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STAFF APPRAISAL REPORT

BRAZIL

MINAS GERAIS STATE PRIVATIZATION PROJECT

April 9, 1998

Poverty Reduction and Economic Management Department
Brazil Country Management Unit
Latin America and the Caribbean Regional Office

CURRENCY UNIT - Real (Rs.$)

Rs.$1.139=US$1.00 (April 8, 1998)

This exchange rate has been used throughout the report unless otherwise indicated

WEIGHTS AND MEASURES

Metric System

FISCAL YEAR

January 1—December 31

ABBREVIATIONS AND ACRONYMS

ADP	Annual Disbursement Plan
BCN	Banco de Crédito Nacional *National Credit (Private) Bank*
BEMGE	Banco do Estado de Minas Gerais *State Bank of Minas Gerais*
BHMR	Belo Horizonte Metropolitan Region
CEMIG	Companhia Energética de Minas Gerais *Minas Gerais State Power Company*
CONAMA	Conselho Nacional de Meio Ambiente *National Environmental Council*
COPAM	Conselho Estadual de Política Ambiental *State Council on Environmental Policy*
CREDIREAL	Banco de Crédito Real de Minas Gerais S.A. *CREDIREAL (state) Bank*
DER/MG	Departamento Estadual de Rodovias de Minas Gerais *State Department of Roads*
ERR	Economic Rate Of Return
FEAM	Fundação Estadual de Política Ambiental *State Environmental Protection Foundation*
FINEP	Financiadora de Estudos e Projetos *Financial Agency for Studies and Projects*
FIRR	Financial Internal Rate of Return
GASMIG	Companhia Estadual de Gas de Minas Gerais *State Gas Company*
GTZ	Gesellschaft fur Technische Zusammenarbeit *German Technical Assistance Organization*
IDB	Inter-American Development Bank
PETROBRAS	Companhia Brasileira de Petroleo *State Oil Company*
PIU	Project Implementation Unit
SEAIN/MPO	Secretaria de Assuntos Internacionais/Ministério do Planejamento e Orçamento International Affairs Secretariat/Ministry of Planning and Budgeting
SOE	Statement of Expenditure
SPP	State Privatization Project
TOR	Terms of Reference

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MINAS GERAIS STATE PRIVATIZATION PROJECT

Loan and Project Summary

Borrower:	The State of Minas Gerais
Guarantor:	The Federative Republic of Brazil
Implementing Agency:	State Secretariat of Planning
Poverty Category:	Not Applicable
Amount:	US$170 million (including up to US$85.0 million in retroactive financing)
Terms:	Standard amortization terms, grace period and fixed interest rate for US dollar single currency loans with an expected disbursement period of 0-3 years.
Commitment Fee:	0.75% on undisbursed loan balances, beginning 60 days after signing, less any waiver.
Financing Plan:	See Table 4.2
Net Present Value:	Not Applicable; See Annex E for ERR
Staff Appraisal Report:	No. 16466-BR
Map:	No. IBRD 28732
Project Identification Number:	BR PA 40033

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Minas Gerais State Privatization Loan

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Preparation of the proposed project began in October 1995. It is a departmental shared-task, involving *all* departmental divisions in the former LA1 and was spearheaded by the former LA1PS. Specifically, the project team includes: Messrs./Mmes.: Vetter (Task Manager), Dillinger, Dabak, Mendes Dos Santos (LCSPR); Alber, Cellier, Liautad, Velez (LCSFP); von Amsberg (LCC5C); Araújo (LCOPR); Gray (PSDDR); Ness, Zanetta (Consultants, LCSPR); Kelman (Consultant, LCSFP); Darche (Consultant, TWUTD). The peer reviewers are Ms. Wallich (SRMPG) and Mr. Mosse (OPRPG).

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BRAZIL
MINAS GERAIS STATE PRIVATIZATION PROJECT

1. COUNTRY AND STATE BACKGROUND

Country Context

1.1 Brazil's public sector is highly decentralized. Its government is comprised of the federal government, 26 state governments, a federal district, and approximately 4,300 local governments or municipalities. Democratization and constitutional revisions in the 1980s increased the degree of resources under subnational control, and the degree of local political autonomy in their allocation. Approximately half of budgetary public expenditures are now made by subnational governments.

1.2 The performance of state and local governments is a source of concern for both macro- and microeconomic reasons. The macroeconomic concern arises from state fiscal behavior. Despite their fundamental importance to macroeconomic policy formulation and implementation, state governments operate semi-independently of the federal government, driven by their own tax bases, formula-driven transfers and borrowing. Periodic state fiscal crises have prompted bailouts or emergency loans from the federal government. Losses at state-owned banks pose a threat to the stability of the financial system. The indebtedness of the Brazilian states has now reached crisis proportions, posing a threat to macroeconomic stability.

1.3 From a microeconomic perspective, the concern is with the cost and quality of services provided by subnational governments. Key infrastructure services, including power and gas, as well as urban transport, are now provided by state-run monopolies. Due to overstaffing and weak management, the coverage and reliability of these services lags behind consumer demand. Subsidies to loss-making enterprises divert funding from key state social services such as education, health, and public security.

Recent Country Economic Policies and Developments

1.4 The most prominent feature of Brazil's recent economic history has been chronic and rising inflation. Monthly inflation peaks of 80 percent and 50 percent were reached in 1990 and 1994, respectively. Large fiscal and quasi-fiscal deficits and an over-extended public sector were major factors underlying this phenomenon. Inflation at these levels slowed growth and investment, distorted the pattern of economic activities and

exacerbated the regressive distribution of income. Successive stabilization plans were introduced in the 1980s--most of them with price and wage freezes --but these were successful in containing prices only for very limited periods.

1.5 In mid-1994, as the Minister of Finance in the prior (Itamar Franco) administration, President Fernando Henrique Cardoso introduced the Real stabilization plan (*Plano Real*). This plan included an initial fiscal and wage adjustment, an exchange rate anchor (modified later in 1995, and made less rigid) and tight monetary policy. The plan has had remarkable success. Annual inflation (CPI) fell from 2668 percent in 1994 to 7.9 percent currently. The positive inflation record appears set to continue in the medium term. Although the current account deficit has increased (to 4.1 percent of GDP in 1997), it remains manageable. Gross international reserves stand at US$60 billion (as of March 1998) or eleven months of imports of goods and services. This has occurred despite a weakening of the current account deficit to an estimated 3.8 percent of GDP (first quarter, 1997). Furthermore, foreign investment remains strong, largely triggered by the government's strong privatization program.

1.6 The *Plano Real* had a major and somewhat unexpected impact on state finances, and, consequently, on the consolidated finances of the government. A tightening of monetary policy as part of the plan caused average annual real overnight interest rates to rise to 25 percent in 1995, before falling to 18 percent in 1996. As much of state debt was either financed on variable terms (the interest rate on state bonds, for example, was tied to the federal bond rate) or indexed to interest-rate-sensitive indicators, states experienced rising costs of debt service and large increases in the size of outstanding principal. State government debt now totals over US$108 billion (excluding arrears). Ninety-eight percent of this is owed to federal government and its agents—the Central Bank, Caixa Econômica Federal, and the Banco do Brasil.

1.7 The *Plano Real* also removed a past mechanism of state internal financial control: the ability to reduce real salaries and pensions via inflation. As a result, state governments have found themselves paying unusually high salaries in real terms. By 1996, many states were undergoing fiscal crises. Even when they deferred paying much of their debt and began cutting capital outlays drastically, they still had insufficient funds to pay wages. Table 1.1 gives the consolidated public sector deficit in Brazil during the 1991-97 period, broken down by level of government. (Given the high level of inflation prevalent prior to 1995, the primary and operational measures of the deficit are more relevant for purposes of comparison than the nominal deficit—the Public Sector Borrowing Requirement). The distinct deterioration of state and local government finances after 1994 is notable.

1.8 In the long run, continuing high fiscal deficits financed by debt are incompatible with stabilization. As a result, there is pressure to adjust. Since Brazil is fiscally decentralized and the deficits are greater at the state level, adjustment is required at the state, as well as the federal, level.

Table 1.1
Brazil - 1991-1997 Consolidated Public Sector Deficit
(Percent of GDP)

	1991	1992	1993	1994	1995	1996	1997
Total nominal PSBR	24.5	44.2	58.1	44.3	7.2	5.9	5.9
Federal government and BCB	6.5	14.9	20.4	16.8	2.3	2.6	2.4
State and local governments	8.8	16.4	24.5	18.9	3.6	2.8	3.0
State enterprises	9.2	12.9	13.3	8.6	1.3	0.6	0.5
Total operational	-1.4	2.2	-0.3	-0.5	-4.9	-3.7	-4.1
Federal government and BCB	-0.3	0.8	0.0	-1.6	-1.7	-1.6	-1.5
State and local governments	-1.2	0.8	-0.2	1.0	-2.4	-1.8	-2.3
State enterprises	0.1	0.6	-0.0	-0.1	-0.9	-0.3	0.3
Total primary	-2.6	-2.3	-2.6	-4.3	-0.4	-0.1	-.7
Federal government and BCB	-0.8	-1.3	-1.4	-3.0	-0.6	0.4	0.0
State and local governments	-1.2	-0.4	-0.6	-0.5	-0.8	-0.6	-0.8
State enterprises	-0.7	-0.6	-0.7	-0.8	-0.1	0.1	0.1

Source: Central Bank of Brazil and IMF estimates.

1.9 Past efforts to induce adjustment at the state level have not been wholly successful. Constitutional amendments that would allow the state (and federal) governments to dismiss excess staff and reduce pension benefits failed to pass in the 1997 session of Congress. More recent efforts to place the states on a sound financial footing through comprehensive debt workouts have not lived up to expectations. The federal government has now signed comprehensive debt agreements with the two of the four largest debtor states--São Paulo and Minas Gerais--and is in the process of negotiating similar agreements with the other two, Rio de Janeiro and Rio Grande do Sul. Under the agreements, the outstanding stock of state bonds is to be refinanced, at a rate between 6 and 7.5 percent for 30 years. To reduce the initial stock of debt, states will make an upfront transfer of assets to the federal government equal to 10 to 20 percent of the value of the refinanced debt. Debt service will be subject to a debt service cap equal to a fixed percentage of revenues. Any amount above the cap will be capitalized into the outstanding stock. These agreements will reduce the carrying costs of the debt in accrual terms. Due to the rigidity of their other spending obligations, however, states are likely to continue to run cash flow deficits. Growth in the stock of arrears, combined with the capitalization of deferred interest, will slow the rate of reduction in the states' outstanding stock of debt. Even if the states refrain from new contractual borrowing, they are unlikely to achieve a sustainable level of debt until well into the next decade.

Bank Strategy

1.10 The proposed Minas Gerais State Privatization Project (SPP) is one of four state reform projects for Brazil. As initially conceived, the projects had two objectives: immediate fiscal adjustment and longer term structural reform. A crucial element of fiscal

adjustment was to be a workout of the debt owed by the states to the federal government. It was expected that this workout, combined with tax increases, payroll cuts, and curbs on investment at the state level, would reduce the states' debt service to an affordable level within two to three years. As noted above, the debt agreements are unlikely to achieve this target. In response, the loans have been restructured. While each project's policy matrix will include a public expenditure review requirement--whose details will be spelled out in the state's Privatization Program Letter-- SPPs will focus specifically on the structural objective—the privatization or concession of state banks and enterprises. The Board has already approved the first three state reform projects -- for Rio Grande do Sul on March 3, 1997, Mato Grosso on June 12, 1997, and Rio de Janeiro on July 17, 1997.

2. THE MINAS GERAIS PRIVATIZATION PROGRAM

Background

2.1 The State of Minas Gerais is located in southeastern Brazil, surrounded by the states of Bahia, Goiás, Mato Grosso do Sul, São Paulo, Rio de Janeiro, and Espírito Santo. The state is Brazil's second largest in terms of population, with 15.7 million inhabitants. Over 75 percent of the population live in urban areas. The state capital, Belo Horizonte, although founded only at the turn of the century, is the third largest population center in Brazil.

2.2 Minas' economy is Brazil's second largest (tied with Rio de Janeiro). The state GDP, at approximately US$70 billion, is larger than the economies of Colombia, Venezuela, or Chile. Development is unevenly distributed within the state. Minas' northern area has much in common with the poor northeast region of Brazil, and indeed is treated legally as a part of the region the federal government targets for special programs. The southern part of the state, however, is heavily industrialized and has more in common with the affluent states of São Paulo and Rio de Janeiro.

Program Setting

2.3 The present Administration, which took office on January 1, 1995, inherited a difficult financial situation, with large commitments to personnel and a heavy debt burden. Minas' overextended civil service consumed 80 percent of state revenues in 1995. State debt totaled Rs.$11.2 billion (as of December 31, 1995), over twice the level of state revenues. Of this, nearly 60 percent consisted of high-cost state bonds, temporarily held by the Central Bank. In 1996, the administration responded by freezing hiring, cutting investments and taking advantage of the federal government's willingness to permit interest on state bonds to be capitalized. These measures were insufficient to staunch the flow of red ink, however. The state was forced to raise another Rs.$1.1 billion through asset sales and borrowing, and finished the year with an unfunded budget deficit of nearly Rs.$390 million, as depicted in Table 2.1 below

2.4 Performance in 1997 was much the same. Personnel spending consumed 93 percent of current revenues, due to salary increases granted during the year. Interest on bonds continued to be capitalized, adding another Rs.$2.4 billion to the stock of debt. To meet its cash flow requirements, the state raised Rs.$1.1 billion through asset sales and borrowing, and finished the year with an unfunded budget deficit of Rs.$700 million.

