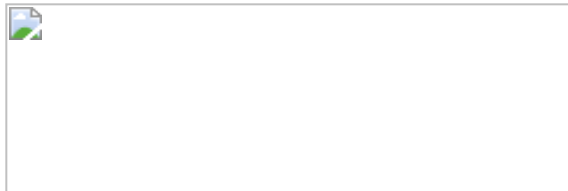
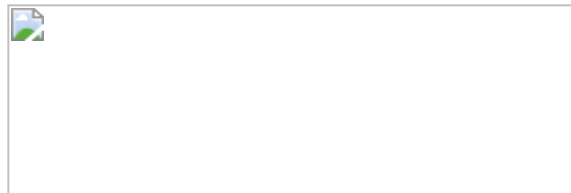


Instituto Cultural Minerva

Institute of Brazilian Issues
The George Washington University



The Regulatory Issue in the Privatization of the Brazilian Railways



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Author: Bernardo von Haehling Braune

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INTRODUCTION

Privatization is a complex technical process that faces tough resistance from "rent seekers", who usually are well represented and organized. In Brazil, the first privatization processes also faced strong resistance from the political parties that opposed the process for ideological reasons and had strong ties with the labor force of state-owned companies.

Privatizing represents a change in thought about the function of government. One should remember that the military administration of the Brazilian economy lasted from 1964 to 1984, and that the military government's successful economic policies of the seventies had as one of its cornerstones the state ownership of enterprises. It can be said that with the end of the military regime the new civil government had as its priority correcting the previous economic growth strategies by attaching to them a social connotation, but the strategies still basically resembled the previous belief in the state as the conductor of economic development.

Privatization in Brazil began discreetly in the end of eighties, mainly as a policy adopted by the Brazilian Development Bank (BNDES) to get rid of time-consuming and unprofitable companies it had acquired through transformation of bad loans into equity. Only with the Collor administration in 1990 did privatization really enter the public agenda, but it was still an abstract concept for the major part of the population. The privatization process began its large scale debut in October 1991 with the privatization of USIMINAS (a steelmill sold for US \$ 1.9 billion), which produced a broad discussion on the subject.

The privatization process continued and the first positive results strengthened the credibility of the program among the population and both the political and economical elite of the country. However, although resistance diminished, it remained a reality for which to be coped.

If resistance made privatizing industrial companies a rather difficult enterprise, privatization became twice as complex when the proposition was made to privatize public services. In addition to the usual problems, the government also faced the challenge of previously (if possible) rewriting the rules of the sector to be privatized, which until then, had functioned with little conflict of interest due to the coincidence of the persons of the conessor

(government) and concessionaire (government controlled companies).

In this context, the institution of a new regulatory framework for the concessioning of public services, including the railway transport service, took place.

Rede Ferroviária Federal S.A. (RFFSA), owned by the Brazilian Federal Government, was the main railway of Brazil, consisting roughly of 22,000 route kilometers, 1,400 locomotives and 37,000 wagons, plus substantial real estate. In 1993, RFFSA transported 39.5 billion metric ton kilometers of freight and generated around US \$ 900 million in revenues. Railway transportation in Brazil in 1990 accounted for 23% of the cargo hauled in the country. In the same year, the percentage in the US rose to 37% and in Canada to 58% (both of which are continental size countries with train transportation mainly devoted to cargo).

RFFSA was primarily a freight railway company. Since 1984 the commuter passenger services had been operated by CBTU (another state owned company) and the long distance passenger services were practically nonexistent. CBTU is currently undergoing a process of being divided up and transferred to the governments of the various states where it operates.

RFFSA was in a permanent financial crisis, needing a constant inflow of funds from the Federal Government. Since its incorporation, RFFSA had not paid dividends to the Government. The decision to privatize RFFSA was formalized through Decree n° 473 in March 1992. At that time the company had about 44,000 employees, which consumed 70% of its earnings, and lacked money for maintenance and expansion of its railway network.

PART I – THE PRIVATIZATION MODEL AND ITS IMPLEMENTATION

1 – THE PRIVATIZATION OBJECTIVES AND THE CONTEXT OF THE PROCESS

The privatization of RFFSA had as main objectives to:

- improve the railway's efficiency and establish lower tariffs for the users;
- establish an economically viable and self sustaining railway system;
- free the Federal Government of the burden of managing railways and to eliminate the competition of RFFSA for funds (always scarce) in the federal budget needed for investment in other areas, such as health, education, public security, etc.

The analysis that resulted in the privatization model of RFFSA considered three factors: I) the business lines; II) the functions; and III) the assets.

1.1 - THE DIVISION OF BUSINESS SERVICES

RFFSA's business was predominantly the transportation of cargo and to a much lesser extent a small passenger service. The suburb passenger transport operated by CBTU was not subject to privatization and is presently being transferred to the State Governments. Therefore, it can be said that the privatization of RFFSA is the story of the privatization of its cargo transportation service. Other specific solutions were found for RFFSA's few passenger lines.

1.2 - THE ASSIGNMENT OF FUNCTIONS

RFFSA followed the traditional model of responsibility over all functions; that is, it was responsible for the two groups of functions, one that congregated the functions related to the operation of the railway line – "maintenance and improvement of the tracks" - and another that congregated the functions related to the operation of transport – "all other functions".

