

SCG Legal

2013 International Meeting

The Regulation of Infrastructure in Brazil

Arthur Barrionuevo

FGV e Tendências Consultoria

Overview

- Characteristics of Infrastructure Investments: Regulation in Brazil
- Privatization 1994-97
- The Downgrade of the Agencies (2003-2008)
- New Tendencies in Government Policies (2009- ?)
- Practical Examples - ANATEL
 - Imposition of Inflation Adjustment Index: Overall Plan for Competitiveness Goals (PGMC)
 - Obligations of Investing in Conditional Access Services (SeAC) – PayTV and Broadband

Characteristics of Infrastructure

- Infrastructure is the backbone of economic activity and competitiveness and there is growing global demand for its expansion.
- Less developed countries have been unable to guarantee the investments necessary to create sufficient infrastructure installations and services.
- In Latin America and in the Caribbean, the financial deficit has been large. The region currently invests, on average, **less than 2% of GDP** in infrastructure per year, while some estimate that it will be **necessary to invest from 3% to 6% of GDP annually** (Omura, 2006; Fay and Morrison, 2007 *apud* WIR, 2008).
- There has been a fundamental change in the role of the State in infrastructure sectors throughout the world, with governments allowing much greater involvement on the part of the private sector – including multinationals – in the financing, investment, ownership and management of infrastructure projects.

Characteristics of Infrastructure

- Defined by technology and regulation, each sector of infrastructure includes segments that are potentially competitive and non-competitive.
- These networks are very capital intensive and involve large fixed costs as well as assets that cannot be used for other purposes (*sunk costs*).
- Despite the expansion of the private sector, the role of the State remains critical, assuming various functions in infrastructure sectors: as investor, client, **regulator** and **mediator** (Doh and Ramamurti, 2003).

Investment in Infrastructure

- Infrastructure activities are frequently considered by investors and operators as being performed by **high risk companies**, especially those that are operating in developing countries.
- Some of these risks are common to all types of infrastructure projects, while others belong to specific sectors.
- The **risks** from a **corporate perspective** include:
 - Uncertainty in terms of the rates of return on infrastructure investments,
 - **Political risk** (for example, governments revoking contracts, popular protests against private or foreign companies) and
 - The infrastructure users' ability to pay.

Characteristics of Regulation in Brazil

- Privatization 1994-97
 - Public Service Law (Law 8,987 of February 13, 1995)
 - General Law of Telecommunications (Law 9,472 of July 16, 1997)
 - Petroleum Law (Law 9,478 of August 6, 1997)
- Regulation Under Attack: The Government Under Lula (2003-2008)
 - Attempt to Delegitimize the Authority of the Agencies:
 - Deemed to be Anti-Democratic
 - Autonomy in Relation to the Executive, who is Directly Elected.
 - Freezing of the Agencies' Budgets
 - Political Nominees with No Experience and/or Vacancies in Agency Positions
 - Lack of Clear Regulatory Agenda and Action

Characteristics of Regulation in Brazil

- New Measures (2009-...)
 - Electricity (MP 579 of 2013)
 - Ports (MP 595 of 2013)
 - New Grants: Highways and Airports
- Contradictory Tendencies
 - Intention to Encourage Private Investment in Infrastructure
 - Excessive State Intervention
 - Establishing Investment Goals and
 - Trying to Control Prices in Competitive Markets)
- Results
 - Conflicts between Concessionaires and the Government
 - Renewal of Concessions for Ports and Electricity Generation
 - Attempt to Establish Low IRR for New Highway and Airport Concessions
 - Agencies Captured by the Government
 - Retreat by the Government and the Agencies in the Face of Resistance from the Private Sector
 - Margin for Negotiation
 - Possible Strengthening of the Agencies' Technical Capability

Case Study #1: Price Controls

- Public Notice and Comment No. 14 of March 15, 2013, realized by the National Telecommunications Agency (ANATEL), proposes to define the Telecommunications Service Index (IST) as the mandatory price index for PayTV and Broadband services.
- The present contribution to Public Notice and Comment No. 14 shows that:
 - The imposition of the IST as the price adjustment index for PayTV and Broadband services will cause financial instability for telecommunications service providers. The variable and fixed costs involved have demonstrated greater increases than the IST, which means that profitability will decrease.
 - Replace the IGP-M index which has been up until now the index used by telecommunications service providers, will have a negligible impact on the official inflation index, the IPCA
 - The PayTV sector, as shown by some of the principal competitiveness indicators: the reduction of the price of the basic package, the volatility of market participation, and the growth in the number of subscribers, is extremely competitive and does not require any form of price controls

