

the corporate muddle of

MANILA'S WATER CONCESSIONS

Jude ESGUERRA

New Rules, New Roles: Does PSP benefit the poor?



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Since this study was written, many events have unfolded. A rate rebasing process approved tariff increases in late 2002, but these were below what one of the companies, Maynilad Water Services Incorporated, petitioned for. As a result, Maynilad pulled out of the concession. An arbitration case has followed to resolve the controversy over Maynilad's claims for reimbursement.

The analysis and position in this study are those of the author's. Nevertheless, WaterAid is publishing this study as it focuses on key issues in the water privatisation debate that are not discussed elsewhere. Contentious arguments are raised here against the companies, hence, WaterAid has included text boxes that provide space for the responses of Ondeo, one of the companies involved.

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Acronyms

ADB	Asian Development Bank
ADR	Automatic Discount Rate
BHC	Benpres Holding Company
CERA	Currency Exchange Rate Adjustment
EPA	Extraordinary Price Adjustment
FCDA	Foreign Currency Differential Adjustment
IFC	International Finance Corporation – World Bank arm providing financing for private sector projects
LDP	Lyonnaise des Eaux Philippine
LYSA	Lyonnais des Eaux Services Association
MWCI	Manila Water Company Incorporated
MWSI	Maynilad Water Services Incorporated
MWSS	Metropolitan Water and Sewerage Systems – a government owned corporation that is the utility delivering water and sanitation services in Metro Manila
MWSS-RO	MWSS Regulatory Office
NEDA	National Economic Development Authority – the economic planning body of the national government
NERA	National Economic Research Associates – founded in 1961, a firm of consulting economists specialising in markets and how they work
NGO	Non governmental organisation
pcm	Per cubic metre
PHP	Philippine peso
SLDE	Suez Lyonnais des Eaux



I. Executive summary of synthesis report

Governments, both northern and southern, have rightly placed themselves under much pressure to achieve better water and sanitation coverage. The Millennium Development Goals aim to halve the proportion of people without access to water and sanitation services by 2015. Millions die every year from lack of access to safe water and adequate sanitation. On one hand there is an undeniable urgency about these issues that makes prolonged discussion frustrating and a questionable use of resources. But on the other, the risk of the blanket promotion of one debatable method of reform is an unnecessary waste of scarce resources.

Most southern governments have consistently failed to deliver affordable and sustainable water and sanitation to the poor. It is difficult to summarise the causes for this failure as each situation is different and complex. However, some broad problems cut across many public utilities and municipal services: bad financial management, low funding priority, lack of staff experience and qualifications, absent or weak customer service orientation, political interference, little or no independent regulation and an absence of civil society consultation. Many of these problems have been described as attributable to weak government capacity – equally acute in urban and rural contexts.

Our research shows that the policy of private sector participation (PSP) does not comprehensively tackle the underlying causes of water utilities' failure to serve the poor. In four key areas capacity building, community participation, finance and institutional reform, major problems persist, making it unlikely that the multinational private sector is going to play any significant role in achieving the Millennium Development Goals.

Currently the pursuit of a policy of PSP generally undermines local and national government capacity. For one, it limits the ability of the public sector to take services back should PSP fail or when contracts end. Private sector contracting must not result in irreversible dependence on

private companies, and there must be clauses in contracts to prevent this dependence.

Without adequate government capacity, no reform processes can be successful. The private sector cannot be contracted without tackling failing government. The government's role to facilitate, monitor and regulate is as much an essential element in PSP as in public and user-managed utilities. Yet, it seems that this requirement is being practically ignored in the rush to establish PSP. It is essential that donors refocus efforts to building government capacity at local and central levels.

The involvement of local communities is often lacking in PSP reform programmes. Where PSP has failed to deliver the promised gains, the case often is that the poor are seen mainly as recipients, rather than contributors to development. Whether projects involve large or small-scale PSP, the focus is on giving contracts or concessions to the private sector. Social mobilisation and community participation, proven time and again as prerequisites for sustainable development, are seen as burdens and non-essential components of the task. Failure to consult communities means that the interests of the poor are often not being represented. It results in a lack of ownership over projects and an absence of accountability between users and service providers. It seems that the lack of community involvement that led to previous failures is continuing, raising serious doubts over the sustainability of PSP projects.

Cost recovery and capital cost contributions are in most cases necessary for water services to be sustainable. However, there are problems in the application of these principles, which often results in denying the poor access to services. Expensive technology choices and a failure to consider the non-cash contribution of the poor are widespread in PSP contracting. Donors are guilty of promoting an approach that is narrow and mechanistic, allowing for little flexibility and absence of perspectives incorporating community action and considering the complexities of poverty.

Changing the role of government, by effectively reducing its capacity through reductions at central level, but not increasing personnel at local government levels, erases benefits that could be gained from decentralisation per se (such as responsiveness to people's needs, greater accountability etc.). Weak decentralised agencies cannot be expected to quickly learn about tenders or forms of contracting and keep track, monitor and supervise the activities of contractors fanning beyond provincial capitals.

In the rural areas that were studied, reduced government roles had a detrimental impact as work was often sub-standard leaving the communities with a costly and unreliable service. The rural case studies also show that there are, so far, no improvements in accountability. In some respects, accountability was compromised in the dilution of responsibilities that accompanied the change in roles. Because projects are between governments and contractors (communities are typically not a party in the contract), the supposed beneficiaries are in no position to seek redress for sub-standard work. Accountability is lost in the commercial/ contractual, quick-fix arrangements of private sector involvement.

Political interference has been seen as contributing to the failure of many public utilities to deliver to the poor. In established democracies there is 'interference' in the running of utilities but this is seen as government exercising its duty to keep institutions to account. There is a fine line between 'interference' and the need for accountability, the difference seems to be the depth and strength of democratic institutions in individual countries.

Civil society working to strengthen the hand of government through, for example, commenting on tender documents prepared by external advisors, increases the likelihood that reforms will further the concerns of the poor. It is in the interests of government to involve a broad constituency, especially one that represents the interests of the poor and poor people themselves in the shaping of privatised basic services. Pro-active openness and transparency by government in reform processes lessens the possibility of civil strife.

With these findings, we are opposed to donors pressuring developing countries to accept PSP in water services as a condition of aid, trade or debt relief. To promote a policy regardless of specific contexts increases the likelihood of failure especially when the likelihood of success of that policy is intensely contested. Furthermore, the enforcement of PSP as the central policy reform limits the options for governments and civil society to improvise and innovate using the best possible arrangements. We believe rather that policies should be used to ensure that in any reform process the poor will be protected, their access to services increased, and the process itself actively seeks the opinion of civil society.

This does not mean that we are rejecting private sector involvement. The private sector has a role that should not be denied. But, where there is corruption and/or political resistance to serve the poor, the private sector can do very little and can, in fact, compound the problem. Where there is lack of information, participation and democratic processes, the situation is thrown wide open to opportunistic behaviour from the private sector. However, given a situation with stable rules, enough political commitment to address the underlying causes, good governance and an informed and active citizenry, the private sector can be a responsible partner in development and an important player in reforming and improving water services.

In order to move forward on this contentious issue, a multi-stakeholder review should be undertaken. We believe that it is only through such a review (similar to the World Commission on Dams) that the final, authoritative word can be made on whether PSP benefits the poor. We also believe in the necessity of building the capacity of civil society actors to influence privatisation processes and to hold governments and the private sector to account. This needs to start with improving their knowledge and understanding of the issues surrounding failing water services, and enabling civil society groups around the world to learn from each other's experiences of intervention in privatisation processes.

II. Case Summary

The privatisation of Manila's water utilities to two companies, which took the East and West zones of the city, was originally regarded as a model of success, with an open and competitive bidding process, followed by a tight and reasonable Concession Arrangement that sharply reduced prices. However, less than three years into the contract, one of the companies was in dire financial straits, and the other was challenging one of the fundamental tenets of the agreement. Both of the companies appeared to have made particularly low bids, on poor foundations, with the assumption they would change the terms of the contract once it was won. Crucially, the contract administrators allowed that to happen. The result is a corporate muddle, whereby the supposed benefits of PSP disappear, and government and public administrators are seemingly unable to prevent it.

Background

Following the major power crisis of the early 1990s in the Philippines that was successfully dealt with by initially privatising the power sector, then President Fidel Ramos wanted the same model adopted to resolve Manila's growing water crisis. Selected for privatisation was the hugely-indebted and grossly inefficient Metropolitan Water and Sewerage Services (MWSS), which served nearly 12 million residential, commercial and industrial customers. Congress gave Ramos the power to enter into private contracts to deal with the problems of MWSS. Though passing much of the technical work to aides, the President retained a direct hand in the decisions. What emerged was a privatisation and bidding process that was hailed as a significant improvement over previous similar deals.

What went wrong?

A few months after signing, a series of events started that sent the Concession Agreement seriously floundering. Maynilad Water Services Inc (MWSI) found itself in dire financial straits. It

first threatened to, and then eventually walked out of the 25-year concession, blaming the Asian financial crisis and the intransigence of government to grant them a bailout through higher prices. Manila Water Company Inc (MWCI) mounted a legal challenge to re-interpret the Concession Agreement to allow it to have increased discounts before the five year rate re-basing process.

Initial suspicion is that the bids made by the two winning companies were unsustainable. They were 'dive bids', where the companies went in with extremely low bids just to win the contract. Dive bids are not unusual, and nor is it unusual for companies to operate at significant loss for the first few years, as long as they forecast higher returns later. But in this case it seems the companies submitted dive bids with the assumption they could later change the terms of the contract in their favour. A lack of attention to dive bidding on the part of those crafting the contract can result when the priority is to conclude the bidding process, rather than to ensure the contract is viable. To reject Manila Water's lower bid, for example, would have been controversial, delaying and unacceptable politically. The bid was accepted, despite some reservations by experts about its financial viability.

One of the contributing problems was that the government had no sound studies on which to measure water demand for Metro Manila. They had no basis on which to judge the feasibility of non-revenue water reduction, such as repairing the network. Thus the financial models submitted in the bids made by the companies could be nothing more than a corporate muddle, with unreliable figures and unsound business propositions.

Maynilad

By the end of December 2000 Maynilad was in deep financial distress. It made heavy losses because it was made to assume 90% of the estimated US\$800 million debt of the MWSS, and the Asian financial crisis massively reduced the

worth of the peso. These losses led to weak revenues, which meant banks and financiers would not lend the company the money needed to improve the network or make the capital outlays necessary to increase its income. Repairing and developing broken networks, which brought in little short term revenue, would have been hugely costly. The only solution, the company argues, was to increase tariffs.

Maynilad's officials claim that none of the problems are the results of the company's own fault, but rather with the Asian financial crisis. This study argues Maynilad's inability to contain costs and to realise the revenue potentials of the network was a cause of its problems, not an effect of them. This study argues that:

- Maynilad put little of its own money at stake.
- The company drastically underestimated its operating costs.
- Maynilad employed expensive partners and technical assistance.
- The company overestimated the revenues it could earn.
- The Concession Agreement actually assured Maynilad's currency losses.

Manila Water

While Manila Water suffered little of the economic muddle Maynilad experienced, it still launched a legal bid to interpret the Concession

The Original Contract

The Philippines government decided to adopt the Paris model for the privatisation, where the service area was split into two (East and West zones) and each part was assigned to a separate concessionaire. The model is supposed to break up monopolies, and allows for the performance of each concessionaire to be compared against the other.

The Contract resulted in the private companies offering to do the work at considerably lower cost to the consumer than they were currently paying. In the East Zone, Manila Water offered to charge just over one quarter (26.39%) of the existing rates. In the West Zone, Maynilad offered to charge just over half (56.59%) of the existing rate. It was not complete privatisation, the government retained ownership of the assets of the MWSS, but leased them to the private companies to use.

The Concession Agreement was a decision to auction off the rights to operate and expand the water and sewage network system to the bidder offering the lowest price of water, for a given set of performance targets. The companies were supposed to be responsible for saddling debts, raising finance, improving the network and charging customers.

Since the companies agreed to take on fixed price contracts, they had the ability to increase their profits by maximising efficiency. The only available options for changing prices, whether upwards or downwards were:

- Inflation. The regulator allowed for increases according to annual rates of inflation.
- Unforeseen events. Companies could change prices once a year due to drastic or other unpredictable events, such as the rapid devaluation of the peso (which occurred).
- Rate re-basing. At the start of each five year period, a review of tariffs could be made so they can be adjusted to reflect "fair returns" for the company agreed in the contract.

There is a valid basis to say the Concession Agreement was a fair deal that allows all stakeholders – government, the companies, and consumer – to reap benefits, and to change arrangements in an open and negotiated way in response to unforeseen circumstances.

Agreement to change the key parameter on rate re-basing. This parameter was the appropriate discount rate (ADR): the amount the company could claim as profits resulting from efficiencies it has created.

Manila Water wanted to raise the ADR to 18 percent, while only 5.2 percent was implied in the original contract. The regulators refused, and the dispute was brought to the Appeals Panel, which was created as part of the Concession Agreement. It eventually led to the granting of a new ADR of 9.3 percent. But the regulators and MWSS board challenged the decision at the Court of Appeals, arguing the Appeals Panel had overstepped its powers. A legal wrangle followed, which remains unresolved in the courts. They are yet to decide which body had the appropriate powers. Crucially, Manila Water won its original bid on financial projections based at the 5.2 percent ADR. Other companies were rejected because their projected cost to the consumer, based on a 10 percent ADR, were higher. Manila Water had won by projecting a small ADR, then attempted to have it changed once the contract was theirs.

Consequences

This study concludes that the relevant public authorities appear to have played into the scheme laid out by the companies, whether knowingly or unwittingly. They never entertained the idea that Maynilad could have been incompetent, or had the right incentives in place to make the scheme viable. Manila Water's legal challenge and the government's stuttered response showed it was not ready to deal with such a challenge. The private companies may have muddled the PSP process, but the response of public institutions and officials – those tasked to uphold the public interest – constitutes half the blame.

Thanks to Manila Water's legal wrangling, and Maynilad's financial difficulties, the Government were forced to negotiate amendments to the Concession Agreement which many had hailed as water tight and effective. The main amendment led to the cost of foreign exchange recovery being completely and immediately passed to consumers.

The amendment was a bailout to Maynilad, and benefited Manila Water as well. Maynilad is closer now to realising its debts, and being regarded as a bankable prospect by creditors, but these things are by no means assured. Creditors are still concerned about the company's financial viability, especially since if it fails to meet its service obligations, it could lose a US\$200m bond put up as a guarantee. However, Maynilad seems to have significant enough political clout to get its service obligations postponed.