Later in this paper, a brief analysis will be presented on why the functions were not separated when RFFSA was privatized.

1.3 – THE ASSETS

The two basic questions involving RFFSA's assets were the convenience (or not) of their division and the form of transference of their possession. RFFSA was structured into 12 Regional Superintendence and a General Administration. In reality, each Superintendence operated almost as an independent company, since each one had its own administrative, commercial, operational, legal and maintenance structure.

At the beginning of the privatization process, it was realized that the traditional method of selling the company stocks could not be applied, since the preliminary projections of revenues resulting from the operation of RFFSA's railway transport were less than the estimated debt of about US\$ 3 billion, a good part of which was already due or to fall due in the short term. A significant part of the liabilities referred to labor debts, verification of which was considered difficult from an auditing perspective. The number of lawsuits against RFFSA was increasing in the face of the deteriorating financial condition of the company, impairing a concrete appraisal of its liabilities on a fixed date.

It is believed that RFFSA has about US\$ 4 billion in non-operational assets scattered all over Brazil. The evaluation of these assets would require years of work. Many of these assets do not have regular ownership titles in favor of RFFSA. To transfer RFFSA with these assets would sidetrack the focus of the privatization because the main value of the company would be the non operational assets instead of the cargo transportation service.

2- THE PRIVATIZATION MODEL

Considering that the passenger transportation service was insignificant in RFFSA as a business service, the government decided to privatize RFFSA solely as a railway service for transportation of cargo. Nevertheless, to ensure the possibility of passenger service in the future (as an independent service possibly explored by third parties) the new cargo concessionaires accepted in the concession agreements the obligation of allowing in the future the crossing of two pairs of passenger trains per day in certain railway lines.

What concerns the separation of railway functions is the underlying idea of equalizing the conditions of competition between the railway and other kinds of transportation, especially transportation by truck. The supporters of this alternative uphold that the competition between railways and trucks is unfair because the state builds and maintains the roads that are used by the trucking companies. Therefore the trucking companies only have expenditures related to the operation and maintenance of the truck fleets, while the railway operator has not only operation and maintenance expenses of rolling stock but also has to face the investment necessary to build the railway lines and the expenses for its maintenance.

Usually the analysis of this question assumes that the state keeps the property of the railway lines and is responsible for their maintenance and for the investments needed for their improvement and expansion. It was decided that the alternative of separation of functions would not attend the objectives established for the privatization of RFFSA and that it would not be attractive to the potential investors for the following reasons:

- the general state of RFFSA's railway network required immediate investments for its recuperation and the Federal Government did not have the necessary funds;
- there was the understanding that a model should be avoided in which it was assumed that the decision of

investments in the railway lines continued under government control (and were consequently vulnerable to political pressures);

- since the quality of the railway line is a determining factor of operational efficiency of a railway service, it was understood that the separation of functions would introduce in the privatization model the need for a high degree of trust by the private operator in the capacity of the state to maintain the lines properly – which was not a probable hypothesis, considering the past bad record of the government in regard to maintenance;
- it was also understood that there would be a conflict of interests between the entity responsible for the maintenance of the lines and the operators of the trains. For the the owner of the railroad lines, reducing costs means minimizing maintenance; while for the operator of the trains, it means using heavy trains (maximizing the production of his fleet), which causes greater wearing of the lines and consequently bigger expenditures in maintenance;
- the responsibility for the quality of the service would be diluted. The transportation concessionaire could always argue that the quality is bad because the government did not maintain the lines properly.

In regard to RFFSA's assets, for the reasons already mentioned, it was perceived as unfeasible to privatize the company through the sale of its shares since the company presented a negative economic value. This value, by the way, would even be difficult to define with reasonable precision.

The decision was made to divide the assets for privatization purposes. Only the operational assets (related to the railway operation) would be privatized, while remaining the non-operational assets would remain with RFFSA along with the totality of its debt.

It was also decided to divide the operational assets into regions due to the gigantism of RFFSA. The division of RFFSA into six networks maximized regional interests in their purchase – certain groups were only interested in specific regions. The urgency of new investments in the railway system also recommended the division of RFFSA, since if it were sold to just one group, this group would have not only to raise bigger funds to pay at the auction for the purchase but also to raise additional funds – on a much larger scale - for the new investments in the railway system. The possibility of pulverizing RFFSA into many short lines was discarded because the government believed that this would oppose the objective of preserving the railways as an integrated system.

The 12 regional superintendences (SRs) of RFFSA were grouped into six networks, which would represent the best operational configuration for independent and self-sufficient business units. One of the determining factors for the way the six networks were grouped was the existence of FEPASA, a railway company controlled by the São Paulo State Government. At that time, the State of São Paulo did not have plans for privatizing FEPASA. This fact led to a first division of RFFSA into lines that did not connect between themselves but only with FEPASA.

