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BRAZIL: Energy reforms may fail to spark investment

SUBJECT: The new electricity sector model and draft natural gas bill.

SIGNIFICANCE: Recent studies suggest that rapid economic growth will force Brazil's energy sector to invest 15-20 billion reais (5.1-6.8 billion dollars) annually in new generation capacity to meet future demand. Growth in both electricity and gas depends on the success of the new electricity sector model and a draft gas bill expected to be unveiled next year.

ANALYSIS: The overriding need to attract private investment in Brazil's energy sector to satisfy future demand was an important reason behind the new electricity sector model (Law 10.848), which was signed into law in March (see BRAZIL: Electricity plan may stifle competition - June 25, 2004). The law sets forth guidelines, complemented by four decrees that specify how the energy model will operate in practice. The main goals of the law are to guarantee regulatory stability and the system's operational reliability, and to encourage moderate tariffs. Another aim is to avert a new energy crisis after the shortages of 2001-02, which led to rationing and undermined the economy (see BRAZIL: Power crisis saps economys energy - June 15, 2001).

Attracting investment. The Chamber of Brazilian Electric Energy Investors (CBIEE), an entity representing 15 major private energy companies that have invested over 30 billion dollars since 1997, sees the sector requiring sizeable investments. In its ten-year forecast from 2005, CBIEE estimates that the sector will require 20 billion reais (6.8 billion dollars) annually if the economy grows during the first three years by 4.5% and by 3.5% during the following seven years. Some 13 billion reais would be earmarked for generation projects, with 3.5 billion reais each going to transmission and distribution.

Given that it is unrealistic for state-owned companies like Eletrobras to meet the whole of Brazil's future energy investment needs, the government hopes the new law will serve as a lure for the private sector to share the cost burden. Whether this happens or not is one of the biggest question marks hanging over the sector: while the new regulations are perceived as an improvement, it is not yet clear whether they will attract sufficient investment. At the same time, concerns remain as to whether the government may intervene to manipulate electricity prices and contracts. One criticism of the new law has been that it empowers the executive to regulate and monitor the energy sector model, without the oversight of a suitable checks and balances system.

Apart from the uncertainty over how much private investment the new energy model will attract, the CBIEE believes there are other factors that make Brazil's power market unattractive -- including the fact that 40% of what Brazilian consumers pay for electricity is composed of taxes. Uncertainty is also fuelled by the role state-owned companies will play in the market, and whether their strategies will be guided by results or by political factors. Private investors would prefer to see a neutral regulator, although it cannot be ruled out that the regulatory entity may be more politicised.

Electricity contracts. The new model stipulates two types of energy supply contracts: regulated (ACR) and free (ACL). Under the ACR scheme, a generating company sells electricity to distribution companies through auctions organised by electricity regulator ANEEL. With only two exceptions, distributors can only acquire energy through ACR contracts. Companies that offer the lowest bids will be the winners at such auctions. The sale of energy to free ACL customers is contracted directly between both parties.

Under the law, generating companies can either sell electricity as ACR or ACL contracts. Electricity is defined as "old" (mostly amortised hydropower plants built before 2000) and "new" (mostly thermal gas-fired installations built after 2000). The law stipulates that "new" energy contracts will last for 15-35 years while for "old" energy they will run from 3-15 years. One of the biggest tests for the new model will be in November-December, when ANEEL will carry out its first auction under the new scheme.

Market restructuring. The Ministry of Energy and Mines recently unveiled the four decrees that set rules for energy commercialisation and the creation of three entities:

- the Electric Energy Commercialisation Chamber (CCEE), a sort of auction house that will replace the wholesale energy market (MAE), which came into force in 2000 but never got off the ground;
- the National Electricity System Operator (ONSE), which will oversee the operation of the national grid; and
- the Electrical Sector Monitoring Committee (CMSE), whose responsibility will be to report to the executive on the progress of power projects.

The Energy Investigation Company (EPE), created by Law 10,847, is another important state entity that will play a role in the new energy model. Its responsibility is to plan the future guidelines of the energy sector for investment in plants and transmission lines.

Natural gas. The Mines and Energy Ministry is soon expected to focus its energies on a new gas bill. Brazil's gas sector is regulated by a law that came into force in 1997, when the country was seen as a net gas importer. Discoveries such as those in the Santos Basin (see BRAZIL: Gas discoveries alter energy calculations - December 24, 2003) and others in regions, including Amazonas, have since radically changed the gas sector -- to the extent that some analysts believe that Brazil will not only become self-sufficient, but in future will also become a net gas exporter to the Southern Cone region.

State oil company Petrobras's optimism over Brazil's new gas wealth potential is visible in its 2004-10 investment plan (see BRAZIL: Petrobras gives greater priority to gas - August 2, 2004), which envisages spending 6.1 billion dollars (11% of the 53.6 billion dollar total) in its gas and energy sector. About half of that sum will be earmarked for the construction of new pipelines.

Legislative framework. Like the energy industry, the gas sector is in need of a solid legislative framework if it wants to attract private investment. However, this may be difficult to achieve, given Petrobras's control over the market. The energy group has a near-monopoly over gas transportation, holds stakes in 19 of Brazil's 26 gas distribution companies and is the undisputed leader in upstream gas projects. This is a contrast with the electricity sector, where state-owned generators control 70% of the market but have only a minority share in the distribution market.

The draft gas bill, which had been expected this year, has been postponed until 2005. The delay fuelled sceptics' suspicions that Petrobras may have sought the delay until it can secure the most important gas pipeline projects. Details of the new gas bill, which is being drafted by Argentine consultancy Strata, are minimal. However, some of the important issues which the bill must address include:

- the tendering of construction of trunklines;
- the granting of 30-year concessions to operate those pipelines;
- access by third parties; and
- transportation rates.

CONCLUSION: One of the main concerns regarding the new energy sector model is whether it will spur enough investment in generation projects -- also a concern related to the forthcoming gas law. The greatest threats to investment include concerns over competition, regulatory uncertainty and government interference in the market. Both laws are vital to future economic growth, and their implementation may represent a cause for concern.