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# **THE PRIVATIZATION OF THE BRAZILIAN TELECOMMUNICATIONS SECTOR\***

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## **1. Introduction**

The change in the Brazilian telecommunications sector in the last five years has been impressive: from a state monopoly system without a regulatory environment – frequently inefficient, and investing much less than necessary – to a new sector with a modern and competitive structure, fueled by large investments and commitments from aggressive investors. What was imagined to be politically impossible five years ago – the privatization of Telebrás – became a reality on July 29, 1998, almost on the eve of the October 1998 presidential elections. The Brazilian government sold 51.79 per cent of the voting shares in Telebrás (approximately 19.26 per cent of the company's total capital) for US\$ 19 billion, in one of the largest ever privatizations, worldwide.

Leading up to this successful result were a series of major challenges. The first was the need to change the Brazilian Constitution of 1988, which instituted the state's monopoly in the sector. The political process involved was a long, provoking criticism from those who wanted faster reforms but, on the positive side, the result was transparent and based on a political consensus. Just before the privatization, public opinion surveys showed that the majority of the population was in favor of Telebrás's privatization.

In addition to a change in the constitution, there were six other necessary steps before there could be a successful privatization: (a) preparation of a new law which would change the role of the state in the sector; (b) establishment of an independent regulatory agency; (c) creation of a competitive environment for after the privatization; (d) rebalancing of tariffs and the reduction of crossed subsidies; (e) creation of a model able to handle the transfer of a state monopoly to the private sector, protecting the sometimes conflicting interests of the government and of the minority shareholders of Telebrás; and (f) preparation of the Telebrás companies for privatization.

This report analyzes the Brazilian telecoms sector and its privatization. Section 2 gives an outline of the history, centering on

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\* Some of the ideas presented in this paper were developed while the author was telecoms analyst at Banco de Investimentos Garantia S.A. (1995-97).

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the process of change to state control which took place in the 1970s, and describes the Telebrás system as it was at the beginning of the Fernando Henrique Cardoso government. Section 3 describes the constitutional changes and other steps which were necessary to enable the privatization to take place, including the correction of the distortions in tariffs. Section 4 describes the new Telecommunications Law, and the new principles governing the sector. Section 5 describes the preparation of Telebrás for privatization, and the reasons for the choice of the privatization model chosen, involving a spin-off of the company. Section 6 describes the first step in liberalizing the sector, with the sale of cellular service concessions in 1997. Section 7 deals with the privatization transaction itself. Section 8 describes the regulatory and competitive environment which prevails after the privatization. Finally, Section 9 contains a summary and conclusion.

## **2. Institutional History of the Sector: Exhaustion of the State-Only Model**

At the beginning of the Fernando Henrique Cardoso government in 1995, the institutional situation of the Brazilian telecoms sector was largely determined by Law 4,117 of August 27, 1962, which instituted the “Brazilian Telecoms Code” and by Decree 52,026 of May 20, 1963, which approved the General Regulations for execution of the Code. The volume of state capital entering the sector was progressively increased, reflecting the basis of the Code, which envisaged the state holding a significant stake in providing and operating telecommunications services. The 1988 Constitution merely formalized the *de facto* situation in which the state already controlled all the operational assets of the sector, as a result of application of the 1962 Code and Law 5,792 of July 11, 1972, which created Telebrás. Article 21 of the 1988 Constitution assigned the state the right to exploit telecommunications services, either directly or through concessions, to companies whose voting capital was controlled by the state.

At the time of the adoption of the 1962 Telecommunications Code, the dominant telephone company in Brazil was a subsidiary of the Canadian Traction, Light and Power Company, which operated 62 per cent of the fixed telephone lines installed in the country, mainly in the states of Rio de Janeiro and São Paulo. This company was nationalized at the end of the 1960s. The remaining 38 per cent of the market consisted of 800 separate entities in the rest of the country, including municipal companies, private sector companies and co-operatives. In 1962 Brazil had 1.3 million telephone lines for a population of 74 million, a density of 1.7 telephones per 100 inhabitants, which compares with 14.8 lines per 100 inhabitants at the time of the privatization of Telebrás.

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The 1962 Code (i) defined the attributes of the state; (ii) defined telecommunications services and divided them into categories; (iii) created the National Telecommunications Council (Contel), a regulatory agency for the sector which was subsequently abolished by the Collor government; (iv) authorized the executive branch of government to constitute a state-controlled company to provide long-distance telecommunications services itself (not through concessions), for which Embratel was then created; and (v) established the National Telecommunications Fund (FNT), which would receive part of a surcharge levied on all telecom service user invoices for ten years, to finance Embratel. The creation of Embratel – whose shareholders under Law 4,117 and Decree 52,026 could only be public sector legal entities, government banks and government companies – was a key step in the process of establishing state control of the sector, and was the result of implementation of Article 10 of the Code. This article stipulated that “*it is the sole responsibility and competence of the federal government [our emphasis] to maintain and exploit directly: (a) the long-distance connection services which make up the National Telecommunications System, including its international connections; (b) public telegraph, interstate telephone and radio communication services, except where otherwise provided by this law, including radio transmission services and international service.*” In other words, all long-distance services should be offered by a state-controlled entity, which was to be Embratel. Ten years after Embratel was created, all the states of Brazil were interlinked. In relation to services *within* each state of the Brazilian federation, the Code was more liberal, and *gave the states and municipalities freedom to organize, regulate and execute telephone services, directly or through concessions*, subject to the regulations set by Contel.

Contel, later absorbed by the Communications Ministry, served an important function as there was a need for an agency to establish the rules of the sector (e.g., tariffs, rules governing interconnections, renewal of concessions, etc.) in an environment in which there were hundreds of private sector and state-controlled companies operating. Some important duties and attributions of Contel were: (a) to approve the tariffs to be charged by companies; (b) to set the rules, criteria and rates for sharing revenues from traffic between telecommunications companies; (c) to give an opinion on granting, cancellation or renewal of concessions; and (d) to set technical standard rules for ensuring efficient integration of services in the national telecommunications system. The criterion adopted for tariffs was that their levels should be set to cover current expenses and provide a fair return on capital. This criterion resulted in: (i) the establishment of crossed subsidies between the domestic and international long-distance services on the one hand, and local service on the other; and (ii) a sharing of revenue between Embratel and the local operators, based on criteria other than economic efficiency.

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In 1972, the government took a further important step in the process of nationalization and unification of the country's telecommunications system with the creation of Telebrás, a company with the majority of its capital held by the state, under the control of the Communications Ministry. The law which created Telebrás provided for it to incorporate private companies which were providing services, when their concessions expired. It also gave Telebrás the right to expropriate privately owned telecom companies, in accordance with the law, and transfer the expropriated assets to its subsidiaries.

The importance of the regulatory agency waned as telecoms services were incorporated by the state, and this was reflected in the absence of any significant consequences when Contel was abolished by the Collor government in 1990.

Telebrás was created as a holding company whose purpose was to control an operating company in each state of the Brazilian federation, and Embratel. Among the functions given to it by the law which created it were: (i) to manage the federal government's stockholdings in each of the operating companies; and (ii) to raise funds in the foreign and domestic capital markets to be transferred to the subsidiaries to execute projects approved by the Communications Ministry.

Within the context in which they were created, Embratel and Telebrás carried out an important role in the unification and creation of a basic telephone network in Brazil. The process of consolidation of the nearly 1,000 companies made it possible to achieve the economies of scale inherent in telephone service, and enabled funds to be raised on a large scale for investments in the sector.

This purely state model, however, began to show clear signs of reaching the limit of its effectiveness at the end of the 1980s. The telecoms sector was already undergoing rapid technological change, and demanded fast reactions from operators of services to meet the growing demand for increasingly specialized and sophisticated services. Telebrás and its subsidiaries did not have the ability to meet this growing demand for investments. As a state company, Telebrás was subject to wide-ranging regulation by the Communications, Finance and Planning Ministries. All the strategic plans and investments of the Telebrás system had to be approved by the Communications Ministry. Tariffs were subject to control by the Finance Ministry, and investments by the Telebrás system also had to be included in the annual federal budget and approved by Congress. The Planning Ministry established and controlled the execution of the state companies' budget targets. Telebrás, like the other state-controlled companies, did not have freedom to decide on its own level of investment. This investment was set by the Planning Ministry, usually at levels different from those requested by the Telebrás companies, and without taking into account their individual situations. Finally,

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the need to obey rules on hiring personnel and public tenders (Article 37 of the Constitution) restricted the speed with which Telebrás's management could act.

