Brazilian railway concessions: Risks and returns

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IN MID-2012 THE government launched the Logistics Investment Program (PIL) to rescue Brazilian railways, promising huge investments to expand the network. The plan was to direct the allocation of R$99.6 billion for the construction and improvement of about 11,000 kilometers (km) of rail.

Three years later and with a second edition, PIL-2, launched this past June, the government has not been able to auction a single stretch of railway. With an area of about 8.5 million square km (km²) and a railway network that is about 33,000km long, Brazil has a rail network with a density of only about 4 meters (m) of railway line for each km² of territory. This number is significantly lower than in countries like the United States (23m / km²), India (23), South Africa (17), Argentina (11), Turkey (11), Mexico (9m), China (8.11) and Russia (5.1).

The high fiscal cost of VALEC’s operations, which the Federal Court of Accounts has identified, combined with the country’s current difficult fiscal situation has forced a review of how Brazilian railways operate. The regulatory framework had been identified as the main reason for the low penetration of rail transport. To address this, the government proposed that Brazil’s railways be unbundled. As a result, the state set up a new enterprise, VALEC, to manage the railway cargo market: VALEC buys the full cargo capacity of new railway lines and sells cargo services to independent rail operators.

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PIL-2, as introduced in June, covers construction of new railway lines, extension of existing concessions contracts, and investments of R$16 billion in the existing network. However, it has been questioned whether the instruments authorized can achieve the PIL-2 objectives.

When the PIL-2 was presented, the government stated that projects were already being negotiated with concessionaires to expand traffic capacity through new railway yards, extensions, new signaling, and renewal of rolling equipment.

The National Ground Transportation Agency
(ANTT) and some private operators have expressed interest in reviving unused lines equivalent to almost 22% of the railway network. These lines could function like U.S. short lines—railways that carry lower volumes over shorter distances, usually feeding cargo to main railway lines. In the U.S., short lines account for about 30% of the entire railway network.

The use of short lines, as well as other railway alternatives, needs further reflection and maturation. Analysis of the feasibility of such lines is a good example of how Brazilian infrastructure sectors could benefit from good practices in other countries.

At present, however, the crucial point is early renewal of concessions. Given the difficult fiscal situation, the government is negotiating with leading concessionaires to promote investment in expanding the railway network in return for extending current contracts.1 Although these negotiations are already quite advanced, it is necessary to analyze how they will affect the structure of the railway sector and whether they are consistent with the strategic objectives of transport and logistics policy.

Another recent development that should be scrutinized concerns the updating of the parameters for estimating the internal rate of return (TIR) to be adopted as a reference for future railway concessions. Initially set at 8.5% per year, the TIR has been raised to 10.6%, as the government tries to align it with the risks involved.2 The methodology used is still that presented in Technical Note 64 STN / SEAE / MF, May 2007, updating parameters for estimating the risk-free rate, market risk premium, Brazil risk premium, and U.S. inflation. This standardization of the estimated weighted average cost of capital for railway concessions is similar to the methodology established a few years ago by the National Electric Energy Agency (ANEEL) for tariff revisions and concessions in the electricity sector.

Despite the current regulatory hurdles, and the many other questions that deserve further consideration, these recent government measures are a move in the right direction to better align investment returns with the risks concessionaires face. What is now necessary to interest investors in the logistics sector and to achieve the government’s goals is more transparency about the policy objectives for transport and logistics, and clear and coherent regulation.

1 According to Valor Econômico newspaper (December 1, 2015), the federal government is seeking to speed up the process for extending railway concessions. The plan calls for R$16 billion in private investments in the current network in return for extending the existing concessions. Negotiations are concentrated in three companies: ALL (América Latina Logística), MRS Logística, and Ferrovia Centro Atlântica (FCA).