Table 2.1 Minas Gerais Annual Receipts and Expenditure (Rs.$ million)				
	1995	1996	1997	1998
	actual	actual	actual	estim.
	nominal	nominal	nominal	real
Current revenues	**5,252**	**5,237**	**5,523**	**5,634**
tax revenues	3,503	4,150	4,304	4,390
federal transfers	892	843	945	963
other current revenues	857	243	275	281
Current Expenditure	**8,186**	**8,333**	**8,860**	**7,165**
personnel	4,262	4,844	5,146	5,146
interest (accural basis)	2,564	2,723	2,961	1,251
other current expenditure	1,360	766	753	768
Capital expenditure	**738**	**676**	**997**	**1,646**
capital investment	632	478	615	1,343
amortization	106	198	382	302
Capital receipts	**2,683**	**3,383**	**3,553**	**1,390**
Borrowing	59	709	259	229
sale of assets	278	412	894	283
interest capitalization	2,346	2,262	2,400	878
Deficit	**989**	**390**	**781**	**1,786**

2.5 The outlook for 1998 is only marginally better. In February 1998, the state reached a debt refinancing agreement with the federal government. Under the agreement, the state's bonds were converted to a 30-40 year contractual debt to the federal treasury. The interest rate on the debt is subsidized and debt service as a whole is subject to a cap of 13 percent of current revenues. As part of the agreement, however, the state was required to borrow Rs.$4.1 billion to implement its financial sector reform. This increased the total amount of state debt to nearly Rs.$20 billion. With the state now required to service debt on a cash basis up to 13 percent of revenues, debt service payments will increase sharply in cash terms. The state is therefore likely to continue to run cash flow deficits, as well as accumulate additional debt due to capitalization of interest above the 13 percent ceiling.

Structural Reforms

2.6 In addition to its efforts at fiscal adjustment, the state is pursuing a program of structural reform. Under the program, the state will exit the commercial banking sector entirely by selling its two deposit-taking banks and liquidating its savings and loan company. Its development bank will be transformed into a development agency that would lend only budgetary resources and those borrowed from national and international development banks. Minas will also reduce its role in public utilities, by privatizing the state gas company. In the highways sector, the state will award long-term concessions for road maintenance to private firms. Each of these elements is described below.

A. Privatization/Liquidation of State Banks

Overview

2.7 At the beginning of the state reform process, the state government had a large presence in the state financial sector and owned two universal banks, a savings bank and a development bank. At the current stage of the reform program, the state already privatized one of its two universal banks, the Banco de Crédito Real (CREDIREAL) in mid-1997. The buyer was the country's fifth largest private bank, Banco de Crédito Nacional (BCN) which in turn was itself acquired in December 1997 by Bradesco, one of Brazil's leading and prime-rated private banks with assets of US$43 billion as of June 1997. The other universal bank, the Banco do Estado de Minas Gerais (BEMGE) is in an advanced stage of privatization. The state savings bank is being liquidated and the state development bank will be converted into a state development agency. To avoid possible contagion effects and the consequent need for Central Bank intervention and support, this new development agency would be prohibited from taking deposits. Any available budgetary resources would be the only permissible funding.

2.8 The need for drastic reform in the state financial sector became pressing with the 1994 Real Plan and the subsequent fall of inflation. Although the entire banking system was affected by the loss of inflation income, state banks had particular difficulties in adjusting because of high operating cost structures, low quality loan portfolios and few earnings alternatives. The State of Minas Gerais recognized that, under more stable macro-economic conditions, it had no choice but to choose a more radical road of reform, namely to privatize CREDIREAL and BEMGE even though both banks have long been used to finance the state government, have long-standing roots, and provided financial services all across the state. Less incisive bank restructuring efforts, such as reducing branches and personnel and cleansing loan portfolios, had been underway before 1994.

2.9 To aid state bank restructuring/privatization, the federal government instituted in 1996 a program of favorable long-term loans (*Médida Provisória 1514*) provided states were willing to either restructure or privatize their state banks. Other advantages of this financing included the inclusion of privatization costs such as consulting and investment banking fees and other restructuring expenditures such as early retirement and pension liabilities. In addition to the restructuring of banks in Minas, this federal financial aid facilitated the privatization of the Rio de Janeiro state bank (BANERJ) and the restructuring of several banks in other states such as in São Paulo (BANESPA) and Mato Grosso (BEMAT).

The BEMGE Privatization Strategy

2.10 BEMGE was founded in 1967 to support economic development in the state. As of December 1996 it had about US$2.6 billion in assets. It acts mostly as a universal bank

providing a gamut of financial services to the small and medium productive sector. As of June 1997, it had about 480 branches, mostly outside the capital city of Belo Horizonte, and about 7,100 staff. Financial performance has been poor with large losses in 1996 that caused negative returns on assets and equity. The decision to privatize BEMGE was taken in 1997, in agreement with the federal government and in exchange for financial aid under *Médida Provisória 1514*.

2.11 To aid privatization, restructuring measures are underway in BEMGE, such as closure of branches and staff reductions, along with increased efforts to recover loans and investments in information technology. However, the bank's asset quality remains precarious with a high concentration in real estate loans (38 percent of total), a significant amount of renegotiated loans and generally a high level of non-performing loans. As of June 1997, BEMGE's capital adequacy was below regulatory requirements.

2.12 BEMGE is currently in the advanced stages of privatization. The state is currently accepting pre-qualification materials from potential bidders. It expects to close this phase of by the end of May. According to the current timetable, the state then plans on issuing auctioning documents for BEMGE with the minimum price for the bank on June 26, 1998. The auction would then take place in July 1998.

Benefits

2.13 The main benefit to the state for privatizing its banks is the avoidance of continued re-capitalizations which become necessary as the state banks have lost the fabric of dynamic and market-oriented institutions. Shifting away from the financial sector will allow the state to re-focus its resources on its basic priorities of health, education, and poverty reduction. From a financial market perspective, the main advantage of privatization is the prospect of providing increased and a greater variety of financial services including resumption of lending to the productive sector.

B. PRIVATIZATION OR CONCESSION OF PUBLIC ENTITIES

Highways

Background

2.14 The Road Department of the State of Minas Gerais (DER/MG) is responsible for a highway network of approximately 20,000 km. The maintenance of about 4,000 km of federal highways is in the process of being delegated to DER/MG by the federal government. About 50 percent of the state's 20,000 km of roads are paved. Based on a 1993 survey, 14 percent of the paved network is in good condition, 64 percent is in fair condition and 22 percent is in poor condition. The average daily traffic on the state's paved network ranges from 500 to 2,000 vehicles, with a mean value of 1,500 vehicles per day. On the 10,000 km of the unpaved network, traffic volumes are generally in the range of 100 to 1,000 vehicles a day.

Table 2.2

Roads in the State of Minas Gerais, by Jurisdiction and Type

Jurisdiction	Paved (km)	Not Paved (km)	Total (km)
Federal	9,227	696	9,923
State	10,124	11,125	21,249
Municipal	847	201,179	202,016
Total	*20,198*	*213,300*	*233,498*

(source: *Diretoria De Manutenção*, DER/MG, 1996)

2.15 Unlike many Brazilian state road departments, DER/MG has a relatively long tradition of effective road management. Over the last 15 to 20 years, the condition of the road system and traffic characteristics as well as construction and maintenance unit costs have been regularly monitored. As a result, several management systems—including those for pavement, maintenance, vehicle weights and costs—have been established and are actively used in supporting management decision-making. DER/MG has also begun to reduce its reliance on force-account for routine road maintenance; nearly 50 percent of routine maintenance operations is now being performed by private contractors. Most maintenance contracts are awarded yearly and are paid on the basis of unit costs.

2.16 Nevertheless, the state's road system is not only suffering from under-funding, but damages resulting from the severe rains of 1996-1997. Addressing the entire backlog of major maintenance work would cost the state about US$75 million per year over the next three years. Annual resources allocated in 1994-95 amount to only half this value, they fell to about US$12 million in 1996. The state's actual needs for financing of road works and maintenance outpaced the earmarked funds in the 1997 budget by 78 percent and 85 percent, respectively. This situation will persist, if not worsen, in 1998, as the federal government will soon be transferring an additional 4,000 km of highways to the state.

Road Concession Program

2.17 The state seeks to provide adequate maintenance and rehabilitation to roads within its network by granting concessions for strategic segments of roads. The state envisions the concession program as a means to improve main highways (federal and state), to generate toll revenues, and to pay for improvements to economically important feeder roads. The concessions program will allow the state to improve its main highways, generate toll revenues, and pay for improvements to feeder roads. The state has already identified groups of state and federal roads that have the highest potential for concessioning. In return for the rights to toll revenues, individual concession agreements would require the concessionaire to expand road capacity, rehabilitate, and periodically maintain the concessioned highway segment, depending on existing road conditions. The Bank's proposed Minas Gerais State Highway Management Project will provide continued technical support for road concessions. Federal Highway Rehabilitation and Decentralization Project (Loan 4188-BR) will finance engineering design and civil works for rehabilitation of federal highway sections to be transferred to the state.

2.18 During the first phase of the concession study, DER/MG identified high-priority projects; tariff policies; criteria to award concessions; and construction, operating, and maintenance standards. Based on a Road Expenditure Program for the Years 1995–2000, DER/MG studied some 6,500 km in 21 groupings of federal and state highways to arrive at the most financially viable segments to be offered for concession.

2.19 Based on this analysis, the state calculated that of the 21 segments identified, 13 groups comprising 4,259 km of highway could provide concessionaires with Financial Internal Rates of Return (FIRRs) over 12 percent. Nine of these segments had potential FIRRs around 18 percent. The tariffs required to support these returns are, on average, US$4.00 for four lanes and US$3.00 for dual lane per 100 km of highway. The total value of the improvements for all 9 groups of roads is about US$1.7 billion expended over the 24 years of the concession. These nine road groupings, including two of the first three concession projects, can support the maintenance of 1,000 km of feeder roads in addition to the main highway segments and still maintain FIRRs over 18 percent.

2.20 Of these 9 groups, the state has identified three initial concessions. The results of the study are currently being used to develop the technical and financial sections of the bidding documents for the selected highway segments. The two concessions included in the Privatization Matrix, totaling 460 km, will be granted for maintenance and rehabilitation, but not any new construction. These two concessions are:

- State Roads MG-010 and MG-424 including the segments from Belo Horizonte-Vespasiano-Aeroporto de Confins - Pedro Leopoldo - Sete Lagoas: 76 kms.

- State Roads MG-050 including segments from Belo Horizonte-Juatubá-Divinópolis-Formiga-Passos-São Sebastião do Paraíso-to the Division toward São Paulo: 385 kms.

These two concessions involve maintenance and rehabilitation, but not any new construction to increase capacity.

2.21 In return for rights to the toll revenues, the individual concession agreements will require the concessionaire to expand capacity, rehabilitate, or merely overlay and periodically maintain the concessioned highway segment, depending on traffic and existing road conditions. The study results will also be used to determine the construction, operating, environmental, and maintenance specifications to be included in the bidding documents. These specifications will be monitored to evaluate the concessionaire's compliance with the contract.

2.22 The state established a pre-qualification and bidding process to award the road concessions. Firms were first evaluated on technical qualifications, and on their financial capacity to undertake the work. Considerable weight was also given to the maintenance of feeder roads, as they currently receive very little maintenance. A public hearing took place to disseminate information about the concession program, and over 300 people were in attendance. The final selection criteria for the concessions will be based on the number

of kilometers the bidder proposes to maintain, in addition to the concessioned highway segment. The tariff will be fixed and the winning firm will be that which proposes to maintain the largest section of feeder roads.

Benefits

2.23 The state's proposed road concession program will have positive economic and fiscal impacts. By reducing the backlog of road maintenance and improving the conditions of the highway network, the state will significantly diminish user vehicle operating expenditures. The state estimates that during the first several years of the program, users should reduce their annual vehicle operating costs by approximately 15 percent. By the fifth year of the concession program the first three road concessions will carry about 79,000 average daily vehicles. This will result in a significant annual operating savings.

2.24 By including improvements to the access roads that feed the main highways, the concession program will have a significant impact on regional economic development. Despite their small size, the two concessions included in the Bank's program, MG-010/MG-424 and MG-050, will have a potentially large impact on the state's economy. By improving these roads, transportation time and costs will ultimately be reduced for the steel, cement, and dairy industries located along these highways. In addition the concession of MG-050 would also reduce costs for through traffic between the state and São Paulo. The other planned concession for federal roads BR-262, BR-381 and BR-458 will improve the conditions of the highway serving Minas' steel industry. Road improvements should reduce travel times—and therefore, costs—for trucks serving the steel plants as well as interstate truck traffic moving goods between northeastern and southeastern states.

