and economic growth is impaired.

As a result of the lack of funds to invest in the sector, the bad quality of services and the need to restructure the size of the government, a big process of privatization has spread over the developing countries.

Privatization enables the state to shift its portfolio of economic intervention from areas of the economy which the private sector can perform better, freeing resources for those areas that are the basic responsibilities of governments.

Over the last decade, the private sector has become a key player in providing financing as well as operational expertise in the various infrastructure areas. The driving force behind its development has been foreign direct investment (FDI).

During 1990-1998, developing countries received an estimated US\$138,5 billion in FDI inflows directly through private infrastructure investments. It represents over 17 percent of total FDI concentrated in a select number of countries. Brazil, as the largest recipient of infrastructure FDI flows worldwide, recorded 33% of its total FDI inflows in infrastructure projects.

Countries that have managed to attract substantial amounts of FDI into their infrastructure sectors have done so by instituting basic reform measures. In order to create incentives to private participation into the infrastructure sector, some measures are necessary, such as:

- ✓ identifying potential private investment projects;
- ✓ preparing and evaluating detailed technical, legal, and financial feasibility studies;
- ✓ developing tender documentation and the bidding process;
- ✓ evaluating bids received;
- ✓ negotiating with preferred bidders.

However, every country experiences resistance from special interest groups and existing state owned enterprises to introduce competition by opening markets to private service providers. This slows down or even stops privatization efforts. At the same time, market entrants through Greenfield investments tend to encounter endless obstacles - political, administrative and legal – that delay project implementation and often lead to the cancellation of planned instruments. There are lots of stories related to investors experiencing lengthy delays or project cancellations because of political, administrative, and legal impediments. Investors were generally blocked by

- ✓ existing state-owned service providers;
- ✓ conflicting government authorities;
- ✓ government bias in favor of official funding or local investor participation;
- ✓ political and social protests against individual projects;
- ✓ unclear award procedures;
- ✓ corruption;
- ✓ governments renegeing on contracts signed by previous administrations;

- ✓ existing legislation impeding effective private sector participation;
- ✓ a lack of overall sector liberalization.

Despite the afore mentioned problems, the private participation in the sector, investing and managing the infrastructure services is irreversible. With limited resources and growing demands from the population, governments have no condition for sponsoring inefficiency. In the other hand, privatization plays an important role in economic reform. This process can attract direct and portfolio foreign investment, which opens the international capital markets to local companies and fosters the globalization of capital markets. Access to the international capital markets adds additional competition and efficiency to the country's financial system. Furthermore, countries with functioning stock markets, even if rudimentary, can undertake privatizations by share sale of SOEs, encouraging private companies to consider selling shares to outside investors to raise equity finance.

The most important types of privatization include public share sales, mass privatization and BOT (Build-Operate-Transfer) privatization for economic infrastructure.

There are described below the most known forms of privatization:

- ✓ Liquidation: it is simply to liquidate the SOE. This may be warranted in cases where no combination of new investment, ownership and operational succeeds in giving the enterprise a positive net present value in terms of future cash flows;
- ✓ Contracting out: a number of services, including management, can be contracted out to the private sector, usually through a competitive bidding process followed by negotiations. It usually leads to an improvement in day-to-day operations. The contracting out does not transfer ownership to the private sector, which is critical for sustained improvement in enterprise performance;
- ✓ Leasing: it enables a private sector group to control a company or assets or both for a period of time, for financial gains. Leasing is a more powerful tool than contracting out since the returns to the lessee are more directly determined by the lessee's success in managing the leased assets;
- ✓ Deregulation and Demonopolization: the government removes regulation which had previously prevented the private sector from competing with a

state-owned monopoly, or changes old regulations or creates new ones to foster greater competition from the private sector;

