International Lawyer

Volume 41 | Number 3 Article 7

2007

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Recent enthusiasm for public-private partnerships (PPPs) in Brazil has led to the approval of a recent regulation on the matter. The new law follows international patterns, and it is seen as a solution for attracting investments in infrastructure. This article analyzes the constitutional grounds and modalities of PPPs in Brazilian law and its legal limits. Moreover, the article presents the jurisdictional aspects of the PPP contract in Brazil, which entails the possibility of judicial intervention or arbitration to solve disputes. The article concludes that the future of PPPs in Brazil depends on overcoming institutional and political problems that may threaten their efficiency. One of these institutional problems is the uncertain evolution of the case law, since an additional judicial risk is related to the local impacts of huge infrastructure projects.

I. Introduction

The last few years have been marked by incentives for private investments in Brazil's infrastructure. Institutional changes have made the oil monopoly more flexible, and new regulatory agencies have brought substantial security against political influence on contracts and bidding procedures. The last move occurred in 2004 with the approval by the National Congress of a new public contract based on the public-private partnerships (PPPs) model.

In fact, these improvements have an explanation: the Brazilian economy currently faces a huge obstacle to its sustainable growth as a result of bottlenecks in its infrastructure. The Brazilian mainstream economic view is that these bottlenecks may negatively affect domestic growth, as well as its trade competitiveness, by raising the final costs of Brazilian manufacturing and commodities.

Indeed, many sectors of the Brazilian infrastructure are accused of unsatisfactory quality standards. For example, 75 percent of the country's road pavement is in deficient, poor, or very poor condition, which reduces trucking transportation by 40 percent, on average.[1]

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1. National Confederation of Transportation (CNT) 2006, *available at* http://www.cnt.org.br.

The estimated cost of repairing the roads so that they will be safe and effective is over US $9 billion, with an additional US $400 million each year for appropriated maintenance.[2]

Water and sewage is another problematic sector. In 2000, the percentage of citizens with average access to water reached 75.2 percent.[3] Sewage, which reached only 44 percent of the population, is in an even worse condition.[4] In these cases, the investment required to universalize the service within twenty years is estimated to be over US $93 billion, far beyond the current public budget.[5] Both examples expose the urgent demand for infrastructure investment in Brazil and also emphasize the considerable amount of resources that must be invested by private capital. "Infusing Brazil's infrastructure with private investment is particularly important when the restrictions on public investments, such as budgetary controls and factual limits for raising revenue with taxes, are taken into account."[6]

Constraints on public investments are the result of a long, macroeconomic stabilization process. For decades, the government funded public spending through inflation and debt. This process allowed economic growth while creating a mounting domestic and external debt with inflation. As a response to persistent financial crisis during the 1980s, different stabilization plans were implemented, but they all failed to reduce inflation to acceptable levels.[7]

In 1994, the *Plano Real* was the first plan to successfully control inflation.[8] In the short term, the plan reached its purpose using an optimistic perspective of gross domestic product (GDP) growth above the levels prevailing before stabilization.[9] Inflation control was achieved through artificially inflated exchange rates and high interest rates.[10] Because the public sector could no longer depend on money issuance to finance its expenditures, a tighter fiscal policy became necessary.[11] High interest rates concomitant with successive deficits in current transactions also suggested the need for a new fiscal policy.

The chosen strategy for a new fiscal policy used two main tools: increasing taxation and reducing expenditures. Taxes were consistently raised for more than a decade; in 1994,

2. *Id.*

3. Brazilian Census Bureau (IBGE), *available at* http://www.ibge.gov.br.

4. *Id.*

5. Brazilian Association of Infrastructure and Basis Industry (ABDIB) 2005, *available at* http://www.abdib.org.br.

6. During the debates on PPPs in the Brazilian Congress, one favorable argument was that the country needed investments of US$ 20 billion per year to fund its infrastructure sectors. Helio Milesky, *Parcerias Público-Privadas: Fundamentos, Aplicação e Alcance da Lei, Elementos Definidores, Princípios, Regras Específicas para Licitações e Contratos, Aspectos Controvertidos, Controle e Perspectivas de Aplicação da Lei nº 11.079, de 30.12.2004*, INTERESSE PÚBLICO, SÃO PAULO, Jan.-Feb. 2005, at 63.

7. Frederico A. Turolla, Tomas Anker & Ricardo Meirelles de Faria, Infrastructure Services in Brazil: The Role of Public-Private Partnership (PPP) in the Water & Sewerage Sector 6 (Nov. 5, 2004) (unpublished manuscript) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=616241 [hereinafter The Role of PPP].

8. Luiz Filgueiras, HISTÓRIA DO PLANO REAL (2003).

9. The Role of PPP, *supra* note 7, at 7. In fact, Brazil grew 4.22 percent in 1995, 2.66 percent in 1996, and 3.27 percent in 1997. Central Bank of Brazil (BACEN), *available at* http://www.bcb.gov.br.