For example, RFFSA's Western network (SR-10) and Southern networks are separated by FEPASA from the rest of RFFSA's system. The Southeastern network is distinct from all the others in that it is the only one with large gauge track. In addition, Tereza Cristina (SR-9) is not connected to the rest of the network, being completely isolated in the eastern part of the State of Santa Catarina. The two remaining systems were created from SRs from two separate regions between which there is no significant rail freight transport (Appendix I shows a map with of the six networks).

It was also decided that the operational assets would be transferred to the new concessionaires through leasing (without an option of

buying them at the end of the lease contract). The sale option was discarded mainly for the following reasons:

- many of the assets had problems related to ownership titles;
- the leasing process avoided the debate over the sale of public assets for "debased" prices;
- the problem of selling assets pledged by RFFSA in lawsuits was also avoided.

In conclusion, it can be said that the privatization model of RFFSA involved the following elements:

- the concession of the public service pertaining to railroad transportation of cargo (granted for 30 years);
- the leasing of operational assets;
- the sale of assets of low value belonging to RFFSA as allocated in the six regional networks;
- Division of RFFSA into six regional networks: Western, Center-Eastern, Southeastern, Northeastern, Southern and Tereza Cristina Railway, the last one a small and isolated railway line;
- Subsistence of RFFSA as a company controlled by the government with the mission of managing its non-operational assets as well as surveying the assets leased to the new concessionaires. Presently RFFSA is in a process of negotiating its debts and putting in order the ownership titles of its assets for the purpose of sale of the non operational assets as a form of generating income to pay off its debts.

3 – THE PRELIMINARY ECONOMIC AND FINANCIAL EVALUATION

After the definition of the privatization, model the economic and financial evaluation work started. The first results presented an economical negative value for almost all the railway networks. The main reasons for this were the state of deterioration of the operational assets and the oversized labor force of RFFSA.

With the appointment in April of 1995, of the present Board of Directors the privatization of RFFSA gained a new impetus. An ambitious plan for reducing personnel was implemented which together with some emergency investments in the Northeastern network made it possible to privatize all the six networks with a positive economic value. The funds for this initiative were partially provided by the World Bank.

4 – THE PRIVATIZATION

The first auction took place in March 1996, and the last one in July 1997. The six networks were transferred to the private sector for the global value of US \$ 1.49 billion.

After each auction there was a transition period during which the new concessionaire had time to incorporate as a stock company to receive the concession, to provide its organizational structure and to get acquainted with the procedures involved for adequate management of the concession. This was done to avoid loss of continuity of the service. During the transition period, usually 60 days, the privatized network continued to belong to the RFFSA' system. During this period it was operated exclusively by RFFSA and continued under its responsibility. It was done in such a way as not to constitute administration sharing with the new concessionaire to avoid imputation of responsibility on them for acts or facts that occurred during this transition period.

The auctioned price of the networks will be paid during the 30 years of concession. The payment schedules are not identical in the six networks because of the different potentials for earnings and the different needs of investments. Before each auction, a minimum price acceptable by the government was established for each network. A minimum payment was required at the time of the settlement of the auction plus the upside offered in the auction of some of the networks.

5 – THE EMPLOYEES

A privatization process usually involves diffuse benefits and concentrated costs. At one side is society as a beneficiary of the reforms while on the other are the segments immediately affected by them which lose significant advantages. Therefore, it can be said that with a privatization there are winners and losers.

In all the companies privatized by the Brazilian Government there was a reduction in number of workers often followed by a growth in production and (frequently) by a raise in the salaries paid to the workers that remained. This was due not only to inefficiency but also to the fact that a state-controlled enterprise must follow various bureaucratic rules that are not necessary for a private company. For example, a state-controlled company has to follow a complex process to buy supplies and equipment. This in itself requires many employees. Since buying is a complex and time consuming operation, state companies have bigger supply reserves in stock – which is a cost that a private company does not have to support. There is also the need for employees to prepare reports and inform bodies such as Congress, the Federal Accounting Court(TCU), etc.

Besides these "structural" inefficiencies, the government owned companies suffered from a clear redundancy in job stations to the point that in some cases this redundancy resulted in the economical unviability of the enterprises. This was the case of RFFSA.

RFFSA was included in the Brazilian Privatization Program in 1992. At that time, it employed 44,000 workers. With the privatization of RFFSA's railway network 25,000 workers were transferred to the six new concessionaires. About 800 employees remained. Up to the end of 1997, the concessionaires had discharged about 9,000 workers.

Different measures were adopted to mitigate the effects of this reduction in work stations, including a program of incentives for those that resigned. This program involved the payment of a "severance indemnity" to the workers that resigned besides the payments due by law. In the privatization process the new concessionaires took on the obligation of adopting these same incentives during the first year of their management in case they discharged any employee transferred from RFFSA.

Retraining was offered to the workers that resigned their jobs aiming to place them in other sectors of the economy.

As part of the obligations of the new concessionaires, it was established that in the company's by-laws there should be a provision determining that at least one member of the Board of Counselors (that establishes the broad strategies of the company, elects the directors, etc) would be elected by appointment of its employees, regardless of the number of shares they held in the company.

In every privatization, the new concessionaire had to sell with a subsidy to the employees 10% of the capital stock. Considering this provision and the perceived need of short-term new investment, each concessionaire had to subscribe a certain minimum capital and realize immediately an established part of it as start-up working capital.