Gas Sector/GASMIG

Background

2.25 The state electricity company, CEMIG, established GASMIG in 1983. CEMIG is GASMIG's main shareholder, with 95 percent of its voting shares. At present, GASMIG's market is comprised of 26 industrial users concentrated in the Belo Horizonte and Juiz de Fora metropolitan areas. Annual revenues in 1997 totaled US$24.2 million. The market for gas could be expanded, based either on domestic supply or the proposed Brazil-Bolivia pipeline. In order to meet GASMIG's potential, a substantial increase in both supply and investment will be needed.

2.26 GASMIG's supply comes from domestic sources provided by a domestic producer from the Campos Field, Rio de Janeiro. The gas is then piped from the State of Rio de Janeiro to Minas. GASMIG currently has only 37 km of pipeline currently in operation. With adequate investment, the pipeline could increase to an estimated total distribution of 1,000,000 m^3/day in 1998 (based solely on domestic supply), and to 1,700,000 m^3/day by the year 2000 when gas from Bolivia would become available.

2.27 GASMIG's market is comprised of industrial users. Over the medium term, GASMIG's market may remain solely industrial, as gas is not yet an attractive alternative for residential customers. Industrial consumers in Minas currently use a variety of fuel sources, including LPG, diesel, coke, wood, pulverized charcoal, and petroleum coke. In order to attract these consumers, GASMIG will need to adjust prices considerably in order to penetrate the market. Once sufficient gas volumes are available from the Brazil-Bolivia pipeline, GASMIG could also begin to attract the high-value electricity industries.

2.28 A quick analysis of GASMIG's financial situation shows that GASMIG is a highly profitable company. The company is largely efficient, and currently has only 40 employees. Even if GASMIG were to expand its market considerably, the total number of employees would not need to be increased dramatically. Based on a US$1/Million British Thermal Units profit margin for GASMIG, the annual operating cost of the pipeline is estimated at about 3 percent of investments. Profits before taxes are estimated at about US$10 million by the year 2000. GASMIG should also have a positive cashflow for 12 of the next 15 years.

The GASMIG Concession Program

2.29 Despite GASMIG's potential, the state has been unable to invest the needed capital to expand its market and distribution capacity. Therefore, the state decided to either sell or concession GASMIG to private investors. Legislation authorizing the sale was approved by the State Assembly on May 29, 1996. Consultants prepared a detailed study of GASMIG that presented the state with comprehensive options for potential sale or concession. The state intends to have the new regulatory framework in place prior to concessioning of GASMIG.

2.30 The consultants estimated that an additional US$85.2 million will be needed to expand its distribution capacity in the industrial areas of Tronco Norte and Vale do Aço. The net cashflow before taxes strongly indicates that the concessionaire could finance the expansion and still receive an adequate return on equity (i.e., about a 15 percent return). The study will also indicate the best methods of attracting new industrial customers.

2.31 Transportation and distribution of natural gas in Minas Gerais will be awarded as a concession for the exclusive provision of these services to consumers in a well-defined geographical area. The concessionaire will negotiate directly and enter into a gas sale purchase contract with suppliers. The concessionaire agreement will stipulate required investments, which were in part determined in the consultants' study. Most likely, a fully flexible price regime to consumers based on price of substitutes will be adopted. The concessioned services will be regulated by an independent entity, which will be in place before any bidding for the concession takes place. The regulatory agency will ensure compliance by the concessionaire with the terms of the concessions (i.e., investments, environment, quality of service, and appropriate pricing to consumers).

Benefits

2.32 Granting a concession for gas distribution to the private sector in a geographical area of the state will reduce the state's capital outlays to GASMIG while ensuring that the necessary investments for market expansion are made. This would have a significant impact in terms of natural gas market expansion, as it would compete with other fuels among the industrial and residential consumers as well as power generation. In effect, the expansion of gas supply—within the proper tariff structure—could lead to an overall reduction in production costs and result in a more competitive industry based in the state.

2.33 From an environmental perspective, an increase in the use of gas could lead to overall reductions in air emissions (CO_2, SO_2, NO_2 and particulate matter) from "dirty" fuels, such as high sulfur fuel oil, diesel oil, charcoal and fuelwood, now being used by industry in general and the steel industry in particular. The adoption of gas-fired plants could also reduce the state's reliance on hydroelectric power and provide flexibility during dry seasons.

C. REGULATORY FRAMEWORK

2.34 To regulate concessions in the various public utility sectors, including roads and gas, the state will establish a new regulatory agency. Consistent with the approach taken by state governments in many other federal systems, and based on Brazil's current expeience with federal and state regulatory agencies, the state proposes to establish a regulatory agency with responsibility for all public services within the competence of the state. The aim will be to create a small, strong and professional agency that fosters the development of the requisite technical expertise and enjoys a high degree of stability and insulation from day-to-day political pressures. The agency would operate in a transparent manner, and would be funded from levies on regulated firms. The agency's detailed responsibilities may vary from sector to sector, and will be defined through concession agreements and possibly augmented by sector-specific decrees. It is envisaged that the agency's core responsibilities will include administering tariff adjustment rules, enforcing the concession contracts, and supervising concessionaires' compliance with regulatory norms. Relationships between the agency, state secretaries and responsible environmental and other authorities will be very carefully defined, and appropriate mechanisms put in place to ensure effective coordination and implementation. The state has recently submitted a law to the State Assembly proposing the creation of this regulatory body.

3. THE PROJECT

A. PROJECT OBJECTIVE

3.1 The project's main objective is to support the state's privatization and concession program, making the state government less vulnerable to losses on banking operations and more efficient in the delivery of gas and highway maintenance services. The project will also support social sector grants to mitigate the social costs of adjustment, as well as high priority road and school maintenance and rehabilitation work to ensure that these physical assets do not deteriorate during the adjustment period.

B. PROJECT DESCRIPTION

3.2 The project consists of the carrying out of the key actions linked to the project objective. The policy matrix in Annex A sets forth these actions (with a completion timetable). These conditions cover: (i) privatization of the state banks (CREDIREAL and BEMGE); (ii) sale or concessioning of GASMIG; (iii) concessioning of two segments of state roads with a total of 460 kilometers; (iv) establishment of an adequate regulatory framework for the private provision of public services; and (v) fiscal performance consistent with the capital spending program and fiscal indicators cited in the state's Privatization Program Letter.

3.3 The loan will disburse against two time-slices of eligible reform costs once the conditions for each time-slice (see policy matrix) are met; the first time-slice would be for US$100 million, and the second US$70 million. The first time-slice disbursement of US$100 million would be released promptly after loan effectiveness since actions required for disbursement have been implemented prior to Board presentation. The time-slice disbursement of US$70 million--planned for about August 1998, would be released following a positive review of the second time-slice actions. The conditions for Board presentation (and release of the first time-slice) were: (a) sale of the state's ownership in CREDIREAL; (b) formal announcement of the state's intention to sell BEMGE; (c) contracting of a study to define the structure of the gas sector, its regulatory structure, and the model for concessioning GASMIG; (d) definition of global strategy and timetable for road concessions; and (e) submission of the state's Privatization Program Letter. The conditions for the release of the second time-slice are: (a) sale of the state's shares in BEMGE; (b) sale or concession of GASMIG; (c) award of two road concessions for 460 km; (d) establishment of an adequate regulatory system and (e) compliance with fiscal performance and major capital investment targets as specified in the Privatization Program Letter.

Table 3.1 Fiscal Performance Indicators					
	1996	1997	1998	1999	2000
growth of revenue (real)		-2%	2%	2%	2%
personnel as % revenue	93%	93%	91%	90%	88%
capital spending as % revenue	9%	11%	24%	15%	15%
total debt service as % revenue	56%	61%	28%	28%	28%
of which financed by capitalization	43%	43%	16%	11%	11%
operational deficit as % revenue	-68%	-72%	-51%	-40%	-39%
stock of debt (EOY) as % revenue	278%	373%	412%	444%	474%
stock of contractual debt as % revenue	240%	322%	330%	329%	328%
primary surplus as % revenue	-16%	-18%	-29%	-18%	-16%

3.4 **Public Expenditure Review** The project will monitor the state's fiscal performance during 1998. The aim is to ensure--since project funds are fungible-- that the increase in debt arising from the Bank loan is compensated by improvements in other aspects of the state's overall fiscal position. Unfortunately, as noted earlier, it will be difficult to achieve major improvements in the state's fiscal position. As shown in Table 3.1, barring unforseen circumstances, the state is expected to run large operational deficits and accumulated increasing stocks of debt even after the federal debt agreement goes into effect.

3.5 ***Fiscal performance.*** Two types of fiscal parameters will be monitored. The first refers to the use of privatization proceeds. The state will be required to use the proceeds from the sale of CEMIG and BEMGE to reduce its debt to the federal government.

Table 3.2.

Major Investment Expenditures in 1998
(Rs.$ million of Jan. 98)

	Total disbursements	Of which financed from debt	Of which financed from revenue and grants
Industrial development fund	340.5		340.5
Highways	529.6	26.0	503.6
ProQualidade (IBRD-financed education program)	95.5	76.0	19.5
SOMMA (IBRD-financed environment program)	98.7	41.9	56.8
Health programs	20.5		20.5
Strategic industrial development fund	140.0		140.0
PROSAM (IBRD)	61.3	43.8	17.5
Secretaria de Obras	9.7		9.7
Jaiba	48.1	41.5	6.6
Total	1343.8	229.3	1114.5

3.6 ***Investment Program.*** The second monitoring indicator will be the size and quality of the state's investment program. Here, the intent is to encourage the state to confine its spending on major capital works to projects with clear economic or social justifications. A

spending program, identifying projects and financing sources, was agreed at negotiations and is cited in the state's Privatization Program Letter. (See Table 3.2.) Prior to the second time-slice disbursement, the Bank will review the state's investment spending during 1998.

3.7 Compliance with these two conditions will be reviewed prior to the disbursement of the second time-slice. If the state violates either condition, the Bank would have the option of suspending the time-slice until or unless remedial actions were taken.

C. Project Sustainability

3.8 The privatization project consists of reforms that are inherently difficult to reverse. Once sold, banks and public utilities are difficult to repurchase. However, the establishment of a transparent and fair regulatory framework for the private provision of public services may be vulnerable in its first years of operation, as it represents a radical change in the way the government has delivered public services so far. In addition, the state's regulatory framework will require periodic adjustments to make it compatible with the framework the federal government is slowly developing.

Lessons Learned From Previous Bank/IDA Involvement

3.9 The Bank has extensive, world-wide experience in the reform of the public sector through SALs and SECALs and with regional subnational development projects in Brazil, Argentina and in other countries. Key lessons (detailed in Annex D) are as follows. First, projects must focus on a few significant reforms that are hard to reverse--such as privatization of public enterprises and banks, and reforms passed via legislation--and can be fully implemented during the mandate of the administration in power. Second, project design and implementation arrangements must be flexible enough to fully achieve targeted reform objectives. Third, reform projects for subnational governments can place very high (sometimes unsustainable) supervision costs on Bank staff. Thus, project implementation should seek to reduce supervision costs by including as much private sector participation as feasible in such areas as auditing, procurement, and verification of compliance with eligibility requirements. Finally, the initiative to reform should be entirely the state government's. The Bank can provide financial and technical support, but should never set the basic policy objectives.

D. Environmental Aspects

Environmental Impact Category

3.10 The proposed project would finance reforms that would have neutral or beneficial environmental impacts. The program will likely improve environmental performance through better environmental oversight of current state enterprises. The project has been classified as Category B regarding its expected environmental impact. Annex C reviews

environmental problems and policies in Minas Gerais and provides a detailed discussion of environmental aspects of the project.

Environmental Safeguards

3.11 The environmental obligations of the new owner/operator in the gas and roads sectors would be determined before the time of sale/concessioning in order to: (a) reduce the uncertainty for potential private sector investors about their environmental obligations; and (b) allow improvements in environmental performance of the affected operations. Following an environmental audit, and still before the time of concessioning or sale, agreement would be reached among the responsible entities on environmental performance targets including the time and the responsible party for remedying the identified problems.

3.12 **Gas Distribution.** Before the time of sale or concessioning of the gas distribution company GASMIG, the consultants, who are assisting the state in the preparation of the privatization would carry out the following tasks:

(a) a review of the environmental regulatory framework and monitoring and enforcement capacity of the responsible agencies with respect to safety and environmental issues in the gas sector, resulting in recommendations for improvements and strengthening activities;

(b) an environmental audit of GASMIG, covering a physical inspection of the facilities, including safety aspects (checking pipelines and other systems for corrosions and leaks) and management of wastes (condensates) from the system with recommendations for necessary measures taken, their time, cost and responsible party; and

(c) a review and recommendations for necessary improvements of procedures and activities that affect system safety (such as procedures for maintenance and repairs).

3.13 **Highway Maintenance Concessions.** The highway maintenance concessions to be awarded under the project are for normal maintenance activities, such as repaving, but do not include widening, realignment, extension or construction of new roads, with the exception of the widening of a short stretch of highway where the right of way has been acquired, no resettlement issues or significant environmental problems exist, and earthworks have already been completed. The concession contracts would contain clauses to ensure the application of sound environmental practices by the concessionaires. The consultants currently preparing the concessioning of road maintenance would perform the following tasks before the time of concessioning:

(a) a review of the environmental regulatory framework and enforcement capacity as it relates to highway maintenance activities and recommendations for their improvements;

(b) preparation of proposals for concession contract clauses that would ensure sound environmental practices by the concessionaire; and

(c) compilation of the technical information required to assess the measures necessary for regularization of roads that do not yet have an environmental license.