The control over tariffs, and Telebrás's lack of autonomy to determine its own level of indebtedness, explain the recourse to the so-called "autofinancing" scheme to finance the expansion of the telephone network. Under it, the consumer financed his or her own telephone line by paying a deposit in advance to the Telebrás subsidiary operating in the consumer's state of domicile. This amount was around US\$ 2,000 at the beginning of the 1990s, and had dropped to US\$ 1,000 when this financing mechanism was abolished in 1997. The telephone company had the duty of installing the line within 24 months. In return, the consumer received shares in Telebrás, based on the book value of the company.<sup>1</sup> This is one of the main reasons why the federal government's stockholding in Telebrás fell, over time, to around only 21 per cent of the total capital of the company by the time of the Telebrás privatization.

The 1995 Constitutional Amendment No. 8 changed Article 21 of the 1988 Constitution. This was the first step in the replacement of the state-controlled model by a model which made possible speedier decisions, and which was able to meet better the growing demand of the private sector for specialized and higher added value services.

### **3. The Impact of the 1995 Constitutional Amendment, and the Steps Required for the Privatization of Telebrás**

Constitutional Amendment No. 8, passed by Congress on August 15, 1995, ended the state monopoly for operating telecommunication services. The text approved by Congress, however, limited the amendment's immediate impact by requiring that a law for the sector should also be passed by Congress detailing the role of the state in the sector and the new general principals that would govern the sector. In addition, the Congress ruled that the executive branch of government could not use "Provisional Measures"<sup>2</sup> to legislate on the subject in the interim

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- 1 When the system began, the shares offered to the consumer were in the local telephone operator company, which explains why all the local Telebrás operational subsidiaries have minority stockholders. The majority of consumers saw no value in these shares since they were not traded in the market. At a later stage in the development of the system, the shares given to consumers were in Telebrás itself, which were more widely traded in the stock market.
  - 2 A provisional measure is a presidential legislation which becomes effective until Congress votes it within a specific period – at that time, 30 days. If Congress does not vote within this period, the provisional measure will be renewed until Congress gives its approval.
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period. In other words, the government would have to submit a new Telecoms Code to Congress for approval.

The Communications Minister at that time, Sérgio Motta, seeing that the need to submit to Congress a change in the Telecoms Code (which would include a proposal to privatize Telebrás) would delay the process of opening of the sector to private capital, decided to propose to Congress a law which would enable the *cellular* telephone service sector to be opened to private enterprise immediately – this became the so-called Minimum Law – leaving the more complex proposal for changes in the Telecoms Code until later.

In parallel with these changes in the legislation, the Communications Ministry worked on the preparation of the Telebrás companies for privatization. There were two conditions that were *sine qua non*: (i) to correct the distortions in the tariffs structure, increasing local tariffs and reducing long distance tariffs, especially international rates; and (ii) to change the system of sharing of long distance revenues between Embratel and the local telephone service companies, thus breaking the backbone of the system of crossed subsidies.

### **3.1. The Telebrás System in 1995**

In 1995, Telebrás, with its 13 million lines installed, controlled the largest telephone system in Latin America, and the eleventh largest in the world, some 95 per cent of all the telephone lines in Brazil.<sup>3</sup> Its annual net sales revenue was of the order of US\$ 7.5 billion. The federal government held the majority control, 52.2 per cent of the voting stock, and 23 per cent of the company's total capital. Non-Brazilian investors held some 27 per cent of the total capital. At the time of privatization, the federal government's holding had fallen to 51.79 per cent of the voting stock (19.26 per cent of the total capital), and 3.68 per cent of the preferred stock (2.17 per cent of the total capital), while foreign investors held approximately 40 per cent of the total capital.

As a pure holding company, Telebrás had no operational activities *per se*. Its main function was to centralize the raising of funds which financed investments in the subsidiaries, as well as coordinating and implementing the policy for the sector. The Telebrás subsidiaries were divided into 26 operators, one for each

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3 The remaining 5 per cent of lines were operated by four concession holders: Companhia Riograndense de Telecomunicações (CRT), of which control was privatized in June 1998 by the government of the state of Rio Grande do Sul; Sercomtel, the municipal company of the city of Londrina; Ceterp, the municipal company of the city of Ribeirão Preto; and Companhia Telefônica do Brasil Central (CTBC), Brazil's only remaining private sector operator in 1995, operating in some municipalities of the states of Minas Gerais, São Paulo, Goiás and Mato Grosso do Sul – it should not be confused with Companhia Telefônica da Borda do Campo (CTBC), which is controlled by Telesp and is listed on the stock exchange.

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of the 26 states,<sup>4</sup> one municipal operator, and the long-distance carrier, Embratel. Telebrás held control of at least 80 per cent of the voting stock, and 67 per cent of the total capital of its subsidiaries, at the time of privatization.

The existence of Telebrás as a holding company was justified, in the context of a country with continental dimensions and marked regional differences, as an instrument for transferring resources from the richer to the poorer regions. The objective was a more homogeneous development of telephone service in Brazil. In this scheme, Embratel was the key instrument for transferring funds, through a mechanism of differentiated sharing of long distance revenue between it and the operators of the individual states. For example, in 1996, Telesp, the largest operator in the system, transferred 35 per cent of the revenue from its domestic long distance and international calls originating in São Paulo state to Embratel, while the companies of the states of the North and Northeast transferred only 10 per cent of their revenue from long distance traffic.

### **3.2. The Need to Correct the Tariff Structure**

A rebalancing of tariffs was a necessary condition for the privatization process, since the government would not succeed in attracting investment in basic telephone service if this activity did not offer an attractive return. By the end of 1995, not only had the level of telecoms tariffs been left far behind in relation to the increase in all other prices, but there was also a major distortion in the form of the high crossed subsidies between rates charged for long distance and local services.

Telebrás's breakdown of revenue by type of service in 1994 clearly reflected the high level of crossed subsidies: long distance tariffs were high, and they subsidized local services. The share of local revenue out total revenue was out of line with the ratio in other countries: in Brazil local service contributed only 21 per cent of total revenue while, for example, this percentage was 45 per cent in Telmex, 63 per cent in CTC of Chile and 34 per cent in New Zealand.

Table 1 shows the marked differences between the level of Brazilian tariffs at the end of 1995 and other tariffs practiced worldwide, and the magnitude of the increases that were necessary to privatize Telebrás. The Brazilian residential subscription was 0.2 per cent of annual per capita income, in comparison with 1.7 per cent in Argentina, 2.4 per cent in Mexico, 0.6 per cent in the US, and an average of 2.2 per cent worldwide.<sup>5</sup> Telebrás's

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4 The exception was the State of Rio Grande do Sul which had its own telephone company (CRT).

5 World Telecommunication Development Report 1994, International Telecommunication Union, Geneva, pp. A-31-A33.

**Table 1**  
**Comparison of Brazilian and World Tariffs in 1995\***  
**(In US\$)**

	<i>Telebrás</i>	<i>World Level</i>
Residential Subscription (US\$/Month)	0.63	6.0-8.0
Commercial Subscription (US\$/Month)	7.43	12.0-28.0
Local Metered Unit (3 Minutes, US\$/Month)	0.029	0.10
Domestic Long Distance Minute (US\$)	0.26	0.20-0.50
International Minute to USA (US\$)	1.94	1.12

*\* The exchange rate at the end of 1995 was R\$ 0.97/US\$. Figures include the ICMS (value added tax on international traffic).*

*Sources: Telebrás, International Telecommunications Union.*

basic monthly subscription of US\$ 0.63 included 90 metered units (i.e. 360 minutes) of local call time, and was the lowest in the world, except for the countries of the former USSR.<sup>6</sup> This amount was lower than the cost of issuing the monthly invoice for local service, which was US\$ 1.60. It should be mentioned that the fall in tariffs for local service had taken place over the previous two decades: in 1975, the basic residential subscription was US\$ 10, and the local metered call unit cost US\$ 0.13.