Economic and Financial Impact

Profit and Loss – First Quarter 2013

Horizontal Results	2009	2010	2011	2012	2013/1	Δ 2013 /2009
1. Net Revenue (PayTV, Broadband, and Others)	84,4	88,0	92,8	97,4	100,0	18%
2. Margin (EBIT)	13,3	13,2	12,3	12,5	12,0	-10%
3. Total Cost	71,1	74,8	80,5	84,9	88,0	24%
3.1. Variable Direct Costs (Link, Programming, Relationship with Users)	27,6	29,1	31,6	33,4	34,9	26%
3.2. Variable Indirect Costs (Commercial Costs, Billing, and Outsourcing)	26,2	27,6	29,6	31,3	32,5	24%
3.3. Fixed Costs (Infrastructure, Poles, Energy, Depreciation, Amortization and Others)	17,3	18,1	19,3	20,1	20,6	19%
Vertical Results	2009	2010	2011	2012	2013/1	
1. Net Revenue (PayTV, Broadband, and Others)	100,0	100,0	100,0	100,0	100,0	
2. Margin (EBIT)	15,7	15,0	13,3	12,9	12,0	
3. Total Cost	84,3	85,0	86,7	87,1	88,0	
3.1. Variable Direct Costs (Link, Programming, Relationship with Users)	32,7	33,1	34,1	34,3	34,9	
3.2. Variable Indirect Costs (Commercial Costs, Billing, and Outsourcing)	31,0	31,3	31,9	32,1	32,5	
3.3. Fixed Costs (Infrastructure, Poles, Energy, Depreciation, Amortization and Others)	20,5	20,6	20,7	20,7	20,6	

Source: ABTA

Case Study #2: Investment Goals

- December 19, 2011, public hearing nº65
- Proposed Regulations of the SeAC and of the rules that will govern the provision of PayTV (Cable TV - TVC, MMDC, DTH)
- Feedback from society
 - Viability of imposing commitments on companies holding SeAC licenses.
 - Encourage investment in cable telecommunications networks, which contribute to the expansion of broadband access in Brazil.

Normative Suggestion

- The purpose of the Hearing is to submit to the public the proposed regulations for the Conditional Access Service (SeAC).
- The Consultation contains material related to broadband services:
 - A subject which is not covered by the SeAC Law.
- This is not the appropriate way for ANATEL to carry out its regulatory function.
- This topic is inconsistent with the aim of the consultation
 - Legal uncertainty

The Proposal

- SeAC providers which belong to major economic groups that have cable networks would be obliged:
 - to offer broadband access in municipalities that are “less economically attractive”
 - to a minimum number of households that would be set by the regulator.
 - to public sector establishments or public utilities, indicated by the regulator.
- Conflict with the legal system

Economic Effects of the Proposal

- Its economic effects would be negative:
 - There would be less investment
 - There would be a decrease in the number of municipalities served by cable networks
 - There would be a drop in the number of subscribers and in the level of competition in these municipalities
- The burden of imposing commitments would fall on operators acting in competitive open markets
 - The providers do not have any guarantee of economic-financial stability and, therefore, depend on the profitability of their investments in order to be able to continue investing.

Economic Effects of the Proposal

- Part of the investments that would be made by TVC providers would generate no return.
 - The network would be remunerated only by those users who were willing and able to contract the service
- The act of imposing investment commitments could turn municipalities with a positive Net Present Value (NPV), into projects with a negative NPV
 - It would not be worth investing
 - It would not be able to cover the funds invested or its Weighted Average Cost of Capital.

Effects of the Compulsory Coverage Index on Investments

Exigência de Cobertura	Cidades com Lucro>0	Cidades com Lucro<0	Soma dos Lucros Positivos	Soma dos Lucros Negativos
10%	180	0	R\$218.647.276,13	R\$0,00
20%	180	0	R\$218.647.276,13	R\$0,00
30%	180	0	R\$218.647.276,13	(R\$606.107,40)
40%	178	2	R\$218.647.276,13	(R\$8.634.781,89)
50%	164	16	R\$218.647.276,13	(R\$25.737.031,56)
60%	126	54	R\$218.647.276,13	(R\$48.328.862,84)
70%	90	90	R\$218.647.276,13	(R\$75.832.714,10)
80%	71	109	R\$218.647.276,13	(R\$107.516.550,82)
90%	53	127	R\$218.647.276,13	(R\$145.009.533,06)
100%	15	165	R\$218.647.276,13	(R\$302.035.309,30)

Fonte: Elaboração própria a partir de informações IBGE, Net Serviços e Almeida (2010)

CONCLUSION

- The imposition of investments would contradict the economic order as defined in the Brazilian Constitution. It is the State's duty to regulate and monitor economic activity, always in accordance with the Law.
- It would derail the entire competitive structure of the broadband and Pay TV market.
 - Resulting in a decrease in the supply of Pay TV and broadband services.