The integrity of the original bidding has been undermined. Had the other bidders guessed that the technical parameters that imposed an upper limit on their bids could be falsified and then later treated with forbearance by the government, they too could have made very low, but unrealistic bids.

The new mechanism for foreign currency exchange cost recovery reduces efficiency. Now the lengthily waiting period is gone, the cost are passed immediately to consumers. The companies will have no incentives for economising on buying materials from abroad or in foreign borrowing.

The private companies have managed to disown the risk associated with foreign exchange fluctuations, but it has not been passed onto anyone else. Only the private sector has access to sophisticated financial mechanisms to shoulder this risk.

The regulatory office was given, as a result of legal wrangles, different and wider powers than was intended under the original contract. There remains a lack of clarity about its terms of reference.

Conclusion

The original bidding process for Manila's water concessions was a success, along with the allocation of risk. The impact on the poor has been positive, bringing greater access to better quality water. But while PSP may have brought efficiencies, the result was a corporate muddle which finally makes the Manila experience a failure. It was turned primarily into a tool for advancing and preserving private, not public,

interest. Some of the lessons to be learned from Manila's experience are:

- It is necessary to do rigorous homework before the tendering process, creating forecasts which can be used to eliminate bids that have unrealistic or optimistic projections of sales.
- Rate re-basing on a set timeframe will install discipline in companies, but the threat of delayed rate re-basing is not always deemed to be credible.
- In no circumstances should the regulator see its role as bailing out companies if they suffer from their own unrealistic bids.
- Regulatory arrangements in one country may not be applicable in another.
- Corporate sponsors should put their own balance sheets on the line, at least during the first couple of years.
- The government must clarify right from the beginning that it will not tolerate dive bidding.

This paper concludes that the Manila water experience shows a corporate muddle to get away from the disciplines of a deal which at the beginning is fair to all stakeholders, and with government, public authorities, donors and lenders allowing this to happen.

III. Introduction

When the winning bids were announced on 6 January 1997, a sense of excitement and vindication swept through the public officials and consultants who made it happen. Particularly buoyant was Philippine President Fidel Ramos. Flushed by the success of a privatisation programme that ended a crippling and economically devastating power crisis early in his term, Ramos gambled on a similar process doing the same for Metro Manila's growing water crisis. Now he had plenty of reasons to be happy.

The award of East-Zone and West-Zone water concessions to two foreign-backed companies not only reduced the cost of water to the consumer by an amazing 50 per cent and 75 per cent (roughly), it also offered a number of politically attractive promises. These promises were contract-mandated obligations that, for instance, made the private companies responsible for over US\$7 billion in investments to be sunk into the water utility over the life of the contracts. The private companies also assumed the huge US\$880 million debt of the Metropolitan Water and Sewerage Service (MWSS), the government-owned utility, thus removing a sizeable chunk of a crippling burden on government finances. And the deal was a significant improvement over past privatisations elsewhere in the world, as it contained more specific guidelines for the protection of consumer interests while ensuring that proper incentives were in place so that the new private operators will consistently strive for efficiency: this constituted a most decisive response to the huge and seemingly intractable problems of the MWSS in serving nearly 12 million customers. The MWSS privatisation was no mean accomplishment; it was a coup of sorts for the Ramos administration. Not only did it remove a huge drain on government resources while bringing real promise of a more efficient service at significantly lower costs, it also went through smoothly, with almost no opposition, especially in Congress. Even the MWSS unions barely raised a cry.

Yet, barely just three years later, the deal was seriously foundering. One of the companies –

Maynilad Water Services Inc. – found itself in dire financial straits. It threatened to walk out of the 25-year concession contract, citing huge losses resulting from a *force majeure* – the July 1997 Asian financial crisis that among other things caused the devaluation of the peso. It petitioned the Regulatory Office for a 70 per cent increase in tariff to bail it out of its mess. Meanwhile, the other company opened a different but related legal battle with the Regulatory Office. Manila Water Company Inc. wanted to interpret the Concession Agreement in a manner that will allow it to have increased discounts (in the form of interest to be paid for by consumers) before the mandatory rate re-basing process is held. This basically meant changing the terms of the Concession Agreement.

From Maynilad's financial woes and Manila Water's legal challenge emerges an intricate and complex debate on the status of the world's biggest privatisation. The bottom line is that the process that initially appeared to be an extremely successful solution now lies in serious doubt. What emerges from an investigation of this debate is a corporate muddle – a process that was not the winning solution it was hyped to be after all. Rather, it could well be a case of street-smart companies making unrealistic and unsustainable bids just to win the tender, and gambling on the possibility that the rules of the game may be changed later on in their favour: a shrewd gamble given the weakness of regulation in the Philippines and the state's historical permeability to private interests.

These companies' confidence in making apparently unrealistic bids may be bolstered by the fact that the Philippines' two wealthiest families were behind the two winning companies, and they were backed by the biggest water and sanitation multinationals in the world. The Lopez family's Benpres Holding Company (BHC) is the majority owner of Maynilad. The French multinational Suez Lyonnaise des Eaux SLDE (now Odeo), is the minority owner. Manila Water is owned mainly by the Ayala family, and backed by Bechtel and United Utilities. It appears that the two companies' approach was

to win the bid at all costs, and then deal with the problems of profitability later. The result is a privatisation that has failed to impose market discipline on the companies, and which, ironically, presents striking parallels to problems of under-performing state corporations under socialist states or petty dictatorships.

This study argues a number of points to untangle this corporate muddle:

- The two companies submitted bids for high service qualities at a low price, and then once the contract was written, tried to re-negotiate, to chisel down quality, to scale down and postpone targets, and to exploit the loosely defined regulatory rules for price adjustments.
- Maynilad's inability to contain costs and to realise the revenue potential of the assets assigned to it is more a *cause*, rather than an *effect* as it claims to be, of the problems of creditworthiness and cash flow of the firm. It tried to put the blame on the Asian financial crisis, which while no doubt led to serious foreign exchange losses, had little to do with water delivered to customers that is not billed due to metering mistakes, stealing, tampering, etc. These accounted for nearly half the non-revenue water it was trying to reduce. In short, the Asian financial crisis merely provided the smokescreen to the more real problems created by the company's own inefficiency and dive-bidding.
- Manila Water was in a better position financially, but also had the same efficiency problems. For instance, it had equally serious problems of inability to deal with

non-revenue water. Manila Water used a legal challenge in the Appeals Panel to change the rules of regulation in its favour.

- Both companies, in striving to move out of the contract terms they originally agreed to, have in effect caused long-term damage to the credibility and viability not only of regulatory processes that were mandated when the concession agreements were signed, but also of private sector participation in general.

The next section of this study will sketch an outline of what has happened with the Manila water concessions in order to describe the circumstances and context in which this corporate muddle took place. It will then discuss separately the arguments it is making and provide supporting evidence to go with it. A review of the lessons learned from this experience follows. In particular, it looks at the lessons on risk mitigation in concession contracts, the setting up of tenders and evaluation of bids, the problems of limited-recourse financing, and the consequences of tampering with regulatory processes. Through this discussion of the lessons, a number of alternatives are recommended. This concludes that while private sector involvement offers a real promise of efficiency and decisiveness in dealing with intractable problems of water and sanitation services delivery in a huge metropolis, the context in which these happen to a large extent determines whether the benefits can actually be delivered. The key then is to understand the financial, political and social contexts well – the best defence against the corporate muddle of an otherwise desirable mechanism for efficiency.

IV. Ondeo's response to this case study

This study is almost entirely built up on a concept it calls 'dive-bidding'. It paints a picture where all the problems are due to a tactic of deliberate under-pricing. This is an allegation that is completely unfounded. There were four bidders each for the two concessions. The bids of Anglian Water, the Vivendi and the Ondeo consortia were separated by the narrowest of margins. This clearly indicates that all the bidders at this level had interpreted the information in very much the same way. The remaining bids from the IWL/Ayala consortium were both at a level of about half the price of the others -- if there were 'dive bids', it was these. Nevertheless, the government accepted this very low bid for one of the two concessions awarded. This was done once the government had received confirmation from IWL/Ayala that they stood by their bid.

Several important differences between the two concessions need to be noted. The most significant is that the government 'loaded' the majority (90%) of the historic debt of MWSS onto the West Concession (awarded to Maynilad) through the concession fee. It is quite likely that government did this as it saw the risk it ran of non-recovery if it shared the debt burden more equitably between the two contracts. In later events, this decision hugely penalised Maynilad: it left Manila Water virtually unexposed to the huge devaluation that devastated Maynilad.

This problem was compounded by the difference in the nature of the two contract areas. The Maynilad zone contains infrastructure in a much worse state, and a large un-connected and low-income population. In comparison, the Manila Water zone has a much more viable situation.

In addition, the accuracy of the technical and operational data provided for the Maynilad zone has proved to be very inaccurate. Major elements such as the length of the distribution network were greatly understated. In the bid documents, it was stated that the length of the network to be maintained was 2534 kilometres – but the actual length on the ground has now been determined to be 3880 kilometres.

There is a strong likelihood that had Maynilad not had to unilaterally support the historic debt of almost the whole of Manila's water system, and with the huge foreign exchange losses due to the devaluation of the Peso, these difficulties might have been overcome.

Maynilad has made great efforts to both negotiate a reasonable solution that would enable it to operate the contract in a stable and sustainable way, and has also achieved some real improvements in service delivery and coverage. For example, the service coverage has been improved from 58% in 1997 to 84% today. Some 144,000 new connections have been completed. In particular, these have provided first time access to over 500,000 urban poor. The study makes scant reference to these facts.

The real situation is that Maynilad and its sponsors have been 'bled' excessively for reasons that are totally beyond their control. They have negotiated in good faith, and proposed many solutions. They have not been able to secure any workable solutions from the client or the Philippine government. Having faced this situation for a long period, they have been left with no realistic alternative to giving notice to terminate the contract.

From our point of view, this is certainly a failure. It is however very unfair to lay the blame of this on the private sector. There are obviously problems with a bidding process that relies on incomplete information and the selection of an operator on the basis of the lowest price alone. These problems have been recognised for many years, yet persist. Many of these problems can, and in the case of Manila, could have been overcome. The main lesson however must be that the private sector should not be expected to take responsibility for risks that it has no means to manage. Almost important is the necessity for the public sector client to maintain an equitable and constructive attitude to problem solving.

V. Context and the Contract

In the early 1990s, the Philippines suffered its worst power crisis. For nearly three years, power blackouts were to hit Manila and its industrial areas, sometimes for as long as eight hours a day. The effect on production was tremendous, and contributed to a significant shrinking of the economy. When a new president, Fidel Ramos, took office in 1992, he vigorously pursued with vigour a policy response to the crisis – the privatisation of the power sector. In a few months' time, the power crisis was substantially resolved.

The quick response of private investors to the power blackouts convinced Ramos of the efficacy of private sector involvement even in areas once thought to be the exclusive domain of provision by the public sector¹. This rapid end to the power outages led the Ramos administration to make a deliberate effort to bring the private sector into the urban water sector of the country as well. And first to be selected for privatisation was one of the government's biggest headaches – the hugely-indebted and grossly inefficient Metropolitan Water and Sewerage Services (MWSS), a utility started in 1878 that by the 1990s had expanded to serve nearly 12 million residential, commercial and industrial customers.

Ramos played his cards well in organising this move. His first step was to get Congress to give him the authority to enter into contracts (with private companies) that would deal with the problems of the MWSS. This authorisation was one of the most important provisions of the Water Crisis Act. The bill was certified as urgent by the President, and passed through Congress with little opposition in 1995, largely because it was presented as a strategic response to the El Niño phenomenon that by then was ravaging agriculture. While Ramos delegated the task of contract-making to his Public Works Secretary, Gregorio Vigilante, who concurrently served as

chair of the MWSS, the President himself took a direct hand in many of the decisions (Dumol, 2000). They took steps to ensure that they got the best advice by hiring consultants from the World Bank's International Finance Corporation (IFC). The details of a contract attractive to private investors and which took into consideration the lessons learned in other water privatisation deals (eg Buenos Aires, England and Wales) were soon crafted. Among other things, this contract sought to achieve the following:

- identification of concessionaire service obligations
- identification of tasks assigned to the MWSS – mainly as parties to the agreement and development of a major water supply source
- setting up of a regulatory office that would monitor compliance with contract obligations and determine rate adjustments based on guidelines set in the contract
- setting up of a dispute resolution mechanism
- identification of rights of creditors
- specification of grounds and procedures for contract amendment and termination
- recommendation of a mechanism for public performance appraisal

The IFC-led team of consultants also played an important role in providing prospective bidders with the assurances and information they needed if they wanted to bid, in collecting data that would be the basis for profit forecasts, in identifying the eligible bids and in identifying the winning bidders.

What emerged was a privatisation and bidding process that was hailed internationally as a significant improvement over previous similar deals. For instance, the government decided to adopt the Paris model, where the service area

¹ However, later problems of overcapacity and extravagantly high and rising prices would lead many to withdraw their effusive praise for the private sector's role in the electricity sector.

was split into two (East and West Zone) and each part was assigned to a separate concessionaire. In theory, this model is a measure intended to break up the monopoly powers that a concessionaire would otherwise have after winning the bid. The regulators can check the performance of one concessionaire against that of the other. It also provides leverage with which to judge petitions for possible price increases². But the most important measure was price. Compared for instance to the experience in Buenos Aires, Metro Manila's privatisation resulted in significantly lower prices. The winning company in Buenos Aires, Aguas Argentinas (partly owned by Suez Lyonnaise) offered to run the concession by charging a price that was 75 per cent of pre-privatisation rates. In Manila, the company that won the East Zone offered to run the concession by charging a price that was only 26.39 per cent of existing rates. Manila Water offered to charge only PHP 2.32 per cubic metre (pcm), as compared to the PHP 8.78 pcm being charged by MWSS. The West Zone was given to the next lowest bidder, Maynilad, which offered to charge only PHP 4.96 pcm, which is around 56.59 per cent of then current prices³.

The MWSS deal was not a full privatisation arrangement, similar to what happened in England and Wales where the government divested itself of ownership of its water utilities, transformed these utilities into corporations, and sold shares of stock to private individuals and companies. The Philippine government retained ownership of MWSS assets. What the Concession Agreement provided was to give the private sector the right to use these assets. It also imposed an obligation on the concessionaire to maintain and expand these assets at the

companies' own expense. At the end of 25 years, everything including all the improvements paid for by the company reverts back to the government. In return for all these, the private companies are given the right to collect a fee from users, which is to be regulated by an MWSS Regulatory Office (MWSS-RO).