- ✓ Management Employee-Buyouts: occasionally, management or employees or both may be ideal buyers for an SOE, especially for smaller enterprises;
- ✓ Trade Sales: it involves the sales of controlling interests in enterprise to the private sector, usually through competitive tendering techniques, an evaluation of proposals, and negotiation between the government and the potential private sector buyer. There are three basic types of trade sales. The first two are used for medium and large scale enterprises. In a “commercial tender”, the decision to award is based on the offer price alone. In an “investment tender”, price and other factors, such as new investment and job retention, are taken into consideration. The third method, the open-outcry auction, is frequently used for small enterprises. A disadvantage of trade sales is that they may effectively limit participation in privatization to wealthy local investors or foreign investors;
- ✓ Public Share sales: brings greater transparency and openness to the public. Properly structured, marketed, and priced, “broad-based” public share sales can help to popularize the privatization program, spread the benefits of economic reform and ownership and develop capital market;
- ✓ Mass privatization: enables countries to privatize thousands of enterprises, utilizing standard techniques, transparent procedures, and vouchers distributed to citizens;
- ✓ Build-Operate-Transfer (BOT): it is a method of privatization well-suited for addressing infrastructure needs. It involves economic infrastructure, such as power, roads, municipal services, and any other projects that would be desirable to construct, but cannot be built owing to budgetary limitations. Using BOT and related techniques, the government tenders these projects to the private sector, which assumes responsibility for the financing, construction, and operation of the infrastructure project.

Theoretically, the Privatization process is very beneficial to the society. It brings several opportunities and advantages that the public sector can not handle. There are also possibilities for misuse of the process. However, the society itself has



to create all means to control and to avoid those excesses. Some of the benefits the privatization process can afford are cited as follows:

- ✓ Greater efficiency and productivity of enterprises. Privatized companies can focus on being competitive to produce, at low cost and acceptable quality, the goods and services that consumers want. This would lead to a more efficient use of resources and improve economic output overall;
- ✓ Generation of Revenue to Reduce Deficits and Debt. Privatization generates revenue from the sale of SOEs shares, what eliminates the need to provide subsidies, and increases tax revenues from restructured and more productive enterprises;
- ✓ Capital Market Development. Privatization has a macroeconomic impact on the development of capital markets. Public sale of shares, mass privatization and BOO/BOT privatization lead to the creation of tradable securities. Public share sales and mass privatization help create broad and diversified share ownership, new companies listed on the stock exchange, and new investment funds. Privatizations by share sale can help to transfer the financial technology of initial public offerings (IPOs) to the fledgling local securities industry, and have a demonstration effect by encouraging private sector companies to undertake their own IPOs and secondary offers to raise equity financing;
- ✓ Attracting Foreign Investment: Many countries that on privatizing would like to such investor can bring capital, new technology, new export market access, and professional management to the enterprise. Privatization also encourages foreign portfolio investment, that are looking for high returns in emerging markets.

To ensure the benefits for the society in the privatization process some conditions have to be provided. First of all, a good basis for establishing private infrastructure service is a fundamental key. Governments also need to design a regulatory framework that can determine the future operating environment of any service provider in a market-private as well as public – based on technical criteria, independent of political interference. Many diverse groups with varying levels of influence on government policymaking have a stake in the political process that shapes the environment for private infrastructure operations. Even the consumers

benefiting from subsidized services may resent price increases associated with privatization. This requires that regulatory agencies be politically independent and equipped with the necessary technical expertise to consistently balance the interests of governments, investors, and consumers in a neutral manner.

When defining the rules and preparing the basic structure of the privatization, governments have to establish some basic conditions in order to guarantee the success of the process, such as:

- ✓ Operating profitability. The main sponsors of private sector infrastructure projects are typically large foreign companies with strong experience in the operation of such projects. Their primary goal is to establish an infrastructure operation that will allow them to profit by providing services in a reasonably predictable environment. Under such conditions they are quite willing to invest;
- ✓ Funding reliable partners. Infrastructure projects tend to be too big to be financed by one investing firm only. The main sponsor will have to identify partners who can furnish additional technical expertise and support for financing, construction and maintenance. Project completion and future operation are critically dependent on the reliability of all partners involved;
- ✓ Diversifying risk. Infrastructure projects present unusual risks. Commercial risks include the timely construction and technical performance of the facilities as well as the quantity and quality of the service provided. Political risks may result from decisions taken by public authorities that shape the business environment. Sponsors are keen on distributing those risks to the parties best equipped to deal with them;
- ✓ Reducing uncertainty. The profitability of a project is critically dependent upon the future environment for the private enterprise. Investors are looking for a clear and sensible regulatory and contractual framework, with specific rules on adjusting tariff rates;
- ✓ Existence of a stable legal framework. Private infrastructure projects are contract-intensive, and the long time horizon of these projects increases the danger of contractual disputes. Sponsors want to be reasonably confident that any such dispute can be solved fairly, whether through the domestic juridical system or by means of arbitration;