10. Filgueiras, *supra* note 8.

11. The Role of PPP, *supra* note 7, at 8.

taxes represented 27.8 percent of the GDP, while in 2005 the percentage reached 37.8 percent, of which 25.5 percent represented federal taxes.[12]

There are other explanations for this massive tax burden. Although the new Fiscal Responsibility Law[13] restrained federal, state, and municipal expenditures, and the federal government adopted primary surplus targets in 1998 (currently at 4.25 percent of the GDP per year), government expenditures were raised substantially. In 1994 the expenditures of the federal government amounted to R$320 billion, and by 2006, it reached R$526 billion.[14] This increase may be partially explained by expanding social security benefits amid unfavorable demographic changes, high interest expenses linked to a tight monetary policy, and an increase in civil servants' payroll. This same period did not witness any evolution in federal public investments; in 2005, these investments reached only R$17 billion, the same as in 1994.[15]

It is also important to mention that as the public sector faces a variety of budgetary constraints, the private sector has been unable to invest in infrastructure. First, Brazilian law limits investments in some sectors. These limits vary from complete prohibition of investment to requiring permission or concessions prior to investing. The second factor constraining investment is the high rate of interest charged by private financial institutions, rates which are a consequence of the high interest rates the federal government pays in public borrowing. As the greater portion of financial resources is allocated to the public sector, the private sector has struggled for funding, thus raising the costs of capital.

This picture helps us understand Brazil's recent enthusiasm for public-private partnerships (PPPs); infrastructure bottlenecks limit sustainable growth, and there is no short-term solution for limited public investments. Conceptually, a PPP delegates responsibilities to execute and operate a project or service granted to the private sector by a public entity under the conditions of delivering both results and a certain level of service performance. The Brazilian PPP Law, otherwise known as the 11.079/04 Act, was published in December 2004, but it is only now that the PPP projects have started to become a reality.[16] The topic has also become a central theme in recent speeches by federal authorities.[17]

Thus, the PPPs are supposed to achieve two objectives. As a legal framework, since long-term contracts are involved, the regulation will guarantee institutional security for investors and private partners against the government's arbitrary acts while avoiding imbalances in the government budget. As a new model of investment, the PPPs should bring efficiency to the administration of public services.

In order to understand the recent evolution of PPPs in Brazil, the first part of this article will analyze the constitutional grounds and modalities of PPPs in Brazilian law as well as the government entities that may use such contracts. The second part will identify

12. Brazilian Census Bureau (IBGE) and National Treasury Secretariat (STN) 2005, *available at* http://www.fazenda.gov.br.

13. In May 2000, Brazil enacted a Fiscal Responsibility Law (LRF) that strengthened fiscal institutions and established a broad framework of fiscal planning, execution, and transparency at the federal, state, and municipal levels. The Brazilian Fiscal Responsibility Law, Supplementary Law 101 (May 4, 2000).

14. Brazilian Census Bureau, *supra* note 3.

15. National Treasure Secretariat (MF/STN), *supra* note 12.

16. Projects currently under analysis are discussed below.

17. *Lula comemora aprovação da PPP*, RADIOBRAS, 22 Dec 2004.

the parties involved in the bidding process along with the legal limits and requirements for participation. The third part will analyze the main clauses in PPP agreements and identify the mandatory and optional clauses. Moreover, this third part will discuss the legal and optional guarantees required by the law. Finally, this article will present the jurisdictional aspects of the PPP contract in Brazil, which entails the possibility of judicial intervention r arbitration to resolve disputes.

II. PPPs in Brazil: Constitutional Grounds and Legal Modalities

A. Constitutional Grounds

The Brazilian Federal Constitution does not expressly mention the regulation of PPPs. It does, however, outline the general rules and principles of concession regimes that affect the bidding process where government entities are involved.

The government, according to the Constitution, is in charge of providing public services, whether directly or indirectly.[18] At the federal level, only two types of services shall be provided directly by the government: the postal service and the air postal service.[19] Indirectly, there is a large, non-exhaustive list of public services that may be provided through transference to private management (*concessões*).[20] The Federal Constitution also requires that administrative contracts for public works, services, and public procurement be made through a bidding process at the federal, state, or municipal level.[21] At the federal level, the Union has the ability to legislate general procurement rules and public contracts.[22]

B. The 11.079/04 Act

The 11.079/04 Act (the PPP Law) establishes the PPPs. The procedure is mandatory not only for the federal government, but also for states, the Federal District of Brasília, and local municipalities.[23] The PPP Law is also applicable to agencies, public foundations, government-owned companies, mixed public-private corporations,[24] and all other entities that are directly or indirectly controlled by the federal government or other government entities.[25]

At first glance the PPP Law may seem widely applicable, but the Federal Constitution establishes that the Union's decision to create general rules does not exclude the complementary jurisdiction of the states.[26] "Complementary," in this context, means that states

18. Constituição Federal [Constitution] art.175 (Brazil).

19. *Id.* art. 21, X.

20. Celso A. Mello, Curso de Direito Administrativo 634-35 (15th ed. 2003).

21. Constituição Federal art. 37, XXI.

22. *Id.* art. 22, XXVII.

23. Lei No. 11.079, de 30 de dezembro de 2004, D.O.U. 31.12.2004, *available at* http://www.planejamento.gov.br/arquivos_down/ppp/Legislacao/Lei_11079_301204_eng.pdf.

24. Mixed public-private corporations are companies partially owned by governmental institutions. The Brazilian Constitution asserts that these corporations are under the same legal treatment as other private corporations. *See* Constituição Federal art. 170.