The reduction in the real value of Brazilian telecom tariffs was associated with policies of containing public sector tariffs as part of governments' efforts to control inflation in the decade that led up to the introduction of the real in July 1994. Because the only service included in the calculation of inflation was the local service, the government avoided increasing local services, and increased long distance rates by larger percentages.

The distortions were certainly significant, and changes were urgently needed to consolidate reforms which would enable the sector to recover its investment capacity, and to become increasingly open and competitive. The government was aware of this. Communications Minister Sérgio Motta himself stated that the "lie" involved in the tariff structure had to be removed. The only obstacle was the inflationary impact of this step.

Telebrás's revenue per line in 1995 reflected this distortion: it was US\$ 591/year for the local operators and US\$ 707/year for the Telebrás system as a whole (including Embratel). This compared to US\$ 830 for the Argentinean operators, US\$ 989 for Telefónica del Peru, and US\$ 720 for the local US operators (which did not have interregional and international long distance revenue). The low tariffs gave Telebrás an unsatisfactory cash flow and prevented an increase in investments.

The first step in correcting tariffs was taken in November 1995, and was a courageous one. At one blow, the Brazilian

government increased the residential subscription by a factor of five, and the cost of local calls by 80 per cent (Table 2). The charge for one minute of domestic long distance call time was increased by 22 per cent, recovering the percentage eroded from this tariff by inflation since July 1994 (the date of the last increase before implementation of the first phase of tariff rebalancing). The 32 per cent reduction in the average cost of one minute of international call time, shown in Table 2, is due to the reduction of the ICMS tax (a VAT tax on goods and services, charged by states), and not due to a reduction in tariffs.

The fact that domestic long distance tariffs were increased by 22 per cent was important for enabling Telebrás to recover its ability to generate cash flow, since domestic long distance services provided 49 per cent of Telebrás's total revenue at that time. The rebalancing of tariffs gave Telebrás a revenue per line closer to international levels, at the time of its privatization: local service provided almost 40 per cent of total revenue, at the date of privatization in 1998, in comparison with only 21 per cent in 1994.

The process of tariff restructuring was completed in May 1997 with a further increase in local tariffs and a reduction in long distance tariffs (Table 2). Telebrás was privatized in July 1998 with those rates in effect. Note that when Telebrás was privatized its tariffs at extremely competitive in world terms, with the exception of the cellular and international services. International tariffs, however, could not be reduced before the revenue-sharing scheme between Embratel and the local subsidiaries was replaced by a system of access charges.

**Table 2**  
**The New Brazilian Tariff Structure (in US\$), with International Comparisons\***

	Brazil			Change (%) (B)/(A)	Change (%) (C)/(B)	Argentina	Chile	USA
	July 1994 (A)	November 1995 (B)	May 1997** (C)					
Wireline Installation Charge	n.a.	n.a.	43,10	n.a.	n.a.	250,00	183,00	50,00
Local Service								
Residential - Monthly Charge	0.63	3.86	11.91	513	209	12.75	19.48	12.50
Commercial - Monthly Charge	7.45	13.45	17.87	80	33	36.16	19.48	17.31
3-Minute Local Call (Peak Time)	0.03	0.05	0.07	79	34	0.09	0.04	0.08
Domestic Long Distance Service (1 Minute)	0.26	0.31	0.21	22	-34	0.28	0.21	0.23
International Service (1 Minute)	2.61	1.78	0.93	-32	-48	1.40	1.35	0.69
Mobile Cellular Service (1 Minute, Local)	0.34	0.38	0.32	12	-16	n.a.	n.a.	n.a.

\*The fall of 32 per cent in international tariffs at the end of 1995 was due to the reduction in the rate of ICMS tax charged on international service, and not to a reduction in the tariff itself. For Brazil, the long distance rate shown is from São Paulo to Rio; for Argentina, it is for distances between 110 km and 240 km; for Chile and the US the figures shown are average tariffs. All long distance tariffs shown are for peak time.

\*\*Rates in effect at the moment of privatization (July 1998).

Sources: Brazil: Telesp and Telebrás; other countries: Caspian Securities, Dresdner Kleinwort Benson Research.

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### **3.3. Introduction of Access Charges for Long Distance Service**

Telebrás was privatized in parallel with the introduction of a system of access charges (similar to those used in the US, Mexico, Chile, the UK, etc.), replacing the system of sharing of long distance revenue, the backbone of the crossed-subsidy regime, which had been in effect until 1998.

Until the privatization, the system was based on sharing of revenue (i) between the local operator which originated the call and Embratel, which made the connection between states; and (ii) between Brazil and other countries. For a domestic long distance call to Rio de Janeiro originating in São Paulo in 1997, Telesp retained 70.48 per cent of the revenue, Embratel received the remaining 29.52 per cent, and the Rio de Janeiro state operator (Telerj) received no payment for completing the call within its network. In a call from Rio to São Paulo, Telerj received 82.22 per cent of the amount charged, Embratel 17.78 per cent, and Telesp received nothing for completing the call in its local network. For incoming international calls, Embratel received 100 per cent of the revenue. The percentage retained by each local operator and by Embratel was revised annually in May, back-dated to April 1. The levels set for this revenue sharing took into account (among other factors) (i) the company's financial situation, (ii) the return on investment which it should have according to the rules in the 1962 Code, which assured a minimum level of return of capital for the companies, and (iii) the company's financing needs. Thus, Telesp and Telesc (the operator for Santa Catarina state) transferred some 30 per cent of their long distance revenue, while the Companhia Riograndense de Telecomunicações (CRT), the Companhia Telefônica da Borda do Campo (CTBC) and operators in less economically favored areas transferred less than 15 per cent of their long distance revenue to Embratel.

Clearly, this system could not continue in a competitive environment, because it did not correct inefficiencies: companies with weak operational performance finished up retaining a higher percentage of their long distance revenue. In this scheme, Embratel was the instrument for putting the crossed subsidies into effect, through the transfer of revenue from operators either more efficient or located in wealthy regions to operators located in less developed areas, in the North and Northeast, or operators operationally inefficient, such as Telerj and CRT. In 1997, the Communications Ministry began to reduce the distortions and established revenue-sharing levels which sought to come closer to the allocation of long distance revenue between the local companies and Embratel which would result if an access charge system were established. As part of this process, Ministerial Order (*Portaria*) 392 of August 8, 1997, significantly reduced the percentages

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retained by the most important local companies such as Telesp, Telerj and Telemig.

The system which came into effect after the privatization (under Resolution 33 of July 13, 1998, made by Anatel, the new regulatory agency for the sector created in 1997)<sup>7</sup> is based on an access charge system, a payment per minute for the use of the network of another operator. After a public consultation on the new system and on the proposed interconnection charges, Anatel accepted some suggestions from the public and established a *maximum* charge for use of a network, plus a transition tariff, to remain in effect until 2001, instead of a *mandatory* access charge. My view is that Anatel's final decision was positive, because it enabled a more competitive environment to be established for the entry of new companies, especially into the long distance segment. The new system was to be totally in place on January 1, 1999. The maximum interconnection charge set for São Paulo is US\$ 0.043/minute for the use of the local network, and US\$ 0.068/minute for the domestic long-distance network. These figures are high in relation to the respective international levels of around US\$ 0.01 and US\$ 0.02, but since they are *maximum* levels, competition is expected to reduce them over time. These high levels favor the existing local companies, vis-à-vis the long-distance companies.

## **4. The General Telecommunications Law and the Government's Role as Regulator**

The passage by Congress of the General Telecoms Law (Law 9,472 of July 16, 1997) was the watershed for the change of the government's role in the telecoms sector. The new law proposed that the state should cease to be a provider of telecommunications services, and become the sector regulator. The main points in the new law covered: (i) the general principle governing telecoms services; (ii) creation of the Agência Nacional de Telecomunicações (Anatel), the regulator; (iii) organization of telecoms services; and (iv) restructuring and privatization of the Telebrás system.