- ✓ Avoiding contingent liabilities. Investors may be concerned about contingent environmental, employment and other forms of liabilities.

## **THE BRITISH EXAMPLE**

In February 1985, the Minister for Housing and Construction announced in the House of Commons that the Government intended to examine the possibility of a “measure of privatization” in the water industry. Despite the efforts of the authorities to implement the process, it just started to show results after a new legislation was introduced to Parliament in 1988. The government made clear its policy and its intentions. However, the methods of regulation remained unclear. That regulation was a key element to be defined in terms of its mission to establish the environmental rules and the competitive terms of exploiting the business.

Initially, the proposals concerning water privatization were related only in England and Wales. This restriction, and the subsequent delay in the implementation of the policy, is partly explained by the evolution of the organizational framework of the industry in the postwar period.

Prior to 1973, the water industry in England and Wales was dominated by three categories of organization: water undertakings, sewage and sewage disposal authorities, and river authorities. By the early 1970's, the number of water undertakings had fallen from over one thousand to one hundred ninety eight of which sixty four were run by individual local government authorities and one hundred one by joint boards comprising more than one local government authority, and thirty three statutory privately owned water companies.

The sewage and sewage disposal authorities were responsible for the treatment and disposal of water-borne wastes and totaled over 1300 organizations.

The river authorities, that amounted 29 in 1971, were responsible, among other things, for water conservation, land drainage, fisheries, control of river pollution, and in some cases, navigation.

In addition to these principal types of institution, a number of other organizations were active in the industry prior to 1973. These included the Water Resources Board (a national agency entrusted with data collection, research, and planning for the industry as a whole), the

British Waterways Board(responsible for canals and some river navigation), navigation authorities, and national drainage boards.

The guiding principle of the Water Act of 1973 tried to reformulate that messy structure, establishing nine regional water authorities in England and the Welsh Water Authority, the single body to planning and controlling all uses of water in each river catchment, a principle generally known as “integrated river-basin management.” Each water supply authority was entrusted with responsibilities for water supply, sewage, sewage disposal, water resource planning, pollution control, fisheries, flood protection, water recreation, and environmental conservation in its own area. In fact, the legislation created organizations based on river catchment areas, rather than on artificial administrative boundaries that required separate bodies to be responsible for different parts of the same river system.

The statutory (privately owned) water companies escaped reorganization in 1973, and were left to operate as before. There existed 28 companies that collectively supplied water to about 25 percent of the households in England and Wales. They were not involved in activities such as sewage and sewage disposal.

The structure of the water industry in Scotland was different from that in England and Wales. Twelve Regional and Island Councils were responsible for water alongside other local services, and an organizational structure based upon administrative boundaries was preferred to one based upon the integrated river-basin management principle. The important point to note is that the physical assets of the water industry in Scotland were not currently owned by public bodies that belonged to the central government. Hence, any legislation to privatize the industry in Scotland would require the disposal of local government assets.

The implementation of the principle of integrated river-basin management, established in 1973, led the authorities to carry out a very wide range of functions. These can be grouped into three general categories: operational activities (the supply of water, and the treatment and disposal of liquid wastes), environmental regulation (the planning and regulation of water resources and uses, control of the quality of river and drinking water, control of waste disposal, fisheries, and navigation), and community services (whose beneficiaries are not identified for charging purposes, and which include land drainage and flood protection, highway drainage, wildlife conservation, amenity, and recreation).

