

# TURNING THE PAGE ON *LAVA JATO*: BRAZIL'S NEW MARKET-BASED APPROACH TO INFRASTRUCTURE

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## New Opportunities for International Participants in Brazilian Infrastructure Development

Earlier this month, Brazil's President Michel Temer launched a new phase of Brazil's infrastructure concessions program, called the **Investment Partnerships Program** (Programa de Parcerias de Investimentos; "PPI"). The new program is driven by several key considerations:

- Brazil is struggling to emerge from its worst-ever recession
- Brazil has suffered (at many levels) from the Lava Jato ("Car Wash") scandal
- Brazil needs to address a multitude of needs across its infrastructure sector
- Brazil is trying to attract both private capital and foreign capital
- Brazil's local infrastructure "majors" have been caught by the Lava Jato scandal, creating a gap in the infrastructure sector that needs to be filled by foreign participants, with the new PPI being structured specifically to facilitate such foreign participation.

President Temer's announcement identified 55 new projects under the program, which added to the list of 35 projects that were designated in 2016. These projects include both greenfield and brownfield projects and comprise the whole range of infrastructure assets, including power generation and transmission/distribution assets, oil & gas infrastructure, roads and highways, cargo port terminals, railways, and airports.

The 2017 announced projects are expected to result in approximately 45 billion reais (approx. \$ 14.4 billion USD) in direct investments required for new projects and contracted upgrades to existing (brownfield) projects, as well as create 200,000 direct and indirect jobs.<sup>1</sup>

The Brazilian government is making project level debt financing available to PPI projects in order to attract foreign investment. The Brazilian Development Bank ("**BNDES**"), along with Banco do Brasil and Caixa Econômica Federal, will provide up to \$5.5 billion USD in funding, and the Workers Compensation Fund will finance up to \$3.5 billion USD, in the form of project debentures and commercial loans.<sup>2</sup> Access to such financing is conditional upon the project sponsor(s) provision of completion bonds (as security instruments in favor of the Government) in order to guard against construction risk. BNDES will charge 150bp over the bank's long term interest rate, plus an extra spread based on the credit risk of the borrower, and is authorized to fund up to 50% of the project debt depending on the type of project. PPI projects are also required to have a minimum 20% equity investment by the project sponsors.<sup>3</sup>

## **I. The Program for Partnerships and Investments (PPI)**

The PPI was adopted into law by the Brazilian Congress in September 2016 (Law No. 13.334 of September 13, 2016, or the "**PPI Law**"). The PPI Law states that it is created "... to expand and strengthen the interaction between the State and private-sector through the signing of partnership agreements for the execution of public infrastructure ventures and other privatization measures...".

At its core, the PPI seeks to restore foreign investor confidence in Brazil and in its public-sector procurement regime (a direct result of the Lava Jato scandal) by increasing the role of private sector participation in infrastructure through both institutional and legal reforms that seek to limit or remove the State's role in the provision of infrastructure and related services. The PPI accomplishes this objective by (a) centralizing critical infrastructure project identification and prioritization in the office of the President, (b) establishing a market-driven procurement and contracting regime for public infrastructure, and (c) creating a legal onus on the Brazilian civil service to work constructively and cross-departmentally in order to fast-track and license/permit PPI projects.

## **II. Main Features of the PPI**

### **The Role of the Presidency and Institutional Reforms**

PPI projects are critical infrastructure projects that have been identified as high-priority and suitable for private sector participation by the office of the President of Brazil. The

PPI Law creates two new institutions within the scope of the Presidency of the Republic of Brazil:

1. The Council of the Program of Investment Partnerships of the Presidency of the Republic (the "**Council**"); and
2. The Secretariat of the Program for Partnerships and Investments (the "**Secretariat**").<sup>4</sup>

The Council is both an advisory and executive board that provides direction, recommendations, and oversight of the PPI generally. Its members are appointed by the PPI Law and include the Chief of Staff to the President as well as the State Ministers from each of the Government departments of (i) Finance, Planning, Development and Management, (ii) Transport, Ports and Civil Aviation, and (iii) the Environment (collectively, the primary Government departments responsible for critical infrastructure procurement and oversight), as well as (x) the Executive-Secretary of the Secretariat, (y) the President of BNDES, and (z) the President of Caixa Econômica Federal, which is the second-largest Government-owned financial institution. The primary functions of the Council are to receive and consider proposals for Government-sponsored projects that are proposed to be PPI designated and to vote as a collective to decide if such status is appropriate. The PPI Law provides that, in the event of any stalemate, the President of Brazil shall make the final decision.<sup>5</sup> The Secretariat, headed by its Executive-Secretary, is an administrative body that functions to both support and implement the work of the Council, by coordinating its activities and guiding its operations.

## Procurement & Contracting

Following designation as a PPI project by Council, PPI projects are subsequently tendered for public auction pursuant to existing Government procurement laws and regulations. However, the PPI adds further requirements, such as requiring tender documents be published in English (to attract foreign investment) and prescribing timeframes for the award of contracts from the date of tender issue, along with other criteria for the design of project documentation, including in respect of the project-specific partnership agreement and pricing/compensation considerations (such as minimum bid price requirements).