### **4.1. General Principle of the Regulatory Environment**

The first part of the General Telecoms Law lays down the basic principles governing the sector, of which the main point is the following: "telecommunications services will be organized on

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<sup>7</sup> The laws and regulations governing the Brazilian telecoms sector (including the former Telecommunications Code of 1962) can be found on Anatel's Internet site at [www.anatel.gov.br](http://www.anatel.gov.br).

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the basis of free, wide-ranging and fair competition between all service providers, and the Public Sector must act to ensure this, to correct the effects of imperfect competition and to suppress actions which may subvert this economic state of affairs” (Section 6). This is a great change from the 1962 Code, which gave the state the role of provider of telecoms services. The new law makes clear the role of the state as regulatory agent, and not provider of services.

#### **4.2. Anatel, the Regulatory Agency**

After years of state monopoly in the sector, opening to the private sector demanded the creation of a regulatory agency which, among other functions, would set the basic rules of the game, and exercise the role of arbiter in disputes between different economic agents operating in the sector. Thus Section 8 of the General Telecoms Law created Anatel. The law safeguarded the administrative flexibility and financial independence of the regulatory agency:

(i) By making hiring of its personnel more flexible (in relation to Law 8,745 of December 1993), no longer requiring a public (announced) examination of candidates. Anatel’s contracts for engineering services and works have to follow the legal procedure for public bids (i.e. Law 8,666), but for other cases, Anatel may choose its own procedures for hiring (Sections 10 and 58).

(ii) By providing enough funds for Anatel to work effectively. Anatel’s revenues include proceeds from: (i) fees paid for concessions, permissions or authorizations to operate telecommunications services, (ii) fees for the use of radio frequencies, and (iii) proceeds of inspection, installation and operating charges collected for the Telecoms Inspection Fund (Fistel).

Among the first duties given to Anatel was the preparation, and proposal to the President of the Republic, of two plans which were necessary for the privatization of Telebrás:

(i) *The General Concessions Plan* (approved on February 12, 1998), which establishes the rules for concessions of public telephone services. The plan lays specifies that concessions are not exclusive, and divides the country into concession areas, indicating the number of service providers in each region and the duration of the concession contracts.

Based on the General Concessions Plan, Brazil was geographically divided into four areas for provision of wireline service for the purposes of privatization: (i) the state of São Paulo (the operating area of Telesp), (ii) the Northern and Northeastern regions, the states of Minas Gerais, Rio de Janeiro and Espírito Santo – the “Tele Norte-Leste” region; (iii) the Center-West regions and the states

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of Paraná and Santa Catarina – the “Tele Centro-Sul” region; and (iv) the whole of the country, for long distance telephone service (corresponding to the area operated by Embratel).

(ii) *The Telecoms Services General Universalization Plan* (Decree 2,592 of May 15, 1998), which establishes targets for numbers of telephones installed, public telephones, the time in which consumers’ demands must be met etc., for the companies holding wireline telephone service concessions. These aims must be met by Embratel and the local wireline telephone companies resulting from the spin-off of Telebrás (Telesp, Tele Norte-Leste and Tele Centro-Sul).

As can be seen, Anatel is now fully operative, and played an important role in the preparation of the institutional structure necessary for the privatization of Telebrás.

### **4.3. The Organization of Telecoms Services**

This part of the Code deals with: (i) definition and classification of the different services; (ii) the rules governing the provision of the so-called *public regime* services (granting of concessions, the concession contracts, cancellation of concessions, etc.); and (iii) services provided under what is referred to as the *private regime*. Anatel has the duty of defining the different types of telecoms services as a function of their purpose, the situations in which they are provided, their form, means of transmission, technology used or other attributes (Section 69). The law classifies services as *collective* or *restricted*, and states that the provision of services of restricted interest may not prejudice the collective interest (Section 62). It creates a different legal situation for *public regime* and *private regime* telecommunications services (Section 63): the *public regime* services are defined as “telecommunications services provided under concession or permission to operate in which the provider has obligations of universalization and continuity” (Section 62).

These classifications and definitions aim at preserving the interest of the public at large, and assure continuation of services in a competitive manner. Clearly the regulations are much stronger and more detailed for the services legally defined as being of a *public regime*, since there is a collective interest involved.

It should be noted that this part of the law states that it is Anatel which establishes the tariff structure for each type of service. Further, tariffs are set by the “concession-granting power”, in the concession contract. Thus, the companies which acquired control of the Telebrás companies were aware of their tariff levels. *This is a very important institutional change.* Before the General Law, tariffs were proposed by the Communications Ministry, but approved by the Finance Ministry. They were fre-

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quently set on the basis of other criteria than the requirement to offer services within a competitive environment (for example, controlling inflation, leading to profound distortions in the tariff structure).

#### **4.4. Restructuring and Privatization of the Telebrás System**

The General Law is very objective in relation to the privatization of Telebrás: in Section 187, it simply states that the executive branch of government is authorized to restructure and privatize the telecoms companies which are directly or indirectly controlled by the federal government. It provided very wide-ranging powers for restructuring the Telebrás group of companies: any type of change of a corporate nature was permitted (merger, spin-off, partial liquidation, etc.). The law made clear that at the moment of privatization, the area for which the concession was being granted would immediately be opened to competition (Section 193).

The General Law laid down that control of a wireline company and the corresponding cellular company could be sold at the same time, but that new controlling shareholders would not be allowed to merge a wireline company with a cellular company. The idea was to ensure fair competition between several companies (Section 194). Indeed, a company controlling both a basic wireline network and a cellular company could try to discriminate against the cellular competitor, in favor of its own cellular company.

## **5. Preparation and Restructuring of Telebrás for Privatization**

### **5.1. Operational Improvement of Telebrás before Privatization**

In addition to the changes in tariffs described above, another process was developed in parallel within Telebrás. The government made efforts to improve the productivity of the Telebrás companies by reducing costs and personnel. The improvement of the operational performance between 1994 and 1997 was impressive. Table 3 illustrates this fact for the Telebrás companies which had a stock exchange listing. Notice that this improvement was achieved while these companies were still under government control. Table 3 also compares the indicators for these companies with the figures for similar companies in other countries. The following points stand out:



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(i) Although the aggregate number of fixed and cellular lines in service grew by only 16 per cent per annum, average revenue per line grew by 19 per cent from 1994 to 1997 for the Telebrás system as a whole, which reflects both the impact of the rebalancing of tariffs and also the increase in the importance of revenue from cellular service as a percentage of companies' total revenue (from 4.5 per cent in 1994 to 20 per cent in 1997), since the cellular service has higher added value and charges higher rates.

(ii) The average cash cost (excluding depreciation) per line in service fell by almost 15 per cent between 1994 and 1997. Although this performance could have been better (the number of lines grew by 16 per cent per year, and scale gains are significant in telecoms as the number of lines grows), this shows that the government at least did not allow the gain from tariff rebalancing to be translated into a larger number of employees and increased expenditure.

(iii) One of the factors which helped reduce the cost per average line in service was the increase in work productivity. There was an improvement of 46 per cent from 1994 to 1997, using as indicator the of number of fixed lines in service per employee. Indeed, the number of employees in the Telebrás system fell from 95,600 in 1994 to 87,300 in 1997, while the number of fixed lines in service increased from 11.2 million to 15.4 million.

(iv) Cash flow showed extraordinary growth: operational cash flow margin (EBITDA margin, where EBITDA = earnings before interest expenses, tax, depreciation and amortization) grew from 45 per cent in 1994 to almost 61 per cent in 1997, with some companies such as Telebrasília showing very high levels (67.3 per cent) on an international comparison. The increase in the EBITDA margin to levels considered to be among the highest in the world reflects the impact of the correction of tariffs, operational improvement and, above all, the absence of competition in a monopoly environment.