The changed emphasis of public policy since the late1970s has had substantial effects on the performance of the water authorities. The 1978 White Paper set out a system of

control over the nationalized industries, expanding the ten authorities' duties. In addition, a number of the authorities have been subject to efficiency audits by the monopolies and mergers Commission (MMC). In Scotland, the Central Government's influence on the industry is less direct, operating through more general financial controls on local authorities that include cash limits on capital expenditure and, in certain cases, rate-capping.

In 1983, there were changes in the general drift of public policy and a consequent reorganization of the boards of the authorities. The reforms targeted reducing the financial contribution of the water industry to the public sector. The changed emphasis of public policy since the late 1970s has had substantial effects on the performance of the water authorities.

Despite the gradual tightening of financial constraints on the water authorities, it seems to have been treated generously in comparison with many other nationalized industries.

The 1986 White Paper on the privatization of the industry did not provide any detailed information about how the Government intended to tackle these fundamental financial issues. Indeed, for the most part, the document was concerned only with setting out the government's plans in the most general of terms, leaving detailed decisions to be made at a later stage. The outline program was as follows:

- ✓ restructure the ten water authorities in England and Wales as "water supply public limited companies" (WSPLCs);
- ✓ establish a system of regulating the WSPLCs;
- ✓ modernize water and sewage law;
- ✓ permit domestic water metering trials on a compulsory basis;
- ✓ improve the legislative framework for the control of drinking water and river water quality.

The ten water authorities were then to be transferred to the private sector in their existing forms. Thus, it was planned that the various regulatory functions relating to environmental matters would be retained by the WSPLCs. However, the exercise of these functions by private bodies was to be underpinned by a clearer strategic framework of national policy for the water environment and by a system of finance whereby the costs of the providing environmental services could be recovered by a mixture of direct charges and general charges.

With respect to regulation, the 1986 proposals envisaged a framework of control that would broadly be in line with the regimes established for the telecommunications and gas industries. Thus, the main water services were to be regulated by a Director General of Water

Services (DGWS) through long-term licenses granted to the WSPLCs. The White Paper expressed a preference for price controls over limitations on profits or dividends. It explicitly recognized the need for regulation of water quality standards and reaffirmed the principle that cross-subsidization among services should be avoided.

The 1986 White paper, in fact, was not precise and in several points could be considered ambiguous. In the short run, it started to have problems in terms of the role of the authorities and the vast number of different legislation.

Those problems led to the presentation of other paving Bills in 1987-1988. In the new proposal, the Water authorities would be stripped of most of their functions relating to regulation of the environment, and those tasks would be guided to the national Rivers Authority. The real impact of this new legislation was restricting the functions of the WSPLCs to the main operational activities of water supply and distribution, sewage and sewage disposal.

Under the 1986 legislation, one central problem would have been the determination of the charges that the companies would have had to pay to the authorities for water abstractions. With the water authority in private hands, there would have been a danger of monopoly pricing for the companies' basic input, which could have left the latter at a substantial disadvantage. One other important problem existed. Given the Government's preference for price rather than dividend controls, the existence of the statutory water companies implied that any future DGWS would be faced with the prospect of regulating not ten but 38 different sets of tariff structures for final customers, with wide variations in cost conditions amongst the various companies. The control of such a large number of tariffs by one office may cause serious administrative problems that could potentially detract from the quality of decisions.

In the water supply sector, the question of the tariff structure was complicated by the fact that a large proportion of the revenues came from unmetered services. The pricing system for unmetered supplies could be regarded as a special case of a two-part tariff comprising a fixed "connection" charge and a variable unit charge, in which the fixed component was set at zero. For most domestic consumers, therefore, the only dimension of choice that was affected by charges was whether or not to receive water and sewage services: once connected to the system, additional services were charged free. Since water and sewage services are basic necessities, this means that, to a first approximation, domestic

demand was independent of the charges that were levied, and that the water authorities therefore effectively faced a completely inelastic demand for much of their output.

It was possible to argue that the market power that would accrue to privatized water authorities under a system in which they could, in effect, levy on taxes on domestic consumers was one of the reasons why the introduction of metering for domestic water supplies might have been beneficial.

