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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS

OF THE PRESIDENT

TO THE EXECUTIVE DIRECTORS:

(1) ON THE PROPOSED LOANS TO
COMPANHIA PAULISTA DE FORCA E LUZ
COMPANHIA FORCA E LUZ DO PARANA
COMPANHIA FORCA E LUZ DE MINAS GERAIS
COMPANHIA BRASILEIRA DE ENERGIA ELETRICA,
FOUR SUBSIDIARIES OF

CENTRAIS ELETRICAS BRASILEIRAS S.A. (ELETROBRAS)

IN BRAZIL,

FOR THEIR

RESPECTIVE TRANSMISSION AND DISTRIBUTION PROJECTS

(2) ON PROPOSED AMENDMENTS TO

THE RESPECTIVE LOAN AND GUARANTEE AGREEMENTS (JAGUARA POWER PROJECT)

DATED MARCH 15, 1966

WITH

CENTRAIS ELETRICAS DE MINAS GERAIS S.A. (CEMIG)

AND THE UNITED STATES OF BRAZIL

December 5, 1966

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS OF THE PRESIDENT TO THE
EXECUTIVE DIRECTORS ON THE PROPOSED LOANS TO

COMPANHIA PAULISTA DE FORCA E LUZ,
COMPANHIA FORCA E LUZ DO PARANA,
COMPANHIA FORCA E LUZ DE MINAS GERAIS,
COMPANHIA BRASILEIRA DE ENERGIA ELETRICA

FOUR SUBSIDIARIES OF CENTRAIS ELETRICAS BRASILEIRAS S.A. -
ELETROBRAS IN BRAZIL
FOR
THEIR RESPECTIVE TRANSMISSION AND DISTRIBUTION PROJECTS

1. I am submitting the following Report and Recommendations on four proposed loans in amounts in various currencies equivalent to \$41.0, \$8.1, \$6.3 and \$6.2 millions respectively, to:

Companhia Paulista de Forca e Luz,
Companhia Forca e Luz do Parana,
Companhia Forca e Luz de Minas Gerais,
Companhia Brasileira de Energia Eletrica,

four subsidiaries of Centrais Eletricas Brasileiras S.A. (ELETROBRAS) to finance part of the cost of their respective transmission and distribution projects in Brazil.

PART I - HISTORICAL

2. The four above-mentioned companies are former subsidiaries of American and Foreign Power (AMFORP). In November 1964, AMFORP sold its ten Brazilian subsidiaries and Companhia Auxiliar de Empresas Eletricas Brasileiras (CAEEB), the management company of the group, to ELETROBRAS, a federal holding company responsible for national power development and planning.

3. In July 1965, ELETROBRAS and the Government requested the Bank to assist in financing the expansion and rehabilitation of the transmission and distribution systems of certain of the former AMFORP companies. These projects were studied by the consultants of these companies, Cia. Internacional de Engenharia e Construcoes (CIECO), the Brazilian subsidiary of the International Engineering Company of San Francisco. In accordance with the Bank's preference to lend directly to the operating entities carrying out the projects, and in order to simplify appraisal and administration, the Bank agreed to consider loans totalling approximately \$60 million to four of them. These four projects were appraised by a Bank mission which visited Brazil in December 1965.

4. In May 1966, the Bank invited representatives of ELETROBRAS, the prospective borrowers, and the Government for negotiations. The Government was represented by Mr. Mauricio Bicalho, Executive Director at the International Monetary Fund, and Mr. Gabriel Carvalho, Lawyer; ELETROBRAS and the prospective borrowers were represented by Mr. Octavio Marcondes Ferraz, President of ELETROBRAS, and Mr. Leo Penna, President of CAEEB. During this phase of the negotiations, we were unable to reach an agreement on the rate covenant. In July Mr. Benedicto Dutra, Deputy Minister of Mines and Energy, accompanied by Messrs. Bicalho and Carvalho, continued the discussions, but it was only in mid-November that final agreement was reached with Mr. Mauro Thibau, Minister of Mines and Energy.