25. Lei No. 11.079 art 1.

26. Constituição Federal art. 24, ¶ 2.

may regulate a particular aspect or fulfill a legal gap, although federal law will always prevail over state law where they conflict. Actually, some Brazilian states created their own methods of regulating PPPs even before the federal law was in force.[27] In these cases, the state law will be valid as long as it is in accordance with the federal law.[28]

C. Objectives and Types

In Brazilian law, a PPP is created when the government delegates a project or service's operation to a private entity. Two kinds of objectives may be involved in a contract: 1) a *concessao* to manage public services; or 2) a contract to provide a service in which the administration is the direct or indirect user.

Brazil created two modalities of PPPs in accordance with these objectives. One is the "sponsored concession" (*concessão patrocinada*) related to the management of a public service, which may or may not be preceded by the construction of a public project. In both instances the contract implies a direct government payment to the private partner in addition to user charges collected by the private partner.[29] Thus far, sponsored concessions have been used to delegate the construction, conservation, reform, enlargement, and improvement of roads.

Sponsored concessions should not, however, be confused with "common concessions," which are not covered by the PPP Law. A common concession is also applied where the government delegates a public service, preceded or not by the construction of a public project, but does not pay; thus, remuneration to the investor is paid only by the users. Common concessions are regulated by the 8.987/95 Act and the 9.074 Act.[30]

Another modality of PPP is the "administrative concession" (*concessão administrativa*). This occurs when the concession involves a contract for providing services to the administration, as the direct or indirect user, even if public works or the supply and installation of goods are involved.[31] Administrative concessions are regulated, additionally, by the 8.987/95 Act (Articles 21, 23, 25 and 27 through 29) and by the 9.074/95 Act (Article 31).[32]

Administrative concessions differ from general building contracts (*contrato de empreitada*). In general building contracts, the administration contracts with a private person to execute a project whereas in an administrative concession, the contractual object is to provide a service to the administration, even when the execution of a project is involved. The 8.666/93 Act will be applicable to general building contracts, and this regulation differs materially from the PPP Law.

Finally, the 11.079/04 Act forbids the use of PPPs when: 1) contracts are under R$20 million, which is roughly US$9 million; 2) the service will continue for fewer than five years; or 3) the contract's sole objective is to supply handwork or goods, or to execute a

27. São Paulo, Minas Gerais, Rio Grande do Sul, Ceara, Goiás, Bahia, and Santa Catarina are some examples.

28. Milesky, *supra* note 6, at 14.

29. Lei No. 11.079 art. 2, § 1. This article makes reference to the 8.987/95 Law, which gives the definition of "*concession of public service*" and "*concession of public service preceded by the construction of public projects*" mentioned in the PPP Law.

30. *Id.* art. 3, § 1. The 9.074/95 Act, as well as the 8.87/95 Act, is applicable to the concession of public services, but it also entails some specific regulation for the energy sector.

31. *Id.* art. 2, § 2.

32. *Id.* art. 3.

public project.[33] In these situations, contracts shall be regulated according to their objectives by the 8.987/95, 9.076/95, or 8.666/93 Act.

There are two substantial differences between the administrative and sponsored concessions. The first difference relates to the final user. In administrative concessions, the user is, directly or indirectly, the administration. In sponsored concessions, on the other hand, the user is the community. The use of administrative concessions to explore public services has been an important discussion. Because the PPP Law mentions that the administration may be, *indirectly*, the user of the service, it was argued that almost all public services—from road conservation to water distribution—are somehow used by the administration. This argument is strengthened by the fact that, as previously mentioned, some articles of the 8.987/95 Act, which regulates the common concessions of public service, are applicable to administrative concessions. As the PPP Law is unclear, and this issue is relatively new, a better definition of the limits of the administrative concession will have to wait for the practices of the administration and future case law.

A second difference between the modalities of PPPs in Brazil is the remuneration paid to the investor. In the administrative concessions, the private partner will be compensated only by government payments, whereas in the sponsored concession, the investor will also receive user charges.

The law establishes two additional special rules to be applied in each modality. In the case of a sponsored concession, if the administration pays more than 70 percent of the compensation for the private partner, the concession will need prior legislative approval.[34] In the case of an administrative concession, the offering of the service will be preceded by payment from the administration.[35]

D. PPPs Planning Underway at the Federal Level in Brazil

As of November 2006, six PPP projects were being executed at the federal level in Brazil. Three of them have been assigned to explore the construction, conservation, reform, enlargement, and improvement of roads. In two of these cases, the administration is using sponsored concessions, but there is one case in which the modality is still undefined (the construction of Federal Road 163).[36] This latter case demonstrates how the administration may use administrative concessions in situations where the private partner could also be remunerated by user charges because the administration is the indirect user of the road.

Another example is the recent project of constructing and operating a data center for federal public banks.[37] Federal public banks are incorporated as mixed public-private entities or government-owned corporations and are therefore within the scope of the law. Because these banks will be the sole users and, consequently, the private partner will not

33. *Id.* art. 2, § 4.

34. *Id.* art. 10, § 3.

35. *Id.* art. 7. This article uses the terminology "services" and not "public service". Thus, by inference, it does not refer to the sponsored concession.

36. One last road, the Federal Road 493, is currently under a technical viability study that will define its modality.

37. Ministério do Planejamento, *Projetos*, *available at* http://www.planejamento.gov.br/ppp/conteudo/Projetos/index.htm.

be paid by private users, this PPP was projected as an administrative concession.[38] Finally, the federal government is planning two PPPs for the construction of railroads.[39] These projects are currently the subject of viability studies, and the PPP modality has not been chosen.[40] According to government officials, at this early stage of PPPs in Brazil, the main criteria for project selection is their logistical integration into export corridors and their distribution throughout the national territory.[41]

III. Parties in PPP Contracts

A PPP contract involves four types of participants: the administration (or public partner), the private partner, the guarantor, and the investor. The PPP Law establishes specific requirements and limitations for these parties, which will be analyzed in the next section.