The more fundamental potential advantage of domestic water metering was the contribution it might have made to improvement in allocative efficiency. There was an obvious tendency towards overconsumption of goods and services that were provided free of charge at the margin, although the avoidance of metering costs had to be set against this detriment of the existing system when determining the overall balance of advantage between the two alternative methods of charging. Again, much depended upon the price sensitivity of demand: the greater the reduction in consumption induced by a given increase in per unit charges the greater will be the cost savings to the supplying firms. In regard of that question, in 1984 the Department of the Environment had commissioned a steering group, chaired by Mr. R Watts, Chairman of Thames Water, to “report to the government on the possible extension of water metering generally to households. In its report (Watts Report, 1985) he concluded that the net benefit of introducing metering for the average domestic consumer was likely to be close to zero but that, because of underlying uncertainties about the price sensitivity of demand and the cost savings that could be achieved from reduced volumes, further research based on metering trials was warranted.

Regarding the methods used to elaborate the report, the difference in the decision criteria between the public and private owned enterprises appeared. Profit-seeking privately owned WSPLCs would ignore consumers’ surplus losses when evaluating investments in metering equipment, since such losses would be irrelevant to the incremental profit calculations. Hence, it had to be emphasized that the water industry has a low level of profitability, what makes more difficult a process of privatization.

Although water authority charges had, in real terms, been steadily increasing in the pre-privatization period, it was unlikely that the Government would be politically attracted by price hikes of the magnitudes suggested by the calculations proposed in the report. In the discussion of the service rates, there came the necessity to determine a viable formula to the future basic rate and also the evaluation of the existing assets considering the post privatization investment needs.

The Government had set forth its proposals for privatization of the water industry only in relatively general terms. Nevertheless, the central strands of policy were clear; the ten water authorities, most probably stripped of many of their environmental functions, would be turned into ten water supply public limited companies that would then be offered for sale on the stock market. Privately owned statutory water companies were likely to be given the option of converting to public limited companies. The industry would be regulated by a new Directory of General Water Services through licenses granted to the WSPLCs. Regulation to protect consumers from abuse of market power would take the form of price controls rather than profit or dividend controls.

Except the unacceptably cost of a spatially fragmented industrial structure, there was little prospect of substantially increasing competition in the core transportation services of water distribution and sewage. However, the non-environmental activities of the water authorities extended beyond the areas of natural monopoly and, with respect to these other operations, the proposed flotations were likely to be less conducive to the development of competition than were alternative policies based on the organizational isolation of natural monopoly activities.

On the assumption that the water authorities were to be privatized without restructuring of their principal operational activities, there were two aspects of the Government's proposals for the regulatory structure. The first in 1987, reversing earlier plans, to create a new environmental regulatory body to which many of the subsidiary functions of the water authorities would be transferred. The original proposal to retain the integrated river-basin management principle by allowing privately owned firms to act as environmental regulators would have created severe long-term problems. While it was not impossible to envision the subcontracting of some regulatory functions to profit-seeking firms, the scope and variety of the environmental activities of the water authorities would, within the timescales usually associated with legislative preparations for privatization, have almost certainly led to a regulatory dilemma. For example, one effect would probably have been substantial duplication of effort, together with undue finalizing decisions, as disgruntled third parties appealed to the government against the judgments of the WSPLCs.

The Government's intentions regarding other aspects of the regulatory framework for a privatized water industry was, at that point, not so clear. Therefore, the most fundamental problem to be solved was how to ensure an adequate supply of financing from private investors for investment purposes. Existing rates of return in the industry were low, and,



unless the yield on new investment would increase, there was a danger that service quality would be damaged in the long term. This can also increase the service's prices.

The British privatization program is really considered as an economic and political success. It has led to a massive expansion in the number of shareholders, billions of pounds have been raised for the Exchequer, and state involvement in industrial decision making has been drastically reduced. However, in the British privatization program, important obstacles to competition have been left in place, and everywhere legal barriers to entry have been removed. Mechanisms to guard against anticompetitive behavior are often weak.

## THE PRIVATIZATION OF THE SANITATION COMPANIES IN BRAZIL

The Federal Government, aiming for the provision of water supply and sewage collection services in an international quality basis, established the Brazilian National Policy for Sanitation. This process is intended to last up to 15 years. The program should lead the population to have satisfactory services and adequate tariffs.