To further stimulate the employees' involvement in the privatization process the Brazilian Development Bank – BNDES financed the acquisition of these shares by the employees. BNDES is responsible for the administrative and operational support of the privatization program.

Although RFFSA's workforce underwent a staggering downsizing there were no strikes, depredations or sabotage.

PART II – REGULATORY ISSUES

1 - THE LEGAL FRAMEWORK

The regulatory issues in the privatization of RFFSA relate to the establishment of general rules for the concessioning of public services in Brazil.

The Brazilian Constitution of 1988 established as a responsibility of the State to render public services, directly or by means of concessions or permissions. The Constitution also establishes that the concessions and permissions may only be granted through public tenders open to all interested parties.

RFFSA was the first public service to be included in the Brazilian Privatization Program. This occurred in March 1992. In January of 1992, Lloyd Brasileiro – a shipping company - had been included in the privatization program. However, it already operated in a relatively competitive market and did not hold a so-called natural monopoly.

At that time, the legislative discipline relative to concessioning of public services was inadequate for the needs of a modern economy in which the private sector acts in partnership with the government in rendering public services. Because of the exhaustion of the development model in which the state played the part of the main investor, the need to review the legal framework that ruled the concessioning of public services arose.

After a long negotiation process, Law n° 8.987 was promulgated in February 1995. This law became known as the "concession law". A few months later Law n° 9.074 was promulgated. This law complemented the concession law and introduced some new rules, especially in the concessioning of services in the energy sector. The telecommunications sector was object of a specific legislation (Law n° 9.472, July 16, 1997).

The concession law is a general law that applies to all concessions of public services with the exception of telecommunications. The railway services were not in the forefront of the debates when of the legislative process that focused on the energy sector.

Consequently some rules of the concession law that must be applied were not "custom tailored" to the railway sector, with the result of not fitting too well to its reality. The privatization of RFFSA had to be adapted to this circumstance and in a certain sense was limited by the concepts underlying the concession law.

In this context the Railroad Transport Regulation was reviewed, the concession agreements were drafted and the Federal Commission on Railway Transport was created.

It is worth mentioning that if the model adopted for the privatization of RFFSA had been the separation of its functions, the regulatory challenge would certainly have been more demanding because the separation of functions implies the necessity to regulate how these players interact.

1.1 - THE GRANTING AUTHORITY

The Federal Government is the grantor of the concessions of the railway service of the six networks into which RFFSA was divided. The Department of Railway Transport of the Ministry of Transportation, in accordance with the applicable legislation and the concession agreements, must survey the performance of the concessionaires, impose penalties, authorize the exploitation of activities associated to the transportation service, extend the concession agreements, establish goals of reduction of accidents, review tariffs, intervene in the concession and reclaim the concession in the case of its extinction among other things.

Since the Department of Railway Transport has only a small force of civil servants to survey an activity that has national dimensions, the Ministry of Transportation contracted RFFSA to help in this

task. Presently RFFSA has presently a labor force of 800 and already has the responsibility of surveilling the assets it has leased to the new concessionaires.

1.2 – THE FEDERAL COMMISSION ON RAILWAY TRANSPORT – ("COFER")

A Federal Commission on Railway Transport – "COFER" was created by Decree n° 1.945 (June 28, 1996). COFER is a collegiate agency part of the organizational structure of the Ministry of Transportation with jurisdiction over the national railway system.

It is composed of seven members, three of who are from the Ministry of Transportation (including the President), two represent the concessionaires and two others the users of the railway service.

COFER has, among others, the following attributions:

- it must decide, as an administrative appeal court, questions related to penalties imposed by the conceding power; controversies between the Federal Government and the concessionaires, between the concessionaires and the users and between the concessionaires themselves;
- it must manifest its understanding in the occurrence of changes in the stockholders composition of a concessionaire company;

Besides considerations related to the concession law, this competence is derived from the fact that the government limited the individual participation of shareholders in the voting capital of the new concessionaires. In the cases of the Western, Center-Eastern, South-Eastern and Southern networks the limitation was of a maximum of 20% of the voting capital per investor, in the North-Eastern network the

limitation was 40% and in Tereza Cristina railway the limitation was 45%.

The idea was to avoid the concentration of power in the hands of only one investor (a mining company, f.ex.) that could transform the railway into a secondary business (a "cost department") instead of an aggressive competitor in the cargo transportation industry. The limitations imposed by the government were well accepted by the market and today the stockholders of the new concessionaires consist of foreign railway operators, banks, pension funds, users, investment funds, truck and shipping companies, etc. Many of the investors had no former experience in the railway business and were attracted by the potential for earnings and by the credibility of the privatization process.

- it must manifest, when asked, about proposals of expansion or suppression of railway services.

The representatives of the concessionaires and of the users are chosen by the Ministry of Transportation from a list presented by each category with three names for each member of the Commission. The length of the mandate is two years.

The Ministry of Transportation is responsible for providing the technical and administrative support necessary to the activities of COFER.

The president of COFER (a representative from the Ministry of Transportation) has not only a quality vote but can veto any decision.