A. Public Administration

The definition of public administration in Brazilian law is very broad.[42] It encompasses special funds, semi-autonomous agencies, public foundations, government-owned companies, mixed public-private corporations, and all other entities that are directly or indirectly controlled by the federal government, the states, municipalities, and the Federal District of Brasília. Under this expansive definition, the administration must fulfill some requirements before opening a bidding process. For example, expenses created by a PPP project must not affect the primary surplus targets defined by the Fiscal Responsibility Law and must respect other imposed limits.[43] The bidding process must be preceded by an estimate of budgetary impact[44] and a statement from the responsible authority, stating that the obligations established by the contract are in accordance with the budgetary laws.[45] The administration must also present an estimate of public resources sufficient to pay the contractual obligations during the period of the contract and during each fiscal year.[46] The PPP's objective should also be inserted in the current multi-year planning law.[47]

Finally, at the federal level, the law prohibits contracting with PPPs: 1) when the sum of the current expenditures derived from the partnership contracts already signed has exceeded 1 percent of the current net revenue of the previous fiscal year, and 2) when the annual expenditures of contracts in the subsequent ten years do not exceed 1 percent of the current net revenue forecast for the respective fiscal years.[48]

38. *Id.*
39. *Id.*
40. *Id.*
41. Ministério do Planejamento, *Projetos*, *available at* http://www.planejamento.gov.br/ppp/conteudo/Projetos/index.htm.
42. *See id.* § 1.2.
43. Lei No. 11.079 art. 10, I(b)-(c).
44. *Id.* art. 10, II.
45. *Id.* The Brazilian federal budget process includes two legal instruments, the Budget Directives Law and the budget itself. Another instrument involved is the Multi-Year Planning or PPA (*Planejamento Pluri-Anual*). It is created by the Executive and voted by the Congress every fiscal year.
46. Lei No. 11.079 art. 10, IV.
47. *Id.* art. 10, V.
48. *Id.* art. 22.

In addition, the law forbids the federal government from making voluntary transfers to states and municipalities if those same conditions are not met. In this situation, PPPs are not forbidden, but the states will not receive voluntary resources from the federal government.[49] Nevertheless, state laws on PPPs may stipulate other restraints or requirements, in order to adjust the federal law to their specific fiscal characteristics. Another administrative requirement of the PPP is to demonstrate the convenience and appropriateness of opting for the PPP model by identifying the justifications for it.[50] Additionally, the draft contract must be published and submitted for public consultation, and a prior environmental license must be obtained when the subject matter requires it.[51]

B. The Private Partner

The most important requirement for the private partner, under the PPP Law, is the creation of a Special Purpose Company (SPC). The SPC, whose legal personality will be different from the bidder, will be legally responsible for implementing and managing the project. Therefore, before signing the contract, the winner of the bidding process must create a specific company to manage the project. This company must obey all Brazilian accounting rules and use corporate management patterns.[52]

Because the Brazilian General Procurement Law allows the participation of natural persons in contracts with the administration, the SPC may be comprised of natural persons as well.[53] However, this alternative may be inconvenient for tax reasons. Moreover, there are no restrictions against using foreign capital in the SPC.

This SPC may be incorporated under any model allowed by the Brazilian law, including a publicly traded corporation[54]. The transfer of its control will be subject to a public authorization, as established in the contract.[55] The majority of the voting capital cannot be held by the administration, except when a public financial institution is part of the contract as an investor, and acquires control of the SPC upon default.[56]

C. The Guarantor

The PPP Law also regulates the guarantor's role because of the large amount of capital usually necessary for investments in infrastructure. The existence of a guarantor is not mandatory under the law, as guarantees may be offered solely by the administration, but the law seems to encourage the participation of third parties. In fact, the law authorizes, in a non-exhaustive list, participation by guarantors of multilateral entities, special funds, and private financial institutions. The law also created a private corporation, the PPP

49. *Id.* art. 28.
50. *Id.* art. 10, I(a).
51. *Id.* art. 10, VI-VII.
52. *Id.* art. 9, § 3.
53. Marcelo Féres, *As Sociedade de Propósito Específico (SPEs) no Âmbito das Parcerias Público-Privadas (PPPs): Algumas Observações de Direito Comercial sobre o Artigo 9º da Lei nº 11.079, de 30 de dezembro de 2004*, 2 Revista IOB de Direito Administrativo 115 (2006).
54. Lei No. 11.079 art. 9, § 2.
55. *Id.* art. 9, § 1.
56. *Id.* art. 9, §§ 4-5.