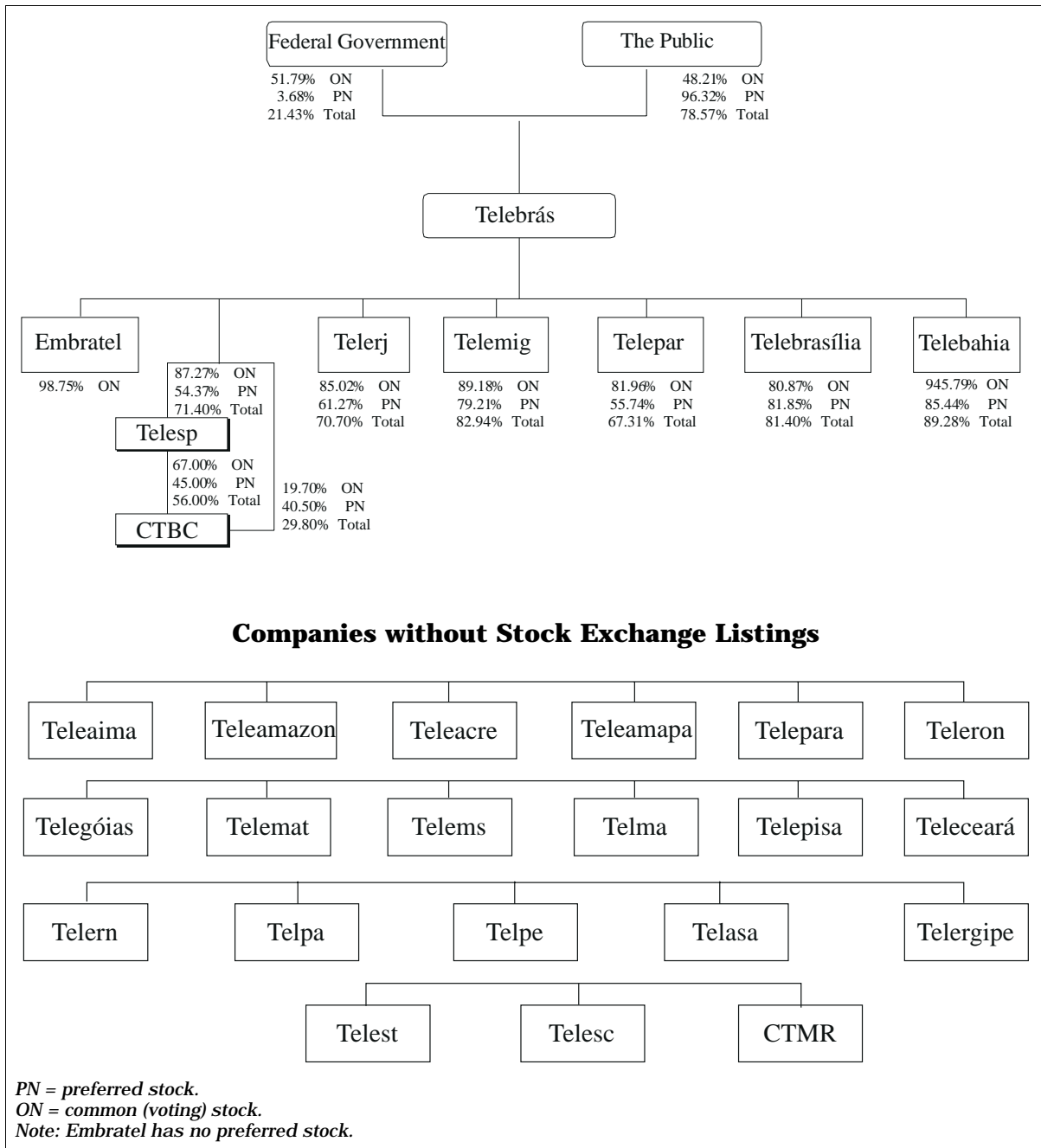
## **5.2. The Privatization Model: Why the Government Opted for the Split Model for Privatization, Concerns with the Market and Minority Shareholders?**

The Telebrás privatization was not only one of the largest in the world, but also one of the most complex. There was not only the regulatory challenge of avoiding the transfer of a state monopoly to the hands of the private sector, but also the challenge of assuring the rights of minority shareholders, while also guaranteeing that the government (and only the government) would

receive the premium paid for control at the moment of privatization.

Diagram 1 shows the complex stockholding structure of Telebrás, and the consequent complexity involved in its privatization. In contrast with the case of Argentina, Mexico or Peru – where the privatization involved the sale of one company 100 per cent controlled by the respective government – there were 27 companies controlled by Telebrás, and all had minority shareholders whose rights had to be assured.

**Diagram 1**  
**Structure of Telebrás before Privatization, and its Stockholdings in the Subsidiaries**



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At the beginning of 1995, the perception of market risk (from the point of view of minority shareholders) in relation to Telebrás was great: its stock market valuation was less than US\$ 10 billion. The idea prevailing in the market was that the government would sell the subsidiaries and force Telebrás to invest the proceeds in NTN-P government debt securities, which have 15-year maturity, zero coupon and annual interest of only 6 per cent per annum. This was the worst possible scenario for the Telebrás minority shareholder, who would see his or her assets sold and the proceeds invested in low-yield government securities. The perception of the “NTN-P risk” by the market diminished substantially during 1996, with the presentation to Congress of the draft of the General Law: its Section 197 (which became Section 198 of the final law) stated that only cash would be accepted in payment for privatization of the telecoms companies. In other words, by not accepting the “privatization currencies” (government junk bonds), the law made it more difficult for Telebrás to invest the proceeds of privatization of its subsidiaries in NTN-Ps: if it were to do so, the government would be forcing Telebrás to receive cash and exchange it for privatization currencies. This would directly hurt the rights of the minority shareholders.

With the possibility of investment of the proceeds in NTN-Ps out of the way, it was possible to imagine three possible models for the privatization of Telebrás:

Model A: the government would sell its 51.79 per cent stake in the voting stock of Telebrás (19.2 per cent of the total stock);

Model B: the government would maintain its stake in Telebrás, and Telebrás would begin to sell its subsidiaries, starting, say, with Telesp and Embratel; and

Model C: the government would spin-off Telebrás into local companies, plus the long distance carrier company.

### **Model A: Privatization through the Sale of the Government’s Direct Holding in Telebrás**

This would be the format resulting in the most rapid privatization sale. The government would simply sell its 51.79 per cent stake in the voting capital of Telebrás (19.26 per cent of the total capital) to a strategic investor (or to a consortium in which institutional investors would also be members). At one blow, all the Telebrás subsidiaries would be privatized by the sale of the Telebrás holding company. There would be no legal challenges to the sale, and the government would receive the funds, investing them as it pleased. Minority shareholders in Telebrás would become minority partners of a private sector company, which would in turn control the management of all the Telebrás subsidiaries.

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The government, however, was not in favor of transforming a “state monopoly” into a “private sector monopoly”, and thus this scenario was a remote possibility. From an economic point of view, even if the government was immediately to open all the segments to competition, the privatized Telebrás as a whole would have very strong power in relation to its future competitors. The government feared that potential future competitors would find it difficult to compete as equals with Telebrás. Further, the country had no regulatory tradition in the sector to avoid any possible abuses of economic power by an incumbent that controls the majority of assets of the sector. Finally, from the political point of view, it would be difficult for the government to justify the transfer of the whole of the Telebrás group of companies to a single foreign operator.

### **Model B: Telebrás Remains under the Government’s Control, and the Subsidiaries Are Privatized**

This scenario was the least favorable for Telebrás’ minority shareholders. The majority shareholder (the government) would order Telebrás to begin to sell its stakes in the subsidiaries, probably starting with the most attractive assets, Telesp and Embratel. Unless the proceeds were distributed as special dividends to shareholders (i.e. to both the government and minorities), there would be risks for the minority shareholders, even if the possibility of investment of the proceeds in NTN-P government debt securities were discarded. One risk would be the sale of the most attractive subsidiaries, such as Telesp, and the use of the funds for investment in areas with lower return, such as public telephone service in the poorer states of Brazil. In this scenario, the government could have difficulty in selling the smaller companies, since they would not be attractive due to their smaller size and their location in poorer regions.