The creation of COFER itself represented an important institutional step in the relations between the granter of the railway service and the concessionaires and between these and their clients (users). With COFER a forum was created where sensitive questions may be discussed between the agents involved in the railway business, where their interests and individual positions may be presented to the evaluation and critique of the other players of the railway business.

In addition, an important role of COFER is that it functions as an administrative forum where issues may be quickly resolved without recourse to the judiciary.

1.3- THE REGULATION OF RAILROAD TRANSPORT

It became necessary to update the Railroad Transport Regulation and to this end the Federal Government promulgated Decree n° 1.832, of March 4, 1996, that regulated the implementation of the concession law in the railway sector. Main questions addressed were the relationship between the government and the concessionaires, between the concessionaires and the users of the railway service, between the concessionaires themselves (including regulation on mutual traffic and right of passage) and the safety of the railway services.

1.4 – AN ASSOCIATION OF RAILWAY CONCESSIONAIRES

The privatization model foresaw the need for an association of concessionaires that should be a non-governmental agency with the mandate of providing a structure necessary to the integration of the different railway networks so that they may operate as a national system.

This association should: provide a system for compensation of freight charges that result from inter-railway traffic according to mutual traffic agreements; provide a system for control of railcars

used in mutual traffic; control the services of railcar maintenance guaranteeing that these services will be executed at the right time wherever the railcar may be; uphold the interests of the railway sector; etc.

2 - THE CONCESSION AGREEMENT

In Brazil a concession is a contractual delegation of the execution of a public service. The law considers that a concession agreement is done *intuitu personae*. That means that the technical and financial conditions of the company, which proposes to execute the public service by delegation of the conceding power, are taken into consideration. As a corollary of this logic the transfer of a concession depends on authorization of the conceding power. The same is true for the transfer of the controlling shares of a company that holds a concession.

The concession agreements became the instrument through which the government, the concessionaires, and the shareholders of the controlling stock of the concessionaires regulated their rights and obligations. The concession agreements established, so to say, a regulatory framework through the contracts that observed the determinations of the concession law but went beyond, building a consensual regulation (the draft of the concession agreement was always part of the invitation to bid).

The concession agreement may be, by legal definition, altered unilaterally by the conceding power. This eventual alteration is restricted to the "service clauses", always for the better service of the public. If the alteration of a "service clause" has as a consequence the breaking of the economic and financial equilibrium of the concession agreement, the government will have to adjust the remuneration clauses of the contract so as to compensate through higher tariffs or other ways the new burden imposed on the concessionaire.

This legal provision introduces an instability in the business but it is unavoidable since the contracts are usually long term agreements during which many conditions may change. To counterbalance this potential instability the government - including the legislative and judiciary powers - must have credibility that they will act in good faith and respect the rights of the investors.

The concession agreements for the operation of public railroad transport of cargo were signed by the Federal Government and the winners of the public auctions. At the same time RFFSA and the new concessionaires signed the lease contracts for assets linked to the services being privatized. These two contracts are linked, so that all changes in the concession agreement shall be reflected in the lease contract. This also means that a default in the concession agreement will automatically imply the default of the lease contract.

2.1 - OBJECT AND DURATION OF THE CONCESSION

The concession's object is the operation of a public service of railroad freight transport. Any other business activities are forbidden except those activities associated with the railroad service or other associated projects, always with previous authorization from the Government.

The concession is granted for 30 years. There is a provision allowing the concession to be extended up to another 30 years in conditions to be defined then. The concessionaire may request the extension of the concession only if it has rendered an adequate railway service and is not recidivist in administrative or judicial decisions declaring it guilty of abuse of economic power.

2.2 - SERVICE QUALITY

The concessionaire must provide, in the first five years, minimum levels of annual production, providing the necessary investments to meet the established goals. The Government will establish new annual goals for transport production agreed with the concessionaire for each subsequent quinquennium. The concessionaire must present to the Government the demand forecasts for railroad transport supported by market studies.

The concessionaire shall comply with security rules in force for the railway services and maintenance of the facilities. The security of the services provided by the concessionaire is evaluated by an index (number of accidents/million of trains.kilometer), taking as reference the last index recorded in each specific railway network under RFFSA's management. The concession agreement establishes goals for reduction of accidents for the first five years, and the government will establish new annual goals, agreed with the concessionaire, for each subsequent quinquennium.

These goals were devised as an indirect form of inducing the concessionaires to invest in the railway system without the government having to determine beforehand which investments are necessary. There was an understanding that this decision should be left to the new concessionaires, since each of them has a specific plan of investments in the railway according to their commercial and financial strategy. Besides, railway investment plans are time consuming and expensive. The government was not interested in spending more money and time on a privatization that needed to be done quickly. The main reasons were: this would stop governmental losses in RFFSA; bring revenues from the concession and lease of the networks; and for macroeconomic reasons, since the privatization and the consequent upgrade of the railway network done by private investors would make the Brazilian economy more competitive.

What concerns the goals themselves, they were established in reasonable terms, considering a large suppressed demand in

railway transport and, in comparison with international standards, the high rates of accidents registered during the operation of the network by RFFSA, mostly due to the lack of money for maintenance and new investments in the system.

