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Lighting a candle

Fixing a messy, half-privatised electricity industry

BRAZIL'S market for electricity is almost as volatile as its exchange rate, and with consequences that are nearly as disruptive. In 2001, when drought cut output from hydroelectric dams, the government told Brazilians to chop their electricity use by a fifth. They complied. But that has created the opposite problem: a glut that has helped to push many electricity companies deep into debt. Investors have backed away. When demand eventually picks up, shortages could reappear. Electricity has become a fizzing political issue, and the first regulatory challenge for President Luiz Inácio Lula da Silva.

To Lula's left-wing Workers' Party (PT), this dysfunctional industry looked like an ideal candidate for state intervention. Its problems stem partly from the mismanaged privatisation of electricity distribution, and a fumbled attempt to get generators to compete. In the 1990s, foreign investors were eager for a slice of Brazil's energy market. They paid high prices for distribution companies before the rules and a regulator for the privatized industry were in place. Often, they took out dollar loans to finance their purchases. Then, just when power rationing shrank the business, Brazil's currency crashed.

The result: even though tariff rises for household consumers have outstripped inflation, the distributors want bigger increases. AES, a tarnished American giant, which owns the biggest distributor, has defaulted on loans from a Brazilian bank; other distributors are trying to restructure debt. Meanwhile, many generators cannot find customers. Some customers, such as a utility owned by the state of Paraná, are backing out of contracts. Last year Brazil's electricity companies, excluding those belonging to Eletrobrás, the main state owned generation and transmission firm, lost 11billion *reais* ($3.8billion).

The Workers' Party came to office denouncing the "market model" and promising to resurrect "strategic planning". But as with its macroeconomic policy, stern realities seem likely to trump ideology in the government's new model for electricity, soon to be unveiled. The state cannot afford the $6 billion a year of new investment needed for supply to keep pace with demand once the economy recovers. Electricity policy may also set a pattern for future PT initiatives, by smuggling a social programme into an economic one. This carries a cost. Ironically, it may be paid partly by the people it is intended to help.

If Brazil is to see new investment in electricity, the government must tackle two problems. The first is fuzzy and erratic regulation. Distributors claim, for example, that in setting tariffs the regulator has valued their assets at market prices rather than at what they paid for them, ignoring the effect of devaluation. That will cost them 16 billion *reais* in revenue, they say. Investors have also been unnerved by government threats to curb the regulator's independente. **"How can you feel comfortable if you fear every four years the laws and regulations can be changed again?" asks Claudio Sales, an industry lobbyist.**

The second problem is structural. Demand is volatile and difficult to forecast. And generators must grapple with Brazil's unusual reliance on hydroelectricity for 90% of its supply. Once built, dams churn out electricity more cheaply than new gas-fired plants can manage.

Whom to comfort, the state or private investors, and how, has been at the heart of a five-month debate over the government's "new energy model". The goals, says the energy minister, Dilma Roussef, are to hold tariffs down, to give "just remuneration" to investors and to connect up the 13m Brazilians who lack electricity. The method, still being refined, is likely to be an investor-friendly sort of state-guided planning.

Under the current system, generators are at the mercy of the market. If demand is too low, they risk not finding buyers. During shortages, generators are often forced to supplement their output by buying in the

spot market, at stratospheric prices. Mrs. Roussef wants to eliminate such risks. The new model may oblige distributors, with government help, to forecast demand, and to contract adequate new generating capacity. Generators would be paid a flat fee for building new plants. If the planners commission too much capacity, consumers would pay.

This scheme has virtues. Assured of steady returns, generators might build new plants. State-owned hydroelectric generators would be paid according to their (low) costs rather than the market rate. This would hold tariffs down, and reduce the risk of state companies crowding out private ones by subsidising new plants with profits from old. Electricity connections for the poor should become affordable. Mrs Rousseff also says that the regulator's role will be "reinforced".

Overall, the model should please both consumers and investors. But there are drawbacks. One is that it may transfer to consumers too much of the risk of excess supply. Another is that, by capping the price paid to hydro generators, it would in effect subsidise electricity at the expense of other social needs, such as education.

Even with steadier policies, electricity firms, traumatised by problems in Brazil and in their home markets, may hesitate. "I'm pretty sure capital will not flow back quickly to Brazil," says Charles Wortman of the São Paulo office of J.P. Morgan Chase, an American bank. Still, the Workers' Party may yet conquer the skepticism of investors in energy as it has done, more quickly, in the financial markets. If efficiency suffers, few will notice.

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