On the other hand, the Brazilian system has several structural problems that generate large deficits such as:

- ✓ In the urban area, 51% of the houses do not have adequate collection, 90% do not have sewage disposal collection, and 8.8% do not have water supply;
- ✓ In the rural area, 80.5% do not have water supply and 85.1% do not have sewage collection;
- ✓ The low income families are in charge of 49% of the water supply deficit and 37% of the sewage collection.
- ✓ The north and northeast states have the majority of the sanitation deficits (30.7% and 14.5% of the houses respectively do not have access to drinking water);

The scenario presented above brings us the necessity to establish an agenda with immediate actions to be developed under the Federal Government's coordination. That agenda must contain:

- ✓ The establishment of a legal framework that regulates the provision of the services. There are some unsolved questions regarding the ownership of the services' exploitation capacity. Along those lines, the state governments and the municipalities must set up the limits of each part in that process, establishing the way the system is going to work, the rules to be followed by each of the agents, and any other duty related to the subject;
- ✓ The regulatory agent that had just been created, the National Agency for Water (ANA), will have to have enough capacity to determine and to audit the limits of the players in the sector;

- ✓ in conjunction with the creation and the implementation of the Agency, a Federal Law should be created to establish the guidelines to the services' regulation;
- ✓ the state governments and municipalities will have to create specific laws in their areas of action to regulate the sector in accordance with the Federal Government Policies and Legislation;
- ✓ alternatives to the continuity of investments in the sector must be defined. The companies should have access to the financial market, specifically the project finance and private equity ones. The money raised in those operations should be directed to investments in the companies, improving their productivity and efficiency, thus adding wealth to their prices;
- ✓ Federal Government would just directly intervene by establishing incentives for the poorest parts of the country. The government would subsidize, when necessary, but would also implement forms of controlling the effective use of the funds and the results achieved with that action;
- ✓ The functioning model of the system should be remodeled, creating opportunities for the private sector to invest in the specific projects and to manage the provision of the services;
- ✓ The federal government could also provide incentives to the state governments and municipalities to sell their control over the sanitation companies.

The Brazilian model of water supply and sewage is based on state owned enterprises. This model is being discussed in order that imposes several restrictions such as new credit for investments and a slow and limited capacity to respond to the inefficiencies of the system and the needs of the population.

Those outlines will demonstrate the need for the sanitation system's privatization. Privatization is a matter that is, generally, related to investments. It entails change in the status of a large and powerful company, and it is also implicit that it is a way of improving industrial efficiency. In implementing that process guidelines would be established regarding the privatization system. Privatization will have to provide incentives to induce higher competition for the existing companies or for the new areas to be offered and then, developed.

The sanitation system is a natural monopoly, thus the authorities will have to establish an efficient regulatory environment. The privatization should be accompanied by adequate measures to reduce and contain market power. Where the monopoly still remains, the government's task is to implement regulatory mechanisms that encourage appropriate efficiency and discourage strategic behavior by the firm towards the regulatory authority. Unless effective competition and/or regulation are introduced, the privatization of the firms with market power will bring private ownership in precisely the circumstances where it has the least to offer. Therefore, a bigger number of operators should be chosen in order to create competition and also to provide the population with quality service.

It must be emphasized that privatization is a very slow process that must be maintained. The profits earned in that process should not only be in financial terms, but mainly in the population's satisfaction. One example that can be cited is that new investments into the sanitation system affect the country's health system. Protecting the population from diseases will certainly contribute in terms of a better condition of living for the society.

Conditions for the market to operate by its own with less interference of the government authorities, should be provided. A system of guarantee to fund the new operations should emphasize the companies receivables and other forms of private equity.

Another fact that has to be emphasized in the search for the success of the new model is competition. Competition among firms improves efficiency by enabling managerial incentive structures to be based on comparative performance measurement. Competition serves to overcome asymmetries of information between owners and managers, and thereby diminishes inefficiency and slack. Despite these advantages, head-to-head competition, if not well structured, can, at times, be wasteful and inefficient.