Guarantee Fund (FGP), to guarantee government payments. General directives for the FGP are outlined in the PPP Law, while other decrees regulate fiscal details.[57]

Generally speaking, the FGP's purpose is to protect private investments by offering guarantees which are redeemable when the contracted public payments are not made.[58] The declared intent is to reduce the risk of a political default and, consequently, transaction costs. Although foreseen by the PPP Law in 2004, the FGP was effectively created as a mixed public-private financial corporation in January of 2006.[59] Its resources came from public or private capital, and in the case of public capital, the federal government is allowed to contribute up to R$6 billion.[60] The FGP shareholders will not receive dividends and are allowed to make redemptions at any time.[61]

The institutional features of the FGP emphasize its independence from governmental influence. Legally, it has a private nature and its own capital, different from the capital of its shareholders, and, consequently, it is responsible for its own for its own duties and rights.[62] Also, the administrator, and not the shareholders, is responsible for decisions about management and disposal of the fund's assets.[63]

To ensure the high quality of FGP management, the financial institution chosen to create the fund and its trustee must be specialized in asset management. Additionally, he FGP regulation has articulated strict measures to maintain transparency: a periodic report on the evolution of assets; required periodic reports on relevant facts, as defined; an annual report on the management; the availability of detailed data about the FGP for private partners; and an independent board.[64]

Not only the payments by the FGP to the private partner will entail subrogation of the credits of the private partner against the public partner, but the FGP assets may also be submitted to seizure in order to fulfill its obligations.[65] Moreover, the FGP is prohibited from providing guarantees that exceed the current value of its assets.[66] In order to reinforce institutional security, the FGP regulation has taken a conservative position by restraining offers of guarantees in high risk contracts.[67]

D. The Investor

In an attempt to stimulate private investment in PPP projects, the law authorizes the federal government to grant financial institutions the power to give tax incentives to private investors who invest in PPPs.[68] The National Monetary Council is in charge of

57. Some states have also created their own FGP, normally regulated by its corresponding state law and executive decrees.

58. Lei No. 11.079 art. 16.

59. *Id.* art. 16.

60. *Id.* art. 16.

61. *Id.* art. 19.

62. *Id.* art. 16, § 1.

63. *Id.* art. 17, § 3.

64. Comunicado do Ministerio da Fazenda, Ministry of Finance, *available at* http://www.stn.fazenda.gov.br/hp/downloads/Comunicado_STN_FGP_2701061.pdf. (last visited July 29, 2007).

65. Lei No. 11.079 art. 18, § 4.

66. *Id.* art. 18.

67. Comunicado do Ministério da Fazenda, *supra* note 64.

68. Lei No. 11.079 art. 23.

setting the guidelines for tax incentives related to PPPs, as well as the role of pension funds in funding partnership contracts.[69]

The law also establishes a role for public financial institutions as investors. Credit transactions made by these institutions may not exceed 70 percent of the private partner's total resources. In the less developed regions, the North, Northeast, and Southwest, where the Human Developing Index (HDI) is below the national average, this participation may not exceed 80 percent.[70] These percentages rise to 80 percent and 90 percent, respectively, when, besides the public financial institution, the credit transactions are made cumulatively by closed entities of social security.[71] These variations are grounded on the abysmal economic differences among regions in Brazil. The political rationale is that poorer regions are less apt to attract investments, while the populations of those regions cannot afford high charges for public services.

IV. The PPP Contract and its Main Clauses

In addition to the general clauses of an administrative contract, the law requires the PPP contracts to contain specific clauses. When the administration opens a bidding process, it must publicize the contract with all the details entailing the exploration of the service. These details may vary in each case, depending mainly on what modality of PPP was chosen and what kind of public service will be executed. Nevertheless, this chapter intends to analyze the most important clauses while underlining those of special significance for the private partner and investor.

A. Period of the Contract

The term of the contract may vary from five to thirty-five years, and the law indicates that the term must be in line with the amortization of the investments to be made by the private partner.[72] In the case of administrative concessions, the contract must establish a determined term, while in sponsored concessions the term may be variable, such as between fifteen and twenty years. Because the private partner will be remunerated by charges, the number of users may vary and, consequently, the amortization of the investments may require more or less time to be reached.

B. The Quality Criteria

The PPP Law requires the contract to stipulate objective criteria for evaluating the performance of the private partner[73] and mechanisms to evaluate services provided.[74] Both rules highlight the need to establish, in a clear way, the private partner's obligations in terms of performance.

69. *Id.* art. 24.
70. *Id.* art. 27.
71. *Id.* art. 27, § 1.
72. *Id.* art. 5, I.
73. *Id.* art. 5, VII.
74. *Id.*

C. Penalties

Penalties may be applied to the private or to the public partner whenever a breach of the contract is identified. The law specifies that the penalties must be proportional to the breach and to the nature of the violated obligations.[75] The contract must detail the facts that characterize a pecuniary breach of contract made by the public partner as well as the procedures and the period for requiring the guarantee.[76] In this regard, it is important to note that, as the public partner has some prerogatives in Brazilian law, the penalties applied against it are limited. Recent PPP contracts usually stipulate a fixed fine and, in certain circumstances, the right to suspend investments after a specific period of delay without prejudice to the private partner's right to invoke the guarantee.

On the other side, penalties applicable to the private partner may vary from a warning notice to contract revocation. The PPP Law does not stipulate these penalties, but, per the 8.666/93 Act, they may include: warning notices, fines, and prohibition to contract with the Administration for a specific period of time.[77] More serious breaches may lead to revocation of the contract. Which breaches will be classified as sufficient to revoke the contract will be defined by administrative regulations and case law.

