

A New Dawn for Eletrobras?

In what could become Brazil's boldest privatization move since the 1990s, in late January President Michel Temer sent to Congress much-anticipated legislation proposing to privatize Eletrobras (or Centrais Elétricas Brasileiras S.A), one of the largest power companies in the world, and by far the largest in Latin America. The Temer administration hopes the privatization of Eletrobras, which serves as a holding company for numerous electricity generation, transmission and distribution companies throughout Brazil, will raise more than \$4 billion for public coffers and overhaul Brazil's structurally-deficient electricity market.

Investors welcomed news of the privatization, as Eletrobras has suffered from mismanagement, political interference and corruption for decades: the company's shares jumped 49.3% immediately after Temer's announcement. However, despite growing interest and grounds for optimism in the privatization, prudent investors should consider their prospects with a healthy degree of skepticism. The current and historical context around Eletrobras raises numerous potential impediments, risks and challenges for investors, with the following factors being particularly relevant:

- Given Brazil's current political volatility, the presidential and legislative elections in 2018, and growing resistance to the privatization in Congress, the nature and timing of the privatization—if it even takes place at all—remains very unclear;
- With Eletrobras embroiled in corruption scandals and facing a securities class action in New York, assessing the company's corruption liabilities will remain difficult over the short-to-medium term, while corruption and related risks will continue to be a central concern for investors going forward;
- Brazil's regulatory environment for electricity is transitioning and may benefit substantially from policies such as the so-called "descotização", allowing for more market-driven energy prices, but the level of uncertainty regarding reforms will remain high and the 2018 presidential and legislative election may impose severe setbacks; and
- In view of Brazil's record with privatizations and the role the company plays in local and national politics, investors should expect Eletrobras to remain "hyper-politicized"

even if Temer's current proposal is fully implemented as planned by the end of 2018.

The proposal

The legislation recently sent to the Chamber of Deputies, Brazil's lower house, proposes to dilute the Brazilian government's ownership of Eletrobras through an offering of newly-issued ordinary shares. If necessary, the government may also reduce its ownership through a secondary offering of its existing shares. Although the plan is to reduce the government to a minority position, the legislation also prohibits any individual investor from acquiring more than 10% of the company's voting shares and similarly limits shareholder agreements to a 10% threshold. Likewise, the government will retain a golden share, granting it exclusive powers over bankruptcy, alterations to corporate purpose, name or headquarters and changes to Eletrobras' bylaws.

Temer's proposal allows for a non-government appointed Chairman of the Board, however at least one seat on the Board is reserved for the government (presumably in addition to any other seats obtained through exercise of their minority interest). As anticipated, the legislation does not include two of Eletrobras' most strategic assets—Eletronuclear, the state-owned nuclear power generator, and Itaipu, a joint venture with the government of Paraguay. It is still unclear exactly how these subsidiaries will be spun off from Eletrobras and, more importantly for investors, how Eletronuclear's \$800 million debt will be addressed.

"Descotização" and other regulatory changes

The Temer administration is also taking a number of steps to incentivize investment in Eletrobras. First, it will renew Eletrobras' existing generation concessions for another 30 years. Second, and more importantly, the administration simultaneously, and much more controversially, plans to enable greater flexibility for Eletrobras to negotiate electricity prices at competitive, market rates. In particular, the administration plans to reverse the current quota system implemented by former President Dilma Rousseff in 2013, which mandates Eletrobras' sale of electricity to generators at the cost of maintenance to limit electricity prices for consumers.

Through a process of "descotização", the administration proposes to gradually grant Eletrobras autonomy to freely negotiate electricity prices with distributors. However, to ensure a degree of price stability in the short term and appease consumer fears that price flexibility will result in significant energy price hikes, certain proceeds from the

share offering will be used by the government to reduce the impact on consumers of future electricity price increases.

The "descotização" is part of a broader package of reforms to Brazil's electricity sector proposed by the government, which, among other things, also includes curbing the use of subsidized credit through public banks. The Temer administration initially proposed to change the formula used for calculating the deficit between hydroelectric companies' actual and assured energy delivery (known as "Generating Scaling Factor," or GSF), since the current model imposes enormous financial burdens on power generators, leading to legal battles involving over \$1.5 billion. These changes, however, would increase energy prices in the short run—something that key powerbrokers in Congress and industrial groups are determined to resist. For example, on the GSF discussion, Temer caved to political pressure and removed it altogether from the legislation sent to Congress last week.

Ultimately, however, the value and feasibility of Eletrobras' privatization will be determined by these broader changes to the regulatory environment for the electricity market in 2018—changes which remain deeply uncertain.

At the same time, some things will certainly not change: Eletrobras is a hyper-regulated entity and will continue as such even if the privatization and at least some structural reforms take place. The myriad entities that directly or indirectly oversee Eletrobras' activities include the Ministry of Mines and Energy (MME), National Council for Energy Policy (CNPE), National Electricity Regulatory Agency (ANEEL), Electricity Monitoring Committee (CMSE), Energy Research Office (EPE), National Grid Operator (ONS) and Clearing House for Electricity Commercialization (CCEE), not to mention the Institute of Environment and Renewable Natural Resources (IBAMA), National Indigenous Foundation (FUNAI) and the National Water Agency (ANA). Even if Eletrobras' management and decision making is somehow isolated from direct political interference, these regulators, almost all of which are led by government appointees, certainly are not. The chess game in which Eletrobras will operate will be heavily restricted by government-imposed rules of the game, severely limiting business judgment and discretion. And those rules will be tilted toward promoting the strategic interests of political powerbrokers—irrespective of whether they maximize profits for investors.