The main tool for PPI projects is the partnership agreement, which is to be entered into between the private sector entity responsible for the PPI project (the party that wins the tender award for the Project) and the appropriate Government ministry or Government-affiliated entity (the tender issuer). The PPI Law designates the partnership agreement as

a generic label for a variety of long-term (20-30 year) contracting arrangements that incorporate the PPI market-driven procurement approach. Pursuant to the PPI Law, these contracting models include (1) common concessions, (2) public-private partnerships (PPPs), (3) leases of public property, (4) certain public sector permits and (5) "other public-private businesses that, due to their strategic nature and complexity, specificity, volume of investments, long-term risks or uncertainties involved, adopt a similar legal structure..."<sup>6</sup>

As it is standard with any major infrastructure project agreement, these contracts include extensive provisions specifying the contractor's/operator's performance obligations, particularly with respect to service levels and standards. Delays and low quality services that result in contract non-compliance may result in significant financial deductions and possibly early termination of the agreement (and project concession).

## **Bureaucratic Prioritization**

In addition to the innovating contracting modalities described above, what makes PPI projects unique is the special status they are afforded within the Brazilian state apparatus. The PPI Law specifically states that "... PPI ventures (projects) shall be treated as a national priority by all public execution or controlling officials...."<sup>7</sup>. The PPI Law further describes the responsibilities of civil servants to act collectively and efficiently to process PPI project-required permitting, licensing, other authorizations in a uniform, economic and time-sensitive manner. The intent of these requirements is to "fast-track" PPI projects and reduce the possibility for administrative delays on the part of governmental authorities that could harm the PPI project completion and/or performance (as well as project economics).

## **III. Operation *Lava Jato***

In March 2014, the Federal Police of Brazil commenced its "Car Wash" investigation into allegations of corruption and money laundering involving officials of state-controlled entities (most notably Petrobras) and the tender and award of major public construction projects. The investigation subsequently triggered further allegations, investigations and criminal convictions involving over 40 politicians at the highest levels of Government from multiple political parties, including the impeachment and removal from office of Brazilian President Dilma Rousseff in August of 2016, pursuant to a majority vote of the Brazilian Senate.

It is no surprise that many commentators attribute the Lava Jato scandal as the main

contributing factor to Brazil presently sustaining its worst recession on modern record, following many years of exceptional economic growth. While Lava Jato and the ensuing political scandal remain front-page news, Brazil's greater structural problems of high-unemployment and aging public infrastructure are yet to be resolved.

Several major infrastructure players, including Odebrecht, have been caught up in, and brought down by, Lava Jato, which will have an enduring impact on how infrastructure projects are bid, awarded, structured, and executed in Brazil. Of note, the impact of Lava Jato has spread to other Latin American jurisdictions, such as Peru. While these more widespread impacts are beyond the scope of this note, it remains to be seen what the long term affects will be for the region. That said, we expect similar opportunities for outside contractors to fill in the gaps that are created by similar investigations and indictments.

## **IV. Initial Success of the Program and Next Steps**

On March 16, 2017, it was announced that the Brazilian federal government had raised 3.72 billion reais (\$1.2 billion USD) by the auction of 25-30 year concession contracts in respect of four operating airports to foreign investors.<sup>8</sup> In each case, the proponent's financial commitments well exceeded minimum bid prices required by the auction procurement process. Third party observers believe this accomplishment is a tremendous endorsement for the financeability and viability of the PPI generally and a stimulus to future foreign investor participation in other PPI auctions.

At the time of the launch of PPI, Executive-Secretary of the Secretariat Mr. Wellington Moreira Franco remarked that the stated goal of the program is to provide more transparency to the procurement process and attract foreign capital to fund and run infrastructure projects. The success of the airports auction seems to be very much in line with these goals.<sup>9</sup>

The PPI generally and the airports auction in particular are desperately needed to advance Brazil's economy beyond Lava Jato and accelerate the much-needed investment required to reduce unemployment and replenish and revitalize the country's infrastructure stock. A highly successful PPI in Brazil could stimulate South American neighbors in other jurisdictions to consider the PPI model for fast-tracking critical infrastructure and monetizing existing government owned or controlled brownfield projects.

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[1] "Brazil's Temer Launches 45 Billion Reais Infrastructure Concession Plan", Reuters, 7 March 2017.

[2] Faria, Fernando and Endo, Mauricio. "Foresight - Brazil's pragmatic new infrastructure program", KPMG - Insights, September 27, 2016. Available at:

<https://home.kpmg.com/xx/en/home/insights/2016/09/foresight-brazils-pragmatic-new-infrastructure-program.html>

[3] "Brazil says markets, no politics, will drive infrastructure investments", LatinFinance, September 28, 2016. Available at: : <http://www.latinfinance.com/Article/3589008/Brazil-says-markets-not-politics-will-drive-infrastructure-investments.html#.WNkbbk28rJ1M>

[4] PPI Law, Section II and Section III.

[5] PPI Law, Section II, 7<sup>th</sup> Art.

[6] PPI Law, Section I, 1<sup>st</sup> Art., 2<sup>nd</sup> para.

[7] PPI Law, Section 1, 5<sup>th</sup> Art.

[8] Fraport AG Frankfurt Airport Services Worldwide won concession contracts to operate the Porto Alegre and Fortaleza airports. Vinci SA won the rights to Salvador airport, while Flughafen Zuerich AG was awarded the concession for Florianapolis airport.

[9] "New Concessions Plan Will Bring More Transparency to Attract Foreign Capital", BrazilGovNews, August 13, 2016. Available at:

<http://www.brazilgovnews.gov.br/news/2016/08/new-concessions-plan-will-bring-more-transparency-to-attract-foreign-capital>

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