3.14 The project will also finance high-priority road conservation and rehabilitation. Road maintenance works do not require an environmental license. However, it was agreed that the road maintenance contracts would include explicit clauses ensuring the environmentally acceptable behavior of the contractors (covering issues such as construction wastes, construction camp management and equipment maintenance). The contracts would be enforced by DER/MG. In addition, the contracts would require a valid environmental license for extraction and disposal sites, borrow pits, and asphalt plants. These licenses are issued and enforced by the Fundação Estadual de Política Ambiental (FEAM).

E. Project Objective Category

3.15 The primary objective category of the project is "economic management" (EA), as it seeks to improve the overall performance of the state's public sector.

F. Participatory Approach

3.16 Minas Gerais is a state with a long history of public participation in governance and policy-making. In 1993, the state introduced a system of public fora (audiências públicas) which were designed to be a direct link between the voting public and the state legislative assembly. The main objective of the public fora is to identify regional developmental and budget priorities for use in developing the state's annual budget. Since its initial success in 1993, the public fora have been held yearly—with some minor improvements. Apart from the public fora, the government has been actively debating the major elements of its state Reform Program in the state assembly and in the press, through articles signed by the Governor, Vice-Governor, and Cabinet Secretaries.

3.17 When designing certain aspects of the state's reform program (e.g., severance payments and funding of pension liabilities), the state worked with stakeholders to pinpoint potential areas of conflict to help arrive at mutually acceptable agreements. The downsizing programs that have been undertaken by both of the state banks--CREDIREAL and BEMGE--include both voluntary and involuntary dismissals, as well as incentive programs for early retirement programs. Due to the problems that arose during the privatization efforts in other states, the officials of both banks worked directly with employees to design an attractive, while financially viable, benefits package.

3.18 The two banks set up programs to provide information and counseling on the benefits of the different voluntary programs to all eligible employees. The cost of the involuntary dismissal programs was based on the provisions made under Brazilian law. In

calibrating the severance payments for the voluntary dismissals and incentive programs for early retirement, each enterprise took into account obligations toward employees, applicable laws including labor laws and agreements, prevailing labor market conditions, and the affordability and replicability of the package.

3.19 In addition, employees opting for withdrawal could participate in training programs and career counseling. For example, in BEMGE, each participant was eligible for 20 hours of coursework in a wide variety of fields, plus 5 hours of individual counseling. The state federation of industries also provided courses on opening a small business through its training branch.

3.20 In addition, the adoption of a regulatory agency as a function of the privatizations and granting of concessions under the State Reform Program will create a new avenue for community participation. This will be an important step, as the current system allows public monopolies to virtually regulate themselves. While many branch offices of state utilities currently have customer service offices, they are not effectively regulated by the state. Instead, they regulate themselves, with proactive input from municipalities. The adoption of an independent regulatory agency will ensure that consumers are informed of their rights, and are treated in a fair, efficient, and transparent manner.

4. PROJECT IMPLEMENTATION

A. IMPLEMENTATION ARRANGEMENTS

4.1 Minas' State Privatization Program is being implemented under the Vice-Governor's direction and the Planning Secretariat's coordination. Given the breadth of the program, several participating agencies are involved. The state's privatization council *(Comissão de Desestatização)* is specifically coordinating the gas sector privatization program. The Budget Office of the Planning Secretariat works with the Finance Secretariat on budget, public finance, and debt issues. The Finance Secretariat is managing the CREDIREAL and BEMGE bank privatization for the state. DER/MG and the Planning Secretariat are working on the road concessions.

4.2 Project supervision will be coordinated by a Project Implementation Unit (PIU) within the Planning Secretariat that will focus on: (a) continuous monitoring of progress in the different reform areas; (b) evaluation of compliance with performance benchmarks prior to release of time-slice disbursements; and (c) compliance with evaluation, procurement, disbursement and auditing agreements which are reflected in a Project Manual (see para. 4.3). Each of the secretariats participating in the reform program or using loan resources will name representatives necessary for reform monitoring and/or operations (e.g., procurement, accounting, disbursement, and auditing issues). The general coordinator of the PIU is the Secretary of Planning. The PIU would have an Executive Coordinator that would handle day-to-day operations and two full-time senior staff members, one of whom would be responsible for monitoring the reform program and the other who would handle operational matters and necessary support staff.

4.3 To assure adequate reform monitoring and also that subprojects are adequately evaluated and the procurement thereunder performed in strict conformity with Bank guidelines, a concise Project Manual has been prepared with detailed rules and procedures for subproject evaluation, procurement, disbursement, accounting, reporting, and auditing. State agencies identified in the Project Manual will be responsible for procurement, disbursement, and accounting for each of the different activities with review as also specified in the Project Manual.

B. PROGRAM/PROJECT COSTS AND FINANCING

4.4 The total cost of the reform program and of the project supporting it is shown in Table 4.1 below; it is estimated at about US$1.4 billion. Only the items listed below in para. 4.14 - 4.20 would be eligible for Bank financing in the time-slices; table 4.3 details the amounts to be financed by the Bank. The program's main components are:

Costs of Privatizing the State Banks

4.5 Privatization of the two state banks, CREDIREAL and BEMGE, with losses estimated at US$500 million as well as significant pension liabilities (US$225 million). This cost to the state is being financed by a federal government loan.

Severance Payments

4.6 Severance payments (US$316 million) for the voluntary departure and incentives for early retirement programs for both the state's Direct Administration, as well as state-owned enterprises and banks. Of this total, US$76 million was financed by the federal government for the downsizing of the Direct Administration.

Studies, Consultant Services, and Equipment

4.7 Studies and consultant work have been quite important in the preparation of the reform program and will continue to be during its implementation, as will be training and equipment. The reform program includes the following elements:

(a) The costs of modernizing the Finance Secretariat (US$26 million, including US$25 million of financing from the IDB's National Fiscal Administration Program), as well as overhauling the Secretariat's financial management system involving purchases of equipment and software, and retraining of current employees.

(b) Other reform costs that will be eligible for Bank financing under the project, including reform-related studies, consultant services (including auditing) training, and equipment (e.g., computers and software), totaling US$5 million.

4.8 A pre-privatization/concession gas study was financed under the **Municipal Development and Environment Management Loan** (Ln. 3639-BR); the study cost approximately US$1 million. A number of studies aimed at facilitating reform implementation and identifying further sector reforms will be funded with resources from a loan from the federal agency FINEP (US$10 million).

Grants

4.9 These include transfers to municipalities and private institutions. They cover incremental expenditures for early childhood, public health, sewerage and basic education. These expenditures are justified on the grounds of alleviating the social impact that the reform program may have, particularly arising from the financial duress that the public sector will experience in its quest for fiscal balance. Other transfers to municipalities and private institutions for social services, such as early childhood development, public health, sewerage and basic education could be financed if agreed by the Bank. Included in this

category are such costs as decentralization and outsourcing of health services (US$131 million):

(a) Health decentralization (US$60 million) to municipal consortia.

(b) Emergency health care services contracted out to private hospitals (US$45 million). Incremental recurrent costs of outsourcing emergency services in the Belo Horizonte Metropolitan Region on a declining basis.

(c) Family preventive medicine program (US$26 million) Incremental recurrent payments to municipalities on a declining basis. The Family Preventive Health Care program transfers to municipalities the responsibility for providing preventive health care services.

Other Incremental Costs of Reforms

4.10 These are defined as direct (i.e., non-transfer) recurrent costs incurred by the state government in connection with the reform program (e.g., salaries of additional tax auditors), estimated at US$8 million.

High-Priority Investments

4.11 In addition to the reforms, the project will include high-priority investments during the adjustment period:

(a) Road maintenance and rehabilitation works (US$50 million)

(b) Decentralization to school associations for small maintenance and repair, and to buy basic school furniture, and equipment (US$89.0 million).

(c) other maintenance and rehabilitation acceptable to the Bank (e.g., school maintenance too large to be done by the school associations).

4.12 Less than six percent of the total project cost is foreign. Careful appraisal of the Brazil's overall development program shows that this level of local cost financing is needed for this high-priority project[1]. Local costs can be financed by a state government out of budgetary savings, borrowing from the federal government (which will be eventually financed out of a drawdown of Brazil's reserves), or borrowing from abroad. In the present context, budgetary savings are not available. Further borrowing from the federal government will not be consistent with the overall stabilization program. This leaves financing local costs through foreign borrowing as the most appropriate mechanism. These estimates do **not** include estimated expenditures by foreign firms that might eventually bid on the concessions and privatizations of Minas' reform program.

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[1] This complies with the Memorandum on Financing Local Expenditures, April 5, 1996, para. 4, page 17.

Table 4.1: Estimated Program Cost
(in US$ million)

Categories	Local	Foreign	Total	Foreign as % of total cost
Direct Costs of Reform				
Total Losses from Privatization of CREDIREAL and BEMGE	725.0		725.0	0%
"Downsizing" of the work force				
Direct Administration	76.0		76.0	0%
Enterprises and Banks	240.0		240.0	0%
Reform-related studies, consultants, training, and equipment				
Modernization of the Secretary of the Treasury	11.0	15.0	26.0	58%
Reform Studies financed by FINEP	8.0	2.0	10.0	20%
Other studies, consultants, training, and equipment	3.0	2.0	5.0	40%
Incremental Grants				
Health Service Outsourcing and Family Preventative Medicine	71.0		71.0	0%
Municipal Health Consortia	25.0	35.0	60.0	58%
Incremental Recurrent Costs of Reform on a Declining Basis				
Incremental Salaries of Reform Program	8.0		8.0	
High Priority Investments During the Reform Period				
Road Maintenance	40.0	11.0	50.0	22%
Decentralization of school maintenance and equipment	89.0		89.0	0%
Total Project Costs	1296.0	65.0	1360.0	5%

4.13 The plan in Table 4.2 shows that the Bank financing accounts for 12.5 percent of the total reform cost.

Table 4.2 Project Financing Plan
(in US$ million)

Source	Amount	Percentage
IBRD	170.0	12.5%
National Fiscal Administration Program (IDB Project)	25.0	1.8%
State of Minas Gerais	354.0	26.0%
Federal Government	811.0	59.6%
Total	1360.0	100.0%

Eligibility for Financing

4.14 To attain its ambitious reform objectives, implementation must focus on the reform efforts *per se*, rather than on subcomponent evaluation, procurement and disbursement procedures. Thus, in this case, every effort has been made to keep evaluation procedures, procurement and disbursement as simple and cost effective as possible by selecting those items for which evaluation, procurement and disbursement would be done simply and quickly at very low cost.

4.15 To this end, although all of the costs included in Table 4.1 are legitimate project costs of the reform program, only the following costs would be financed by the project (as shown in Table 4.3):

severance costs for workers leaving state banks and enterprises being privatized or restructured, including BEMGE and CREDIREAL. Only those costs not being financed by the federal government would be eligible for Bank financing.
studies, consultants, and equipment, especially those necessary for reform implementation.
incremental grants for social programs associated with the decentralization of health services, primary and secondary education, and other such programs acceptable to the Bank.
other incremental costs of reform implementation on a declining basis.
high priority road, and other maintenance and rehabilitation outlays.
The eligibility criteria for each of these components are included in the Project Manual.

Severance Payments

4.16 The loan will finance severance payments only for employees of state enterprises and banks being restructured or privatized, including those for dismissal and voluntary departure and early retirement of redundant employees of CREDIREAL and BEMGE, as well as other enterprises that meet the criteria below. Severance programs for the Direct Administration, as well as state enterprises and banks being liquidated will not be eligible for financing. In all cases, the financing of severance payments will met the criteria established by the Bank and included in the Project Manual (for details, including a financial and economic cost-benefit analysis, see Annex E). The following discussion of compliance with Bank criteria covers the state banks listed above:

(a) *Impact on Productivity.* The layoffs were initiated only after careful studies to develop a strategy to improve their productivity and, therefore, their selling prices. The downsizing program was one element of these strategies.

(b) *Measures to Avoid Reversal.* As these banks are being privatized, there is no problem with reversal, unless the state rehires the employees who are dismissed. Although the state cannot deny these employees who leave their constitutionally guaranteed right to participate in public examinations for state employment, the banks felt that withdrawing employees would not normally be interested in entry level positions that would be offered in public examinations. Under Brazilian law, employees who retire once are not entitled to any additional retirement benefits if they do enter another public service job. Increased private sector participation should increase market discipline in all enterprises. In calibrating the severance payments, the state took into account obligations toward employees, applicable laws including labor laws, prevailing labor market conditions, and the affordability and replicability of the package.

(c) *Steps Taken to Mitigate Negative Impacts.* The banks set up programs to provide information and counseling on the benefits to all eligible employees. In addition, employees opting for withdrawal could participate in training programs and career counseling. For example, in BEMGE, each participant was eligible for 20 hours of coursework in a wide variety of fields, plus 5 hours of individual counseling. The state

federation of industries provides training on opening a small business through its training branch.

(d) *Economic and Financial Analysis.* Economic cost-benefit analysis showed economic rates of return (ERR) of 133 percent for BEMGE and 202 percent for CREDIREAL. The internal financial rate of return was 216 percent for BEMGE and 324 percent for CREDIREAL.