5. In early 1966, the Brazilian Government had agreed in principle that additional protection against inflation was necessary for the power companies to operate on a sounder basis. The Government had also indicated that while it would explore the possibility of modifying the rate legislation to that effect, the Bank could include in the rate covenants of the forthcoming power loans provisions which would achieve similar results. Shortly thereafter, during the negotiations of the \$49 million loan to Centrais Eletricas de Minas Gerais (CEMIG) for the Jaguará hydroelectric project, the Bank proposed and the Government accepted a rate covenant securing a 10 percent return on net fixed assets in operation in real terms. In May, however, during the negotiations of the other power loans which are now presented to the Executive Directors, the Government took the position that some of the provisions contained in the then proposed rate covenants, which were almost identical to those of the Jaguará covenant, were not fully compatible with Brazilian legislation and therefore not acceptable. During the subsequent discussions with the Bank, the Government maintained its position. In the meantime, however, it promulgated a new law, which provides for annual compulsory revaluation of assets of all power companies, thus substantially achieving results similar to those sought in the proposed Bank covenants. The Bank subsequently agreed to withdraw its original proposal and to replace it with provisions obligating the power companies to conform with the Brazilian power tariff regime in effect on the date of the proposed Agreements (see Section 5.15 of the Loan Agreements).

6. To protect the prospective borrowers against changes in this tariff regime, which would, in the judgment of the Bank, adversely affect their operations, the Government, the Bank and the companies have also agreed that such adverse changes in legislation would, at the Bank's option, constitute an event of default (see Section 6.02 (b) of the Loan Agreements). The Government and the prospective borrowers will be informed in writing of the standard which the Bank intends to employ for this purpose. (See Supplemental Letter on electricity rates).

7. The arrangements described above would also apply to the proposed \$39 million loan to Central Eletrica de Furnas S.A. (FURNAS) for the second stage of the Estreito hydroelectric project which I am presenting simultaneously herewith and to the \$49 million Jaguará loan to CEMIG which was signed on March 15, 1966, but is not yet effective. The proposed amendments to the CEMIG loan documents are attached.

8. The proposed loans would bring the total number of Bank loans to Brazil to twenty and would increase total Bank lending to Brazil to \$457.1 million (net of cancellations). The following is a summary statement of Bank loans to Brazil as of October 31, 1966:

<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount (US\$ Million)</u>	
			<u>Bank</u>	<u>Undisbursed</u>
	Loans Fully Disbursed		267.0	
1965	FURNAS - Estreito (1st stage)	Power	57.0	55.0
1965	USELPA - Xavantes	Power	22.5	21.7
1966	CEMIG - Jaguará	Power	<u>49.0</u>	49.0
	Total (less cancellations)		395.5	
	of which has been repaid		<u>106.3</u>	
	Total now outstanding		289.2	
	Amount sold	7.4		
	of which has been repaid	<u>6.5</u>	<u>0.9</u>	
	Total now held by Bank		<u>288.3</u>	
	Total undisbursed		<u>125.7</u>	<u>125.7</u>

The above undisbursed amount includes the \$49 million loan for the Jaguará Project which is not yet effective. Disbursements for the Xavantes Project were delayed because the loan only became effective in April of this year owing to delayed approval by the Sao Paulo State Legislature. Work on this Project has been somewhat delayed for the same reason. Disbursements for the Estreito Project have been slower than originally estimated because progress payments are only beginning now. Work on this Project is proceeding on schedule.

PART II - DESCRIPTION OF THE PROPOSED LOANS

9. The main features of the proposed Loans are as follows:

Borrowers: Companhia Paulista de Força e Luz,
 Companhia Força e Luz do Paraná,
 Companhia Força e Luz de Minas Gerais,
 Companhia Brasileira de Energia Elétrica.

Guarantor: The United States of Brazil.

Amounts: The equivalent in various currencies of \$41.0, \$8.1, \$6.3 and \$6.2 millions, respectively.

Purpose: Assist in financing equipment and materials for the expansion and rehabilitation of the transmission and distribution systems of these companies.

Amortization: Term of 20 years including a 5-year grace period with semi-annual payment dates of February 15 and August 15, and payments beginning on February 15, 1972 and ending on February 15, 1987.

