

Private investment and the universalization of basic sanitation in Brazil

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The history of basic sanitation in Brazil is marked by a lack of investment. Half of Brazil's population does not have access to sewage systems, according to data from the Ministry of Regional Development, a fact that can be attributed to the government's inability to meet the sector's needs.

Participation by the private sector can change this scenario. According to studies by Abcon and Sindcon (associations representing private sector providers of water and sewage services under government concessions), private investors are present in only 6% of the country's municipalities; despite the interest in the sector, the lack of legal certainty and concentration of services in state-owned enterprises act as disincentives to private investment.

Against this background, the New Basic Sanitation Framework Law's (Law 14.026/2020) seeks to attract private investment as a means to propel universalization of basic sanitation services, based on three pillars: (i) competition in access to new basic sanitation contracts, (ii) legal certainty for sector participants, and (iii) incentives for privatization.

With a view to promoting competitiveness in the sector – the first pillar – the Framework Law's prohibits "Program Contracts", a type of contract that allowed state-owned enterprises to provide basic sanitation services without competition. Now, all new contracts for basic sanitation services must be concessions awarded through a competitive bidding process.

One point of uncertainty, however, is the transition of Program Contracts and other "precarious arrangements" (services provided without a written contract or under an expired contract) to the new model. Under the Senate's original proposal, these contracts could be renewed for 30

years, with certain adaptations, as long as the renewal occurred by March 2022. This provision was vetoed by the President of Brazil on the grounds that the 30-year period was excessive and would obstruct the competitive environment sought by the Framework Law's. With the presidential veto, the transition to the concession model will be immediate, although it is possible that Congress will reverse the veto.

The Framework Law's also strengthens competition by creating new efficiency standards. Basic sanitation contracts must contain universalization targets, aiming to ensure that by December 31, 2033, 99% of the population has potable water and 90% has sewage collection and treatment systems. Contracts currently in force that do not contain universalization targets will have until March 31, 2022 to set them.

The new legislation also requires proof that service providers have the capacity to meet the targets, although the criteria for evaluating their capacity will be detailed by an executive decree, to be issued within 90 days. At the moment, only 6% of Brazilian municipalities meet the requirements under the New Basic Sanitation Framework Law's, which may represent an opportunity for private investors to enter the market.

The Framework Law's also establishes restrictions on distribution of dividends if service providers do not meet contractual targets – a point which may generate some controversy because of the compulsory minimum dividend under the Brazilian Corporations Law.

Legal certainty – the second pillar – is promoted in two ways. First, by making it compulsory to include certain essential provisions compulsory in concession contracts, dealing with issues such as indemnification and the re-establishment of the contractual balance. Second, by encouraging municipalities to adopt uniform regulations. Only those municipalities that adopt the regulatory standards established by the ANA will be eligible to receive new financing from the federal government. In this way, the Framework Law's recognizes that federal financing will continue to be essential, and uses it as a tool to direct

municipalities' conduct. The same tool can also be used to align private investors' interests with the public interest, since the Framework Law's provides that the federal government will give priority to financing regionalized basic sanitation systems, which generally bring together municipalities that have the potential to generate profit with those that are less attractive.

The Framework Law's provides incentives for privatization – the third pillar – by allowing program contracts and concessions currently in force to be replaced by new concession contracts without the need to obtaining the contracting municipalities' consent, as long as the acquirer of control of the state-owned basic sanitation enterprise does not make any changes to the purposes, term or other provisions of the contract, except for changes required under the Framework Law's.

There is already much speculation as to the potential candidates for privatization, with the São Paulo and Minas Geras state sanitation companies garnering the most attention. Nonetheless, participants in privatization processes should be aware of the risks, such as the need for prior authorizations (including authorization under state legislation) and change-of-control clauses under Program Contracts.

The incentives under the New Basic Sanitation Framework Law's are expected to create a much more competitive environment for new concessions, with both companies already active in the sector and new entrants looking to gain a competitive edge through contributions from new investors or M&A transactions. Universalization of water and sewage treatment services will demand very sizeable investments – market sources estimate amounts ranging from BRL 400 to 750 billion. Private investment in the sector has the potential to generate value for investors and produce enormous social and economic benefits for Brazil.

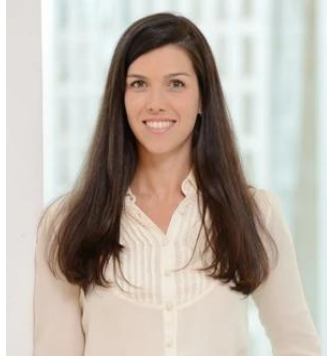
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