D. Remuneration

Another issue that the PPP contract must clearly address is remuneration. In fact, the PPP Law allows remuneration in several ways, either indirectly through tax subsidies or cession of public assets or directly through transfer of funds. An interesting alternative is the stipulation of a variable method of payment, which is linked to the private partner's performance as measured by standards of quality and the target goals of the service provided.[78] Finally, mechanisms used to adjust remuneration are required by the law to be clearly stated in the contract. Clauses of automatic adjustment, which are based on mathematical indexes such as inflation indexes, may be applied without the public partner's previous agreement. If a disagreement arises, the parties will resolve the dispute through arbitration.[79]

E. Risk Allocation

Because investments in long-term projects involve considerable risks, the contract must address how these risks will be shared between the public and the private partner throughout the duration of the contract. Two kinds of risk are identified by the PPP Law: the normal and the extraordinary.[80] Normal risks are those inherent in any venture, such as management inefficiency or an inexact calculation on demands for the service.[81] Extraordinary risks result from facts that are impossible to foresee or to avoid, like an act of

75. *Id.* art. 5, IV.
76. *Id.* art. 5, VI.
77. Lei No. 8.666, de 21 de junho de 1993, D.O.U., *available at* http://www.planalto.gov.br/ccivil_03/leis/l8666cons.htm.
78. Lei No. 11.079 art 6.
79. *Id.* art. 5, IV.
80. *Id.* art. 5, III.
81. Mello, *supra* note 20, at 689.

God, an act of State, or any extraordinary economic event. Extraordinary risks also include those situations that increase the price inputs, such as tax raises or any future additional duty imposed upon the private partner.[82]

In reality, risk allocation is an important distinction between the PPP and the common concession. In the latter case, normal risks are completely supported by the concessionaire. If the results of the venture are favorable, it will receive proportional profits. If not, the concessionaire assumes the costs.[83] The problem is that, in a final analysis, this risk is transferred to the users through increased fees.[84] In the case of extraordinary risks, they are supported by the administration, and the contract must be adjusted in order to maintain its balance.

In a PPP, however, risks are shared between the public and the private partners. This principle has particular significance for sponsored concessions because the private partner's remuneration depends on the demand for the service, which is something that may not occur. If risks are shared between the contracting parties, the same will happen with profits if the loan conditions are modified.[85] This situation may occur when interest rates decrease or a longer period of repayment is negotiated with the investor. The possibility of benefiting from future conditions is, theoretically, an important advantage for the public partner.

F. Step-in Rights

The PPP contract may also establish the conditions and requirements authorizing the investor to assume control of the SPC; the purpose of this is to maintain the quality and continuity of the service and promote the financial restructuring of the PPP. [86] Of course, this situation will only occur once there is evidence of a default, and the current PPP contracts have included this clause even though it is not mandatory because it gives the investor an indirect guarantee and thus stimulates their involvement in the projects.

V. Guarantees in the Public-Private Partnership

As mentioned before, the PPP contracts must set all the clauses and conditions of the project. These conditions detail the specific guarantees that each party will offer, as outlined below.

A. Guarantees to the Private Partner

The PPP Law includes a non-exhaustive list of possible guarantees that could be offered to the private partner but expressly permits the use of others not prescribed in the Law.[87] The guarantees listed are: attachment of government revenues,[88] creation of special

82. *Id.* at 688.
83. Alexandre Nester, *O Risco do Empreendimento nas Parcerias Público-Privadas*, *in* Parcerias Puúblico-Privadas : Um Enfoque Multidisciplinar. 183 (2005).
84. Marçal Justen Filho, Teoria Geral das Concessões de Serviço Público 72 (2003).
85. Lei No. 11.079 art. 5, IX.
86. *Id.* art. 5, § 2, I.
87. *Id.* art. 8, VI.
88. *Id.* art. 8, I.

funds,[89] surety bonds from companies not controlled by the government,[90] offering of guarantees provided by international organizations or private financial institutions,[91]and guarantees provided by a guarantee fund.[92]

There are two main requirements for the public partner to offer guarantees to the private partner: respect for budgetary laws and preexisting legal authorization. Because these requirements are achieved, the public partner may choose the pertinent guarantee in each project. However, there is an emergent discussion based on constitutional grounds regarding the provision that authorizes the use of government revenues to pay the private partner. Another debate claims that special funds are unconstitutional as prescribed by the PPP Law. In fact, according to the interpretations of some jurists, the concession of these guarantees is against some principles of the Federal Constitution that address fiscal law.[93] In any event, as the current PPP projects did not establish these guarantees, this discussion will be solved only through future case law.

Based upon the recent PPPs, it is possible to say that the most used guarantee is the guarantee fund. While seeming to be the most convenient, the guarantee fund has already been created, and its operation has a detailed legal framework to regulate the use of its resources and mechanisms in order to assure the reliability of the guarantees conceded.[94]

Offering guarantees by a third person, such as an international organization or private financial institution, or even the contracting of insurance with a company to assure the public partner's participation, will depend on their ability to trust existing conditions to honor payments. Nonetheless, once the guarantee fund has some legal limits to offer guarantees, those other modalities of guarantees may be important in the short or long-term.