In the implementation of the new measures to the system, one important component is the participation of the society as a whole. The participation of several other institutions in the society can help bring new rewards to the population.

It has to be emphasized that the existence of a new manager for the system itself does not guarantee the new investments needed in the system. Another threat that must be avoided in giving the companies the capacity to increase the services'

prices without a specific methodology. It would give the company the capacity to establish the profit margin without any guarantees of the efficiency improvement in the system.

## ✓ **Chapter IV**      Conclusions

The previous chapters tried to describe the scenario of the Sanitation sector in Brazil. It will be remembered that the system is structured to be managed by State Owned Enterprises (SOEs). That model is outdated and there is no capacity for companies to continue investing the amounts needed to perform the services demanded by the Brazilian population. The funds invested recently came from few sources and, most of the time those funds came from the Federal Government.

After considering the system's inefficiencies, in which the companies perform poorly and have big financial risks, the federal government is trying to establish as one of the country's priorities, the privatization of the sanitation system. The process is not simple and there are lots of problems. The legal framework is very confusing and generally weak in terms of consistency and effectiveness.

In establishing the privatization program the authorities will have to match the public and private interests, and provide the private players with mechanisms that assure complete insurance against the political risk of the country.

Before a real start in the privatization process, some measures must be provided in terms of guaranteeing the success of the program, such as:

- ✓ establishment of the legal framework, regulating the sanitation services' provision, such as:
  - supplementary law or constitutional amendments regarding the service's exploitation titularity;
  - federal law regarding services' general procedures;
  - state and municipal laws regarding services' regulation;
  - set the powers of the new Regulatory Agency for Water (ANA);
  - personnel training in regulatory activities;
  - increase the efficiency of the services' providers, through:
    - hiring of advisory and auditory company regarding the creation of an action's plan;
    - establishment of indexes regarding expenditures limits in personnel, levels of losses and tax collection, and revenues commitment;
    - management contracts
    - technological modernization;

- partnership with the private sector.

Another necessary measure to be taken is to strengthen the internal capital markets. This would bring liquidity to the companies' shares and make their capital more worthy. Working through different but complementary channels, privatization and capital markets are key components of reform, and will be able to help promote economic growth. The negative implications of inefficient SOEs and distorted financial markets for governments are evident. Policy dialogue must be stepped up in order to explain to governments why the failure to privatize reduces the efficiency, productivity, and growth of the economy, and obstructs the development of more efficient capital markets, which further constrains economic growth. Privatization needs to expand in scope and increase in intensity.

Public-awareness programs are needed to explain the benefits of capital markets and privatization. A regulatory framework is necessary for the public to have confidence in capital markets' instruments. The government must disclose the synergies between capital market development and privatization and how both programs will be benefited. The effort to expand the scope of privatization will increase the wideness, depth and efficiency of capital markets. The parallel streams and cross-cutting currents of privatization and capital markets development will contribute to overall economic growth.

That is one of the key areas in which the multilateral credit's agencies are focusing on. The programs of guarantees in the internal market's operations searches for the development of a consistent market in developing countries. The guarantee programs are managed by the IDB private sector department and the World Bank group's IFC. Although the importance of these programs cannot be denied, the amounts directed to these operations are too small to change the status of these markets alone. They will have to be matched with local policies to achieve an effective change in the market.

In chapter two, the principal focus is to describe the way the multilateral credit agencies play. In analyzing their policies and the way the agencies and their affiliates proceed when doing business, it is possible to have a better perception of the effectiveness of their course of action. It is then possible to perceive the weakness of foreign assistance in the non developed countries. In practical terms,

the system's structure allows aid only for a wealthy few. The big problems in terms of accessing foreign assistance are as follows:

- ✓ capital resources are generally insufficient;
- ✓ small poor countries, or the poorest regions in the non-developed countries, are hardly able to create and establish an efficient project to be presented to the credit agencies;
- ✓ foreign Investment can often make a significant contribution to resource availability, but domestic savings finance are the largest share of industrial investment in the third world;
- ✓ as countries industrialize, the shortage of capital tends to diminish because of capital accumulation within the industrial sector. Therefore, the industrial growth requires the development of local financial institutions and money capital markets;
- ✓ non-industrial countries need to establish and expand commercial and development banks and other financial institutions that concentrate on the mobilization of savings;
- ✓ as the use of financial assets grows and a more diversified industrial base emerges, more sophisticated types of financial intermediaries dealing in short and long term securities may be needed.