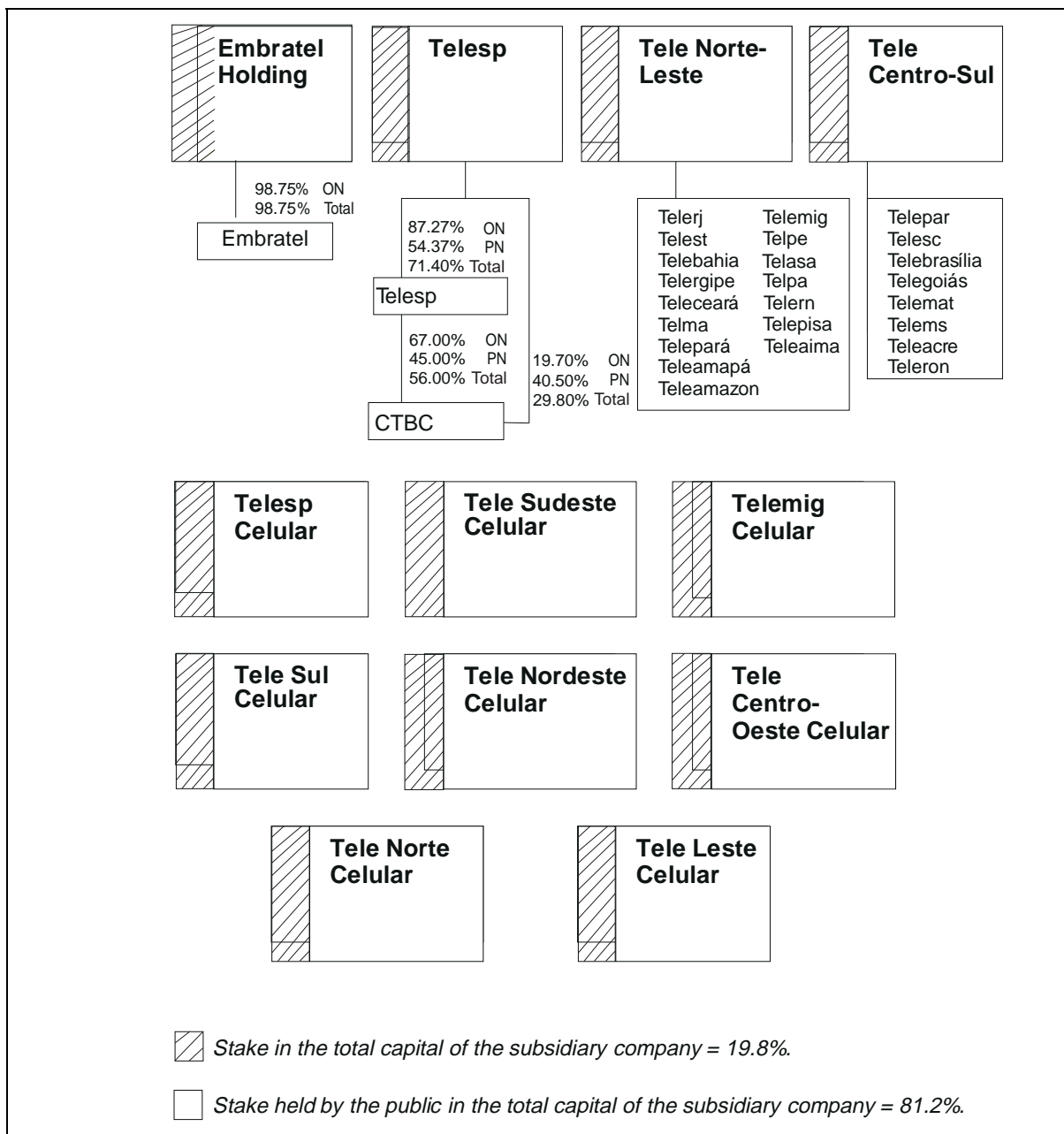
Notice the important point here: if the model involved the sale of Telebrás’ subsidiaries and the proceeds were distributed to all shareholders, the government would be distributing to minority shareholders the premium of control captured in the sale process. Clearly, this was not in the interest of the government which wanted itself, and only itself, to appropriate the control premium. Indeed the government was the controlling shareholder and nothing was more fair than capturing for itself the control premium.

### **Model C: Spin-off of Telebrás, Followed by Privatization**

This was the model finally adopted by the government after discussions with participants in the market, and with the help of consultants hired by the Communications Ministry to model the

sale. The main advantages of this model were: (i) to assure that only the government would receive the control premium from privatization; and (ii) to assure the rights of minority shareholders. Note that with the passage of the new Corporate Law in 1997, there were no longer legal difficulties involved in the spin-off of a company listed on stock exchanges. Diagram 2 shows the spin-off privatization model. Telebrás was divided into three large local wireline companies (Tele Norte-Leste, Telesp and Tele Centro-Sul), eight cellular telephone companies corresponding to the cellular concession areas defined by the “Minimum Law” on cellular service of July 1996, and Embratel, the long-distance carrier.

**Diagram 2**  
**The Model which Spin-off Telebrás into 12 Companies for Privatization**



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The point to be observed is that, at the moment when Telebrás was spun-off into parts, one holding company had to be created to control Embratel, and another had to be created to control Telesp. If the government did not create the Embratel holding company and the Telesp holding company (each having the same stockholding structure as Telebrás), the privatizations of Embratel and Telesp would take place without the government capturing, for itself, the control premium. The Embratel example illustrates this: the government had only 21.43 per cent of the total capital of Telebrás, so that if it did not create the Embratel holding company, it would have to exchange the stockholdings of every Telebrás shareholder for shares of Embratel. However, Embratel's shares are all common (i.e. with voting rights). The fact that the government held 51.79 per cent of the voting stock of Telebrás did not mean that it would receive 51.79 per cent of the voting stock of Embratel. If this were to be the case, the government would hold 51.79 per cent of the total capital of Embratel (which has only voting stock), but this could not be the case because the government had only 21.43 per cent of the total capital of Telebrás. Since Telebrás held 98.75 per cent of the capital of Embratel, the government's final holding in Embratel would be 21.43 per cent of 98.75 per cent, or 21 per cent. The conclusion is that if the stockholdings in Telebrás were exchanged for stockholdings in Embratel, the minority shareholders of Telebrás would receive 79 per cent of the total capital of Embratel, which would have the effect of a "spontaneous privatization" of Embratel, and the government would not be able to capture for itself 100 per cent of the control premium through the sale of a strategic block of stock. The same reasoning would apply to Telesp.

Thus, the government would only be able to capture the control premium on the sale of Embratel if it created Embratel holding company – with both ON (voting), and PN (preferred) stock – in which the government would have 51.79 per cent of the voting stock (19.26 per cent of the total capital), and 3.68 per cent of the preferred stock (2.17 per cent of the total capital) resulting in a holding of 21.43 per cent of the total capital. This is the same stockholding ownership and structure of Telebrás that needed to be replicated for each of the 12 new companies. At the moment when the government sold its common stock in the Embratel holding company, it would in fact be privatizing control of the management of the Embratel holding company, which in turn would own 98.75 per cent of the Embratel operational company.

Summing up, Model C allowed the government to achieve its objectives: (i) to create the necessary conditions for establishing a competitive environment; (ii) to assure that the government (and only the government) received the control premium; and (iii) to assure a transparent privatization which also guaranteed the rights of Telebrás minority shareholders.

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## **6. The Beginning of Liberalization of the Sector: The Sale of “B Band” Concessions**

As mentioned in Section 3, when the Communications Ministry perceived that the need for Congress to approve a new Telecommunications Code would excessively delay the opening of the sector to the private sector, it decided to present to Congress a proposal of a specific law for liberalization of the cellular market (Law 9,295 of July 19, 1996). The main points of this “Minimum Cellular Law” and of its enabling regulations were: (i) the country was divided into ten regions for cellular service; (ii) sales of concessions to operate the so-called “B Band” were proposed;<sup>8</sup> (iii) the wireline and cellular business of all the companies would be totally separated within two years; and (iv) the government would only begin to invite tenders for the frequency corresponding to Personal Communication Systems (PCS) in the year 2000. As a result of the law, all the local operators were spun-off into separate wireline and cellular companies in March 1998. Thus, instead of one telephone operator in each state, at the moment of privatization of Telebrás in July 1998 in each state there were two telephone companies, both controlled by Telebrás, one wireline service company and one cellular service company.

