The new Responsibility Law for State owned Enterprise

Joisa Dutra
Director of the Getulio Vargas Foundation Center for Regulation and Infrastructure (Ceri)

THE NEW RESPONSIBILITY Law of State-Owned Enterprises was approved by President Michel Temer on July 1st. Long overdue, the law closes a serious gap considering how extensively state-owned enterprises (SOEs) participate in the Brazilian economy.

In Brazil, SOEs dominate the infrastructure sector. According to Ceri data, about 30% of consumers are served by power distribution companies that are controlled by the government. Even though the oil and natural gas sector was opened to private participation 20 years ago, SOE Petrobras still accounts for over 82% of domestic production of natural gas. In the sanitation sector, of 28 regional service providers, 26 are state-owned. The same is true in the transportation sector, where only a few airports have private owners. That is also the case for highways.

Unfortunately, there is abundant evidence that Brazilian SOEs have serious governance issues. In the economic literature, inadequate governance in companies in general reflects the difficulty of aligning the incentives of owners and of company managers, exacerbating the difficulty owners have in controlling the company's goals.

Unfortunately, there is abundant evidence that Brazilian state-owned enterprises have serious governance issues.

In Brazil, Petrobras is the most notorious case of poor SOE governance. It is true that the Revenue Watch Institute in 2013 rated Petrobras as the third best oil and gas SOE worldwide, but that misleading good rating demonstrates that assessment of the governance of a company is often limited to formal aspects, and there is little ability to effectively assess whether the objectives of owners and managers are aligned.

In 2014, when the corruption investigations in Petrobras became public, it also became clear that the company has serious management problems, among them politically motivated nominations of managers, limited engagement of private shareholders, deficient internal control systems, and failure to adhere to best corporate governance practices, both national and international.

Such scandals, emblematic as they are of the crisis of governance in Brazilian SOEs, attest to the distance between the activities of these companies and the public interest.

The economic literature recognizes that the objectives of SOEs go well beyond simply maximizing profits. In Brazil's legal framework there has been some difficulty, even confusion, in understanding the objectives of these companies. Evidence of this is how their social and their market functions conflict when SOE shares trade on stock markets.

The Responsibility Law of State-Owned Enterprises addresses the social function that should guide the actions of state enterprises and its foundation—the collective interest or national security imperatives. The collective

interest may, for instance, involve expansion of economically sustainable access to public services (universalization) or industrial policy (development or use of Brazilian technology).

The law

The responsibility law deals with two major topics: (1) governance of SOEs and mixed capital companies (companies capitalized by both government and the private sector), and (2) bidding procedures and contracts awarded by public enterprises and joint stock companies.

With regard to governance, the law establishes the criteria for appointment and the powers of the controlling shareholder, management, the Board of Directors, and the Audit Committee.

Before the Petrobras issue, governance had already been of concern, as evidenced by the report of the Court of Auditors on Furnas, a subsidiary of Eletrobras (a Brazilian electric utility), which is a mixed capital company engaged in the generation and transmission of electricity. The Court was concerned with how SOEs operate and the lack of internal control mechanisms: it identified 81 Furnas subsidiaries that together represent total investments of about R$48 billion, of which R$7.9 billion are a direct responsibility of Furnas.

The Court found (1) no policy or standards to guide subsidiaries on issues of planning, control, and management, or even profitability criteria; (2) no criteria for selecting companies to partner with subsidiaries; (3) no criteria for selecting Furnas officials to sit on the boards of these subsidiaries; and (4) the presence of construction companies as partners in subsidiaries.

These problems lie at the root of a number of questionable practices that the Court identified, such as renegotiations that ultimately produced a general deterioration in the profitability of investments. The Court reported that of 79 subsidiaries analyzed, 21 were reviewing their business plans, and of these 17 had lower returns than were planned.

Brazil has an undeniable need to invest more in infrastructure, and reaching this goal depends on improvements in the law and regulation.

As a result of its analysis of the Furnas case, the Court recommended establishing criteria for selecting representatives of the SOE to monitor subsidiaries and sit on the Board of Directors and the Audit Committee, and setting up monitoring and control systems. The responsibility law largely responds to the Court's concerns.

The major question that arises now is the extent to which the law will have a disciplining effect on the functioning of SOEs, which have a significant role in the economy.

SOEs have 24 months to carry out the measures necessary to comply with the law. The government's intentions to adhere to the dictates of the law thus recognize this period as a period of adjustment. One way to monitor how well SOEs are adjusting to the new law, for example, would be to monitor the extent to which nominations for the Board of Directors, the CEO, and other senior management staff meet the law's criteria.

Brazil has an undeniable need to invest more in infrastructure, and reaching this goal depends on improvements in the law and regulation. The willingness of the federal government to promote reforms by enacting laws to deal with issues such as the Investment Partnership Program and the organization of SOEs is welcome. But the actual results will come only if the best practices established by these laws are complied with. It is therefore critical that the government make a diligent effort to monitor compliance.