One of the main problems described above is that as the countries start to grow their industrial economy, it becomes more difficult to get low cost assistance. Thus, the capacity of the country to continue growing is by large, reduced. The theory suggests that these kind of funds should be replaced by Foreign Direct Investment (FDI). Foreign investment can often make an important contribution in this specialized field.

Foreign direct investment in infrastructure is a relatively recent phenomenon that presents tremendous opportunities for investors and governments alike. Investment volume in the various infrastructure sectors in developing countries grew dramatically during the 1990s. This resulted in the creation of an entirely new industry of companies now willing not only to supply equipment and services, but to take the commercial risks involved with the operation of facilities for long time periods. However, the country's political risk limits the amounts to be invested and the opportunities to be explored.



The first thing that must be done is related to government actions. The government needs to devote substantial effort to designing broad reforms that will sustain an investor-friendly environment. Failure to do so will almost invariably result in lengthy delays in project implementation, cancellation of projects, and frustrated investors abandoning potential projects after having devoted considerable resources to them. However, the government cannot supply all the means alone. The past brings us the history of inefficient governments, corruption and other serious problems. Despite the fact that the reality can be different, countries cannot change their history, and there are always doubts in foreign investors' minds.

This scenario reflects the essentiality of the multilateral credit agencies to support those countries. An effective change in the status of those countries could reduce the agencies' mission there in a reasonable amount of time; Those can then become another source of funds to international assistance.

The privatization process is a great opportunity for changing the situation discussed above. While the agencies' mission is said to be the reduction of poverty in the world, the sanitation system is one that can help in providing better conditions of living for the population and, therefore, better health. The financial conditions of the old companies have brought problems in terms of issuing loans to clients that would not pay for the debt. The financial conditions of those companies really count, despite the fact that the institutional guarantees are provided by the central government of the country.

After privatization, there will be new management in those companies that will be able to add new capital, new technologies and effectiveness in the processes. Therefore, the investments needed are very big, and the new companies will have to have access to the international capital markets. As reported in the first chapter, the amounts of investment needed for the sector in the next twelve years amount approximately fifty nine billion reais. In order to provide support to those new companies, the multilateral credit agencies would have to increase the scope of their action with the private sector. Nowadays, those businesses represent a very small part of the agencies operations. In the Inter-American Development Bank, there is a limit of 5% of the institution operations to be directed to the private sector. In the World Bank Group, while the IBDR has an outstanding amount of loans of around US\$164 billion dollars, the IFC has an amount of around US\$10,9 billion.

The additional support provision to the private sector does not mean that the loans with governments would lose importance. However, after dealing new business options and new kinds of guarantees, the agencies' volume of trades in the international capital markets could increase considerably, and not affect negatively their triple A rating.

The new approach in operations could generate excellent results to the developing countries' activities, and allow them to survive alone in the market in future. There could be efforts to reduce the participation of the organizations in the respectively developing country. The success of providing the funds' schemes could be measured in terms of the volume of savings that would have been generated. In this sense, the importance of the participation of the private sector in investing into the infrastructure sector recurs.

When analyzing the multilateral credits to the public sector, it should be emphasized that the majority of resources go to a small number of countries that have better conditions to pay their debt. Furthermore, these countries are better structured and have superior conditions to introduce more viable projects. These regions can be one entire country or any specific region within it. One strategic policy that could be established in the agencies is an act to prepare the poorest countries to structure themselves in a way that allows them to participate more in the credit's role. It would even give the agencies more flexibility in distributing the funds. It can be emphasized that every time one of the big borrowers faces a process of internal reform and public debt restructuring, the number of loans directed to that country can reduce; sometimes there are no other countries with technical and financial capacity to apply for the funds available. Finally, it would lead to more fairness in the system and in the main purposes of those institutions.

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