With the approval by Congress of the Cellular Law, the government began to auction concessions to operate mobile cellular service on the “B Band” frequency. To ensure that there were a reasonable number of new operators, the invitation to tender divided the country into two groups: the first included all the more economically favored areas, and the second included the less favored areas. Each potential buyer of the concession could only buy one company in each of the groups. Further, the invitation to tender: (i) demanded the presence of a strategic investor in each of the consortia bidding for concessions, with proven experience in management of cellular telephone companies; (ii) limited the participation of non-Brazilian capital to 49 per cent of the voting stock; and (iii) set targets for service to the localities in each region. Table 4 shows the revenue obtained by the government from the sales of the “B Band” cellular concessions.

Except for the lack of the initial interest in the Amazon region at a minimum auction price of US\$ 180 million, the “B Band” auctions were a major success for the government and showed the strong interest of non-Brazilian operators in the Brazilian telephone service market. The premium obtained from the auction as a whole was 237 per cent over the aggregate of the

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8 Brazilian cellular service operates on a frequency band at 800 MHz. This band was divided into two parts: Band A, operated by the Telebrás companies; and Band B, operated by private companies competing with the Telebrás companies.

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**Table 4**  
**Results of the “B Band” Cellular Concession Auctions**

Area	Winning Consortium	Population (Million)	Offer (US\$ Million)	Premium on Minimum Price (%)	US\$ Bid Per Pop.
1 Greater São Paulo	BCP (Bell South, Splice, Oesp, Safra)*	15.50	2,414.6	341.3	155.78
2 Interior of São Paulo State	Telia, Eriline, Primav	18.56	1,215.7	121.2	65.50
3 Rio de Janeiro, Espírito Santo	Korea Telecom Mobile, Queiroz Galvão, Lightel	16.10	1,325.8	201.6	82.35
4 Minas Gerais	Stet, Vicunha, Globo, Bradesco	16.66	456.8	30.0	27.42
5 Paraná, Santa Catarina	DDI, Inepar, Motorola, Suzano	9.00	679.6	134.5	75.51
6 Rio Grande do Sul	Bell Canada, Local Pension Funds	9.95	293.3	1.4	29.49
7 Center-West	Bell Canada, Local Pension Funds	12.17	315.5	25.4	25.92
8 Amazon Region	No Bids Made	13.75	n.a.	n.a.	n.a.
9 Bahia, Sergipe	Stet, Vicunha, Globo, Bradesco	14.15	228.1	8.7	16.12
10 Northeast	BCP (Bell South, Splice, Oesp, Safra)*	25.38	511.6	141.5	20.16
<b>Total</b>		<b>151.22</b>	<b>7,441.0</b>	<b>236.7</b>	<b>49.21</b>

\*BCP (Areas 1 and 10) and Americell paid cash at the end of the first year to avoid additional payment of inflation adjustment plus 1% per month.

minimum prices. The value paid per population of the concession areas (last column of Table 4) indicates the potential for growth of the sector. As much as US\$ 156/pop<sup>9</sup> was paid for the concession to operate Greater São Paulo, an amount similar to the stock market price of major cellular companies *already in operation* (for example: US\$ 133/pop for US Cellular and US\$ 142/pop for Orange of the UK, at the time of this writing). How high these values per pop paid for concessions were becomes clear when they are compared with the experience of other countries: US\$ 24/pop in Ecuador (in 1993); between US\$ 12 and US\$ 24/pop in Colombia, in 1994; US\$ 16 in Spain, in 1994; and US\$ 40 in the US (July 1995).

The experience of the cellular service concession sales was extremely useful for the government in preparation of a larger challenge, the privatization of the assets of Telebrás. There was one clear lesson: the clearer the regulatory environment, the greater the interest from potential buyers. It was with this in mind that the authorities continued to work on the regulatory structure, so that there would be no uncertainty which could place the privatization of Telebrás at risk.

## **7. The Privatization of Telebrás**

After the approval of the spin-off of Telebrás into 12 holding companies in April 1998 (Diagram 2), the auction of these 12 companies was scheduled for July 29, 1998. Contrary to the

9 “Pop” is used to refer to the population resident in the area of the concession.

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expectation of most analysts, the auction was not postponed until after the October 1998 presidential elections. The government also arrayed an army of lawyers to avoid the auction being delayed by applications for injunction to restrain the government from going ahead with the privatization auction. The auction took place on the scheduled date, and was completed earlier than the most optimistic of analysts had expected: all the 12 companies were auctioned in less than 6 hours at the auction on the Rio de Janeiro stock exchange.

As in the case of the cellular companies, the government imposed certain restrictions on acquisition by a single group of more than one telephone company. The 12 companies to be privatized were divided into three groups for the auction:

Group 1: wireline and long distance (Telesp, Tele Norte-Leste, Tele Centro-Sul and Embratel);

Group 2: cellular telephony in the more economically favored areas (Telesp Celular, Tele Sudeste Celular, Tele Sul Celular and Telemig Celular); and

Group 3: cellular telephony in the less economically favored areas (Tele Leste Celular, Tele Nordeste Celular, Tele Norte Celular and Tele Centro-Oeste Celular).

Under the auction rules, only one company in each of the groups could be acquired by a single controlling shareholder. In contrast to the auction of the "B Band" cellular concessions, the government placed no restrictions on participation of non-Brazilian capital, and also did not demand the presence of a telephone service operator in the consortia bidding for Telebrás companies.

Table 5 shows the result of the auction. It is important to remember that the prices paid in the auction were for only 19.26 per cent of the total capital of the respective companies. The purchase price was to be paid in three installments: the first 40 per cent of the total, immediately, and two further installments of 30 per cent each, 12 and 24 months later, with their values adjusted by inflation plus 12 per cent interest p.a. The premiums obtained by the government exceeded all the market's expectations. The most optimistic expectations were for a premium of no more than 40 per cent, much less than the 64 per cent obtained (last column of Table 5). It should be remembered that on the day the minimum auction price was announced, it represented a premium of 70 per cent over the market price of Telebrás (Telebrás was trading for US\$ 110 per thousand shares, while the sum of the minimum auction prices of the 12 companies set by the government was US\$ 183 per thousand shares). The usual premium over market price paid for control of a company is between 25 per cent and 45 per cent. The premium achieved by the Brazilian government clearly exceeded all expectations. If there

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was one negative point in the result of the auction, it was the absence of a strategic investor in the consortium which bought control of Tele Norte-Leste, the holding company which would control the Telebrás companies which needed the greatest restructuring, such as Telerj (the company serving Rio de Janeiro state), Telasa (the company serving Alagoas state), and Telern (the company serving Rio Grande do Norte state). Further, the new controlling shareholders of Tele Norte-Leste do not have a track record in operating as listed companies. The stock market, led as ever by minority shareholders, was unforgiving: the stock prices of the listed companies controlled by Tele Norte-Leste fell heavily – for example, the price of Telerj fell 37 per cent, and the price of Telemig (one of the best operators, if not the best, in the Telebrás group of companies) fell 27 per cent – in the ten days after the auction, compared to a fall of only 10 per cent in the São Paulo (Bovespa) stock index.