Interest rate: 6 percent per annum.

Commitment charge: 3/8 of one percent per annum.

PART III - THE PROJECTS

10. Four appraisal reports on the Power Transmission and Distribution Projects of the four prospective borrowers (Nos. TO-538b, TO-537b, TO-536b and TO-535b) are attached.

11. As proposed at the time of appraisal in December 1965, the Projects consisted of the first three-year portion (1966 to 1968) of the Project companies' five-year expansion programs comprising the rehabilitation and expansion of their transmission and distribution systems. These programs are, however, part of a continuing investment process which has been globally defined for a five-year period but which consists of yearly tranches. With the delay in negotiations the proposed loans can no longer cover the expenditures initially envisaged for 1966, the first year of the program. I am therefore proposing that the Projects cover the years 1967, 1968 and 1969, instead of 1966, 1967 and 1968. The amounts of the proposed loans will not be changed since the total investments during the 1967/69 period will be of the same magnitude as those during the originally contemplated 1966/68 period. We are satisfied that there has been no adverse change in the financial condition of these companies and we have satisfactory technical information on their five-year programs. In these circumstances, and in order to avoid further delays, I felt that it would not be necessary to send another field mission to reappraise these Projects. The provision (see Section 2.03 of the Loan Agreements) which calls for prior approval by the Bank of each year's investment program before withdrawals on account of such year are authorized, is an additional assurance that loan funds will be properly spent.

12. The distribution networks of the four Project Companies serve the states of Sao Paulo, Parana, Minas Gerais and Rio de Janeiro, respectively. In the recent past these companies have not been able to satisfy the increasing demand for power because inadequate rate levels did not generate income sufficient to finance their expansion programs. The market for power in these areas has been studied by CIECO, the Companies' consultants. Projected sales cover normal market growth as well as accumulated demand backlog.

13. As noted in paragraph 2 above, the four Project Companies are former subsidiaries of AMFORP. They are autonomous entities in which ELETROBRAS now holds equity participations of about 75, 90, 65 and 70 percent respectively. The organization instituted by AMFORP has been retained and CAEEB, the former Management Company of the AMFORP Group, still controls the Companies' operations. Some members of CAEEB's Board and Management participate also in the Boards and Managements of the Project Companies. The Boards and Managements of CAEEB and of these Companies are experienced and competent and with the assistance of their consultants they should be able to carry out the Projects efficiently.

14. The Projects consist of a three-year portion of the Project Companies' five-year expansion programs comprising the rehabilitation and expansion of their transmission and distribution systems. About 20 to 25 percent of the total expenditures would be for rehabilitation. Facilities to be installed include high-voltage connecting lines and related substations, low-voltage distribution feeders and transformers and related distribution hardware such as switchgear, meters, etc.

15. Notwithstanding the aforementioned delays, the cost totals of the (three-year) Projects are still estimated at about US\$93.7, \$15.3, \$11.7 and \$10.8 millions, respectively. Bank lending would mainly cover the cost of equipment and materials procured abroad or in Brazil under international competitive bidding and would on the average represent about 47 percent of the total aggregate cost of the Projects.

16. The cost totals of the entire five-year expansion programs from 1966 through 1970 had been estimated at approximately US\$174.0, \$21.4, \$19.3 and \$25.0 millions, respectively. These programs were expected to be financed from the following sources:

	CIA Paulista de Forca e Luz	CIA Forca e Luz do Parana	CIA Forca e Luz de Minas Gerais	CIA Brasileira de Energia Eletrica
	(Percent)			
Net Internal Cash Generation	18.2	22.9	28.7	31.8
Additional Share Capital	45.3	37.7	36.3	40.1
Proposed IBRD Loans	23.5	37.7	32.7	24.8
AID Loan (Peixoto)	10.5	-	-	-
Other Resources	<u>2.6</u>	<u>2.3</u>	<u>3.4</u>	<u>3.9</u>
	100.1	100.6	101.1	100.6
Net Decrease in Cash	<u>(0.1)</u>	<u>(0.6)</u>	<u>(1.1)</u>	<u>(0.6)</u>
	100.0	100.0	100.0	100.0

The above estimates are still considered to give a fair representation of the sources of financing. Satisfactory assurances have been received that all necessary funds to carry out the five-year expansion programs will be provided by Eletrobras (see Sections 5.13 and 5.14 of the Loan Agreements and Section 2.04 of the Eletrobras Shareholder Agreement).