In sum, the Concession Agreement was a decision to auction off the rights to operate and expand the water and sewerage network system to the bidder offering the lowest price of water, for a given set of performance parameters. These parameters included the expansion of service coverage, and the maintenance of the assets, both of which require large sunk investments. The Agreement can thus be seen as a procurement contract. The government, saddled by rising debts and inefficiencies, asks a company to run and operate the network and be responsible for getting the investments needed to expand coverage and improve service expansion. The company spends its own money, or uses its credit worthiness to borrow money from the banks, which will be sunk as investments into the network. It is then given the right to *reimburse* these investments and expenses they have made, via the collection of a regulated fee from users.

The implicit reimbursement rules provide incentives for increased efficiency because they take on the character of fixed price contracts or price caps. Since the prices are essentially fixed and could not easily be moved, the only way a profit-maximising company can gain greater profits is to improve efficiency, ie reduce costs, reduce non-revenue water, improve billing and expand the service to get more customers. The contract allows the company to keep the rewards of being efficient.

Mechanisms have been provided in the contract to adjust prices, whether upwards or downwards. There are three grounds on which rates may be adjusted. First is inflation. The regulator automatically allows for increases to the standard rates annually based on changes in the consumer price index. The concessionaires therefore have some protection against inflation – their revenues grow with the pace of inflation. Second is Extraordinary Price Adjustment (EPA),

² It was however up to the ingenuity of regulators to develop the guidelines and find practical use of this arrangement. The first five years did not see the regulatory office taking full advantage of the possibilities that this arrangement held. It became clear that what was applicable to Paris was not necessarily automatically applicable to Manila.

³ It should be noted though that the price reductions would not have been as dramatic when compared with the August 1996 MWSS price of PHP 6.43 pcm. MWSS increased its prices in August 1996 to PHP 8.78 pcm, using the tariff trend since 1990, which is a 38 per cent jump. It may be that the tariff was increased to minimise the shock should water rates increase following privatisation.

adjustments that may be initiated once a year to capture the financial effects of certain unforeseen events applicable to the concessionaire. Hence, should there be a drastic devaluation of the peso (as actually happened) extraordinary price adjustments may be made. The EPA essentially provides protection to the company against a *force majeure*, or unanticipated costs arising from, for instance, new health or environmental standards that may be legislated in the future. This mechanism is well defined by the Concession Agreement. There is a strict set of validation procedures and needs evaluation to be conducted by the MWSS-RO to determine whether an extraordinary event has indeed happened that necessitates price increases. Inflation adjustments and EPAs may also be made quarterly, and are covered by rules in the Agreement.

The third mechanism for price adjustment is rate re-basing. At the start of every five-year period, the Concession Agreement provides for a review of tariffs so that they can be adjusted in case they exceed the definition of "fair returns" stipulated in the contract. The company reaps the higher profits they make as a result of improved efficiency, but these are reviewed at the end of every five years. This gradual readjustment (in this case a lowering of tariffs) at the end of every five-year cycle simply means that consumers also subsequently benefit from the concessionaire's efficiency gains.

The Concession Agreement also had provisions for a performance bond – US\$200 million – put up by each of the concessionaires and accessible by the MWSS. The performance bond serves as a kind of insurance money – in case a concessionaire reneges on its contract obligations, the government can forfeit this bond and use it to finance the unfulfilled contract obligation, like hiring another company to do it.

In general, these mechanisms have established procedures that leave little room for discretion. But there are also certain *soft targets* – decisions that can be made which involve greater discretion by the MWSS-RO or the authorities concerned. For instance, it was initially publicised that prices in real terms cannot exceed the public sector's last price before the

contract was awarded. This is a soft target – the MWSS-RO can allow for an increase in prices beyond the public sector's last price if they see that this is necessitated by extraordinary circumstances. The idea for the Concession Agreement was to make the arrangement as unambiguous as possible, i.e. to reduce the number of soft targets and therefore leave less room for discretion or political interference.

In short, there are plenty of valid bases to say that the Concession Agreement was indeed a success. It was a fair deal that allows all stakeholders – government, the companies, and consumer – to reap benefits, and more importantly, to change the arrangements in an open and negotiated process should unforeseen or extraordinary events happen. There are sufficient guarantees for a fair return for efficiency-maximising companies, and adequate protection against risks that the companies may face. The deal therefore left little room for it to turn into a losing business venture for the concessionaire. Ramos was rightfully happy over the arrangement they had crafted. But as events would later show, the success was theoretical and largely on paper. What happened in practice, particularly the moves taken by the companies, would turn a successful privatisation into what can be justly called a failure.

A Bidder's Bag of Tricks

There is a joke among consultants that disparage some of multinational companies that dominate the world's privatised water and sanitation market. The joke goes that these companies' executives only start to be serious the day after a contract is won. They would then plan to renegotiate the contract or change the rules of the game. As a result, the seemingly envious consultants say, three French companies alone – Vivendi, Ondeo, and Saur – control nearly 75 per cent of the world's privatised market. Their closest rival is Thames Water, formerly British-owned but now controlled by the German multinational RWE, which controls 10 per cent of this market (PSIRU, 2001). Dumol himself recounted how the filing of petitions for temporary restraining orders in courts around the

world was Standard Operating Procedures of companies who lose bids.

Hence, the initial suspicion is that the bids made by the two winning companies for the Manila Water concessions were unsustainable – these were dive bids that were meant to win the tender, not to provide a realistic assessment of how the companies would actually operate the Manila concessions if they won the contracts.

Aggressive dive bidding, or bidding at such a low level that will require the company to operate at a loss, is not irrational behaviour, at least when the bidder expects to be able to renegotiate once the contract is signed. Bidding for a concession is itself costly. The losses incurred at the start of the contract need not be permanent. The gamble will have a greater propensity of eventually paying off if regulatory structures are weak, or if there is a greater role for non-formal political interference to play a role in future decisions. Similarly, the more ambiguous the contract (ie more rather than less soft targets), the greater the incentive there are for dive bidding.

The responsibility for protecting all other stakeholders against dive bidding therefore lies with the crafters of the contract agreement, who must themselves take the political context into account. The Ramos administration took steps to get the best possible advice – by hiring the International Finance Corporation and its consultants. The assumption was that these consultants were in possession of cutting-edge information that enables them to give the best possible economic, financial and technical advice. But as the experience of Manila shows, there is actually no guarantee that the advice and information even from the best of experts is always correct.

A lack of attention to dive bidding on the part of those crafting the contract can result when their priority is to conclude the bidding process, rather than to ensure the contract is viable. In the tender for the Manila water concessions, rejecting the lowest bids would undoubtedly have been controversial (leading to delays), would probably have been unacceptable politically, and might have resulted in the executive losing its congressional authorisation to enter into a

contract. As two University of the Philippines economists, Solon and Pamintuan pointed out, the IFC accepted the bid of Manila Water as feasible, despite the observations of its own consultants that:

- Manila Water's consumer demand projections were 45 per cent higher than the earlier study made by the French consulting firm SOGREAH.
- Manila Water was optimistic that it could reduce by half non-revenue water in five years' time. (This would have meant huge capital investments to repair leaks, and would have meant a general overhaul of the underground pipe system that would result in further traffic problems for already-congested Manila. This also would have meant aggressive prosecution for water theft.)
- Manila Water assumed that it would be able to secure yen-denominated project finance at a very low rate of 2.79 per cent (which did not happen).
- It had a gearing ratio of 87 per cent, ie 87 per cent of its operating capital is borrowed money, which therefore incurs more costs.
- Its capital spending in the first five years was low — at least 25 per cent less than the amount earmarked by the other bidders.
- Its projected internal rate of return was set at 3.6 per cent, whereas the other bidders had 9 to 11 per cent.
- Cash flow was projected to be negative for the first ten years — the company would be operating at a cumulative loss of US\$496 million. (The IFC expressed concern over how MWCI would gain access to debt funding under these terms to finance this negative cash flow.)

In the case of the bid of Maynilad, fewer doubts were raised about its feasibility mainly because it was closer to the bids submitted by the other losing companies. But a short IFC review cited concerns over Maynilad's highly aggressive and

optimistic projections about the reduction of non-revenue water, and the consequent rapid incremental increase in the volume of water that the company assumed it could automatically collect revenues from. The review pointed out that this was no more aggressive than Manila Water's own plan. The IFC and the government did not appear to have any technical studies that would assist them in judging the feasibility of the non-revenue water reduction assumptions in the financial models of the bidders. Cristina David of the Philippine Institute for Development Studies reveals that no studies on water demand projections for Metro Manila existed⁴. The only technical study that could have been used — the one done by SOGREAH — clearly warned about the assumptions of the bidders (David, 2001).

The IFC review may not have been as thorough as it needed to be. Subsequent performance of the two companies showed how far off the mark they were in their non-revenue water reduction targets. Actual billed water volumes and revenues reported by Manila Water from 1997 to 2000 were PHP 586 million (12 per cent) below projections. In the case of Maynilad, it was PHP 2,789 million or 25 per cent below financial model expectations, although the company explain this as being a result of the Asian financial crisis. The concerns in the IFC review showed that the consultants had suspected that the targets for non-revenue water reduction, and therefore revenue generation, were unrealistic. But they did not pursue that suspicion, and instead merely hoped for the best.

Thus, the financial models submitted in the bids made by the companies could be nothing more than a corporate muddle. The figures were unreliable, and the bids were therefore not sound business propositions being offered to the government. More evidence of a muddle has been made clear recently. Staff at the financial regulation division of the MWSS-RO pointed out that the debt assumed by Maynilad (a part of its service obligations in the contract) was PHP 3.9 billion shy of what it was instructed to assume.

⁴ Had these studies been made, they could have warned not only the consultants but, more importantly, the regulatory office to be set up, about the extent to which sales could decline as a result of the jump in tariff levels arising from the amendment to the concession agreements.

Could this have been a mistake, or a deliberate effort to make the company's financial position look better so that it could obtain project financing? Also, if this were detected early on when the bids were being considered, is this not sufficient grounds for rejecting Maynilad's bid altogether?

Maynilad's Story

By the end of December 2000, Maynilad found itself in deep financial distress. Its revenues were down and its costs had risen beyond the expectations found in its financial model. Its lenders would not approve the term loan of US\$350 million that it needed to fulfil its planned capital investments for the first five years of its concession contract (see Alunan 2001). What it was able to assemble were bridge-financing arrangements to keep the company going while it was trying to achieve financial closure on the term loan.

Maynilad blamed its problems on the Asian financial crisis which triggered a fall in the peso's value from PHP26:US\$1 to PHP50:US\$1 by 2000. It announced losses of PHP 2.7 billion in additional and unanticipated foreign exchange costs by the end of the year 2000. The immediate impact of the peso's fall was much greater on Maynilad than Manila Water because the former inherited 90 per cent of the foreign indebtedness of the MWSS. Maynilad had to nearly double its peso payments on the dollar loans it assumed (Alunan 2001)⁵.

This triggered a cycle of problems for the company. Foreign exchange losses led to weak revenues. Weak revenues, in turn, made the company ineligible for the loans it was applying for — it lost credit worthiness as a result. Inability to get the loans, as well as the lack of revenues itself, prevented the company from making capital outlays that it needed to reduce non-revenue water, improve billing and expand its income-generating base. It was stuck in a rut, and the only way to get out of this rut, the

⁵ Project loans that were to be disbursed after the contract signing, however, were destined for the East Zone (Manila Water) and would reduce this percentage share of Maynilad's inherited loans to 80 per cent.

company argued, was to increase the tariff it collected.

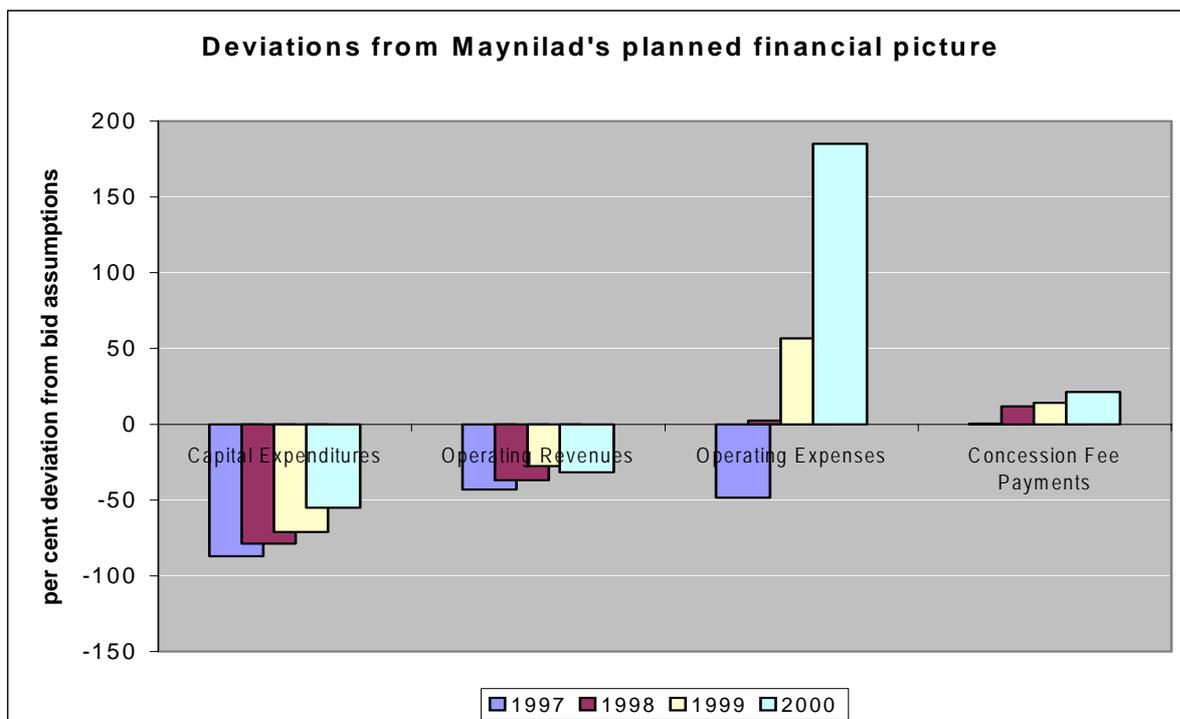
Thus, it is a *force majeure* that is pinpointed as the source of the problem — an event beyond the control of anyone — argued Maynilad. The Asian financial crisis could not have been foreseen, and was therefore uninsurable. On December 2000, it submitted proposals to the government that would:

- Allow for an accelerated recovery of unanticipated foreign exchange costs through an automatic currency exchange rate adjustment (auto-CERA). This cost recovery mechanism allows for water rates to immediately adjust on a monthly basis (up or down) for foreign exchange losses. It is 'automatic' because it does not need evaluation and approval by the MWSS-RO — the costs or gains are automatically passed on to consumers as reflected in monthly bills. Auto-CERA is a new

mechanism not covered by the Concession Agreement.