2.3 - TARIFFS

The tariff system of the concession agreement had to follow the concession law, that is, had to be established in the agreement. The upper limits of tariffs fixed in the agreement were those already practiced by RFFSA. The concessionaire may charge tariffs recognized as commercially sufficient within the limits of the established tariffs. Since the tariffs practiced by RFFSA were acceptable this was not perceived as a problem by private investors and in certain cases the concessionaires are already offering discounts to their clients.

As mentioned above, the tariffs had to be established by force of the law. It could be argued that this provision was unnecessary for those cargoes in which the railway faces competition from other means of transportation (truck, for example).

Because of the reality of inflation, the government established the adjustment of the reference tariffs "as legislation in force", that is, presently once a year. The upper limits of the tariffs are to be adjusted by an index (IGP-DI) that measures the variation of prices (that is, the change in purchasing power of the legal tender – the Brazilian Real).

Besides the provision of adjustments of the tariffs, they may be reviewed, to higher or lower levels, in case of permanent changes in market or costs which may alter the economic-financial balance of the concession agreement, at the concessionaire's request, at any time, or as determined by the concessor, at every five years.

2.4 - THE CONCESSIONAIRE'S OBLIGATIONS

The concessionaire had to agree with a number of obligations, which include:

- keep updated inventory and records of assets linked to the service under concession;
- render adequate service to the users, without any kind of discrimination and economic abuse of power;
- replace equipment linked to the service, as well as the acquisition of new assets, in order to ensure adequate services;
- keep civil and accident insurance, compatible with its responsibilities towards the concessor, users and third-parties;
- ensure mutual traffic or, if impossible, allow crossing right to other railroad operators, through agreements, informing the concessor about them. This is considered relevant since it is in the public interest that the railway network functions integrated. The Brazilian regulation of railroad transport (Decree n° 1.832/96) established this as a mandatory obligation. In the eventual case that the concessionaires do not come to an agreement, the aforementioned regulation determines that the Ministry of Transportation will decide about the conflict;
- ensure to any railroad operator, within the duration of the contract, the crossing of two pairs of passenger trains, per day, in areas with annual traffic of at least 1,500,000 TKU/km. This obligation relates to the fact that only the cargo transportation service was privatized.

2.5 - THE CONCESSIONAIRE'S RIGHTS

The most relevant:

- build railroad branch lines, stations, repair shops, and other facilities, with previous authorization from the concessor. The government has the obligation to declare of public utility, for expropriation purposes, assets considered necessary to the concession, but it is the concessionaire who carries the burden of promoting the expropriation and the payment of indemnization;

- contract with third-parties the development of activities directly related or complementary to the service under concession, but without disclaiming responsibility for the acts of third-parties.

2.6 - SURVEILLANCE

The Ministry of Transportation monitors the service with the assistance of RFFSA. This arrangement was a consequence of an agreement between the Ministry of Transportation and RFFSA (allowed by the concession law).

On a timely basis the surveillance must be carried out by a commission of representatives from the government, concessionaires and users of the railway, as a requirement of the concession law.

The concession agreement establishes, in this regard, a series of obligations, for example:

- remit, up to February of each year, statistical data of the previous year relating to the operation of the railroad transport;
- provide, within certain limits, any requested information;
- keep regular accounting entries and records in order to enable permanent surveillance by the concessor;
- send, up to April of each year, the financial statements issued, a report about the services rendered during the previous year and the report of the independent auditors.

2.7 - SANCTIONS

Any breach of the provisions of the concession agreement by the concessionaire is subject to a sanction. According to the nature of the default of an obligation the concessionaire will be warned or fined. Recurrent defaults of obligations by the concessionaire may cause the concession to be forfeited. The concessionaire has the right to request the reconsideration of the fines applied by the concessor to a higher authority in the Ministry of Transportation.

As an instance in the administrative domain the concessionaire may appeal to COFER (the Federal Commission on Railway Transport).

The seriousness of the default is categorized into three groups. Each group compromises certain obligations of the concession agreement. Group I default generates a warning by the government. Group II may generate either a warning or a fine. And group III always generates a fine. There are two fine amounts established in the concession agreement (one for group II default and the other for group III).

2.8 - INTERVENTION

The conessor may intervene in the concession to ensure proper service or the compliance with the concession's agreement clauses or with legal or regulatory standards.

Any such intervention shall be decreed by the government, who shall appoint an interventor, the duration, objective, and limits of the intervention. The intervention must be complete in 180 days. In the case that the intervention is completed and the concession is not extinguished, the administration of the railway service shall be returned to the concessionaire after a rendering of accounts by the government.

2.9 - TERMINATION OF THE CONCESSION

The concession is extinguished in the following cases:

- expiration of contract term (30 years, if not extended);
- expropriation of the railway service;
- caducity;
- rescission;
- annulment and
- bankruptcy or liquidation of the concessionaire.

Expropriation of the services may occur whenever during the concession term public interest determines the reversal to the government of the services rendered by the concessionaire. To expropriate a public service conceded to a private company the government needs first a specific legal authorization (which goes through Congress) and to pre-pay the compensations due to the expropriated concessionaire. This rigid expropriation process was introduced by the concession law and it certainly contributes to making the concessionaire's position more stable, thus attracting investors who otherwise would fear being subject to a sudden and abusive expropriation.