Studies, Consultants, Training, and Equipment

4.17 Studies, training and equipment (office equipment, including PCs and computer software) are needed to define and/or implement the reforms supported by the project. Therefore, these expenses are linked to the achievement of the project objectives, and may include diagnostic or implementation studies to undertake the privatization actions in the sectors supported by the project (banks, gas, roads, etc.). Auditing necessary for project implementation would be eligible for financing, as would studies, training, or equipment that raise the efficiency of public expenditure. Priority will be given to supporting the design and establishment of a satisfactory regulatory framework (including design of concession agreements) through technical assistance and training for: (i) the creation and establishment of the public services regulatory entity; and (ii) assisting the *Comissão de Desestatização* in carrying out the privatization and concession program and proposing the necessary sector regulations (US$1 million).

Grants

4.18 Health decentralization (See para. 4.9) would complement the proposed Minas Gerais health reforms. The manual and criteria developed as part of a proposed Bank health project would be useful to guide these purchases. This financing will assure that this important program is funded during the adjustment period.

Other Incremental Costs of Reforms

4.19 These are defined in para. 4.10. As with regular investment projects, the proposed loan would finance recurrent reform costs while the state implements reforms.[2]

High Priority Investments

4.20 In addition to the reforms, the project will finance high priority investments during the adjustment period, including:

Road maintenance and rehabilitation works (US$40 million) done in 1997 and 1998 would be partially financed under the SPP using criteria to select segments for rehabilitation and maintenance that would also be applied under the proposed State Highway Management Loan to Minas (scheduled for Board presentation in FY99).
Decentralization of school maintenance, as well as funds transferred to School Associations to buy basic furniture and equipment totaling US$89.0 million would also be partially financed. Costs included under the Bank's existing education loan to Minas (ProQualidade, **State of Minas Gerais Basic Education Quality Improvement Project, Loan 3733-BR)** would not be financed under the present loan.
The Project Manual will include detailed eligibility criteria for each element included.

C. PROCUREMENT

Procurement Methods

4.21 Severance payments are direct government expenditures and, therefore, are not procured. To keep procurement and disbursement for the other components as simple and cost-effective as possible, the focus will be on smaller contracts that can be procured using simpler procedures. No procurement under ICB is anticipated. A summary of proposed procurement arrangements is provided in Table 4.3.

4.22 Works would be undertaken through contracts with private firms, in accordance with the Bank's *Guidelines Procurement under IBRD Loans and IDA Credits* (January 1995, as revised in January and June 1996, and September 1997). In line with the need to keep procurement simple to meet the project's reform objectives, most works and goods contracts would be small enough to be procured using the simple shopping and three price quotations. While no NCB is envisaged for financing under the SPP, it may become necessary during project implementation to contract goods and works under NCB

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2 The rationale for financing recurrent costs is much the same as that for traditional investment projects, in which such financing would be allowed on a declining basis as the project is being implemented until it can become self-sustaining. In this same manner, the SPP would finance recurrent reform costs while the state implements its reform program. Once implemented, these reforms will enable the state to finance more efficient recurrent and capital expenditures on a sustainable basis with its own resources and prudent borrowing.

Table 4.3: Summary of Proposed Procurement Arrangements
(US$ million) 1/

Components	Procurement Method			NBF/3	Total Cost
	ICB	NCB	Other 2/		
Direct Costs of Reform					
Total Losses from Privatization of CREDIREAL and BEMGE				725.0	725.0
"Downsizing" of the work force					
Direct Administration				76.0	76.0
Enterprises and Banks			240.0		240.0
			(76.0)		(76.0)
Reform-related studies, consultants, training, and equipment					
Modernization of the Secretary of the Treasury				26.0	26.0
Reform studies financed by FINEP				10.0	10.0
Other studies, consultants, training and equipment			5.0		5.0
			(2.0)		(2.0)
Incremental Grants					
Health Service Outsourcing and Family Preventive Medicine			73.0		71.0
			(31.0)		(31.0)
Municipal Health Consortia			60.0		60.0
			(25.0)		(25.0)
Incremental Recurrent Costs on a Declining Basis					
Incremental Salaries of the Reform Program			8.0		8.0
			(6.0)		(6.0)
High Priority Investments During the Reform Period					
Road Maintenance		11.0	40.0		50.0
			(15.0)		(15.0)
Decentralization of school maintenance and equipment			89.0		89.0
			(15.0)		(15.0)
TOTAL		11.0	515.0	837.0	1360.0
(Bank Financed)	0	0.0	(170.0)	0.0	(170.0)

1/ Amounts in parentheses indicate Bank financing.
2/ Shopping, price quotations, and consultant services to be selected according to the Guidelines "Selection and Employment of Consultants by World Bank Borrowers" (January 1997, revised September 1997).
3/ Not Bank Financed
4/ Includes transfers to municipalities for expenditures on basic health provision and emergency health care
ICB = International Competitive Bidding
NCB = National Competitive Bidding

procedures. Any NCB to be contracted and financed under the SPP would follow the Bank's Procurement Guidelines. A procurement audit following each time-slice disbursement will review an adequate sample of contracts to assure that procurement procedures have been performed in accord with Bank guidelines. See Table 4.4 for a summary of procurement thresholds and review requirements.

4.23 Contracts for works expected to cost US$350,000 or more, but less than US$5 million, and contracts for goods expected to cost more than US$100,000 but less than US$350,000 would be awarded on the basis of NCB procedures acceptable to the Bank. Procurement for works costing less than US$350,000 and goods costing less than US$100,000 would be carried out through price quotations, and international or local shopping. NCB would be based on agreed Standard Bidding Documents (SBDs) for the procurement of small and major works, and goods. (Revised Portuguese version of documents prepared by SEAIN/MPO and the Bank in 1995).

4.24 Recruitment of consultant services (consulting firms or individual consultants) for the technical studies, training, and audits, expected to cost approximately US$32 million, would be carried out in accord with the *Guidelines Selection and Employment of Consultants by World Bank Borrowers* (January 1997 and revised September 1997). Consulting firms will be selected in accordance with the quality and cost basis procedure. Individual consultants will be employed as provided in the guidelines.

Procurement Review Procedures

4.25 To meet the project's reform objectives, activities requiring the simpler procurement procedures and no prior review have been given priority. An *ex-post* audit of an adequate sample of contracts awarded under NCB and under international and local shopping procedures, or price quotations would be done following each time-slice disbursement. These procurement procedures will not only streamline project execution but also reduce the Bank's supervision burden.

4.26 Table 4.4 summarizes the procurement review for each type of procurement and consultant contracting procedure. Prior review would be concentrated only on consultant contracts. To ensure that all participating entities are fully capable of using Bank procurement procedures at the onset of project implementation, the PIU would hire consultants to review *ex-ante* the procedures for the first three procurement procedures for goods and works by shopping or price quotations by each such entity. The Bank would not perform an *ex-ante* review of consultant contracts in which: (i) individuals consultants are hired on a competitive basis for amounts less than US$50,000; or (ii) consulting firms are hired on a competitive basis for amounts less than US$100,000. In all other cases (including all single-source contracts and consultancies of a critical nature), the Bank would review *ex-ante* all documents of each contract for consultancies. Following the above procedures the Bank would review *ex-ante* only about 10 percent of the total cost of all procurement carried out under the project.

Table 4.4 Summary of Procurement and Prior Review Thresholds

Description	Type of Procurement	Prior PIU Review Limit	Prior Bank Review Limit	Contract Value (US$1,000)
CIVIL WORKS	NCB	All	None	350 to 5,000
	Price Quotations	First 3 of each entity	None	<350
GOODS	NCB	All	None	100 to 350
	Shopping	First 3 of each entity	None	<100
CONSULTING SERVICES				
• Firms	Local and International Consulting Firms	All	Only TORs All	<100 >100
• Individuals	Local and International Consultants	All	Only TORs All	<50 >50

4.27 The capacity of the PIU and the state's Executing Agencies for effective implementation and review of procurement documents and procedures in line with Bank's procedures improved greatly during the comprehensive training initiative to enhance the implementation and management of public investment operations in Brazil at the federal, state and municipal levels in which staff of executing agencies in the State of Minas Gerais participated. The Training and Dissemination Program in Procurement took place with Bank participation in 1995.

D. DISBURSEMENT

4.28 Time-slice disbursement would follow successful completion of the required actions at two points in time: after conditions of effectiveness have been met and after the first project review has been successfully completed. Disbursement for this reform component will be in two time-slices of US$100 million and US$70 million.

4.29 To facilitate disbursement, the PIU will submit to the Bank for its review an Annual Disbursement Plan (ADP) at the Project Reviews that it would prepare in accordance with the instructions in the Project Manual. It will list the items to be disbursed and amounts to be submitted for disbursement, required subproject evaluations, and the procurement procedures to be used in their purchase as established in the Project Manual. The PIU may submit modifications in the ADP to the Bank for its review at any time before the time-slice has been fully disbursed.

4.30 Withdrawals will be made for each time-slice only for expenditures for items included in an ADP acceptable to the Bank. The disbursement percentages for severance payments and consultants will be 100 percent of the non-tax expenditure. As the financing

of incremental recurrent costs will be on a declining basis, the disbursement percentage will be as follows: 90 percent for withdrawals made until August 30, 1998; and 80 percent thereafter. The disbursement percentages for all goods and works would be 100 percent of foreign costs and 83 percent of local costs.

4.31 To ensure that the state has adequate resources to finance its reform program (especially the heavy initial downsizing costs), 50 percent retroactive financing is proposed and the special account should include amounts greater than normally approved. Expenditures up to this limit that were made 18 or less months prior to loan signing, would be eligible for retroactive financing. A higher than normal percentage of retroactive financing and the 18 month period is justifiable since Minas began to absorb many of the costs of its reform program in 1996 (especially downsizing). These two exceptions were approved by the Regional Vice President on April 24, 1997. Disbursement projections are shown in Table 4.5. The Project Completion Date will be September 30, 1999 and the Closing Date will be December 31, 1999.

Table 4.5: Disbursement Projections

(US$ million)				
IBRD Fiscal Year and Semester	**Time-slice**	**Cumulative Disbursements**		**Semester**
		Absolute	**%**	
1999				
Jul-Dec 98	1&2	80	47	1
Jan-Jun 99	2	80	47	2
2000				
Jul-Dec 99	3	10	6	1
TOTAL		**170**	**100**	
Closing date: December 31, 1999				

4.32 **Documentation of Expenditures**. Withdrawal applications for recurrent costs and services not requiring the Bank's prior review, would be disbursed on the basis of statements of expenditure (SOE) certified by the PIU. Supporting documents would not be submitted to the Bank but would be subject to ex-post independent audits and Bank review. Selective review of SOE documentation, covering not less than 20 percent of expenses disbursed under SOE, would be undertaken as part of the annual project audit. Only technical assistance and auditor's contracts estimated to cost more than the equivalent of US$50,000 for individuals and US$100,000 and for consulting or accounting firms would be disbursed against standard documentation. No withdrawals shall be made for each time-slice unless they are part of the eligible expenditures agreed upon with the Bank and disbursement conditions have been fulfilled.

E. ACCOUNTS AND AUDITS

4.33 A **special account** in dollars with an authorized allocation of US$17.0 million would be opened in a commercial bank acceptable to the Bank. The sum of the first deposit to the special account and the amounts withdrawn from the loan in respect of retroactive financing shall not exceed US$17.0 million. The same applies to the second time-slice. The special account will be maintained and operated by the PIU which will also be responsible for submitting replenishment requests to the Bank.

4.34 **Accounts.** The participating executing agencies will maintain identified accounts of the project in accordance with internationally accepted accounting procedures. The accounts will show expenditures for each project component, subdivided by expenditures financed by the Bank and the Borrower.

4.35 **Audits.** The state government will maintain separate accounts for the expenditures financed out of the proceeds of the loan (i.e., incremental recurrent costs of reform on a declining basis and technical assistance). These accounts as well as the special account will be audited annually by independent auditors acceptable to the Bank in accordance with the Bank auditing guidelines. The Borrower shall submit to the Bank the audit reports of expenditures within 6 months of the closure of each fiscal year. The audit reports would certify that the funds were used for eligible expenditures and were procured as defined in the Loan Agreement.

F. PROGRAM SUPERVISION

4.36 Given the loan's complex nature and short implementation schedule, supervision would be at least biannual, and more likely every other month.

G. PROJECT BENEFITS AND RISKS

4.37 Bank involvement in Minas' state privatization program is prompted by the substantial economic benefits of the program, and its potential as a model for other states.

Project Benefits

4.38 The project's chief economic benefits derive from the sale of the state banks and the privatization of state infrastructure services (See Annex B for a matrix summarizing these benefits.)The sale of the banks will eliminate the economic costs--in the form of resource misallocations--arising from their poor lending decisions. It will also confer fiscal benefits to the state. The sale of CREDIREAL and BEMGE will eliminate the state's exposure to further losses from the banks' operations.

4.39 The privatization and concession of state infrastructure services will also confer economic benefits. Deficient infrastructure services are a constraint on the growth of Minas' economy. Poor highway maintenance impedes economic growth, by increasing the costs of transportation in the state. Coverage of natural gas lines lags demand by major industries. The concessioning of state highway maintenance and the sale of the state gas company will improve the reliability and increase the coverage of the services provided by these companies. This will significantly increase the productivity of Minas' economy, Brazil's second largest.