- Postpone some service obligations. Lenders, including the Asian Development Bank, would not release the US\$350 million Maynilad is applying for unless the MWSS-RO allowed the company to postpone some service obligations as enshrined in the contract. These are water pressure targets and investments in new sewerage networks. Essentially, the lenders were worried that Maynilad would not meet these obligations, risking the event of forfeiting its performance bond, which places the company in an even more uncreditworthy position.
- Alter the volume of water that the company is expected to bill. This means that the company will not be able to meet its targets on billing and non-revenue water reduction, and will consequently have a smaller revenue intake.

Chart 1 – Deviations from Maynilad's planned financial picture



One spectre raised in the event of government not agreeing to these proposals was a potential domino effect on the financial system that an impasse would cause. It was feared that because BHC was highly leveraged and suffering the effects of bad performance of other affiliates, a call on its guarantees on the bridge loans would have acted as the proverbial last straw that would cause BHC to default on its loan obligations. In other words, government could not allow BHC to go under because of its size, which it was claimed would have potentially disastrous effects on the economy. There is no clear indication, however, of exactly how a BHC default would actually rock the financial system. But the raising of this spectre alone would have had a profound effect on the decision-making process.

Maynilad's arguments to support these proposals are convincing, except for one key flaw — Maynilad officials claim that none of the problems are the results of the company's own fault. Everything is blamed on the Asian financial crisis. This study argues the opposite: Maynilad's inability to contain costs and to realise the revenue potentials of viable assets assigned to it is a *cause* and not an *effect* of the problems of creditworthiness and cash flow of the firm. A different diagnosis and explanation is possible. The evidence to support this argument is as follows:

(a) *Maynilad only had its reputation, not its money, at stake*

There is a major difference in the financing model adopted by Maynilad in contrast to Manila Water. This may also account for the difficulty encountered by Maynilad in securing its term loan of US\$350 to finance its investment plans in the first five years. Maynilad used a *limited recourse financing* scheme for its US\$350 million term loan. This means that the collateral on which the loan is secured is the receivables of the project itself, unlike Manila Water, which put the assets of its owners Bechtel and Ayala Corporation at stake.

Other things being equal, the risk premium that creditors would assign to Maynilad would be higher and this raises the financing cost.

Maynilad's creditors would also be far more meticulous than Manila Water's creditors when it came to rights of third parties (eg, creditors) which claims on Maynilad's assets and future income streams, especially in case of bankruptcy or default. Such things added tremendously to the difficulty of achieving financial closure for Maynilad's US\$350 million term loan. In the meantime, it transpired that the limited recourse financing could not be secured, Maynilad had to secure bridge financing backed by the equity of the French and Filipino partners, and simply postpone payments due to its suppliers and subcontractors.

That project finance is inherently more technically demanding than corporate finance does not mean that it is less desirable. But this raises the question of whether Maynilad's sponsors were unwilling to bet on the success of their own project. There is also another consequence arising from this mode of finance. The creditors wanted the MWSS to allow Maynilad to postpone service obligations on water pressure targets and investment in new sewerage networks.

With its own money *not* at stake, it makes it easier for Maynilad to risk bankruptcy, unlike projects where financing is mobilised by putting the corporate balance sheets of the sponsors on the line.

(b) *Maynilad underestimated operating costs*

In the financial model it submitted, Maynilad estimated operating expenses for 1997, 1998 and 1999 to be PHP 4,369 million. Actual operating expenses for this period were PHP 6,259 million, or 43 per cent more. This study has not been able to access sufficient information to fully explain the overestimation of costs. It learned from Maynilad's disclosure in a 28 May 2001 meeting with Public Works and Highways Secretary Simeon Datumanong that the pipe network is actually much more extensive than it thought it was. But there are also claims from disgruntled employees at Maynilad and from an MWSS source that the company had very expensive contracts with the affiliate companies of the French and Filipino corporate

sponsors. This included a management consultancy contract with Lyonnaise des Eaux Philippine (LDEP), and interest bearing advances from BHC as well as from LDEP for bidding and start-up costs. There was also a technical assistance and service agreement with both BHC and LDEP. Maynilad also paid charges for guarantee fees related to loans and standby letters of credit guaranteed by BHC and SLDE. Then, there was an interim programme management deal with Safage Consulting and Montgomery Watson, an affiliate of SLDE. Finally, there was a technical assistance agreement with Lyonnaise des Eaux Services Association (LYSA) for the revenue enhancement programme of reducing the non-revenue water. All of these deals are denominated in foreign currency and thus became inflated as a result of the peso devaluation.

However, there is no easy way of verifying these allegations and of arriving at a judgement of whether these costs may have been imprudent. Ordinarily, the magnitude of operating expenditures need not be a public concern because of the presumption that the company is interested in reducing costs whenever it can. However, there are certain accounting procedures that cleverly pass on some of the costs to the consumers, rather than to the company. For instance, there is an allegation that costs for the deals enumerated in the preceding paragraph were accounted for not as operating costs but as capital expenditures. If these were treated as operating costs, then it would mean a reduction in the company's profits. If accounted for as capital expenditures, however, these costs are passed on to consumers. Hence, Maynilad had no incentive to minimise these costs. Thus, the presumption that companies are cost-minimising has to be applied with care when the procurement relationship is with affiliate companies.

(c) Maynilad overestimated revenues

In its financial model, Maynilad expected revenues totalling PHP 7,255 million for the years 1997 to 1999. Actual revenues were only PHP 4,729 million, which is 33 per cent off target. This serious underestimation was clearly seen in

1997, before the effects of the Asian financial crisis set in. Maynilad expected to collect PHP 1,316 million in 1997; actual collections that year were only PHP 751 million, which was 43 per cent off target.

Maynilad claims that because it did not get the loan it applied for, it had to postpone urgent capital expenditures that had direct negative consequences on its non-revenue water reduction programme and therefore on its revenues. These claims are only partially correct. Addressing physical losses needs a lot of capital expenditure as it means expensive repairs and replacement of pipes and mains (although some leaks do not entail huge costs). But Maynilad itself reported that leaks accounted for only one half of its non-revenue water problems. Water delivered to customers that is not billed due to illegal connections, metering mistakes, tampering, etc make up the other half, and these do not require high capital investments, and deliver high returns. One is led to doubt whether Maynilad had the will to deal at all with these latter problems.

Thus, whether Maynilad's own numbers are reliable or not, one may reasonably expect that even without capital expenditures, palpable reduction in non-revenue water could have been achieved. This in turn would have improved Maynilad's creditworthiness and its ability to raise funds through means other than the US\$350 million term loan.

World Bank data from various countries show that loss of revenue due to physical losses is generally less than losses due to ineffective monitoring by the water concessionaire. It notes that "lack of accountability and managerial incentives to deal with the problem" have been offered as the main factor to explain⁶ why programmes to reduce non-revenue water are largely frustrating experiences. If these observations apply to Maynilad, then its growing rather than decreasing non-revenue water problems can only be interpreted as bad management. At present, for every three cubic metres of water it produces, Maynilad earns from

⁶ Yepes, Guillermo (1995) "Reduction of unaccounted for water : the job can be done!" Working Paper. The World Bank

only one. Yet it has to use up resources for storing, purifying and pumping not just for one cubic metre of water but for three. The same problem can be seen in sewerage; Maynilad is able to bill for only one-half of the volume of sewage that it had originally intended to bill. This situation is clearly unsustainable.

(d) A mechanism is in place to cover foreign exchange losses

Article 9.3.1 of the Concession Agreement assures Maynilad that it will be able to recover additional costs incurred as a result of the devaluation of the peso from the reference rate (P26:US\$1) in December 1996. Thus, strictly speaking, there can be no foreign exchange losses as the Concession Agreement guarantees that Maynilad will be paid for all such losses. The problem for the company however is timing. The agreement states that it is the obligation of the concessionaires to pay unanticipated forex costs on any given year up-front. The concessionaires will then be allowed to collect these with interest and on instalment from consumers over the life of the contract. But Maynilad needed the "losses" recovered immediately to improve its credit rating and qualify for the US\$350 million loan it is applying for. The recovery of the unanticipated foreign exchange "losses" only became an issue because banks would not lend to Maynilad on the basis of the assured but gradual recovery of these costs over the life of the contract. Even Maynilad officials readily acknowledge this. In other words, if creditors saw Maynilad as a viable concern despite the company's own immediate cash problems it should have been possible to "convert" at least some of the future revenue stream on unanticipated foreign exchange loss recovery into cash.

Practitioners in the business community call this conversion "securitisation". Private placements of securities of this type are common in the Philippines, especially with highly liquid insurance companies as holders of the securities. However, it is not all that easy to assign future income streams from consumers to the holders of the security. The legal issues aside (these may be manageable), one financial analyst, Gina Ledesma, says that the difficulty

about securitising revenue from water tariffs is that the company will have to collect the tariffs first (interview). This is one important matter that creditors would have to worry about, especially if the company they are dealing with is Maynilad.

Also, while no one could have anticipated a fall of the peso from P26:US\$1 to P50:US\$1 by end-2000, the concessionaires were expected to anticipate some fall in the exchange rate, from P26:US\$1 in 1996 to P35:US\$1 in 2000. For such a contingency the company would also have been expected to be ready to respond to capital calls by bringing in additional equity⁷ as needed or by tapping credit lines if the peso fell.

The bottom line is, as far as the banks are concerned, Maynilad lacked creditworthiness.

Manila Water's challenge

Manila Water, for its part, opened a separate but related legal battle with the regulatory office on another front. As shown by the diagram below, Manila Water wanted to interpret the Concession Agreement in a manner that allowed it to change a key bid parameter before rate re-basing. This bid parameter is the appropriate discount rate (ADR). The ADR determines the interest rate that consumers must pay for the deferred recovery by the concessionaires of costs that are approved during Extraordinary Price Adjustment petitions.

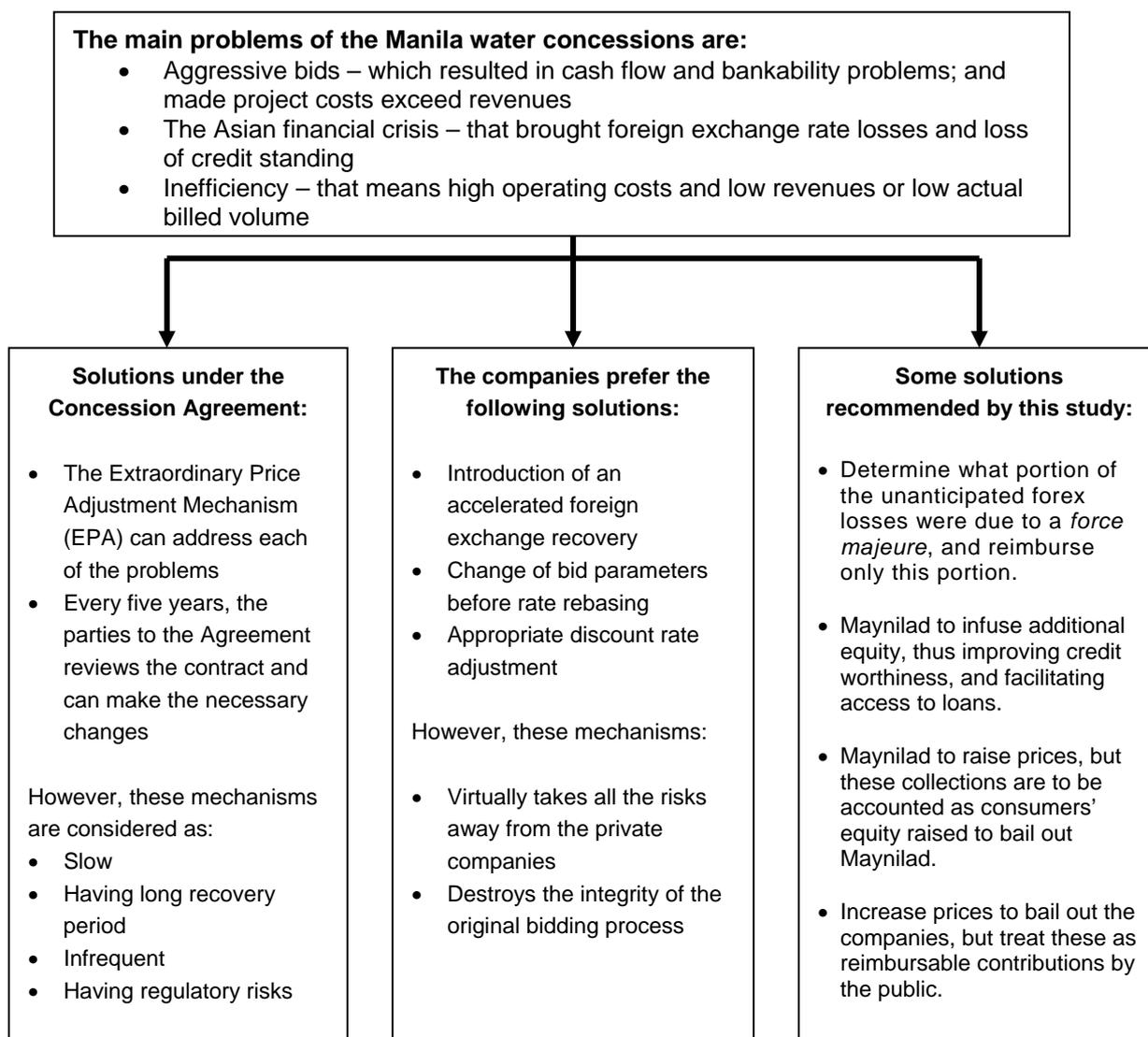
The ADR implicit in the original bid was 5.2 per cent. Manila Water wanted this raised to 18 per cent but the regulators refused. The dispute was brought to the Appeals Panel (a body created under the terms of the Concession Agreement)

⁷ In a meeting with economic planning secretary Dante Canlas, (on 4 October 2001 immediately before he was to give official acknowledgment of the amendment to the concession agreement), he said that it did not seem reasonable to require the private sector to put in more capital than it had originally expected to put in, especially because the cost of capital has risen since the Asian financial crisis, while the returns to capital are regulated and limited under the contract. This is only partly true. The returns to the concessionaires are only partly regulated (see appendix on rate re-basing). Most recently, in a ruling favouring Manila Water the international arbitration panel also allowed for the use of a market-based discount rate in the calculation of annual tariff escalation due to the protracted recovery of unanticipated costs such as those arising from additional foreign exchange costs.

and it led to a grant of a new ADR at 9.3 per cent. The regulators and the MWSS Board responded by sending a *certiorari* petition before the Court of Appeals, arguing that the Appeals

Panel overstepped its powers. The Appeals Panel, the MWSS petition argued, can only judge on whether proper procedures were followed, and not act like it was the Regulatory Office itself.