In response to speculation about the financial capacity of the new controlling group, and the possible treatment to be given to minority shareholders of the companies controlled by Tele Norte-Leste, the government partially took back control of the

**Table 5**  
**Result of the Telebrás Auction**

<i>Company</i>	<i>Winning Consortium</i>	<i>Lines 1998</i>	<i>Population (Million)</i>	<i>Minimum Price (US\$ Million)</i>	<i>Price Obtained at Auction (US\$ Million)</i>	<i>Premium (%)</i>
Telesp	Telefónica de España, Portugal Telecom, RBS, Iberdrola, BBV	6,102	34,564	3,028	4,974	64.3
Tele Norte-Leste	Andrade Gutierrez, La Fonte, Inepar, Macal, Local Insurance Companies	7,671	89,441	2,924	2,954	1.0
Tele Centro-Sul	Telecom Italia, Algar, Opportunity, Splice	3,704	27,189	1,677	1,780	6.2
<b>Subtotal Wireline Companies</b>		<b>17,477</b>	<b>151,194</b>	<b>7,629</b>	<b>9,708</b>	<b>27.2</b>
Telesp Celular	Portugal Telecom	1,637	34,564	946	3,086	226.2
Tele Sudeste Celular	Telefónica de España, Iberdrola, NTT, Itochu	798	16,633	490	1,170	138.6
Telemig Celular	Telesystem, Local Pension Funds, Opportunity	537	17,109	198	650	228.7
Tele Sul Celular	Telecom Italia, Globopar, Bradesco	562	14,587	198	602	204.3
Tele Centro Celular	Splice	495	12,602	198	378	91.3
Tele Nordeste Celular	Telecom Italia, Globopar, Bradesco	572	26,239	194	568	193.3
Tele Leste Celular	Telefónica de España, Iberdrola	298	14,536	108	348	224.0
Tele Norte Celular	Telesystem, Local Pension Funds, Opportunity	263	14,924	77	162	108.9
<b>Subtotal Cellular Companies</b>		<b>5,162</b>	<b>151,194</b>	<b>2,408</b>	<b>6,965</b>	<b>189.2</b>
<b>Embratel</b>	MCI			<b>1,548</b>	<b>2,279</b>	<b>47.2</b>
<b>Telebrás</b>		<b>22,639</b>	<b>151,194</b>	<b>11,586</b>	<b>18,952</b>	<b>63.6</b>

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management of the Tele Norte-Leste. For this purpose, the government used the BNDES (Brazilian Development Bank, 100 per cent owned by the government) which bought a significant stake of 25 per cent of the voting capital auctioned by the federal government in Tele Norte-Leste. The idea is that this BNDES stake will be sold to a strategic investor in the near future.

One of the factors which enabled the government to be successful in the Telebrás privatization was the establishment of the “rules of the game”, in particular in relation to the competitive environment to take effect following privatization.

## **8. Competition and the Regulatory Environment after Privatization**

The process of privatization and liberalization of the Brazilian telecommunications sector was one of the last to take place in Latin America. This enabled Brazil to benefit from the experience of its neighbors. There were marked differences between the process in Brazil and that in other countries, especially in relation to the introduction of competition, and to tariffs:

(i) After the privatization, the Brazilian government did not give a *period of exclusivity* (monopoly) to the new controlling shareholders. This enabled part of the productivity gains to be passed on to consumers, and not enjoyed exclusively by the shareholders of the privatized companies.

(ii) The *tariff distortions* were corrected before privatization, and the rules for tariffs were included in the concession contract. Correction of the distortions before privatization made the impact on companies' cash flow clear, and benefited the government in terms of the privatization price by reducing uncertainties for potential buyers. On this point the Brazilian process was different from the process in Mexico, Peru and Argentina, where tariffs were rebalanced after privatization, leading to (a) uncertainties on the part of buyers, and (b) protests from critics of privatization who argued that, at the new tariff levels, the state-controlled companies would have been profitable, and the privatization would thus have been unnecessary.

(iii) The government's concern for the interests of *minority shareholders* led it to limit the management fee allowed to be paid to the strategic operator of a telecoms company in Brazil. In Argentina, Telefónica de España and Telecom Italia receive 5 per cent of net sales revenue (regardless of the company's operational performance), as a management fee. In Peru, Telefónica de España receives around 9 per cent of the cash flow (EBITDA) of

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Telefónica del Perú. The Brazilian government clearly acted in the interests of development of the Brazilian stock market, and in accordance with the interests of minority shareholders, even if this went against its own proprietary interest. The larger the management fee allowed for the strategic operator (that is to say, the larger the percentage of revenue paid to the operator for managing the company, regardless of the company's operational performance), the greater the interest of a given operator in controlling that company, and thus the greater the potential proceeds obtainable by the government from privatization. The concession contracts of the privatized companies in Brazil enable the new operator to collect a management fee (referred to in Brazil as technology transfer remuneration) of up to 1 per cent of net sales revenue between 1998 and 2000, falling to 0.5 per cent in 2001, and being eliminated altogether in 2005. Even so, the new operator has to have any agreement to pay a management fee passed by a special General Meeting of Shareholders of the company, and in this meeting the holders of preferred (non-voting) stock – 63 per cent of the total capital of the 12 companies – have the right to vote on the question. This rule gives the minority shareholders of the privatized companies much greater protection.

(iv) The *regulatory agency* was established and made fully operational before the privatization. This also reduced the perception of institutional risk by strategic investors in the privatization. The agency took part in the process, and demonstrated its full independence and strength before the privatization date, making it clear to investors that the rules of the game had been established and that the agency would follow them. This was one more positive factor helping to reduce the perception of risk in the Brazilian experience, when compared with other countries which delayed the creation of their regulatory agencies, or did not give them the due degree of independence when they were established.

The government made explicitly clear that competition would be introduced in each concession area immediately after the privatization. Immediately after the Telebrás privatization, Anatel put out for public consultation the proposed invitation to bid for the authorizations to operate companies which would compete with the companies which had just been privatized (these new authorizations were to be operated by the so-called “mirror companies”). The government's aim was to publish the final version of this invitation to bid on September 3, 1998, and to receive bids on November 3, 1998. The principal criterion in awarding the authorizations to operate “mirror” companies will be a technical one: the bidder offering higher penetration of individual customer service and of public telephones than the minimum levels specified in the invitation to bid will have an advantage in the auction, since the technical criteria carry a weighting of 70 per cent in the final score, compared to a 30 per cent weighting for the price criterion. Anatel demands proven

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experience from bidders, and does not restrain a single buyer from simultaneously purchasing the wireline operation authorizations for regions 1 (São Paulo), 2 (Center and South of the country) and 3 (Southeast, North and Northeast of the country), although it does prohibit a single company from buying one wireline authorization and one long distance authorization within the same individual area (of the three). There will thus be a “duopoly” between 1998 and December 2001, after which all restrictions will be removed on the maximum permissible number of operators of both wireline and long distance service in all regions of the country. All companies will be able to compete with each other in all of the services.

## **9. Conclusion: The Challenges Ahead**

The changes in the Brazilian telecommunications sector in the last five years were profound, culminating in the privatization of Telebrás in July 1998. The government established a competitive environment, in particular in relation to tariffs. Since tariffs were set at a noticeably competitive level, the result could be reduced interest on the part of new companies in participating in the Brazilian market: the price margin in wireline and long distance telephony is relatively low in terms of attracting the interest of many companies to build networks in parallel to those of the companies recently privatized. On the other hand, the government has set rigid targets for universal service, to which the privatized companies, but not the mirror companies, are subject. If the sale of the authorizations to operate new wireline companies, scheduled for November 1998, is successful, the Brazilian government will have completed a major achievement: it will have succeeded in creating a competitive environment, with tariffs which were already competitive at the outset, rather than being the result of a process which occurs after competition has been introduced.

In mobile service, further competition will come with the auction, programmed for the year 2000, of the PCS service frequencies which compete with the present cellular services. A process of consolidation of the market is expected to take place over the next few years, especially in mobile service, which is characteristically more competitive. Under the General Telecoms Law, any consolidation of the sector must be approved by the Administrative Council for Defense of the Economy (Cade), the independent agency responsible for the existence of a competitive environment in all the sectors of the Brazilian economy and which will be responsible for assuring that a competitive environment continues to prevail in the telecoms sector.

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The final conclusion is that the Brazilian government succeeded, in the Telebrás privatization, in balancing its two conflicting roles of regulator and shareholder. On the one hand it was responsible, as concession-granting authority, for establishing a competitive environment, while on the other hand it had an interest, as the majority shareholder, in trying to capture the maximum possible value from the sale of its assets. It would clearly have achieved higher proceeds from the privatization if it had opted to give purchasers of Telebrás companies a period of monopoly, or if it had set higher tariffs. However, this was against the interest of society as a whole and of consumers. The route chosen was a balanced one, in which it sought to make the regulatory environment clear. The figures speak for themselves: the government obtained US\$ 300 for each thousand shares it held, compared to Telebrás's market trading price of US\$ 97 on the day this concluding paragraph is being written (August 1998), a difference of 200 per cent. The government gained from the process, and Brazilian society as a whole also gained, as it will have better and more competitive telecommunications service.

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