Rationale for Bank/IDA Involvement

4.40 The project is fully supportive of the key objectives of the CAS, as discussed at the Board on June 12, 1997; indeed it was specifically consistent with what is mentioned in paragraph 60 of the CAS. The project specifically supports two elements of the CAS' public sector reform strategy reducing the role of the state banks and continuing the privatization of state public enterprises. Although the state government is proceeding with its privatization program on its own initiative, the Bank has provided the state selectively with expertise when required. Moreover, the Bank is providing continuous support to the state this what is a traditionally a multi-year, politically onerous, and fragile privatization process. In this regard, the Bank is acting as an anchor to see that the overall reforms--particularly in the state financial sector--are completed. Furthermore, the loan is well coordinated with the: Central Bank Technical Assistance Loan (Loan 4245-BR), which promotes further improvement in the state bank privatization process, such as in the resolution of residual bad assets; the proposed Minas Gerais State Highway Management Project, which will provide continued technical support for road concessions; and the Federal Highway Rehabilitation and Decentralization Project (Loan 4188-BR), which will finance engineering design and civil works for rehabilitation of federal highway sections to be transferred to the state.

Project Risks

4.41 A key project risk is the political uncertainty generated by the gubernatorial elections in November 1998. The current governor, Eduardo Azeredo, is running for re-election. If Governor Azeredo is not elected, there is a substantial risk that the governor taking office in January 1999 would not support the reform program under the terms negotiated by the current Governor and his team. Other key risks to the project are that government's commitment to reform program or its capacity to successfully implement it would wane. While Governor Azeredo was elected on a reform platform and has repeatedly reiterated his commitment to privatization, the struggle to implement the reforms has been long and hard fought.

4.42 To address these risks, the project will reward the reforms on an ex-post basis. Privatizations and concessions must be completed as a condition of time-slice release. In addition, much progress has been made in the implementation of the privatization program during the delay in loan processing after negotiation. One of the most important reforms—sale of CREDIREAL—has already been completed as a condition of Board

presentation. The sale of BEMGE is well advanced and it is expected to be sold by August 1998. The state has prequalified a number of firms for the two road concessions. The law establishing the regulatory framework has been sent to the State Assembly. Only the privatization of the gas company is slightly behind schedule. Intensive supervision during the first months after Board approval will seek to push these reforms to fruition during the governor's mandate.

4.43 Another risk is that the state will spend the net returns from privatization imprudently. The approach of the gubernatorial campaign season, combined with tight restraint on capital spending from 1995 to 1997, could increase pressure for spending on ill-conceived capital works. The following steps have been taken to mitigate this risk. The state's debt agreement with the federal government requires that the returns from the sale of the two state banks be used to pay down federal debt. In addition, the Bank will review the state's capital spending program, and may suspend disbursement of any of the time-slices, if the state deviates substantially from the agreed investment program in the in the Privatization Program Letter. This will assure that the net proceeds of the gas company (that is not covered in the debt agreement) will be used wisely.

4.44 There is also some risk that the regulatory framework will not function as fairly and impartially as intended. The concept of regulated private utilities will take time to become institutionalized, as it represents a radical change in the way the government has traditionally provided infrastructure services. It will also require frequent adjustment to remain compatible with the evolving regulatory framework at the federal level. If any federal regulatory development were to cast uncertainty on existing state regulatory arrangements, already-agreed concession contracts may become unstable and require renegotiations costly to the state. Intensive supervision during the implementation of this regulatory framework will seek to assure its effective establishment.

ANNEXES

ANNEX A

PRIVATIZATION MATRIX
Conditions of First Annual Review

Actions	First Annual Review
Privatize BEMGE	Sale of the state's share of BEMGE on mutually acceptable terms
Establishment of public utility regulatory entity(ies) for gas, and road concessions.	Full implementation of a mutually acceptable regulatory system for privatized or concessioned services.
Privatize Gas Energy (GASMIG)	GASMIG sold or concessioned on mutually acceptable terms, and in accordance with environmental obligations and targets established on the basis of environmental audits satisfactory to the Bank.
Road Maintenance Concessions	Two sets of road concessions for 460 kilometers on mutually acceptable terms, and in accordance with environmental obligations and targets established on the basis of environmental audits satisfactory to the Bank.
Public finance	Mutually satisfactory public expenditure review in accord with the targets in the Privatization Program Letter.

ANNEX B

IMPACT MATRIX
ASSESSMENT OF MINAS GERAIS' STATE PRIVATIZATION PROGRAM

Policies	Key Actions	Impact of Actions on Policies	Reversibility of Actions	Efficiency Gains of Actions	Fiscal Impact of Actions
I. Privatization of Banks and Other Public Enterprises					
Privatization of banks	Sale of voting control of CREDIREAL and BEMGE or complete other acceptable actions.	The final objective is to totally remove the state from the commercial banking business.	Sales of CREDIREAL and BEMGE are very unlikely to be reversed.	Privatization would help to consolidate and strengthen the banking system. Improved service, resource allocation.	The state could receive revenues from sale of assets. It would also stop losses and avoid recapitalization expenditures. Moreover, privatized banks could also generate significant tax revenues for the government.
Privatize gas distribution	Restructuring of the gas sector in Minas, including the sale or concessioning of GASMIG.	Actions would develop the regulatory framework for the private delivery of gas services to the state.	Once the restructuring is implemented, it would be difficult to reverse.	Actions set the grounds for private gas distribution with potential gains in efficiency from: reductions in operational costs, elimination of potential losses, and expansion of services to meet demand growth which is particularly important given Minas' major industrial economic base.	The state could receive revenues from sale or concessioning of assets. The state could receive tax revenues on expanded gas services. Private distribution firms would generate federal taxes on profits of about 14% of their billing.
Road maintenance concessions	Award of road maintenance concessions.	Concessions of about 460 kilometers.	Actions are long-term concession contracts unlikely to be reversed.	Significant productivity gains for productive activities from savings in transport costs from improved road systems, including gas, labor, vehicle maintenance, etc. Capital and operating costs to be increasingly recovered from final user.	State would no longer be responsible for road maintenance costs and would have significant capital construction savings. Concessionaire's profits would be subject to federal income tax.

ENVIRONMENTAL ASPECTS OF THE MINAS GERAIS STATE PRIVATIZATION PROJECT

ENVIRONMENTAL PROBLEMS AND POLICIES

Environmental Problems

1. The main environmental problems in the State of Minas Gerais include pollution problems related to urban and industrial activities (water pollution, air pollution, solid waste), pollution problems related to agricultural activities (mainly water pollution) and degradation of the natural resource base, for example, in the form of soil erosion. Pollution problems are most severe in the Belo Horizonte Metropolitan Region (BHMR), part of the São Francisco river basin and the industrial zones of the Vale do Aço which forms part of the Rio Doce river basin.

2. Various entities undertake basic monitoring of water quality in the main river basins. The Bank is assisting the State in its environmental management efforts through financing of the ongoing **Minas Gerais Water Quality and Pollution Control Project (Loan 3554-BR)** which includes the construction of interceptors for two small rivers crossing the BHMR. So far, wastewaters are discharged into the das Velhas river and cause severe pollution levels in a thinly populated stretch of about 100 km. Plans for the construction of wastewater treatment plants for the BHMR are now proceeding. In addition, the Bank is financing a **Municipal Management and Environmental Infrastructure Project (Loan 3639-BR)** which contains support for solid waste management.

3. There is limited air quality monitoring in the BHMR. Air pollution is an obvious problem at the street level of major urban centers and around industrial locations. However, regional air quality levels in the BHMR are mostly within ambient quality standards.

Environmental Policies

4. The combination of federal, state and local environmental regulations has created a complex system of requirements that covers most potentially environmentally harmful activities but is at times confusing for polluters and difficult to enforce. The objectives of environmental policy are formally defined in ambient environmental standards. The federal government has established water and air quality standards through resolutions of the National Environment Council (CONAMA). For example, CONAMA Resolution 20/1986 determines ambient standards for nine water use classes for the main water pollutants. Several water bodies in Minas Gerais have been classified according to water use classes.

5. At the national level, there are the PROAGUA national water quality program and the PRONAR national air quality control program, which include ambient monitoring, administration of emission licenses, and a national emissions inventory. The implementation of most policies, however, is the responsibility of the state. In Minas Gerais, the basic legal provisions for environmental management are contained in the Basic Environment Law of 1980, regulated in March 1981.

6. The main instruments for pollution management is a comprehensive licensing system that was established in 1981 and requires a valid license for every potentially environmentally harmful activity. The firms' licensing applications contain information on technical parameters and environmental impacts based on which the state grants or refuses the license. An environmental license determines the environmental conditions and norms under which the respective activity is permitted. The licensing process involves three steps: a preliminary license granted during the planning process of a new project, an installation license required for actual construction, and an operation license. For activities with potentially large environmental impact, the evaluation of an Environmental Impact Assessment (EIA) forms part of the licensing process. The state can initiate the licensing process for facilities that precede the licensing system. In these cases, a corrective operating license is issued and includes necessary remedial measures.

7. Current environmental management instruments are largely based on administrative instruments and a command-and-control system. Moreover, there is no effective link that ties environmental policies to the ambient environmental conditions in specific locations. Cross-sectoral planning and coordination of environmental policy is insufficient. Economic thinking and the desire to develop flexible and cost-effective solutions to pollution problems is not yet well-developed. For example, lacking integration between effluent controls from industry and the sewerage sector undermine the development of cost-effective pollution control strategies. There has been insufficient cooperation between environmental agencies and, in particular, the sewerage sector, even though experience elsewhere suggest that such cooperation is critical for effective pollution reduction.

8. The key reforms of environmental management instruments comprise the introduction of a comprehensive system of water basin management. A 1994 law created the legal basis for such systems in which water basin management plans are prepared by water basin agencies and approved by committees representing the users of the respective water basin. The instruments of water basin management would include water charges and effluent discharge fees. While a few water basin committees or similar arrangements are currently being formed, full implementation of the system will have to await the further regulation of the law.

9. Environmental management in Minas Gerais is the responsibility of the Fundação Estadual de Meio Ambiente (FEAM) which reports to the newly formed Secretary of Environment and Sustainable Development, Health and Environment. FEAM has a total staff of about 140. Working conditions of FEAM are difficult but not desperate, and overall capacity to deal with the comprehensive environmental management demands is better than in many Brazilian States. On the other hand, resources are insufficient to comprehensively deal with environmental management in a state as large as Minas, which is the size of France. For

example, the overall database of ambient quality and, thus, the information base for effective environmental policy is relatively limited. While FEAM follows up on citizens' complaints on pollution problems, resources are insufficient for a comprehensive program of regular visits and spot-checks at polluting sites. Given resource constraints, FEAM's strategy to rely on cooperation with municipalities and industry federations is reasonable.

10. An interesting aspect of Minas Gerais' environmental management system is the Conselho Estadual de Política Ambiental (COPAM). This council is responsible for granting or refusing licenses and relies on FEAM as its technical arm. COPAM is composed of representatives of the state government, industry, and civil society and deliberates in public sessions. The result of this arrangement, which combines the functions of deliberative state councils with public sector representation only and consultative councils with broader representation in other states, allows more transparency in licensing and a more explicit approach toward the discussion of costs and benefits of environmental regulations.

11. FEAM has historically focused on industrial pollution and achieved significant progress in particular with the larger polluters. However, similar to many environmental agencies elsewhere, FEAM is often not substantially involved in important government decision processes with significant environmental impacts. The result of this exclusion is that environmental concerns are often not considered from the beginning in important planning decisions and investment projects but encountered as a constraint after the planning process is substantially completed. This approach leads to polarization and stigmatization of environmental agencies as obstacles to effective execution of investment projects. FEAM is receiving technical assistance from German GTZ and the Bank through the Water Quality Project and the National Industrial Pollution Control Project (Loan 3480-BR).

ENVIRONMENTAL ASPECTS OF THE STATE PRIVATIZATION PROJECT

12. The Minas Gerais State Privatization Project will not have adverse environmental impacts. The program will likely improve environmental performance through better environmental oversight of current state enterprises. The government recognizes the importance of considering the environmental aspects early in the process of privatizations planned under the State Privatization Program. This approach will: (a) reduce the uncertainty for potential private sector investors about their environmental obligations; and (b) allow improvements in environmental performance at least cost.

13. It was agreed that for each company or activity with a potentially significant environmental impact, the environmental obligations of the new owner/operator would be determined before the time of sale/concessioning. Following an environmental audit, and still before the time of concessioning or sale, agreement would be reached among the responsible entities on environmental performance targets including the time and the responsible party for remedying the identified problems.

14. Within the components of the State Privatization Project, three sectors raise environmental issues that are discussed below: the reforms of the water and sewerage sector, the concessioning of road maintenance, and the sale or concessioning of the gas distribution

company. For the environmental audits in these sectors, the terms of reference for environmental audits and draft reports of the consultants would be sent to the Bank for comments. Other components of the project, such as the privatization of the state banks, do not require an analysis of environmental aspects since potential environmental impacts from the sector are non-existent or minimal.