Figure 1 – The Manila water concession’s problems and its solutions



As the Maynilad issue brewed, Manila Water was granted a provisional implementation of the final awards granted by the Appeals Panel. Things got even better for Manila Water when later on, the MWSS Board acting through the Office of the Government Corporate Counsel, unilaterally withdrew its own petition from the Court of Appeals, without even consulting or even notifying its co-

petitioner, the Regulatory Office⁸. Although there is now a provisional implementation of the Appeals Panel decision, this issue is probably not yet closed because of the procedural irregularities and the inconsistency in the actions of the MWSS Board. The MWSS-RO may yet re-file this petition.

⁸ The MWSS board could not produce a written resolution justifying this move empowering the Office of the Government Corporate Counsel to withdraw the petition.

In greater detail: in the 1998 Extraordinary Price Adjustment process, Manila Water made two specific requests in its petition before the MWSS-RO regarding the way EPA was to be treated over the life of the concession. First, it requested that a discount rate of 18 per cent be used in cash flow calculations. Second, that the cash flow be front-ended over the first four years. Both requests would help relieve the burden of negative cash flows that Manila Water had to face in the first ten years of operation as IFC pointed out during the bid evaluations.

The MWSS-RO ruled that to preserve the competitive spirit of the privatisation process, the discount rate implicit in the financial models submitted during the bidding process were to be used until changes were made during rate re-basing. Furthermore, the discount rate alone determined how cash flows were to be discounted so that the request for a four-year front end was deemed inconsistent with the spirit of the bid⁹ (Solon and Pamintuan 2000).

In the exercise of its discretion as provided in the Concession Agreement, the MWSS-RO chose to use the discount rate implied in the bid. The resolution of the regulatory office says the following: "the regulatory office deemed it appropriate to use 5.2 per cent as the ADR over other claims, which is consistent with its bid price of P2.32 per cubic metre... Any other figure to substitute 5.2 per cent will effect changes (higher or lower) on the petitioner's bid price. This means that the use of any other bid price such as 15 per cent will result in two scenarios 1) a change in the bid price 2) a negative net present value."

Manila Water won with an implied 5.2 per cent ADR, which is one crucial factor for its very low bid price. Others bid using an explicit ADR assumption nearer 10 per cent, which is one reason they lost. If Manila Water's ADR petition (and some other cost escalation appeals it made

less than a year into the Concession Agreement) were granted, this would have effectively made its original bid price at P5.55 pcm. Philwater (which bid P4.99 pcm) and Maynilad (P4.96 pcm) would have been chosen.

In effect, the regulatory office was claiming that, at least for the years before the first rate re-basing, the fair rate of return that would be used in calculating cash flows "has been established by the concessionaires themselves in the process of participating in competitive bidding" (Solon and Pamintuan, 2000). Maynilad won with a rate of return of 10.4 per cent and Manila Water won with a rate of return of 5.2 per cent. By sticking with these rates, the MWSS-RO was using the rate that the concessionaires themselves provided. The assumption here is that the bidders bid at this level and would be getting a fair return on capital. Thus it seems that the MWSS-RO petition to invalidate the decision of the Appeals Panel stands on solid conceptual ground.

There is some evidence from Dumol (2000) that also supports this interpretation. According to Dumol, who was at the centre of the creation of the MWSS concession arrangements: "NERA wanted the ADR to be adjusted retroactively. We (government) felt that the ADR should be fixed until the next rate re-basing date. This was based on the concept that the investments for every period up to the next rate re-basing were entitled to a certain rate of return, owing to the economic situation at that time. It did not seem logical to retroactively adjust the ADR. The Concession Agreement reflects our concept of an ADR that is fixed until the next rate re-basing."

To some extent, however, the debate in the legal petitions has been rendered moot for now by virtue of the contract amendment granting accelerated EPA on foreign exchange loss recovery to Maynilad, which was subsequently applied to Manila Water as well.

The matter that remains extant in the courts is to decide if what arbitrator did was within his powers. The petitioners were asking for a judgement on the correctness of the procedure for calculating the appropriate discount rate; the arbitrator proposed a new appropriate discount rate.

⁹ It should be noted that the petition for a four-year front-ended recovery of EPA instead of recovery during the life of the contract is basically identical to the accelerated EPA petition that required an amendment to the contract. NEDA's Dante Canlas insists, however, that acceleration of cost recovery is consistent with maintaining the discount rate implied in the original bids.

These problems could have been avoided from the very beginning had the Concession Agreement set the rules on the ADR very specifically. Even if there was doubt that the set of rules on the ADR that could have been constructed was the best option, having specific rules could have limited the scope for chiselling or skirting the commitments made in the original bids.

The Mangling of the Concession Agreement

The Maynilad petition of December 2000 and Manila Water's subsequent legal challenge are moves that are to be expected from any profit-maximising company placed in the situation they were in. The more critical point that this study raises is that the response of the relevant public authorities appears to have played into the scheme laid out by the company, whether knowingly or unwittingly. For instance, the authorities involved in the negotiations never entertained the idea that Maynilad may have been incompetent, or that if it were competent, that it did not have the right incentives to place the attainment of contract targets above avoiding financial risk. Equally, these authorities did not entertain the possibility that the current financial difficulties of Maynilad are also the result of faulty bid assumptions. Even if the firm were efficient and even if a sudden devaluation of the peso had never occurred, Maynilad's actual operating costs will still be greater than projected and its revenues below the levels originally assumed. Manila Water for its part sent in a financial model with assumptions that were relatively more realistic. But still, the legal challenge it pursued to change the Concession Agreement before rate re-basing and the provisional implementation of a decision in the company's favour showed how government was not that ready to deal with such a challenge. Overall, the two concessionaires' moves to muddle the arrangements constitute only half of the explanation on why the Concession Agreement was effectively mangled. The response of public institutions and officials — those tasked to uphold the public interest — constitutes the other half.

The December 2000 Maynilad petition was initially swept aside by larger political unrest

taking place. Then President Joseph Estrada, with whom the Lopez family have developed close relations¹⁰, was forced out of office on January 2001 because of corruption and incompetence. The Vice-President, Gloria Macapagal-Arroyo, took over and appointed her own set of officials to the MWSS Board of Trustees, the Department of Finance, and the National Economic Development Authority (NEDA).

As has already been stated earlier, the Concession Agreement *protects* the concessionaires from exactly the problems in unanticipated foreign exchange losses that Maynilad experienced. There was a mechanism in the Concession Agreement for an Extraordinary Price Adjustment (EPA). The proper sequence of the EPA process is for the concessionaires to file a petition before the MWSS-RO for costs incurred during the previous charging year arising from unanticipated exogenous events. The MWSS-RO will then hold a public hearing, verify the legality of the grounds for the price increase petition, and verify that the costs reported for claims are legally valid. The MWSS-RO then calculates the necessary price increase for various consumer categories, using financial model parameters as reference. Then, it draws up a resolution recommending a price increase and presents this to the MWSS Board of Trustees (MWSS-BoT). The Board draws up its own resolution, authorising a price increase consistent with the MWSS charter. The Board transmits this to the concessionaire and to the President.

The Concession Agreement also provides for redress if a concessionaire is not happy with the MWSS-RO and Board resolutions. It may contest the resolutions before an international arbitration panel. Otherwise, the MWSS Board resolution is executory after its publication. Should an international arbitration panel be called in, its decision is final and executory. In the Concession Agreement, the translation of the arbitration panel's decision into a new MWSS-BoT resolution authorising implementation is ministerial.

¹⁰ Beaver Lopez was married to Estrada's daughter, Jackie Ejercito, in 2000.

Going through the mandated EPA process, however, will not suffice to solve Maynilad's cash and creditworthiness problems. Thus, the company sought an alternative, ad hoc, *extra-Agreement* price adjustment mechanism. The concessionaires submitted a proposal to amend the Concession Agreement to permit the *immediate* recovery of specific amounts of foreign exchange losses incurred over three charging years. The MWSS-BoT created a technical working group, headed by Tantiongco. This technical working group recommended to the MWSS-BoT the approval of the proposal. Maynilad and the MWSS-BoT then jointly presented a draft amendment to Finance Secretary Alberto Romulo.

On 8 March 2001, the discussion reached the new cabinet and the President. Macapagal-Arroyo then directed the Department of Finance and the MWSS to meet with the concessionaire to look for ways other than the auto-CERA to recoup Maynilad's reported P2.7 billion losses in foreign exchange.

At this time, it became evident that chief regulator Rex Tantiongco had become an advocate for the Maynilad proposals. Tantiongco is said to have explained that this was his regulatory 'style', supposedly meant to speed up things and make regulatory decision-making less bureaucratic and more decisive. This he said was the style he had used in running the now defunct Energy Regulatory Board.

Tantiongco openly flouted his partiality for ad hoc modifications to price escalation mechanisms that dispense with the procedures carefully defined in the Concession Agreement. It was perhaps his style that emboldened Maynilad to think that the MWSS Board and rest of the regulatory office would accept its proposal for the automatic pass-through mechanism that accelerates the recovery of unanticipated foreign exchange costs. To lend a semblance of public support for the proposal Maynilad also managed to circulate a congressional resolution supporting its petition that was signed by 70 congressional representatives of the Lower House of Congress. Maynilad also sought and was given the public written support from some urban poor communities that happen to have been among

the first beneficiaries of the extension of Maynilad's pipe network. Here they had a credible spokesperson in the person of a Catholic nun and urban poor advocate, Sister Christine Tan.¹¹

Aside from the auto-CERA, members of the Cabinet who earlier received briefings from groups studying the issue noted that there were still other options to help the Lopez-owned water firm recover its financial losses due to foreign exchange changes. "I am sure there will be a solution other than the auto-CERA," said Macapagal-Arroyo, who stressed the need for a solution that would be beneficial and acceptable to the government, consumers and the concessionaires. One option was the tapping of various models of bridge financing such as the Maynilad shareholders themselves, a government guarantee to help secure financing from the ADB-led consortium or a commercial loan from one of the government financial institutions. The President and the Cabinet also discussed the possibility of subjecting the West Zone service concession to a re-bidding process if the MWSS and Maynilad would not be able to come up with any agreement. Maynilad has earlier said it was ready to return its concession to the MWSS if the government would not allow the auto-CERA (Trinidad and Tubeza, March 8, 2001).

The French counterpart of Rafael Alunan in Maynilad, Yves Boris, appears to have been caught unaware by this turn of events. In an April 2001 meeting¹², he said that the delay was unnecessary because there was no way consumers could avoid absorbing the price increases implied by an accelerated recovery of Maynilad's foreign exchange costs. M. Boris defended Tantiongco's outright advocacy at the MWSS Board for Maynilad's proposal, which by then was already causing some controversy at the regulatory office. Two other regulators thought Tantiongco was undermining the

¹¹ Even at the height of the Estrada impeachment trial, Maynilad president Rafael Alunan was doing the rounds in media and public interest groups like the Freedom from Debt Coalition to explain Maynilad petition and to neutralise potential opposition.

¹² Meeting with Yves Boris, Rafael Alunan and other Maynilad officials sometime in April 2001 together with staff and officers of the Freedom from Debt Coalition.

independence and the integrity of the regulatory office by taking on the role of an advocate for rules and rate increase petitions, which the regulatory office would be obliged to interpret and implement. It is the duty of the regulatory office to validate the concessionaire's claims and check the petitions for their conformity to the Concession Agreement.

The MWSS Trustees initially did nothing. The President told them of her desire to find solutions that did not violate the contract and the parameters of the original bidding e.g., that do not improve upon the original bids. This was interpreted as an instruction for the parties to stick to the contract, rather than as a more general requirement to avoid changes that would be unfair to bidders who lost. The auto-CERA option was already discarded at the 7 March cabinet meeting. With this intervention, the amendment route was also closed.

The cabinet cluster on social services¹³ (which includes the Public Works and Highways Secretary who sits ex-officio as chair of the MWSS-BoT) formed its own technical working group to draw up new proposals. When these 'new' proposals were finished, the cabinet cluster approved it, apparently after consulting with Maynilad. The new proposal was to become the basis for a formal Memorandum of Cooperation, and was not very different from the original amendment proposed.

Manila Water, for its part, was the beneficiary of a move in early 2001 by powerful members of the MWSS Board and the, then chief regulator, Rex Tantiogco, to withdraw a case contesting the jurisdiction of the International Appeals Panel when it decided to increase Manila Water's ADR. While the case was filed jointly by the MWSS Board and the MWSS-RO, the withdrawal was made by individuals without the backing of formal consent of either the MWSS Board or the MWSS-RO. Key members of the MWSS-RO were not even informed of the decision to withdraw the case contesting the Appeals

Panel's decision. These irregularities, with their far-reaching consequences, put the integrity of the regulatory institutions to question.

At around this time, an effort, ostensibly by some MWSS-RO staff but cheered on by Mr. Tantiogco and Maynilad officials, to remove the two opposition regulators emerged. This move even found its way into later proposals of Maynilad in the guise of restructuring the regulatory office. The MWSS Board and Maynilad sought a reorganisation of the regulatory office and a change of its members. The idea was that since the MWSS-RO was merely a creation of the contract, the contracting parties could agree to change the regulatory set-up.

The possibility of 'regulatory capture' is quite well known in the Philippines in principle and in practice. In the MWSS set-up, the regulatory office may have been generally competent and upright. Supposedly, its decisions may be reviewed only by the international dispute body. 'Capture' may thus be sought through other means, like changing regulators who were opposed to the granting of the auto-CERA and changing the role that the chief regulator was taking in the deliberations at the MWSS Board. Reflecting on a meta-theory of regulatory practice that is in line with his positive view of the chief regulator's actions, Yves Boris said that in his opinion that the role of the regulator should not just be confined to implementing the Concession Agreement. He believes that the regulator should contribute to a forward-looking assessment of current events that can have important implications on future price increases, or which can affect the ability of the concessionaire to deliver on service obligations. He believes that the MWSS-RO should not initiate action only after damage has taken place and the concessionaires will therefore need to petition for reparation or relief.