17. As noted in paragraphs 5 and 6 above, the Government, ELETROBRAS and the four Project companies, have agreed to establish and maintain tariffs in accordance with the prevailing power rate legislation which essentially provides that the power companies shall earn a 10 percent return on revalued investment after covering all operating expenses, including depreciation. This arrangement should result in a satisfactory level of net operating income. Debt service coverage over the period would be adequate. The companies have agreed to limit their debt to two-thirds of the value of their total fixed assets (net of depreciation) (see Section 5.16 of the Loan Agreements).

18. In accordance with an agreement reached with the Government and previous Bank borrowers in the power sector the proposed loans would cover procurement of equipment and materials on the basis of international competitive bidding with Brazilian suppliers participating with a preference of 15 percent in lieu of customs duties.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

19. The Draft Loan Agreements between the Bank and Companhia Paulista de Forca e Luz, Companhia Forca e Luz do Parana, Companhia Forca e Luz de Minas Gerais, and Companhia Brasileira de Energia Eletrica, respectively; the Draft Guarantee Agreements between the United States of Brazil and the Bank, the Draft ELETROBRAS Shareholder Agreement between the Bank and Centrais Eletricas Brasileiras S.A. - ELETROBRAS, the Draft Supplemental Letters on Electricity Rates, and the Report of the Committee provided for in Article III, Section 4 (iii) of the Articles of Agreement are being distributed to the Executive Directors separately.

20. Most of the provisions included in these Draft Loan and Guarantee Agreements are similar to those usually encountered in electric power loans of the same nature. The Draft ELETROBRAS Shareholder Agreement contains provisions usually to be found in agreements between the Bank and holding companies controlling the borrowers and thus, the Projects. The following sections of the Draft ELETROBRAS Shareholder Agreement are of special interest: (a) Section 2.03, in which ELETROBRAS undertakes not to relinquish control of the Project or Other Companies and to keep its relations with them on the basis of arms-length dealings; (b) Section 2.05 which gives the Bank claims against the Project Companies equal ranking to those of ELETROBRAS.

21. The Guarantor is authorized by existing legislation to give its guarantee to the proposed Loans.

PART V - THE ECONOMY

22. An economic report entitled "Current Economic Position and Prospects of Brazil" (WH-161a) was circulated to the Executive Directors in June 1966. It is planned to send a new economic mission to Brazil in January 1967, which will undertake another comprehensive review of the economy.

23. Although complete success is still far from being achieved, Brazil's economic situation has improved markedly since 1964 when the present Government took office. At that time the economy was stagnating - real product per head had declined in 1963 and was barely above the 1961 level - and was undergoing rapid and accelerating price inflation. Domestic wholesale prices had risen 75 percent during 1963 and were almost seven times as high as in 1958. Moreover, the structure of the economy was thoroughly distorted by a complex system of price controls, subsidies, negative real interest rates, exchange and import restrictions and multiple exchange rates. The balance of payments had been in a state of crisis for some years. The new Government's main economic goals were shaped by this situation; (a) economic growth was to resume, (b) reasonable price stability was to be achieved in the course of three years by means of appropriate monetary, fiscal and wage policies and (c) the main distortions and rigid-

ities of the economy were to be removed and the role of free market forces in allocating resources efficiently was to be greatly enhanced. The main measures that were to be taken under each heading were defined in agreement with the major external financing agencies and were based on a gradual approach to achieving stabilization. These measures were quite far reaching: many price controls and subsidies were reduced or abolished; the Government's cash deficit - one of the main causes of the inflation - was reduced from 25 percent of total expenditure in 1964 to 15 percent in 1965; the exchange rate was twice devalued to respond to domestic price changes; a wage policy which involved lagging adjustments in real incomes was enforced; utility rates were raised; commercial interest rates were allowed to become positive; and some of the restraints on imports were eased.