B. Guarantees Conceded to the Investor

The contract may also stipulate three types of guarantees to the investor in order to stimulate investment in the PPPs. The first is indirect and consists in setting out the conditions and requirements necessary for step-in rights.[95] Others guarantees include the possibility that the public sector payment can be made directly to the investor instead of the private partner,[96] the declaration of legitimacy of the investor to receive compensation in the case of early termination of the contract, and payments made by the public guarantors of the contract.[97]

The guarantees allow the investor to substitute the private partner in its rights and receive the payments or the guarantee that had been conceded. It is relevant to mention

89. *Id.* art. 8, II.
90. *Id.* art. 8, III.
91. *Id.* art. 8, IV.
92. *Id.* art. 8, V.
93. Kiyoshi Harada, *Parecer. Consulente: Comissão de Precatórios da Ordem dos Advogados do Brasil, Seção de São Paulo. Assunto: Artigo 8º da Lei nº 11.079/04, conhecida como Lei das PPPs, que permite a vinculação de receitas públicas e instituição ou utilização de fundos especiais previstos em lei*, 2005 Boletim de Direito Administrativo 308-315.
94. Lei No. 11.079 §. 2.3.
95. *Id.* § 3.6.
96. *Id.* art. 5, § 2, II.
97. *Id.* art. 5, § 2, III.

that current PPP projects have been authorizing these hypotheses, but each one has its own peculiarities, some of that give the investor more favorable treatment than others.

C. Guarantees to the Public Partner

In any kind of PPP, the public partner and the end users are subject to a specific risk: the private partner's inability to provide the service, which may result from its inefficiency, negligence, or another service failure.

In this sense, the continuity of the service is considered particularly important. It is this reasoning that motivates insertion of a clause into PPP contracts authorizing the investor to take control of the SPC. Nevertheless, the insertion of such a clause does not repair any damage that the interruption of the service may cause for the public partner. Therefore, PPP contracts also require that the private partner offer guarantees for the completion of the service. These clauses are mandatory and must be proportional to the risks and responsibilities involved in the contract.[98] The limit of the guarantee differs depending on the modality of PPP. In the case of sponsored concessions, the pecuniary limit for the private partner guarantee is the total value of the public project that precedes the providing of the service.[99] In the case of administrative concessions, the limit of the guarantee is 10 percent of the contract value.[100]

As a final point, the private partner has three possible ways to grant the guarantee: through a pledge of money or government bonds, through safety bonds, or through a financial institution as a bailer.[101]

VI. Dispute Settlement and Arbitration

A. Recourse to Courts

The Brazilian Federal Constitution establishes different mechanisms to control public institutions, particularly the administration. Because the PPP contracts involve the expenditure of considerable public resources, they are subject to these controls.

One of these mechanisms is the Accounting Court (*Tribunal de Contas*) that exists within the scope of the federal and state governments. Its main function is to inspect and review public balances from the financial and budgetary point of view, including PPP contracts.[102] The court also has the prerogative to apply the penalties prescribed by law for any act that results in damage to the public treasury.[103] Nonetheless, the Accounting Court is only a bureau of the legislative power, and is not a part of the judiciary.

Judicial intervention is considered another of the administration's control mechanisms. As opposed to the European model, the Brazilian legal system adopted the principle of sole jurisdiction, meaning that the judicial power may decide any dispute about the correct application of the law to a case, regardless of the identity of the parties. It is possible to

98. *Id.*
99. Lei No. 8.987, de 13 de fevereiro de 1995, D.O.U., art.18, XV.
100. Lei No. 8.666/93 art. 56 § 3.
101. *Id.* art. 56, I-III.
102. Constituição Federal art. 70, 71, II.
103. *Id.* art. 71, VIII.

say that, in general terms, PPPs are subject to three main situations which could lead to judicial intervention.

The first situation occurs when an individual or a group has a particular right that has been infringed by an administrative act.[104] This could happen, for example, in the case of irregular dispossession of private land in order to build a road. The proper suit may be proposed by whoever was offended, either against the public authority that committed the act or against the entity in charge of the public position. The sentence may nullify the act.

The second situation occurs when an administrative act damages the public treasury, the administrative morality, or the environmental, historical, or cultural patrimony of the country.[105] This suit may be proposed by any citizen against the public authority that has authorized, approved, confirmed, or performed the irregular act and against any other persons who received benefits from the illegal act, including private persons.[106] The sentence, besides declaring the nullification of the act, may condemn the responsible party to repay the damages caused.[107]

The third situation refers to the administrative or civil acts that may result in damage to the environment, consumers, artistic assets, esthetical or historical value, or another collective interest.[108] The action here may be proposed by the prosecutor, civil associations, the government, and the entities against whom the damage occurred.[109] The decision may also require the responsible party to repay this damage.[110] The most common of these situations in PPP projects will probably be linked to environmental rights.

In reality, it is impossible to list all the occasions involving a PPP that may provoke judicial intervention. The private partner has the same duties of any legal person, including tax, labor, and civil responsibilities. The situations mentioned above are the most important because the decision could result in judicial measures that suspend or prohibit the project.

B. Arbitration in the Public-Private Partnerships

The situations described above are related to public interests and may lead to judicial intervention. Nonetheless, most of them are not between the public and the private partner and are not referred to exclusively by the contract. The relevant question here is whether it is possible for the existence of an arbitral clause in a PPP contract to determine the choice of an arbitral tribunal to decide the dispute between the public and the private partner.