Gas Distribution

15. GASMIG is a gas distribution company which is owned by the State energy company CEMIG and serves 27 industrial consumers in the BHMR (specifically, Belo Horizonte, Betim, and Contagem) and Juiz de Fora. GASMIG obtains its gas from the transmission pipeline of PETROBRAS which originates in Rio de Janeiro and reaches Belo Horizonte through Juiz de Fora. The current distribution network consists of 12 km in Juiz de Fora and 25 km in BHMR. All of GASMIG's installations have a valid environmental license with the exception of 4 or 5 connections of industrial customers which are in the process of being regularized.

16. GASMIG is currently undertaking an expansion of its gas distribution to additional customers to the north of Belo Horizonte. This expansion is expected to be completed before privatization of the company. The expansion of the distribution network follows the public road network and does not involve either relocation or significant environmental issues. The related works were preceded by an Environmental Impact Assessment and were fully licensed by FEAM. In addition, GASMIG undertook an extensive public education and consultation campaign before beginning this expansion. The care exercised during the preparation and execution of the Environmental Control Action Plan for this expansion demonstrates good capacity by GASMIG and FEAM in the environmentally sound execution of such projects.

17. GASMIG has plans for the extension of its distribution network to Sete Lagoas and the Vale do Aço. The details of these plans and its relation to the planned privatization have not yet been worked out. In any event, a complete Environmental Impact Assessment and subsequent licensing by FEAM would be required under Brazilian regulation before such expansion could proceed.

18. Before the time of sale or concessioning of the gas distribution company GASMIG, the consultants, which are assisting the state in the preparation of the privatization would carry out the following tasks:

a) A review of the environmental regulatory framework and monitoring and enforcement capacity of the responsible agencies with respect to safety and environmental issues in the gas sector;

b) an environmental audit of GASMIG, covering a physical inspection of the facilities, including safety aspects (checking pipelines and other systems for corrosions and leaks) and management of wastes (condensates) from the system with recommendations for necessary measures taken, their time, cost and responsible party; and

c) a review and recommendations for necessary improvements of procedures and activities that affect system safety (such as procedures for maintenance and repairs).

Highway Maintenance Concessions

19. Minas intends to concession the maintenance of two major State highways: MG-050 from BR-262 to the São Paulo State border (385 km) and MG-010/424 from Belo Horizonte to Sete Lagoas (76 km). The highway maintenance concessions to be awarded under the project are for normal maintenance activities, such as repaving, but do not include widening, realignment, extension or construction of new roads. The only exception is a 13-km stretch of MG-010/424 near the international airport which is currently being widened. The right of way has been acquired, earthworks have already been completed, and no resettlement issues or significant environmental problems exist. The concessionaire would effectively take on the obligation of paving the already prepared surface for widening this stretch of road.

20. Routine road maintenance works do not require an environmental license. However, it was agreed that the road maintenance contracts would include explicit clauses ensuring the environmentally acceptable behavior of the contractors (covering issues such as construction wastes, construction camp management and equipment maintenance). The contracts would be enforced by the Road Department (DER/MG). In addition, the contracts would require a valid environmental license where legally required, such as for extraction and disposal sites, burrow pits, and asphalt plants. The conditions of such licenses would be enforced by FEAM.

21. Roads which have been constructed before environmental licensing became mandatory (such as the highways to be concessioned) can be called by FEAM for retroactive licensing (regularization). DER/MG and FEAM are currently engaged in a joint process to regularize all roads within the state. Also, it is FEAM's policy to require such licensing in the case of private sector concessions. The concessionaire would therefore be required to regularize the respective highways. Bidding documents would contain corresponding references and the terms of reference for the required documentation.

22. The consultants currently preparing the concessioning of road maintenance would perform the following tasks before the time of concessioning:

a) A review of the environmental regulatory framework and enforcement capacity as it relates to highway maintenance activities and recommendations for their improvements;

b) preparation of proposals for concession contract clauses that would ensure sound environmental practices by the concessionaire;

c) compilation of the technical information required to assess the measures necessary for regularization of roads that do not yet have an environmental license.

LESSONS LEARNED AND PREVIOUS BANK EXPERIENCE IN THE SECTOR

1. The Minas Gerais State Privatization Project draws on lessons of experience from a number of Bank projects of similar scope and design in both the Latin America and Caribbean region and Brazil. Because the Bank and other institutions are increasingly supporting regional development, a wider range of experiences in operationalizing and implementing these projects can be used. In addition, the Bank's experience with subnational government projects has evolved rapidly, offering many country-specific insights.

Subnational Development Projects

2. Complex project design has often been cited as a key reason for weakening important components of subnational development projects. Aspects such as institutional development and financial management are often neglected in these projects, due to the high demand placed on state implementation and coordination capacities.

3. Experience shows that by identifying and designing key implementation arrangements early in the project preparation process allows for greater flexibility and improved project implementation. In the case of the **Minas Gerais Municipal Management and Environmental Infrastructure Project** (Loan 3639-BR), the Terms of Reference to be used and implementation arrangements were discussed during the project's preparation phase. This helped shape the dialogue between the Bank and the state, and, moreover clarified and better defined project objectives and scope for both parties. Increased borrower involvement during these stages also has the benefit of giving governments greater project ownership.

4. In its 1992 review of urban and municipal projects in Brazil, OED found that many projects did not pay enough attention to the external environment in which they would be implemented. Tailoring project implementation periods to political mandates is particularly important in the case of Brazil, as it helps to capture government support for a project. As an alternative, projects that have a flexible design can easily accommodate shifting political priorities. Additionally, any pilot programs need to be quickly implemented to capitalize on a climate of favorable political and community support.

Project Sector Reforms in Brazil

5. One of the most relevant projects with respect to design and scope of the Minas Gerais SPP is the **Brazil Public Sector Management Project** (Loan 2721-BR). This project sought to develop planning and management capacity on the federal level in the areas of sector and project analysis, multi-year investment planning, and program monitoring. Another major component of the project was an integrated budget information and control system. One key lesson of experience is that project design should not be overly ambitious since the loan size, the project's operational complexity, and the number of project components can ultimately burden both the Borrower and the Bank during implementation and supervision.

Privatization of Public Enterprises in Argentina

6. Under the **Public Enterprise Reform Project** in Argentina (Loan 3291-AR), the following lessons were learned. The initiative to privatize was entirely the government's. The Bank was vital in providing financial and technical support, but never set the basic policy objective.

7. The Bank prudently kept a low profile. In spite of an ubiquitous Bank presence, privatization never became a "World Bank Program" in the eyes of political or public opinion.

8. A large amount of relevant sector work had been done by the Bank before there was any indication that a privatization program might be possible. Since at the time, the chances for any lending resulting from this work were quite low, it may well be thought of as a high-risk gamble. The gamble paid off; but without this technical work, it would have been difficult for the new government to seize the moment and push ahead with privatization when a pervasive sense of national crisis gave it the needed political support.

9. Implementation was greatly enhanced by a highly effective Project Unit. The fact that the head of the Unit participated, from the beginning, in loan discussions and formal negotiations, enabled the Unit to play a constructive role during implementation.

10. The Bank's imaginative use of adjustment lending, in allowing visible application of counterpart proceeds to finance severance payments, was decisive in making railroad privatization feasible. But its justification hinged on two circumstances: monitoring to prevent rehiring or replacement and, even more important, imminent privatization, after which the pressures to overstaff would, presumably, largely disappear.

Operational Aspects

11. Disbursement has been a traditional problem in Brazil due to the long-standing incompatibility between Brazil's federal procurement law and Bank guidelines. Disbursement lags also persisted due to federal regulation that mandated that all special accounts be held in the Central Bank. In 1993, federal legislation was enacted to allow public entities to hold

projects accounts in institutions outside the central bank. Concrete steps have also been taken to improve procurement procedures thorough the issuance of Standard Bidding Documents for National Competitive Bidding (NCB) that were agreed upon by the federal government and the Bank.

ECONOMIC AND FINANCIAL EVALUATION OF STAFF-REDUCTION PROGRAMS

1. The loan will finance the cost of severance payments under the downsizing programs of BEMGE and CREDIREAL and other state enterprises that meet the criteria established on the Project Manual. These are two government-owned banks that are legally autonomous and have assets as well as their own sources of revenue. The downsizing programs that have been undertaken by these enterprises include both voluntary and involuntary dismissals, as well as incentive programs for early retirement programs. These downsizing programs, which account for a 30 percent reduction in the overall employment in these two entities, are just one component within a comprehensive set of measures that has been adopted by each of these enterprises ultimately aimed at their drastic restructuring or privatization.

2. This annex will analyze how the downsizing programs adopted by BEMGE and CREDIREAL provide for increased productivity and also deal with the potential problems associated with such severance programs, including: rehiring, excessive severance payments, adverse publicity, and negative impacts on those who withdraw. Finally, the results of financial and cost-benefit analyses are presented.

Impact on Productivity

3. The different state employment reduction programs currently being implemented in Minas Gerais were initiated only after careful studies to develop a strategy to improve the banks' productivity, each being just one element of these strategies. Each bank has a detailed program for increasing productivity and the sale price. In many cases, the enterprises also revised their career and salary plans to assure that the remaining employees are more effectively utilized.

Measures to Avoid Reversal

4. As these two banks would be privatized, rehiring would be subject to market discipline. Other state enterprises not being privatized cannot deny employees who leave under the different programs their constitutionally guaranteed right to participate in public examinations for employment. Moreover, those employees accepting the benefit packages are not required to return the full amount of the withdrawal package if they reenter any state entity. However, by Brazilian law, they will not be entitled to any additional retirement benefits due to a change in their employment status. Furthermore, it is not expected that the withdrawing employees would be interested in the entry level positions that would be offered in these public examinations. Finally, the increased private sector participation being sought in

all the enterprises, ranging from major restructuring to full privatization, should also increase market discipline in the future hirings.

5. The cost of the involuntary dismissal programs was based on the provisions made under Brazilian law. In calibrating the severance payments for the voluntary dismissals and incentive programs for early retirement, each enterprise took into account obligations toward employees, applicable laws including labor laws and agreements, prevailing labor market conditions, and the affordability and replicability of the package. In some cases, trade unions opposed these downsizing program, but were unsuccessful to block them. Due to the problems that arose during the privatization efforts in other states, the officials at CREDIREAL worked directly with employees to design an attractive, while financially viable benefits package.

Steps Taken to Mitigate Negative Impacts

6. The two banks set up programs to provide information and counseling on the benefits of the different voluntary programs to all eligible employees. In addition, employees opting for withdrawal could participate in training programs and career counseling. For example, in BEMGE, each participant was eligible for 20 hours of coursework in a wide variety of fields, plus 5 hours of individual counseling. The state federation of industries provides training on opening a small business through its training branch.

Economic Costs and Benefits

7. This section analyzes the impact of the different employment-reduction programs on the productivity of the enterprise. An economic analysis, which encompasses economy-wide costs and benefits, is conducted to determine whether the different programs are economically viable.

8. Economic cost-benefit analysis showed economic rate of returns (ERR) of 133 percent for BEMGE and 202 percent for CREDIREAL. The financial internal rate of return was 216 percent for BEMGE and 324 percent for CREDIREAL.

Methodology

9. The economic (rather than financial) costs and benefits of the employment-reduction programs are defined as follows. The costs cover mainly the amount of the severance payments (early retirement and financial incentives in the case of voluntary withdraw and retirement programs, and costs of dismissal as required by law in involuntary dismissal programs) and the training costs. There is no loss of service to any of the enterprises since, by definition, the workers declared redundant have a zero marginal productivity. The benefits include the additional contribution to the economy that the workers will be able to deliver where there is demand for their services. In particular:

10. *Economic Costs:* The costs of the employment-reduction program in each enterprise are given by the sum of the net present value of:

the marginal productivity value of laid-off or retired employees from the state enterprises, differentiated by year (i), employee (j), and enterprise (k) (R^r_{ijk})

(i) the severance payments (S_{ij}).

(ii) the early retirement payments (P_{ij}).

(iii) the training costs (T_{ijk}).

11. Item (i) represents the services not rendered by the employees being laid-off or retired. Since the remaining personnel is sufficient to carry out current production levels of these enterprises, the value of the marginal production productivity of retrenched workers is assumed to be zero.

12. In an environment without budget constraints or price distortions, items (ii) and (iii) would not normally be labeled economic costs. Assuming no subsidy and no government budget constraint, these outlays would be considered income-efficient transfers to the redundant employees and would not be included as a cost in the analysis. Brazil, however, does have a budget constraint and a highly distorted tax system which results in price distortions. These two items were therefore included to recognize the importance of the opportunity costs of public funds. The underlying assumption is that the shadow price of public funds is 100 percent and that each dollar of public resources used to finance severance payments or early retirement packages has an equivalent economic cost which needs to be taken into account. This also contributes to the conservative estimates of the rate of return as the cost estimates are an upper bound of the costs rather than a lower bound. These payments are differentiated by year (i) and employee (j).

13. Item (iv), training costs, have an economic component attached as long as the training agency (or firm) has an alternative use for its resources. In this case, training will be provided by state-supported agencies that operate far below their service capacity limits. Nevertheless, the full cost of the training program was included. Training costs were estimated at US$1,143 per employee, and all redundant workers under the voluntary dismissal program have been included as potential candidates. Training is differentiated by year (i) employee (j), and enterprise (k).