24. Although economic growth recovered somewhat in 1965 - to about 4.7 percent, after a 3.1 percent (about equal to population growth) rise in 1964 - at a pace that seems to be maintained in 1966, the results of the policy were less satisfactory than had been expected. The rate of price increases fell from 90 percent in 1964 to 50 percent in 1965 but has not abated significantly in 1966 since during the first nine months wholesale prices (excluding coffee) rose by 35 percent. In part this resulted from special factors; the 1965/66 coffee crop greatly exceeded expectations and upset the execution of the monetary program. Moreover, part of the price increases were corrective in nature and themselves resulted from the vigorous implementation of other facets of the Government's program, particularly the removal of price controls and subsidies, and the exchange devaluations. The results of these measures should emerge gradually if the underlying objectives are maintained and adequate policies are pursued. Consequently, it is important to note that the President Elect, Field Marshal Costa e Silva, who will take office on March 15, 1967, has stated his intention to continue, in general, his predecessor's economic policy.

25. One of the notable improvements that has resulted from the policy measures of the past two years has been in Brazil's balance of payments. Non-coffee exports rose by about US\$220 million in 1965 - about one-fourth of this increase was in manufactures - and the year ended with a substantial (US\$225 million) surplus on current account. There have been further increases in exports in 1966. Imports which had been stagnant for several years responded markedly to the recovery in industrial demand and to the easing of import restrictions in 1966; the current account of the balance of payments is thus expected to show a lower surplus in 1966 than in 1965. The exchange reserve position has improved proportionately; gross exchange reserves rose by US\$320 million in 1965 to a level of US\$688 million and, on the basis of information through October 1966, this reserve position remains substantially unchanged. Furthermore, Brazil has been able to liquidate a large portion of the earlier accumulated commercial arrears.

26. Brazil still faces heavy debt service obligations. The official debt service ratio was 26 percent in 1965; with debt service payments of some US\$480 million, this ratio will approximate 29 percent in 1966. However, while service payments will remain heavy during 1967 and 1968, they are scheduled to begin declining from 1967 onward. Brazil's debt

service burden should therefore begin to improve if Brazil continues to be successful in implementing its policy of lengthening the present short average maturity of its external indebtedness by limiting strictly the amounts and maturities of new suppliers' credits and seeking new loans on as long terms as possible, with grace periods that burden to the minimum Brazil's balance of payments during the next few years. The terms of the proposed Bank loans are appropriate in Brazil's present economic situation. The burden of debt also makes it particularly important during the next few years for Brazil to follow general economic and financial policies which would ensure a continuation of the recent improvements in Brazil's balance of payments situation and a continued strengthening of confidence of private investors. In this connection it should be noted that during the last two years Brazil has made significant progress in the settlement of foreign investment disputes. Two claims were settled in 1964 and in the last few months agreement was reached on two other long standing disputes. The Government has assured the Bank that in the cases in which it does not recognize a claim, legal redress remains available to the claimants.

27. There are many uncertainties in the Brazilian situation. The forthcoming economic mission will provide the occasion for a new assessment of Brazil's economic problems and prospects and for reviewing in detail the new Brazilian Government's own assessment of these prospects and their policy intentions. In the meantime, the thrust of recent Brazilian economic performance and policy warrants proceeding with the loans now under consideration.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

28. I am satisfied that the proposed Loans would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATIONS

29. I recommend that the Executive Directors adopt the following resolutions in respect of the four Power Distribution Loans:

RESOLUTION NO.

Approval of Loan to Companhia Brasileira de Energia Eletrica in an amount equivalent to US\$6,200,000 to be guaranteed by The United States of Brazil.