For a long time, the Brazilian legal system did not allow the use of arbitration in disputes involving the administration because there was no law authorizing it. The Federal Constitution established the principle of legality as a basic pattern of administrative law. The principle means that the administration is only allowed to perform what the law

104. *Id.* art. 5, LXIX-LXX.
105. *Id.* art. 5, LXXIII.
106. Lei No. 4.717, de 29 de junho de 1965, D.O.U., art. 6.
107. *Id.* art. 11.
108. Constituição Federal art. 129, III.
109. Lei No 7.347, de 24 de julho de 1985, D.O.U., art. 5, *available at* http://www.planalto.gov.br/ccivil_03/leis/L7347orig.htm.
110. *Id.* art. 3.

authorizes as opposed to private persons who can do everything that the law does not prohibit.[111] Thus, the reasoning was that if no law authorized arbitration in administrative contracts, it could not be used. This position was uniformly adopted by the case law.

However, some changes have been introduced in recent years. It is possible to say that the Brazilian legal system started from a rule of complete prohibition, passed by a period of few exceptions, but there is a growing pattern allowing arbitral clauses in certain situations.[112] Especially in public concessions, these advances were notable. While the 8.666/93 Act, which regulates general administrative contracts, resists the inclusion of an arbitration clause to decide related disputes, the 8.987/95 Act and the 11.079/04 Act, which regulate the common concession and PPPs, respectively, expressly authorize its inclusion.[113]

Once the first requirement, the existence of a law authorizing arbitration clauses involving the administration, is fulfilled, there are other conclusions in the Brazilian legal literature and case law about this issue. The existence of a law is necessary but insufficient. Additionally, the nature of the interests in the dispute is a supplementary criterion to define which disputes may be decided by an arbitral court. In this sense, the rights of the administration, as opposed to the private person, may be preferred to public and collective interests. The Administration could not make free use of these rights and, by inference, these disputes could not be solved by arbitration.

To clarify this principle, the Brazilian literature and case law divided the concept of Administration interest between primary and secondary interests.[114] The primary interests are those regarding the collectivity as a whole, and can only be persecuted by the administration. They are inherent to the ends of the public administration. On the other hand, the secondary interests are those that the administration performs as an entity, when contracting with other parties.[115] They are interests of patrimonial nature and may be measured in current values.[116] Therefore, the acceptance of the arbitral clause in any administrative contract will take as a reference the interests involved in the dispute and, as a result, whether the administration is allowed to freely dispose of these interests.

A good example of secondary interests is related to the clauses that regulate the public partner's participation, guarantees, mechanisms for risk sharing, and performance targets contracted in the PPP. These clauses refer to patrimonial rights that the administration could freely dispose of without offending the public interests.

Current PPPs have been adopting arbitration clauses to solve their future disputes. However, most of them have not clearly defined what issues will be within the scope of the arbitral court. On the other hand, few of them have completely detailed what will be subject to arbitral jurisdiction. Creating more detailed contracts may bring predictability

111. Mello, *supra* note 20, at 76.

112. S. Medeiros, 233 REVISTA DE DIREITO ADMINISTRATIVO 76 (2003).

113. Lei No. 11.079 art. 11, III. Furthermore, the PPP Law does require arbitration to be seated in Brazil and the use of Portuguese as the working language.

114. Eros Roberto Grau, *Arbitragem e Contrato Administrativo*, 32 REVISTA TRIMESTRAL DE DIREITO PÚBLICO 14 (2000).

115. Mello, *supra* note 20, at 63.

116. Diogo Moreira Neto, *Arbitragem nos contratos administrativos*, 209 REVISTA DE DIREITO ADMINISTRATIVO 81 (1997).

to the contract and may avoid any debates about the scope of the jurisdiction of the tribunal, a result that would be in tune with the current case law.

VII. PPPs in Brazil: the Way Forward

The upcoming years in Brazil may witness a boom of infrastructure projects. Indeed, in January of 2007, the federal government presented its ambitious Growth Acceleration Plan (the "Plan"), promising policy measures to concentrate investments in demanding sectors in the country.

PPP projects may become a useful tool with which to implement these policy measures. The legal framework brought by the PPP Law was a remarkable improvement over the state-centered administrative legislation in Brazil. The PPP Law and the Plan expressly recognize that funding infrastructure cannot be accomplished exclusively with a government budget. An optimistic observer may, therefore, praise the Brazilian efforts, especially when comparing this recent legislative evolution with the State-controlling bias that is reappearing in other Latin American countries.

Besides the lighter fiscal impact, PPPs have been advocated all over the world as a mechanism to rationalize management of public services, to attract investments in long-term projects, and to guarantee dispute resolution through means that do not compromise the continuous offering of public services.

But reality will not be changed only by legal improvements. The future of PPPs in Brazil depends on overcoming institutional and political problems that may threaten their efficiency. One of these institutional problems is the uncertain evolution of the case law. It is true that any new law will require some time before the courts reach a general consensus. But in the case of PPPs, an additional judicial risk is related to the local impacts of huge infrastructure projects. The Brazilian legal system allows considerable leeway for courts to interpret the common good, and this feature may lead, albeit temporarily, until the higher courts achieve a harmonized interpretation.

Judicial intervention, especially provoked by local prosecutors, reflects pressure from public opinion, mainly in projects with environmental impacts. Public opinion in Brazil is also particularly sensitive to raises in concession charges. Populist politicians have capitalized on this sensitivity by criticizing existing contracts and increasing the risks involved. This social reality may affect particular projects in some states and municipalities.

At the administrative level, PPP projects in Brazil will depend on institutional changes, leading to more efficient negotiation and implementation with private partners. The current administrative structure is developing its skills, but an effort to build capacity at the federal level seems urgent.