The problem for Yves Boris and Rafael Alunan is that the MWSS-RO was split on this issue. Tantiogco thought that it was the role of the regulatory office to propose relief options for the concessionaire. The regulator for finance, on the other hand, tended to see a problem with the regulatory office taking too much of an active role

¹³ The Cabinet is composed of 24 members, and is divided into "clusters" that meet separately to focus on particular thrusts. Aside from the cluster on social services, there is a cluster on security, economic development, etc.

in the formulation of new rules address unanticipated contingencies. She was also convinced that Tantiongco was giving undue advantage to the concessionaires¹⁴. She much preferred that the regulatory office should avoid making an endorsement on rate increases or service obligation postponements that either party to the contract (the MWSS or the concessionaire) might propose. The regulator for finance believed that it was necessary for the chief regulator to desist from direct involvement in the formulation of rules over which the regulatory office would later have to render judgment.

The chief regulator's involvement did not seem to bother members of the MWSS-BoT given that the Board mostly consisted of political appointees. The Board did not have the professional staff with sufficient acumen to consider technical options that can best match the intention of the original concession agreement.

On the other hand, the separateness and independence of the regulatory office is also a matter that cannot be taken too lightly. A strict legal interpretation of what the regulatory office is and is not supposed to do is important in a context where checks and balances need to be strengthened, and where there is no history of legal judgments serving to define what is or is not acceptable conduct. Overstepping prerogatives and the flouting of what may seem like cumbersome procedures may indeed result from a zealous commitment to work as partisans of Tantiongco would claim¹⁵. But too often, this was merely a poor excuse for getting around the fact that there is no institutional consensus on the substance of a policy. A graft case has been filed by a citizens' group against the chief regulator on the grounds that his action against regulatory procedure tended to unduly favour the concessionaires.

Ultimately, Rex Tantiongco was not able to carry the day for the concessionaires. The five-man

regulatory body could not arrive at a majority to overrule the objections of the regulator for tariff and the regulator for legal affairs (Virgilio Ocaya). There are two reasons for this. First, the two regulators insisted that they did not want to be party to "an improvement of the bid" of Maynilad. Second, they also insisted that the integrity of the regulatory office needed to be preserved by ensuring that the decisions of the regulatory office are consistent with its own past decisions¹⁶. Finally, the two regulators cannot really be ignored because within the regulatory office they were the ones invested with the technical expertise to propose legal and technical judgements on the merits of rate proposals affecting rate increases. Established regulatory procedures¹⁷ also required that the proposal pass through their offices. Try as he did, Tantiongco failed in his efforts to marginalize the two regulators.

Because Tantiongco could not get an endorsement for the contract amendment from the entire regulatory office, the amendment path seems to have been considered closed at that juncture. What he and Maynilad did next was to operate in venues outside of the regulatory office. They were quick to lobby in the cabinet cluster committees, technical working groups, even in the media to mimic regulatory procedures, like validating the numbers reported by the concessionaires that justified their appeal for an immediate rate increase of PHP 4.21 per cubic metre of water. These venues were not really created with an explicit intent to shut out the regulatory office. They were created by the President and her cabinet secretaries to study other possible modes of addressing the financial and operational predicament of Maynilad.

In July 2001, a *Memorandum of Cooperation* (MoC) between Maynilad and the MWSS was announced. The MoC is intended as a supplemental document to the Concession

¹⁴ These allegations find some documentary substantiation in a corruption case that has been filed against Tantiongco — *Labajo v Tantiongco*.

¹⁵ Discussions with MWSS regulatory staff on the occasion of the public hearing on the auto-CERA petition on March 20, 2001.

¹⁶ The regulatory office recently rejected an extraordinary price adjustment (EPA) proposal by the Manila Water Services Inc for charging year 1999. This was basically the same as Maynilad's December 2000 auto CERA proposal that would accelerate the recovery of forex costs. This was rejected for being inconsistent with the rate adjustment provisions of the Concession Agreement and for causing an improvement in the bid ADR.

¹⁷ MWSS Regulatory Office Manuals of Operations.

Agreement, and supplants some of the original Concession Agreement's provisions. The MoC in many ways is no different from the original auto-CERA proposed by Maynilad. Both the auto-CERA and the MoC are ad hoc modifications to price escalation mechanisms and procedures that were carefully defined in the Concession Agreement.

But an impasse occurred right after the announcement. First, it was signed by Rafael Alunan, and by the MWSS administrator, without any prior formal MWSS Board authorisation. Then, the Memorandum itself prescribed a particular tariff rate increase, rather than procedures that the regulatory office should use as its guidelines for making the rate increase computations. Members of the cabinet cluster were not ready to trust numbers supplied to them by Maynilad. The cabinet thus insisted that a verification of the computations be made by the MWSS-RO. But the regulator for finance and the regulator for legal affairs maintained that the MoC was not consistent with the Concession Agreement nor with previous rate increase resolutions issued by the MWSS-RO. Using the Concession Agreement as their frame, both regulators issued memoranda disputing the legality of the rate increase and questioning whether they could be implemented.

Ultimately the correct procedure was followed. The Concession Agreement was first amended so that rate increase determinations consistent with the rules could be made. An amendment in the Concession Agreement was negotiated and made on October 2001. It saved the day for Maynilad.

Consequences and Analysis of the Amendments to the Concession Agreement¹⁸

Because the regulators for finance and legal affairs stood their ground, both government and Maynilad were 'forced' to drop the (MoC) and

instead negotiate amendments to the Concession Agreement. Overall, the amendments constitute a victory for the companies. The main amendment is a new mechanism for foreign exchange cost recovery called Foreign Currency Differential Adjustment (FCDA), which completely and immediately passes foreign exchange costs to consumers. Maynilad got what it wanted. A number of consequences are quite clear:

- (a) *The amendment increases the bankability of Maynilad and gave the company an undeserved bailout*

The amendment granted Maynilad (and eventually, Manila Water as well) a rapid foreign exchange cost recovery mechanism. This change improves the immediate cash flow situation of Maynilad and moves it several steps closer to achieving financial closure for the US\$350 million term loan with its creditors. It also paves the way for the capital investments that it failed to make in the first years. Lenders can also anticipate a further boost to Maynilad's financial situation following implementation of rate re-basing in January 2003, based on a framework that drawn up in early 2002, one which they can then use as a reference for the term loan contract.

Financial closure on the US\$350 million term loan, however, is not guaranteed despite the amendment. [Closure can be reached within 2002 only under two circumstances. First, Maynilad's corporate sponsors (Benpres and Ondeo) will have to use their revenues from other business concerns (their balance sheets) as collateral for the term loan. Second, financial closure may be approved if the MWSS relaxes or postpones other performance water pressure commitments and major sewerage investment commitments.]

If the project sponsors do not provide security for the loan using their corporate balance sheets, the creditors are "concerned" that Maynilad's cash flow picture will again become problematic due to the possible drawdown by the MWSS on Maynilad's performance bond in the near future. The creditors are concerned that Maynilad is not about to meet these contract obligations as

¹⁸ The first amendment to the Concession Agreement between Maynilad and the MWSS is largely summarised in a letter addressed to President Gloria Macapagal-Arroyo from two cabinet secretaries who were in charge of negotiating with the concessionaires regarding the amendment (appendix three).

originally scheduled, partly because of time lost due to the delay in achieving financial closure on the term loan. According to Rafael Alunan, Maynilad itself is not keen on making the sewerage investments until legislation is repaired to make connection to the sewer trunks mandatory.

Staff at the Asian Development Bank also point out that even if the government revises the relevant rules, Maynilad itself may not be keen on implementing the sewerage investments on schedule because this will significantly raise household bills¹⁹. With the sudden rise in average tariffs resulting from the amendment, households may resist a mandatory increase sewerage charge. Besides, many of the households have septic tanks and mandatory sewerage connections will render these redundant.

Maynilad appears to have sufficient political clout to get the service obligation postponements. These are after all included — cryptically — in the first amendment to the contract. Within 90 days after signing the amendment the MWSS "will enter into an agreement with Maynilad...on the issues to be addressed regarding the concerns of the lenders of Maynilad" (MWSS, 2001).

On the other hand, the postponement of performance obligations can cease being "creditors' concerns" if Maynilad's corporate sponsors provide some form of acceptable collateral for the term loan. Problems of non-compliance with service obligations can then properly be addressed in some other way, e.g. the drawdown of Maynilad's performance bond or another amendment to the contract with corresponding negative adjustments to the basic tariff to make up for the non-compliance with contract obligations.

(b) The integrity of the original bidding has been undermined

The amendment may be interpreted as an official intervention, with the government declaring

¹⁹ Discussions with ADB Private Sector staff on 19 October 2001

"enough already!" and implying that Maynilad's shareholders have already paid for a possible dive bid through the negative profits that they have had to sustain during most of the first five years of the Concession Agreement. However, the use of actual instead of financial model billed water volumes even before rate re-basing can commence and the possible retroactive application of actual billed volumes to the years 1997 to 2001 means that the integrity of bidding procedure has been sacrificed.

Had the other bidders guessed that the technical parameters that imposed an upper limit on their bids could be falsified and then later treated with forbearance by the government, they too could have made very low but unrealistic bids just to win. The government had the option to do nothing about Maynilad's distress other than providing for an acceleration of foreign exchange loss recovery until the mandatory rate re-basing on the tenth year. But that would have implied sustained losses, perhaps even bankruptcy for Maynilad. It would have also given the government occasion to draw down on the performance bond of Maynilad in order to hire an alternative operator to implement Maynilad's contractual obligations.

(c) The new mechanism for foreign exchange cost recovery (FCDA) reduces efficiency

Under the original contract agreement, Maynilad was required to wait for many years before it could recover or reimburse unanticipated foreign exchange costs. In such a situation, the company would have to reduce its use of industrial inputs requiring the expenditure and borrowing of foreign exchange. Now that the original lengthy waiting period is removed, there is a complete *and immediate* pass through to the consumers of foreign exchange costs. In effect because of the FCDA, Maynilad and the other concessionaire will have no incentives for economising on imported industrial inputs and loans even in a situation where all other private corporations are being forced by the devaluation to increasingly shift to cheaper local inputs. Foreign suppliers of goods and services to Maynilad benefit from the FCDA.

- (d) *The task of hedging against future foreign exchange fluctuations is taken off the shoulders of the private sector but it is not assigned to anyone*

Consumer welfare is normally maximised when there is some degree of hedging or insurance against sudden fluctuations in the Philippine exchange rate vis-à-vis other currencies. One presumes that the original contract assigned some of the risk associated with exchange rate fluctuations to the concessionaires because, unlike most consumers, the corporate sector has access to sophisticated financial instruments that will allow them to insure against and mitigate the risk. This principle has been set aside without much of a thought on the part of policy makers.

- (d) *The regulatory office has been given new powers and assigned new tasks despite the weakness of the regulatory system*

An MWSS Board resolution that became part of the contract amendment restated the rate re-basing process mandating the MWSS-RO to ensure that gains recovered by Maynilad from the FCDA shall finance only concession fees and capital expenditures that have been prudently and efficiently incurred.

This provision can be understood as a recognition by some government officials that the formula-based FCDA mechanism takes away some of the review functions that the regulatory office used to exercise under the original foreign exchange cost recovery mechanism. In the original mechanism, foreign exchange cost recovery petitions were not granted automatically but had to go through the regulatory office's perusal and through public hearings. It appears that it was officials at NEDA who insisted on this new provision to give the MWSS-RO scope for exercising veto over purchases and investment decisions by the private concessionaires by specifying that only expenditures that were "prudently and efficiently incurred" are allowed to be recovered²⁰. Prudence and efficiency,

however, can mean many things to many people. What one may regard as an imprudent and risky venture may be regarded by another as a wise and necessary investment. The concessionaires and the regulatory office may find themselves debating on issues of what technological path is best for the sewerage and water distribution system such as whether to invest in new but expensive sewerage treatment technology or to continue to incur costs in the transport of particularly pollutive sludge from the sewerage system to far away disposal sites. This responsibility of screening specific investment being assigned to the regulatory body as a result of the amendment to the contract was clearly not contemplated when the concession arrangement was chosen. The general presumption was that the concessionaires were to have the leeway in choosing the method for complying with their contractual commitments because the contract had enough incentives to compel them to be prudent in matters of investments. But the amendment blunted these incentives and so there is now a divergence between the demands of prudence and of the concessionaires' self-interest.

²⁰ Discussion with NEDA deputy Director General Perpetuo Lotilla.

VI. Ondeo's specific responses

1. That bidders submitted low prices and tried to negotiate an increase later on, after they were awarded the concession. The bid of Ondeo and its local partner was only a few centavos from the other bidders (Vivendi and Anglian Water). If the economic situation were the same, the financial projections Ondeo made would have held up and prices would be more stable. The bulk of the tariff increase is attributed to foreign exchange losses incurred by the company. The fact is that by the end of 2000, the company's total revenues (PhP 2.7 billion) directly matched its concession fee payments for that period. No company can survive that.
2. That Maynilad only had its reputation, not its money, at stake. Both sponsors have exceeded the contractual PhP 3 Billion equity requirement under the bid. To date, total equity committed is PhP 5.24 billion. Limited recourse financing for the US\$ 350 million term loan is necessary for loans of this magnitude. This cannot be compared to Manila Water's loan which was a mere US\$ 130 million.
3. That Maynilad underestimated operating costs. The figures in the bid are all in 1996 constant prices, when the actual ones are all in current pesos. Therefore, corrections should be introduced for inflation, exchange rates, concession fees, extraordinary price adjustments, before comparisons can be made. Has this been done in the study?
4. That Maynilad overestimated revenues. Revenue collection is poor. The collection rate of Maynilad had become 94%, the same as Manila Water. Moreover, the only way to increase revenues is to reduce non-revenue water, and to reduce it, CAPEX is required. As the company was in a tight "cash squeeze" brought about by the staggering foreign exchange losses, it had no money for such CAPEX. Neither did the term loan materialise because the existing tariff cannot justify the loan repayments. This further exacerbated the problem. Even though we are not proud of the NRW levels, it should be noted that Manila Water is exactly in the same position. Both companies are at the same levels as they were when they began in 1997. In addition, it must be pointed out that regularising illegal connections to increase revenues and decrease non-revenue water requires the support of government in enforcing the Water Crisis Act. Maynilad had no police power to apprehend illegal users nor to enter property without the necessary warrants from the courts.
5. That a mechanism is already in place to cover for forex losses, and need not be changed. The existing mechanism has become inappropriate given the severe devaluation of the peso vis-à-vis the US dollar. The IFC, in a handbook prepared to guide the Regulatory Office, explains that the EPA mechanism to recover forex losses assumes a devaluation of between 2-3% per year. They were even optimistic that the peso was going to strengthen. The mechanism did not anticipate a devaluation of 100 percent. Note that when the concessionaires took over in August 1997, the peso was already at Php 38 to the US dollar! It slid further the following year, settling at Php 53 today. It is true that the recovery would have been total towards the end of the concession contract. No company can survive that long. Besides, doesn't this go against the basic "users pay" principle that have been accepted? Under the EPA process, future generations will bear the burden of the consumption of the present generation.

continued...