RESOLVED:

THAT the Bank shall grant a loan to Companhia Brasileira de Energia Eletrica to be guaranteed by The United States of Brazil, in an amount in various currencies equivalent to six million two hundred thousand United States dollars (US\$6,200,000), to mature on and prior to February 15, 1987, to bear interest at the rate of six percent (6%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with terms and conditions set forth in the form of Loan Agreement (Power Distribution Program - A) between the Bank and Companhia Brasileira de Energia Eletrica, the form of Guarantee Agreement (Power Distribution Program - A) between The United States of Brazil and the Bank, and the form of Eletrobras Shareholder Agreement (Power Distribution Program) between the Bank and Centrais Eletricas Brasileiras - ELETROBRAS, which have been presented to this meeting.

RESOLUTION NO.

Approval of Loan to Companhia Forca e Luz do Parana in an amount equivalent to US\$8,100,000 to be guaranteed by The United States of Brazil.

RESOLVED:

THAT the Bank shall grant a loan to Companhia Forca e Luz do Parana to be guaranteed by The United States of Brazil, in an amount in various currencies equivalent to eight million one hundred thousand United States dollars (US\$8,100,000), to mature on and prior to February 15, 1987, to bear interest at the rate of six percent (6%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Loan Agreement (Power Distribution Program - B) between the Bank and Companhia Forca e Luz do Parana, the form of Guarantee Agreement (Power Distribution Program - B) between The United States of Brazil and the Bank, and the form of Eletrobras Shareholder Agreement (Power Distribution Program) between the Bank and Centrais Eletricas Brasileiras - ELETROBRAS, which have been presented to this meeting.

RESOLUTION NO.

Approval of Loan to Companhia Paulista de Forca e Luz in an amount equivalent to US\$41,000,000 to be guaranteed by The United States of Brazil.

RESOLVED:

THAT the Bank shall grant a loan to Companhia Paulista de Forca e Luz to be guaranteed by The United States of Brazil, in an amount in various currencies equivalent to forty-one million United States dollars (US\$41,000,000), to mature on and prior to February 15, 1987, to bear interest at the rate of six percent (6%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Loan Agreement (Power Distribution Program - C) between the Bank and Companhia Paulista de Forca e Luz, the form of Guarantee Agreement (Power Distribution Program - C) between The United States of Brazil and the Bank, and the form of Eletrobras Shareholder Agreement (Power Distribution Program) between the Bank and Centrais Eletricas Brasileiras - ELETROBRAS, which have been presented to this meeting.

RESOLUTION NO.

Approval of Loan to Companhia Forca e Luz de Minas Gerais in an amount equivalent to US\$6,300,000 to be guaranteed by The United States of Brazil.

RESOLVED:

THAT the Bank shall grant a loan to Companhia Forca e Luz de Minas Gerais to be guaranteed by The United States of Brazil, in an amount in various currencies equivalent to six million three hundred thousand United States dollars (US\$6,300,000), to mature on and prior to February 15, 1987, to bear interest at the rate of six percent (6%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Loan Agreement (Power Distribution Program - D) between the Bank and Companhia Forca e Luz de Minas Gerais, the form of Guarantee Agreement (Power Distribution Program - D) between The United States of Brazil and the Bank, and the form of Eletrobras Shareholder Agreement (Power Distribution Program) between the Bank and Centrais Eletricas Brasileiras - ELETROBRAS, which have been presented to this meeting.

30. I further recommend that the Executive Directors adopt the following resolution in respect of the agreements amending the Loan and Guarantee Agreements (Jaguara Power Project):

RESOLUTION NO.

Approval of Amendment to Loan Agreement (Jaguara Power Project) and Guarantee Agreement (Jaguara Power Project) - Loan Number 442 BR.

RESOLVED:

THAT the Bank shall enter into: (a) an agreement with Centrais Eletricas de Minas Gerais, S.A. (CEMIG), amending the Loan Agreement (Jaguara Power Project) between the Bank and CEMIG, dated March 15, 1966 and (b) an agreement with The United States of Brazil amending the Guarantee Agreement (Jaguara Power Project) between The United States of Brazil and the Bank, of even date therewith, such agreements to be upon such terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the forms of the agreements between the Bank and CEMIG and between The United States of Brazil and the Bank, which have been presented to this meeting.

Attachments

George D. Woods
President

Washington, D.C.
December 5, 1966