In the case of default of obligations by the concessionaire the government may either declare the caducity of the concession agreement or impose penalties as mentioned above. The caducity of the concession agreement will also be declared in the case of financial default of the lease contract of the railway assets between the concessionaire and RFFSA.

The caducity declaration must be preceded by a verification of the concessionaire's default in an administrative process in which the concession law guarantees the concessionaire the right to ample defense. Before the initiation of this process the government must inform the concessionaire the nature of the default and give it time to correct the appointed transgressions. In case this does not happen and the caducity of the concession is declared during the administrative process, the railway service reverts to the conessor. In this case the conessor must pay the concessionaire a compensation that covers investments in railway assets that are not depreciated as shall be discussed in the next topic (deduced eventual fines and indemnization of damages resulting by the default of the concessionaire).

Rescission may occur through judicial action by the concessionaire based on the government's failure to comply with the provisions of the concession agreement. In any case of

concession termination the concessionaire must keep rendering the railway service until the assumption of the railway by the concessor.

The termination of the concession may also occur in the case of annulment of the process that granted the railway concession (public invitation to bid - auction), through judicial or administrative decision.

2.10 – REVERSION OF ASSETS AND COMPENSATION

When the concession ends all rights and privileges transferred to the concessionaire return to the government. All assets considered necessary by the government in rendering the railway service are also transferred to the concessor, including those owned by the concessionaire and the investments it has made in assets leased from RFFSA.

The concessionaire is entitled to a compensation for all assets declared reversible (that is, necessary to the railway service and that are transferred to the concessor). This compensation covers investments in the assets that have not been depreciated (minus any revaluation additions). There is one exception to this rule foreseen in the concession agreement, that is, any improvement made in the permanent track superstructure (leased from RFFSA) shall not be considered investment for the purpose of indemnization. The reason for this provision was the difficulty to differentiate in this case between maintenance and improvement (new investment), since maintenance is already an obligation of the concessionaire as part of his operational expenses.

The concessor, during the appraisals necessary to determine the value of the compensation, shall also include physical inventories of the assets leased from RFFSA, stating their general appearance, and shall withhold the necessary amounts to recover any damages

to the aforementioned assets due to the lack of maintenance from the concessionaire.

3 – THE LEASE CONTRACT FOR RAILWAY ASSETS

The privatization model (as already seen) did not foresee the sale of the operational assets linked to the six railway networks into which RFFSA was divided. To transfer their possession to the new concessionaires these assets were leased to them to be used in rendering the railroad service object of the concession agreements.

The public invitation to bid at the auction of each railway network cumulated the concession grant, the transfer of the operational assets by means of a lease contract and the sale of assets of low value. The interested parties made their bids through their representing brokerage companies at the Rio de Janeiro Stock Exchange. The winning group was the one which made the highest offer. The equivalent to 5% of the auction bid was due as payment of the concession grant. The remaining 95% were due to RFFSA as payment for the lease of the operational assets and for the sale of the assets of low value. These payments are made in installments due along the 30 years of the concession while the payment of the assets of low value was fully received by RFFSA at the settlement of the auction.

The lease contract is directly linked to the corresponding concession agreement so that all changes in the concession shall be reflected and its efficacy shall cease at the same time the concession ceases.

The lessee (leaseholder) is allowed to carry out improvements and other changes in the leased equipment at its own expenses, but any changes in the original project must be previously authorized by RFFSA.

The lease is valid for 30 years and may be extended. The negotiations for extension of the lease agreement shall occur under the same terms and conditions stipulated for the extension of the concession agreement. The concession agreement stipulates that the concessionaire may request the extension under certain conditions and that the government (concessor) shall establish the technical, administrative, economic and financial conditions for the extension.

If the concessionaire decides to return to RFFSA any of the leased assets the amounts due to RFFSA will not be reduced. This is because the concession and the operational assets were appraised as an entirety. The lessee has the obligation to return to RFFSA any leased assets that are excluded from the concession. An exception is the scrap resulting from the maintenance or upgrade of the railway superstructure (this is relevant considering the extension of the six networks – about 22,000 km).

FINAL REMARKS

An interesting characteristic of RFFSA's privatization was that the model itself had regulatory aspects when, f. ex., it limited the amount of voting stock that each investor can hold in a concessionaire. The idea behind this limitation is that a railway concessionaire should be controlled by different groups of investors so that one specific group cannot use its controlling power to divert the concessionaire from its main objective, which is to render a good quality service for reasonable prices.

More than maximizing the results of a privatization, the regulatory issue may define the future success or failure of the process in the eyes of society. In the international experience there are already some cases where the lack of adequate regulation frustrated the expectations of society. Especially important is the establishment of rules that will foster a service of good quality. Not only must these rules be established, but there is also need for the

government to modernize and equip itself with the means necessary to monitor the services. For these reasons it can be said that a good regulatory framework and an efficient regulatory agency are essential for the long term success of the privatization of a public service.