6. *That amendment to the Concession Agreement gave the company an undeserved bailout.* The amendment allows for a faster mechanism of recovering foreign exchange losses. The company does NOT profit from this but merely recovers forex losses. This something that is lost in the message -- the project has become economically and financially unviable through no fault of either party. The parties had an obligation to continue the contract within the spirit of that intention and not merely stick to the letter of a contract that has become untenable. The service obligations need to be postponed as a result of the limitation on the tariff. If sewerage targets are to be met, the necessary tariff to allow for the same should be approved and implemented. The government opted for a revision in the service targets (lower targets) in exchange for a lower tariff.
7. *That the integrity of the original bid has been undermined.* On the contrary, the parties showed their commitment to the spirit and intent of the contract and not merely to the letter thereof. This is precisely why amendments are allowed under the contract as it is not possible to capture everything during a 25-year period under one contract.
8. *That the new mechanism for forex loss recovery reduces efficiency.* We point out again that what is being recovered are losses. The company does not profit. The fact that the company is compensated for the forex loss does not do anything (good or bad) for its efficiency. The burden of the forex loss cannot be made the responsibility of the private sector as it is powerless to influence it. The burden should rightly belong to the party that is best equipped to manage and deal with it – in this case, the government. It should be emphasised that the forex losses incurred here are from loans to the government (over US\$800 million) prior to the contract, something that the private sector had absolutely no control over.
9. *That the task of hedging future forex is not assigned to anyone.* In effect, it is assigned to the consumer, who in the long run, should pay for what it consumes under the principle of ‘users pay.’ Forex losses are a necessary consequence especially in this case where all the borrowings are in foreign currency. The basic assumption of the contract in the way the IFC designed it (which bidders were not allowed to question) on the issue of forex loss recovery was very optimistic and not realistic. This, coupled with the division of the debt service into a 90/10 percent split between Maynilad and Manila Water, was a sure recipe for disaster.

Note: All the responses from Ondeo presented in this paper came via a correspondence between Jack Moss, Senior Water Adviser of the company, and WaterAid. Ondeo provided comments as well on the Synthesis Report (New Rules, New Roles: Does PSP Benefit the Poor?) and on the Buenos Aires case study (Everyday Water Struggles in Buenos Aires). WaterAid and Tearfund are grateful for Ondeo’s detailed engagement with the results of this research.

VII. Conclusions and Recommendations

Until today, the two companies, the MWSS and donors such as the Asian Development Bank and the World Bank maintain that the 'Manila Experience' is a model of private sector participation that ought to be emulated. PSP, they argue, is desirable because of the infeasibility of public utility reforms. The PSP option chosen — a concession agreement — is the mechanism to improve the service. The bidding process was a success, along with the allocation of risks. The impact on the poor has been positive, especially with greater access to connections, and the reduction in the base rates. And so on. This study has called for a reality check. While PSP may indeed bring efficiencies, and while the initial processes may have been a success, a corporate muddle took place that for all intents and purposes makes the Manila experience a failure. An otherwise desirable policy tool for achieving efficiency has been turned into a tool for advancing and preserving primarily private, not public, interest.

This study has attempted to show that the bidding process is not rocket science. Mostly, in hindsight, a number of further important measures to ensure adequate safeguards are needed. These are some of the lessons that can be extracted from this study, and may be relevant to other concessions:

- It is necessary to be rigorous in doing the homework. For instance, water demand projections are useful in eliminating bids that have overly optimistic projections of sales. It can also warn regulators about the extent to which sales could decline as a result of a jump in tariff levels.
- Rate re-basing on set timeframes is the principal mechanism to instal discipline in the companies. But the threat of delayed rate re-basing may not always be deemed to be credible by bidders²¹, especially in a

situation like the Philippines where the state has historically been permeable to private interests. It is therefore crucial not to mess around with these central mechanisms. The regulatory office should be under no obligation — whether real or imagined — to bail out companies if they suffer the financial consequences of unsustainable bids they have *intentionally* made.

- Regulatory arrangements applicable in one country will not automatically be applicable in another. If the threat of delaying rate re-basing was successful in forestalling dive bids in France, it does not mean that the mechanism will work similarly in the Philippines.
- It makes a lot of sense for concession agreements to insist that the corporate sponsors should put their own corporate balance sheets on the line, at least during the first couple of years. That is, if companies are going to borrow loans for the investments that their contracts require, they should put their own equity as collateral, and not immediately resort to limited recourse financing. As the regulatory set-up improves, higher investments from sponsors can be reduced.
- It is important for the government itself to clarify right at the very beginning that it will not tolerate dive bidding, and should inform the prospective bidders about some of the key assumptions that they must make. Meticulous safeguards that force the bidders to use reasonable assumptions may be the more effective means of preventing adventurous bids from being made in the

lowering of rates for one concessionaire and increasing the rates for the other — i.e., an early rate re-basing would have been less desirable for the first of these concessionaires. The decision to implement an early rate re-basing was bound to have good consequences for one and bad consequences for the other. Even if both concessionaires would benefit from an early rate re-basing there appears to be no clear principle or guideline that members of the regulatory office could use as a reference for decisions that they would have been asked to render.

²¹ At the time of contract commencement it was not clear what circumstances the regulatory office might have used in justifying a decision to reject an appeal by one of the concessionaires to implement a rate re-basing on the fifth year. The IFC believed that rate re-basing (on the tenth year) was going to result in the

first place. There may be no easy way to cure a problem when it already exists. Regulators and other public officials may choose to exercise forbearance if they believe that there is a real danger that service delivery could be jeopardised by the financial difficulties, whatever the nature, of a concessionaire.

It might also be useful to look at Solon and Pamintuan's proposal to use a different bidding procedure — the so-called second-price auctions or what public sector economics textbooks refer to as William Vickrey's truth serum (see for example, pp. 501 of Dixit and Skeath). Second-price auctions mean that bidders will be asked to make their lowest bid for a starter basic water price per cubic metre that, given price escalation provisions, will be sufficient to cover all the financial requirements including profits and return to lenders during the life of the concession. The company that makes the lowest bid still wins. However, the key difference is that it will be allowed to operate at the price quoted by the second lowest bidder. Vickrey, who won the Nobel prize for his work on auctions and truth-revealing procedures, showed that with these rules every bidder will bid truthfully because it gives them profit for doing so and they get no additional potential profit for making aggressive bids²².

The Manila bidding process looked neat and proper on the surface, but was essentially flawed. Dive bids were made, not sound business propositions to run the water utility. As a result, problems soon emerged. The Philippine authorities, including NEDA's Jose Perpetuo Lotilla, Director General Dante Canlas and Department of Finance representative Joji Cruz, were essentially given a *fait accompli* to bail out Maynilad. Asked why they did not choose the option of letting the companies suffer the consequences of the faulty assumptions they had intentionally made, these officials claimed

that the government was not willing to risk the bankruptcy of the company, which can have potentially more debilitating effects. They also argued on technical grounds, that they did not know how to disentangle the revenue effects of inefficiency and a possible dive bid from the second-round revenue effects of Maynilad's failure to secure its term loan and to finance its planned investments.

The Department of Finance appeared as a main source of pressure to provide some degree of relief for Maynilad. This would be explained by the fact that by July 2001, Maynilad defaulted on the payment of the US\$800 million loans it inherited from the MWSS as part of its contract. Because these loans were originally contracted by the Philippine government and carried sovereign guarantees, it was the Department of Finance that was under pressure to look for sources of funds to service these loans. The fiscal difficulties of the government means that a longer period of non-payment of concession fees (roughly P2 billion a year) by Maynilad is something that the government cannot afford. This was also highly vexing for the Department of Finance which at that time was trying to impress the international financial community to show that the newly installed government of Gloria Macapagal-Arroyo "had what it takes" to impose discipline and bring the country's gigantic fiscal deficit under control. The Department of Finance was also concerned that investors in public utilities would continue to see the Philippines as an accommodating host. In that sense, the Metro Manila water concessions had a highly symbolic function because the MWSS privatisation was the biggest water sector privatisation of its kind in the world and an impasse would have sent a wrongly timed message to the world²³.

NEDA Director General Dante Canlas, who gave the official acknowledgement of the contract amendment forged between the MWSS and Maynilad, explained why he supported that amendment²⁴. He was obviously aware of the

²² The IFC consultants also proposed bidding procedures that differed from awarding the concession to the lowest bidder and at the price in its bid. Dumol (2000), explains that these recommendations were not followed because they seemed very complicated and the public will not intuitively understand the value of such procedures and might therefore be easily swayed by those who would argue that the bidding was less than transparent.

²³ The Department of Finance was also at the forefront of trying to entice foreign investors in the privatisation of the National Power Corporation. It should be recalled that the Omnibus Power Bill was the first legislation signed into law by President Arroyo.

²⁴ Interview after 1 October, 2001

valid objections to the amendment but claimed that the objections brought forward have all been taken into consideration and that a judgment call had to be made. The considerations that seemed paramount to them were the following:

1. Benpres (the Maynilad in the Philippines) was said to have been willing to step aside if the French could find a suitable partner — but no suitable group came forward. There was no viable alternative operator and the government did not want to risk service stoppage.
2. Maynilad, mainly because of the financial strength of the French company, is still capable of bringing in investments from foreign capital markets (US\$80 million). In contrast, companies like Aboitiz and Metro-Pacific would not be able to tap foreign capital markets. The Aboitiz group at one point was considering the possibility of becoming a replacement operator. But according to Director Benny Reinoso of NEDA, Aboitiz also required an FCDA.
3. The Ayalas — operators of the East Zone concession expressed interest in replacing Maynilad and were capable of financing the original concession agreement, presumably without the exacting demands of creditors in the limited-recourse financing scheme that Maynilad was trying to close. But the government wanted to maintain the arrangement where quasi-competition could be established between the two concessionaires. It was not clear why the government did not take the Ayalas in as temporary replacement operators until the West Zone concession could be bid out once more. Perhaps one reason is that the Ayalas were not interested in operating the West Zone on a temporary basis only. They were thinking of an arrangement where there would only be one concessionaire (them) for the rest of the life of the concessions.
4. Termination of the contract would have caused the government an outright reimbursement of P8 billion in favor of Maynilad — P3 billion if the Philippine

government were able to legally establish "just cause". If the government determines that it wants to rescind the Concession Agreement altogether and search for a new concessionaire, it will have to compensate the concessionaire to a greater or lesser degree depending on the degree to which the concessionaire admits to faults that government assigns to it. There is an added premium to the compensation for past investment if the concessionaire is able to argue before the Appeals Panel that the non-performance of its obligations is due to *force majeure* or because government has not complied with its end of the bargain. The willingness of a concessionaire to meet the government halfway during disputes will most probably be greater if long legal disputes also have the consequence of immobilising other capital that they have sunk in during the early years of a concession agreement.

5. A non-conciliatory stance would have entailed a drawn out legal battle — the government did not seem ready for that.

Here, another lesson emerges. Because the government was quick to show it was not willing to risk Maynilad's bankruptcy, and because Maynilad itself raised the spectre of a possible domino effect of its default, the government lost a key bargaining leverage. The public authorities went into negotiations with Maynilad within the framework of a bailout. Had Maynilad not ruled out the possibility that the government might stick to the contract and let them suffer the consequences, the company could have been much more open to other proposals from public interest advocacy groups²⁵.

One set of alternative proposals came from the Freedom from Debt Coalition (FDC). It suggested that it was technically possible to determine what portion of the unanticipated

²⁵ Government was advised to take seriously the possibility that Maynilad might choose to walk away from its contract. This would have required the preparation of contingency plans to ensure the continuous operation of the water system until suitable replacement operators could be found. It should be noted that taking Maynilad's threat of giving up its contract was also a way of shoring up the government's bargaining leverage vis-à-vis Maynilad.

foreign exchange costs were a result of *force majeure* or nobody's fault. For instance, the company would have been expected to have risk mitigation plans for a deterioration from P26:US\$1 to P35:US\$1. Hence, the *force*

majeure could be assumed from devaluations above P35:US\$1. There is probably no way of putting this idea into action that will not invite dispute, but it is possible that there may be certain benchmarks that have an intuitive appeal.

A Philippine lesson in risk-mitigation in concession contracts

In those cases where the mode of raising funds is through limited recourse financing, the financial models themselves should contain a description of the risk-mitigation method assumed for a variety of risks and contingencies. An inventory can be drawn up of the risks that the project company can decide to insure against, as opposed to those that it simply chooses to cope with only as and when they occur.

As part of reporting requirements to the regulatory office, the bidders who win the right to become concessionaires would then have to show proof that they were abiding by their own risk-mitigation plans. Bidders will naturally have different appetites for risk. In order to make competitive bids, some bidders will forego insurance contracts or will choose not to set aside cash buffers and liquid assets that can have very high opportunity costs. What the government can do is to require insurance or risk-mitigation for a core set of contingencies and the expense for this should be factored into the bids.

If any or all of the contingencies arise, e.g., a devaluation from P26:US\$1 in 1996 to P35:US\$1 in 2000, the company would be on its own. It could not argue *force majeure* for such contingencies within the range specified by the government. If it chose not to set aside resources for such contingencies it would suffer negative profit that would not be subject to prospective relief when rate re-basing comes. If the consequence is that it would be unable to perform its contractual obligations it would be penalised by the forfeiture of its performance bond. Because this feature was not present in the Philippine concession agreement Maynilad could have claimed that a fall of the peso by an amount much less than that which occurred during the Asian Financial crisis also qualifies as *force majeure*.

Another FDC proposal was for the concessionaires to wait for the rate re-basing exercise that takes effect in 2003 and in the interim, for Maynilad to infuse additional equity. By placing its sponsors' corporate balance sheets on the line to the extent needed, it can improve its creditworthiness and fulfil its contractual obligations. These were the outlines of an extremely workable strategy²⁶. Another possible approach was to allow Maynilad to raise rates over and above what is permitted in the EPA in order to solve its short-term cash difficulties. However, whatever it collects in this rate raising will need to have a different accounting treatment — these collections would have to be entered in the books as equity the consumers raised to bail out Maynilad. They will have to be converted into voting shares held by a trustee of the consumers.