Persistent political risks

Temer hopes to privatize Eletrobras in the second half of 2018 – when Brazil will also hold its most consequential elections in recent history. Only a center or center-right candidate, such as São Paulo governor Geraldo Alckmin (PSDB), is likely to push forward the broader reform plan for the energy sector as devised by the Temer administration. Former President Luiz Inacio Lula da Silva (“Lula”), who remains the front-runner in the polls despite being convicted for corruption and money laundering last year, is running a campaign against Temer by accusing the center and center-right of reversing Brazil’s social gains and selling Brazilian patrimony—including Eletrobras—to foreign capitalists. Lula’s widely-covered, dramatic failure last week to convince an appellate court to overturn his conviction—the three appellate judges, in fact, unanimously ruled against Lula and increased his sentence from nine to 12 years—makes his candidacy increasingly unlikely. However, the fate of his candidacy will ultimately be decided by Brazil’s Supreme Electoral Court later this year, and therefore Lula’s candidacy (and possible victory) nevertheless remains a possibility. Irrespective of whether he’s a candidate or not, Lula’s voice will continue to loom large on the Eletrobras’ privatization process. On the opposite side, the candidate for the extreme-right, Jair Bolsonaro, who is trailing behind Lula in the polls, has systematically opposed privatizations for three decades as a congressional representative. Although he has more recently sought to position himself as a liberal defender of the “free market” as a candidate, there is no real indication that he would embrace privatization as president.

Furthermore, as a practical matter, privatization of state assets is extremely unpopular with Brazilian voters: a recent poll found that [70% are against it](#). Even candidates that support privatization (such as Alckmin) will likely refrain from openly embracing Eletrobras’ privatization during their 2018 campaigns.

Likewise, resistance to privatization is also mounting in Congress. President Temer initially intended to privatize Eletrobras via an executive order, but Rodrigo Maia, the pro-government speaker of the Chamber of Deputies, torpedoed the plan and demanded that Congress have a say. The legislation introduced this week will require two votes in each of the two legislative chambers. The negotiation will not be easy: two “bancadas” (analogous to a temporary caucus) have formed, with over 350 congressional representatives, to oppose Temer’s privatization plans.

Ironically, the vast majority of congressional representatives opposing the privatization hail from parties in Temer’s own ruling coalition, reflecting how deeply politicized Eletrobras has become over the past decades. Regardless of party affiliation, powerbrokers have used the company as an instrument for coalition building at local and federal levels, negotiating directorships and other key positions in exchange for political allegiance.

Privatization may limit their direct influence on macro-level strategy, but local powerbrokers will nevertheless be positioned to indirectly influence regional decision-making involving Eletrobras’ numerous local subsidiaries, such as CHESF and Eletronorte. This dynamic is unlikely to change anytime soon.

Moreover, the 10% limitation on voting participation (including shareholder agreements) means the government, while not a majority owner, will continue to own and control the largest block of voting shares, in addition to their guaranteed minimal board participation and golden share. It remains to be seen how much collective decision-making power and leverage a private, dispersed investor base can yield over the government when their interests inevitably diverge.

Residual liabilities

Last but not least, Eletrobras has been embroiled in a significant corruption scandal since 2013. The company faces a securities class action from US investors in the Southern District of New York, as well as potential additional liabilities if Brazilian or US anticorruption authorities ultimately choose to levy fines and penalties. Given these uncertainties, quantifying the extent of the company’s corruption liabilities will remain difficult throughout 2018.

Similarly, corruption will continue to remain a challenge. Although Eletrobras (and Brazil) has adopted best compliance practices and commendably strengthened leadership on compliance and corporate governance matters, the company’s strategic role and importance in the political economy mean it will remain highly vulnerable to new and evolving forms of corruption. While the 10% limitation on ownership may in some ways insulate investors from direct liability for corruption (i.e., anticorruption authorities rarely go after minority investors with limited power to influence or exercise control over corporate decision making), investors will continue to be exposed to reputational risks as well as indirect harm for any future anticorruption actions taken against the company itself.

Cautious optimism

The privatization and the broader sectoral reforms currently being proposed by the Temer administration certainly provide grounds for optimism and the prospects of a more market-centric, efficient and depoliticized Eletrobras and electricity segment. However, there are many reasons to be skeptical. If Brazil's history is any guide to the future, investors are likely to face numerous potential impediments, risks and challenges investing in such an integral organization in Brazil's political economy, only some of which were addressed above.

Investors would benefit from balancing their optimism with a thorough assessment of the potential downsides, particularly as it pertains to future administrations. At a minimum, investors should consider the following:

- Evaluate a go/no-go investment decision when a clearer picture of the 2018 electoral landscape unfolds, including a possible runoff between two anti-privatization candidates;
- Monitor the progress of necessary regulatory changes to ensure they are evolving in line with the privatization. Some changes, such as the “descotização”, will be essential for making the privatization even remotely viable;
- Understand and monitor political dynamics at the local level affecting key Eletrobras subsidiaries, as local politics and social developments can be even more consequential than political developments at the macro level; and
- However difficult, attempt to assess and quantify potential losses from on-going corruption-related matters, and remain vigilant—through due diligence and on-going intelligence—about potential future corruption liabilities that could bring exposure to reputational harm or further losses.

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