14. The pensions paid to normally retired employees are not included, since these costs would be incurred anyway. Welfare payments to those redundant workers who do not find employment have not been included, as social security payments under Brazilian law are marginal --i.e., the minimum wage for a maximum of three months.

15. *Economic Benefits:* The benefits of redundancy reduction in each year are given by:

(i) the marginal productivity value of each laid-off employee elsewhere in the economy (R^E_{jmp}).

(ii) the marginal productivity value of the foregone labor cost of the enterprises (LC_{ijk}).

16. The marginal productivity value of the laid-off employee is the product of: (i) the probability of the employee's engagement in another productive activity, by (ii) the net income produced by such activity. R^E is influenced by attributes such as age, education, etc., of each employee (j), and the location (m) he is likely to find an occupation (p). Location (m) may or may not be the same as where he previously worked and occupation (p) is related to the employee's attributes and the training which he receives. In some cases, the laid-off employee may get a job at the expense of someone else's job, and his net income contribution may be zero. But since these cases are normally rare, impact on the final results would not be significant. Provision was made for these assumptions by reducing employees' marginal productivity by 10 percent and 20 percent in the sensitivity analyses.

17. The marginal productive value of the foregone labor cost of the enterprises represents the opportunity cost of the outlays that will be saved by the downsizing programs. The savings in labor costs can be used in investments needed to increase and improve the services provided by these enterprises. In the economic analysis they are estimated as equivalent to the foregone labor cost. However, they were excluded from the calculations of the internal rate of return to provide estimates that are a lower bound of the benefits rather than an upper bound, thus resulting in more conservative estimates of the rate of return.

Quantitative Assumptions

18. The quantitative assumptions made in estimating the economic value of staff-reduction programs are conservative, including the assumption that not everyone will find a job. The probability of being rehired is estimated at 0.83 based on employment data for the largest metropolitan areas in the Southeastern region, of which Minas Gerais is a part. This probability provides a conservative estimate, as Minas Gerais now ranks first in Brazil in terms of employment generation. The main reason for the rather short duration of unemployment is that prices adjust to clear the labor market. This implies that unemployment goes down as the price of labor declines. Those who do not find a job at their previous wage have to accept a wage cut consistent with the average probability of being employed. The reduction in wage depends on the region; wage is reduced to the average salary in the region where a worker is declared redundant. These wage losses were estimated at approximately 25 percent in the southeastern region.

Results

19. Table E.1 presents the results for the different employment-reduction initiatives being undertaken by BEMGE and CREDIREAL. The overall net present value of these initiatives is estimated at approximately US$589 million with a 12 percent discount rate. The overall internal rate of return is estimated at 140 percent taking into account only the benefits from the marginal productivity of retrenched employees to obtain more conservative estimates.

Financial Rates of Return

20. Table E.1 also shows the financial rates of return calculated taking into account the costs of the programs and the labor costs savings from retrenchment for the retrenchment programs of BEMGE and CREDIREAL is 228 percent.

21. In summary, all the different programs have a clear economic and financial value, even under the most pessimistic assumptions. The economic value does not result from redundant workers being laid-off, but rather from their productive employment in other sectors of the economy where demand has been identified and their training, which contributes to the enhancement of the labor force. It also releases scarce public resources for better targeted and more effective uses, including education and health care as well as the rebuilding and expansion of the state's infrastructure.

Table E.1

Economic and Financial Analysis of Minas Gerais' Severance Payments

Company:	BEMGE	CREDIREAL	Total
Type of Program:	Weighted Average	Involuntary Dismissal	Weighted Average
Total State Employees	10,118	2,739	12,857
No. of Eligible Employees	10,118	2,739	12,857
No. of Layoffs	3,445	415	3,860
Relative Weights	0.89	0.11	1.00
% of Layoffs	34%	15%	30%
Avg. Monthly Salary (US$)	1,210	701	1,156
Avg. Monthly Wages & Benefits	2,191	1,269	2,092
Annual Average Wage & Benefits (US$)	26,290	15,228	25,101
Probability of Finding a Job	0.83	0.83	0.83
Wage Reduction Coefficient	0.75	0.75	0.75
Marginal Productivity per Employee (US$)	16,366	9,479	15,625
Severance Payment per Employee (US$)	14,431	4,695	13,384
Total Severance Payments (US$000)	49,715	1,949	51,663
Total Program Cost (US$000)	52,035	1,949	53,983
Annual Labor Costs Savings (US$000)	90,570	6,319	96,890
Annual Marginal Productivity Gains (US$000)	56,380	3,934	60,314
PV of Labor Costs Savings (US$ m)	361	36	397
PV of Marginal Productivity Gains (US$ m)	225	22	247
Gross Present Value (US$ m)	586	58	643
Net Present Value (US$ m)	533	56	589
Estimated ERR			
Economic Costs (US$000)	52,035	1,949	53,983
Annual Economic Benefits (US$000)	56,380	3,934	60,314
- Base Case	133%	202%	140%
- Marginal Productivity Reduced by 10%	119%	182%	126%
- Marginal Productivity Reduced by 20%	105%	161%	111%
Estimated Financial Rate of Return			
Financial Costs (US$000)	52,035	1,949	53,983
Annual Cost Savings (US$000)	90,570	6,319	96,890
- Base Case	216%	324%	228%
- Labor Savings Reduced by 10%	194%	292%	205%
- Labor Savings Reduced by 20%	172%	259%	181%
Other Input Data			
Average Age	36	33	35
Avg. Years with Company	11	6	10
Average Remaining Years	6	10	6

PARTICIPATION

1. Minas Gerais is a state with a long history of public participation in governance and policy-making. On the state level, "Participatory Planning" was instituted in the latter part of the 1970s to involve all beneficiaries of economic development in the planning process. In 1993, participatory planning entered a new phase, with the introduction of public fora (*audiência públicas*) at the state level. These public forums were pioneered by the Legislative Assembly as a way to promote more direct communication between the legislative branch and the 41 regions and within Minas. The main objective of the public fora is to identify regional developmental and budget priorities for use in developing the state's annual budget. Due to the initial successes of 1993, the public fora have been held yearly—with some minor improvements—to develop concrete proposals for improvements and investments.

2. Similar levels of participation also exist in the Belo Horizonte Metropolitan Region. An inter-municipal forum was created to address issues that were decentralized from the state to the municipal level. This has become extremely important as the municipalities are increasingly providing social services to the poorer sectors of Belo Horizonte. This forum routinely interacts with the state government, and various other actors, including other governmental agencies, universities, churches, unions, companies and professional organizations to develop and implement projects. The primary focus has been children at risk; to date, projects exist to: improve health services to poor children, reduce child labor within the BHMR, create after-school programs for children at risk.

3. In addition, Minas' involvement with various development projects financed by Bank and the Inter-American Development Bank have contained major participatory components. The state's experience with the **Northeast Rural Development Project** (PAPP-MG, Loan 2861-BR), **Minas Gerais Basic Education Quality Improvement Program** (ProQualidade - Loan 3733-BR); **Minas Gerais Water Quality and Pollution Control Project** (PROSAM - Loan 3554-BR) have given the state concrete examples of how to incorporate participation in a variety of sectoral projects.

4. The Government of Minas Gerais has been actively debating its state privatization program in public. Through a system of public fora the Government holds regular consultations with interested groups. The government has also been actively debating the major elements of its Reform Program in the state assembly and in the press, through articles signed by the Governor, and Vice-Governor and Secretary of Planning. The government has sought, to the extent practicable, to allow a high level of public participation in the preparation of their reform and privatization program. Moreover, when designing certain aspects of the state's reform program (e.g., severance payments and funding of pension

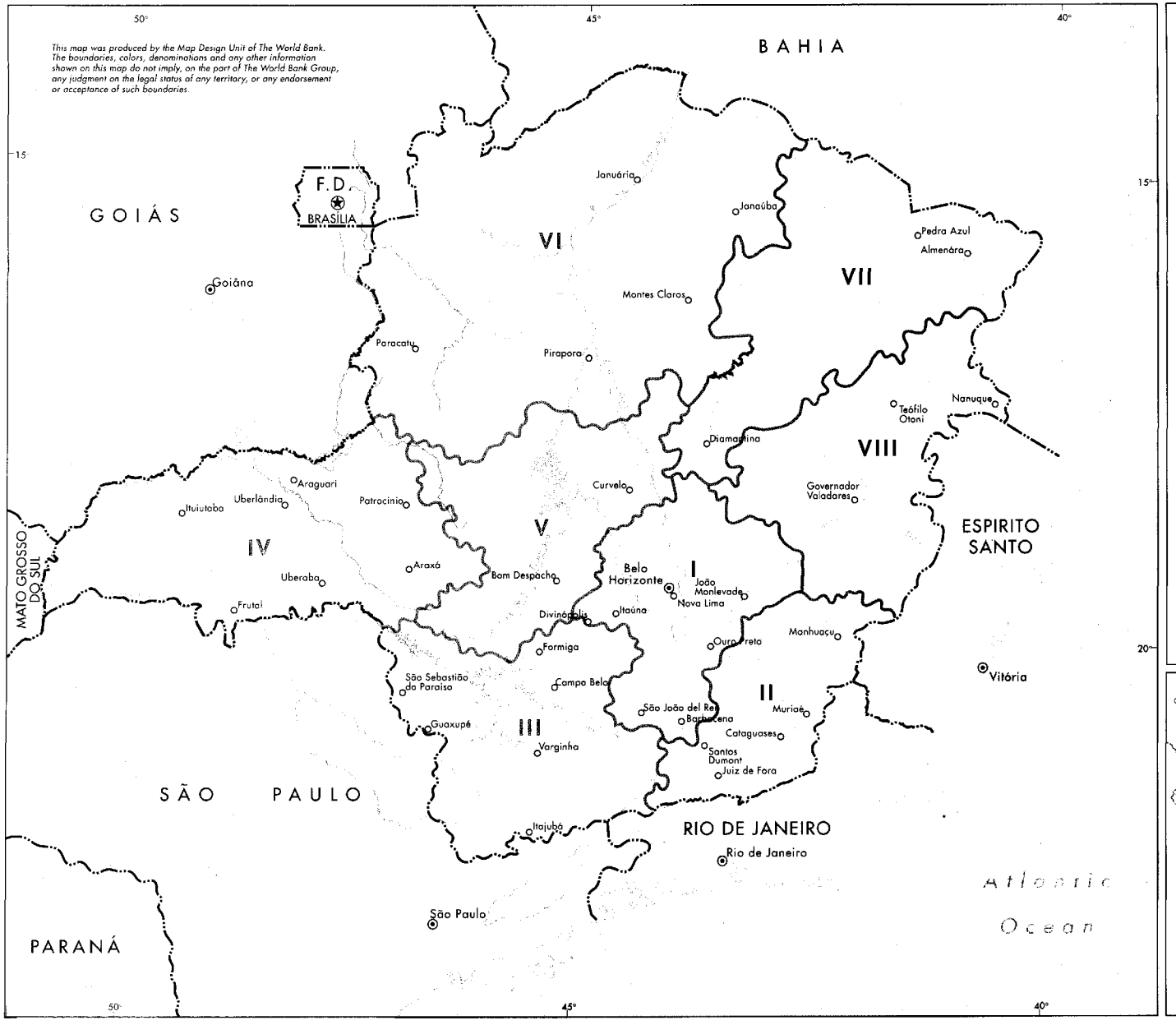
liabilities), the state worked with stakeholders to pinpoint potential areas of conflict to help arrive at mutually acceptable agreements.

4. In addition, the adoption of a regulatory agency as a function of the privatizations and granting of concessions under the State Reform Program will create a new avenue for community participation. The adoption of an independent regulatory agency will ensure that consumers are informed of their rights, and are treated in a fair, efficient, and transparent manner. While many branch offices of state utilities currently have customer service offices, they are not effectively regulated by the state. Instead, they regulate themselves, with proactive input from municipalities.

MAP SECTION

IBRD 28732

BRAZIL
MINAS GERAIS STATE PRIVATIZATION PROJECT



ECONOMIC REGION BOUNDARIES
SELECTED CITIES
STATE CAPITALS
STATE BOUNDARIES
INTERNATIONAL BOUNDARIES

	ECONOMIC REGIONS:	ESTIMATED PERCENT PARTICIPATION IN STATE GDP:
I	METALÚRGICA E CAMPOS DAS VERTENTES	51%
II	MATA	8%
III	SUL	13%
IV	TRIÂNGULO E ALTO PARANAÍBA	11%
V	ALTO SÃO FRANCISCO	4%
VI	NOROESTE	5%
VII	JEQUITINHONHA	2%
VIII	RIO DOCE	6%
	TOTAL	100%

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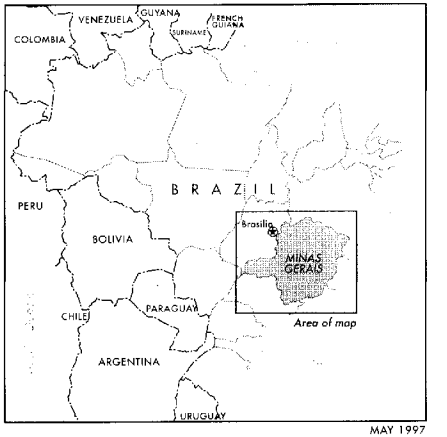
KILOMETERS



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