In conjunction with this, it should have been possible to compel Maynilad to raise and risk more equity, either from its French sponsors or the Lopezes. This new equity could be used to reduce the required rate increase and to achieve acceptable debt-to-equity ratios when closure on the term loan is achieved. It could also provide security for lenders, so they need not ask for too many service obligation postponements and other dilutions of the original contract just to reduce the risks associated with lending to a company like Maynilad. If the capital infusion were to come from Ondeo, this will increase its control of the company relative to the Lopezes. This is desirable if one supposes that the French (because of the reputation they have to protect) rather than the Lopezes, have the greater stake and capability in making the project succeed.²⁷

²⁶ The government intermittently sought the opinion of those who held this view, but never asked them to actually go ahead and make constructive contributions and proposals that could frame the negotiations. One must suspect that extra-economic considerations proved extremely persuasive such that in the end, the objections from regulatory experts were set aside.

²⁷ In this set-up consumers potentially acquire the capability to exercise a swing vote when there is disagreement between the Lopezes and the French.

Another consequence of this alternative proposal is that the regulatory process is kept intact and (possibly) strengthened because disclosure regarding finance and operations can be aided by the presence of significant consumer shareholding. Simply put, *Maynilad does not get an undeserved bailout*. It pays for the cash relief it gets by giving up some corporate control and some of the expected dividends and future appreciation of the Maynilad stocks. This proposal assumes that the French are interested in bringing in more capital, e.g., mezzanine finance, but possibly they may not want to. The Lopezes might insist that the extent of their control should not be diluted or they will give up the concession altogether. It is also possible that the lenders (ADB) may not like the idea of significant consumer ownership as this might create complications and uncertainty as to the ability and willingness of the company to demand rate increases.

Still there is an alternative that both the government and Maynilad have ignored. The excess of what will be billed through the EPA for the year 2001 and onwards can be in the form of *reimbursible contributions*. The company goes to consumers and asks for support for a bailout. What consumers provide (payments in excess of rates allowed by the EPA) will be treated as reimbursible contributions — the consumers can claim back these contributions later on when the company's financial position improves. This can be done by including in the bill a coupon that the customer can use to pay for its future bills. This initial coupon can be large or small depending on the cash needs of the company. If the customer chooses not to liquidate the coupon, this earns an interest rate that sinks down or floats upwards, depending on the company's need for cash. If this arrangement is technically feasible, it will have the advantage of forcing the company to compensate willing lenders at going market rates. Customers who have a very high implicit discount rate need not only pay at the schedule implied by the original EPA mechanism. In contrast, the decision by the authorities to allow an acceleration of rate increases takes little cognisance of the ability of households to raise cash required to make Maynilad bankable.

Some people take a naïve assumption that customer ownership by itself immediately creates incentives for better corporate governance. This may be true in the special case of small water systems, but otherwise, there may be no easy technological or corporate governance solution to for example a water system with huge problems such as pilferage. One may need to create rewards to induce the public to report pilferage and call the attention of maintenance crews to burst pipes. The community will only sanction offenders and care for the common property if there are palpable gains for doing this. If the accounting of costs and rewards is done at the level of small intimate communities then this might work. But if the gains from local action to reduce pilferage and waste are spread to all of the residents of Metro Manila and the big shareholders, the incentives for good behaviour are blunted. Unless something like village level water committees are made residual claimants, turning consumers into shareholders may achieve some equity objectives but not necessarily the objective of improving the efficiency of the water system.

If there is significant enough representation of consumers within the board of the private concessionaire one would expect that there will be ways of addressing problems arising from transactions with connected businesses. There are two possible mechanisms through which the presence of a third party would increase consumer welfare and reduce malfeasance. The first is when a small group of shareholders can act to swing the board decisions towards one or the other sponsor, depending on which one is perceived to preserve shareholder value. The other is when a third party is present in the audit committee to volunteer information to the regulator on connected transactions, when what is being maximised is not the profit of the firm but the profit of a bigger corporate grouping.

In all, the Manila experience on PSP is not at all the success story that its supporters claim it to be. Much is situ to be desired. What would appear to have happened is that two companies are getting away with profits successfully made through a corporate muddle, with government, public authorities, donors and lenders allowing it to happen.

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Meetings and Interviews

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Canlas, Dante and Lotilla, Perpetuo

Cruz, Joji

Datumanong, Simeon

Appendix A – Rate Re-basing

There are three ways through which the concessionaire may get rate adjustments: an adjustment based on the consumer price index, CPI, an adjustment to reflect specific changes to the circumstances under which concessionaires operate and there is a detailed list of grounds for such extraordinary price adjustment (EPA) petitions. The third mode of adjustment – rate re-basing – is discussed below:

The financial performance of the concessionaire will be subject to a wide range of other influences such as:

- higher or lower demand growth;
- higher or lower operating efficiencies;
- the benefits of lower costs arising from technological improvements; and/or
- higher or lower increases in input prices than the general consumer price index.

However detailed and skilful the concessionaires have been in their original forecasts, the one thing that is guaranteed is that their forecasts will be wrong, one way or the other. Without a mechanism for making general adjustments to the level of rates, there would be every likelihood of cumulatively declining financial performance, leading to bankruptcy, or cumulatively spectacular financial performance, which could threaten the foundations of the concession arrangement from a political perspective.

It is possible to design rate-fixing provisions that ensure that the impact of all factors directly feed into rates. However, this would remove the incentive on the concessionaires to achieve efficiency and other improvements. The re-basing provisions are designed to achieve a balance between:

- the need to build a "correction mechanism" into the path of future rates; and
- the importance of ensuring that concessionaires retain strong incentives to operate as efficiently as possible.

This is achieved by passing on the effects of good/bad fortune and cost reduction efforts through to customers, but building in a significant lag.

The re-basing provisions require the regulatory office to reset the level of rates every five years, although they are free to delay the first review until the tenth year if they so wish.

The purpose of this was to discourage bidders from setting the initial level of rates deliberately below the level at which the concession could be financed, in the expectation that the regulatory office would make a compensating upward adjustment at the first re-basing date.

In order to maintain incentives, where a re-basing adjustment has to be downwards, section 9.4 requires this adjustment to be phased over five years. In this way any downward adjustment due to the cost reduction efforts of the concessionaire is only implemented with a lag, in order to ensure that concessionaires keep some of the fruits of their efforts for a longer period, and thus have strong incentives to make those efforts in the first place.

Any upward adjustment, however, is likely to be due in part to bad fortune (e.g., an unexpected drop in demand), and is implemented immediately in order to provide comfort to concessionaires and their creditors.

Based on NERA (1997)

Appendix B – Audited Accounts versus Financial Model Projections of Maynilad and Manila Water (1997 to 1999)

	Financial Model (million pesos)	Audited Financial Statement (million pesos)
Cash position		
<i>Manila Water Co., Inc. (MWCI)</i>		
1997	46	386
1998	41	404
1999	42	696
Total	129	1486
<i>Maynilad Water Services Inc. (MWSI)</i>		
1997	263	578
1998	263	51
1999	263	418
Total	789	1047
Operating Revenues		
<i>Manila Water Co., Inc. (MWCI)</i>		
1997	636	421
1998	1120	990
1999	1423	1310
Total	3179	2721
<i>Maynilad Water Services, Inc. (MWSI)</i>		
1997	1316	751
1998	2651	1662
1999	3288	2379
Total	7255	4792
NRW%		
<i>Manila Water Co., Inc. (MWCI)</i>		
1997	44	45.2
1998	31	38.8
1999	22	39.8
Total	97	123.8
<i>Maynilad Water Services, Inc. (MWSI)</i>		
1997	57.4	63.3
1998	47.9	60.5
1999	42.0	67.0
Total	147.3	190.8

	Financial Model (million pesos)	Audited Financial Statement (million pesos)
Operating Expenses		
<i>Manila Water Co., Inc. (MWCI)</i>		
1997	738	459
1998	998	1057
1999	1029	1209
Total	2765	2725
<i>Maynilad Water Services, Inc. (MWSI)</i>		
1997	1202	959
1998	1612	2222
1999	1555	3078
Total	4369	6259
Concession Fee Payments		
<i>Manila Water Co. Inc. (MWCI)</i>		
1997	287	97
1998	400	360
1999	361	591
Total	1048	1048
<i>Maynilad Water Services, Inc. (MWSI)</i>		
1997	862	866
1998	1941	2265
1999	1670	1978
Total	4437	5109
Capital Expenditure²⁸		
<i>Manila Water Co., Inc. (MWCI)</i>		
1997	494	253
1998	590	820
1999	606	1098
Total	1690	2171
<i>Maynilad Water Services, Inc. (MWSI)²⁹</i>		
1997	1344	176
1998	3313	701
1999	5194	1504
Total	9851	2381

²⁸ If these required tradable purchases, then it should be noted that capital expenditures in real terms may only be half of what was actually needed. An accounting that is in dollar terms would have been more useful. One finds an example of this in the narrative of Raffy Alunan.

²⁹ These figures show that Maynilad was really unable to finance its capital expenditures, despite the bridge finance that was guaranteed by the private sector. Later on NEDA Director General Dante Canlas says that it is very difficult to disentangle the consequences of this non-spending from capital expenditures from the inability to reduce NRW that is due to incompetence. The source of cash flow difficulties is also multiple and, again, creditworthiness is affected by many things including inefficiency, dive bidding, and the failure to implement capital expenditures. According to Dante Canlas and the Department of Finance representative on the MWSS Board, Joji Cruz, it is very difficult to say that such and such portion of the decline in expected revenue or rise in operating expenditure was due to inefficiency while the other part was due to low capital expenditure. The undeniable fact however, is that amendment one to the Concession Agreement assumes all of these things were the result of *force majeure* – nothing was a result of inefficiency. Orville Solon's formula of conditional recovery was better.

Appendix C – Text of the Memorandum of Simeon Datumanong and Dante Canlas to the President before the finalization of amendment number one to the concession agreement with Maynilad.

MEMORANDUM

F O R : Her Excellency President Gloria Macapagal-Arroyo

F R O M : Secretary of Public Works and Highways and Chair, MWSS Board of Trustees
Secretary of Socio Economic Planning

S U B J E C T : MAYNILAD'S RECOVERY OF FOREIGN EXCHANGE LOSSES

D A T E : 26 SEPTEMBER 2001

With reference to the subject, following are the agreements reached to date:

1. Maynilad will be allowed recovery of past forex losses up to December 2000 through an increase in tariff of P4.21 per cubic meter beginning 15 October 2001 until December 2001, prior to the rate rebasing in year 2003.

Forex losses for year 2001 and any unrecovered past forex losses shall be recovered through a special transitory mechanism, which will take effect beginning July 2002 and until the expiration of the concession period shall be through a foreign currency differential adjustment (FCDA).
2. Maynilad shall resume payment of maturing concession fees, at least MWSS' current operating budget, beginning January 2002 and all past due and not paid maturing concession fees, upon the financial closure of its term loan but not later than June 2002.
3. Maynilad shall withdraw its case filed against MWSS and in turn, MWSS shall suspend calling on the performance bond posted by Maynilad.
4. Formulation of the framework for rate rebasing shall commence soonest and shall be implemented in year 2003.
5. Maynilad shall infuse an additional funding support of \$80million from its stockholders.
6. In a letter to secretary Datumanong dated September 25 2001, Maynilad requested clarifications with respect to: 1) de-linking forex loss recovery and the rate rebasing exercise citing that these are two separate issues³⁰ that must be dealt with separately, and (2) the inclusion of a flexibility provision³¹ in case obligations are not met in a timely manner by either or both parties. These requests for clarification have not yet been received by the MWSS Board of Trustees so the latter cannot respond yet.
7. All the agreements and the clarification that will require amendment to the concession Agreement (CA) shall be embodied in an amendment to the CA.

SIMEON DATUMANONG
(signed)

DANTE B. CANLAS
(signed)

³⁰Researcher's note: In the amendment to the concession agreement signed on 31 September, the loans acquired by the concessionaire will be subject to the criteria of "prudence and efficiency" that will be determined by the regulatory office.

³¹ Researcher's note: The amendment featured a provision for the MWSS to address "creditor concerns" within 90 days of the signing of the amendment. The ADB person in charge of the project reports that these have to do with at least the following: a) postponement of sewerage investments beginning year 5 b) postponement of water pressure obligations. Regulatory staff say that creditors were also negotiating to tighten legal provisions creditor rights in case of default by Maynilad.

Appendix D – Change in Tariff levels from 1997 to 2002

Manila Water Company Inc.				
Charging year	Exchange Rate Factor	C Factor (consumer price index)	Resulting Rate Adjustment Limit (RAL)	Average Tariff
Pre-privatisation				P8.78
1997-1998				P2.32
1999	1.83 per cent or P0.04	10.70 per cent or P0.25	12.53 per cent or P0.29	P2.61
2000	0.0 per cent or P.0	5.70 per cent or P0.15	5.70 per cent or P0.15	P2.76
01 Jan – 31 March 2001	2.43 per cent of P0.07	4.30 per cent or P0.12	6.73 per cent or P0.19	P2.95
Provisional Implementation of the Final Award by the Dispute Panel (ADR)			9.28 per cent or P0.27	P3.22
A-EPA – 12 November 2001	31.08 per cent of P1.00	0 per cent P0.00	31.08 per cent or P1.00	P4.22
2002	2.66 per cent or P0.08	6.80 per cent or P0.21	9.46 per cent or P0.29	P4.51 +FCDA
Jan-March 2002 FCDA			49.60 per cent or P2.24	P6.75

Maynilad Water Services Inc.				
Charging year	Exchange Rate Factor	C Factor (consumer price index)	Resulting Rate Adjustment Limit (RAL)	Average Tariff
Pre-Privatization				P8.78
1997-1998				P4.96
1999	6.24 per cent or P0.31	10.70 per cent of P0.53	16.94 per cent or P0.84	P5.80
2000	0 per cent or P0.00	5.70 per cent or P0.33	5.70 per cent or 33 centavos	P6.13
01 Jan – 19 Oct 2001	3.09 per cent of P0.19	4.30 per cent or P0.26 centavos	7.39 per cent or 45 centavos	P6.58
20 Oct 2001	63.98 per cent or P4.21	0 per cent of P0.00	63.98 per cent or P4.21	P10.79
2002	2.37 per cent or P0.16	6.80 per cent or P0.45	9.17 per cent or P0.60	P11.39+F CDA
Jan March FCDA			35.78 per cent or P4.07	P15.46