Considering that the delegation of the railway services is still a recent experience it is not possible to evaluate the effectiveness of the existing regulatory framework. The absence of problems up to now is probably a good sign, but new developments (social, technological, etc.) may impose the introduction of new rules into the existing framework.

Not all changes in a regulatory framework cause instability. The fear of change stems from the past when governments decided that certain public services operated by private investors should be nationalized. In most cases these processes produced heavy losses for the investors. However, there are changes that can benefit both society and investors, so that all interested parties benefit in the long run. These derive from changes in the economic and technological environments that should be accommodated into the existing regulatory framework – inclusively pointing in certain cases to a deregulatory approach.

An example of this is the railway sector, where a large degree of monopoly was inevitable on technical grounds in the nineteenth century. Nevertheless, conditions have changed. The emergence of road and other means of transportation have reduced the monopoly element in railroads, except for those cargoes where they are the only economically viable means of transportation.

A certain amount of regulation on tariffs is necessary to avoid abuse by concessionaires, but maybe this regulation should not be extended to all the transportation services rendered by a railway concessionaire. In the Brazilian regulatory framework all tariffs are controlled by the government (as already discussed in this

essay) due to a provision in the concession law that applies indistinctly to all public services with the exception of the telecommunication services. A change in the regulatory framework, which would give the concessionaires more flexibility in their pricing policies, would not harm society, would be beneficial for the railway sector, and consequently, would be beneficial for society.

Another aspect of the law that possibly deserves to be revised is the concept that the services are delegated *intuitu personae*. This provision aspires to guarantee good quality service by allowing the government to bar the entrance to the control group of the concessionaire of investors perceived as not having the necessary technical and financial conditions. This may possibly be true for technological services, but it is questionable if it applies to the railroad industry (or any other service after it is already operating and has its own staff of qualified personnel). The *intuitu personae* concept resulted in the establishment of restrictions on the transference of the concessions or on the transference of the control of companies that received the concession grants.

There are different consequences from these restrictions, which "lock up" expressive amounts of shares of the concessionaires from the market (at least 50% plus 1 share of voting capital). In the first place it discourages the investor from putting his money in a business where there are some indirect restrictions in getting it back. Another effect of this restriction is that it "sterilizes" the shares linked to the control of the concessionaire, limiting the range of financial structures that could be implemented if those assets were freely marketable (financial structures that could be used to finance the improvement and expansion of the existing railway system, f.ex.).

The concession grant itself (devoid of any attached assets) has an economical value. This was exemplified in the bidding processes for granting wireless telephone concessions (Band "B") by the

Brazilian Government. The auctions raised several billion dollars (US) just for the right to operate the service (without any associated lease or sale of assets).

The belief that the delegation of a public service to a private party is done *intuitu personae* also represents a conceptual barrier to a possible evolution in the legislation, one which would allow not only the free transference of the concession grants between parties without prior authorization by the government, but also their use as collateral in financial transactions.

This would not mean total freedom of the controllers of the concessionaire to do whatever they think best with the company or with the assets linked to the service. The rules concerning the disposition of operational assets of a concessionaire would continue to apply as long as the service retained its character as a public service.

Another consequence of the increased flexibility of the rules governing the transference of concession grants would be the possibility of partial transference of the concession without having to observe a rather impractical procedure prescribed by the concession law (impractical from the private enterprise's perspective).

In relative terms, that is, compared with the regulatory frameworks of other public service sectors, it can be said that the regulatory framework of the railway service in Brazil is lean and market oriented, avoiding unnecessary intervention whenever possible. Nevertheless, there is room for some improvements as argued above, although they are not essential for the success of the railway industry in Brazil. The existing framework is being put to the test now, and time and future developments will be the judge of its effectiveness.

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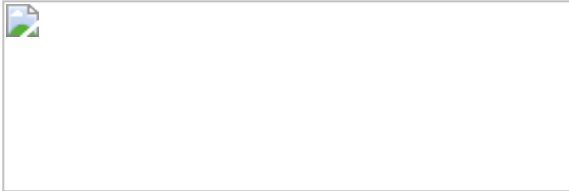
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Bernardo von Haehling Braune

Formado em Direito pela Universidade do Rio de Janeiro, UERJ, o bolsista é funcionário do Banco Nacional de Desenvolvimento Econômico e Social - BNDES, onde atua como assessor do Superintendente da Área de Privatização. No período de 1995/1996, além de trabalhar na área de infra-estrutura, deu apoio jurídico ao grupo responsável pela privatização da Rede Ferroviária Federal. Na área de Infra-estrutura desempenhava a

função de analista de projetos de investimento na geração, transmissão e distribuição de energia elétrica, assim como de telecomunicações, infra-estrutura urbana e indústria de construção naval. Em anos anteriores fez cursos na Inglaterra e no Japão.
Mail to:



Bernardo von Haeling Braune -

braune@bndes.gov.br

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Rua da Ajuda, nº 35 - 20º Andar - Rio de Janeiro, RJ, Brasil, 20040-000. Tel.: (021) 211-8060 - FAX (021) 221-8078

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Last Update: 21/04/98

Dúvidas, janicets@plugnet.com.br