

The Corporate Muddle of Manila's Water Concessions: **How the world's biggest and most successful privatisation turned into a failure**

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Introduction

When the winning bids were announced on January 6, 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 program that ended a crippling and economically devastating power crisis early in his term, Ramos placed his bet that a similar process would do the same wonders for Metro Manila's growing water crisis. Now, he had plenty of reasons to be happy.

The award of an east- and west-zone water concession to two different foreign-backed companies not only reduced the cost of water to the consumer by an amazing 50 percent and 75 percent (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 crippling burdens 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 the new private operators will consistently strive for efficiency. Even the MWSS unions barely raised a cry. There now emerged 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 the real promise of a more efficient service at significantly lower costs, it also went through smoothly, with almost no opposition, especially in Congress.

Yet, barely just three years later, the deal was seriously floundering. 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 it sustains by the day resulting from a *force majeure* - the July 1997 Asian financial crisis that among others caused the devaluation of the peso. It petitioned the Regulatory Office for a 70 percent 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 rates to be paid for by consumers) before the mandatory rate re-basing process is held. This basically meant changing those 'rules of the game' provided for in the Concession Agreement.

Maynilad's financial woes and Manila Water's legal challenge brings out an intricate and complex debate on the status of the world's biggest privatisation. The bottom line is that

the process that initially appeared as 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 'win-win' solution it has 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, given the weakness of regulation in the country 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 big water and sanitation multinationals in the world. Maynilad was owned by the Lopez family's Benpres Holdings, and partly owned by Suez Lyonnaise des Eaux (now Ondeo). Manila Water was owned primarily by the Ayala family, and backed by Bechtel. 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 realize 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 credit-worthiness 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 for instance 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 that 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.

The Companies' Response To This Case Study (interviews with Mai Flor, Business Development Director of Maynilad Water Services Inc. and Virgilio Rivera of Manila Water last May 2002 in Manila)

Maynilad and Manila Water admit that they made aggressive bids to win the concessions, but assert that these were feasible bids. The main problem, they assert, is that they faced a *force majeure* - a problem not of their own making after they were awarded the contracts in January 1997. The Asian financial crisis of July 1997 sent the peso on a rapid devaluation.

The two companies that the problems in their bids and financial model pointed out by Esguerra (e.g. overestimation of costs, underestimation of revenues) were not of their making. They based those projections on information supplied by the technical consultants -- the International Finance Corporation of the World Bank which has contracted to supervise the bidding process. For instance, Maynilad points out that the information told them there were only about 2000 kilometers of main pipes in the West Zone. When they took over the concession, they discovered there were over 3000 kilometers, which meant more leaks to repair, more infrastructure to maintain, more personnel to hire, and so on. Maynilad also questions the basis of why the west zone concessionaires were made to assume 90% of the debts (US\$800) million of the MWSS. The idea they said was that because the west zone was more built up, much of these loans went into building infrastructure in the zone. Maynilad charges that this was an arbitrary choice, not the product of an informed study made by the consultants. Maynilad went to the IFC to demand an explanation and also for assistance to bail them out of the mess. But they were told that the consultants who did work on the Manila bidding had already left the IFC.

Manila Water had similar problems with the assumptions made on the appropriate discount rate, saying that the company should rightfully enjoy the benefits of their efficiencies.

The two companies showed how they were dealing with the issues of the poor in Manila. They have both adapted flexible approaches by devolving decisions on billing structure, customer expansion to local area managers. For instance, in the slum areas where residents have no legal land tenure, the companies do not use formal registration of real estate and an address as a prerequisite for a household connection. In some areas, they have sub-contracted revenue collection to neighbourhood associations. In other areas, to go over legal problems, they name water meters to the incumbent local officials. This flexible approach has effectively dealt with the problems poor communities have in accessing water services.

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 by as much 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 over in 1992, he 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 sector². 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 put up for privatisation was one of 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 have 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 will 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 Vigilar, 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 get 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 (e.g. Buenos Aires, England and Wales) were soon crafted. Among others, this contract sought to achieve the following:

- a) identification of concessionaire service obligations
- b) identification of tasks assigned to the MWSS -- mainly as parties to the agreement and development of a major water supply source
- c) setting up of a regulatory office that would monitor compliance with contract obligations and determine rate adjustments based on guidelines set in the contract.
- d) setting up of a dispute resolution mechanism
- e) identification of rights of creditors
- f) specification of grounds and procedures for contract amendment and termination
- g) 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

² However, later problems of overcapacity and extravagantly high and rising prices would later on lead many to withdraw their effusive praise for the private sector's role in the electricity sector.

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 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 a concessionaire will have after winning the bid. The regulators can check performance of one concessionaire against that of the other. It also provides leverage with which to judge petitions for possible price increases.³ 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 (largely owned by Suez Lyonnaise) offered to run the concession by charging a price that was 75 percent 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 percent of existing rates. Manila Water offered to charge only PHP 2.32 per cubic meter (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 percent of then current prices.⁴

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

³ 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.

⁴ It should be noted though that the price reductions would not have been as dramatic when compared against 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% jump. It may be that the tariff was increased to 'minimise' the shock should water rates increase following privatization.

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 — reduce costs, reduce non-revenue water, improve billing, 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), adjustments that may be initiated once a year to capture the financial effects of certain unforeseen events to the concessionaire. Hence, should there be a drastic devaluation of the peso (as what 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 to the MWSS. The performance bond serves as some 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 publicized 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 'win-win' arrangement they have 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 multinational companies that dominate the world's privatised water and sanitation market. The joke goes that these companies' executives only start to be serious only on Day 1 after a contract is won. They would sit to lay down plans to renegotiate the contract or on how the rules of the game can be changed, in their favour. As a result, the seemingly envious consultants say, three French companies alone -- Vivendi, Ondeo, and Saur -- control nearly 75 percent 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 percent of this market. (PSIRU, 2001) Dumol himself recounted how the filing of petitions for temporary restraining orders in courts around the world were SOPs (Standard Operating Procedures) of companies who lose the bid.

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 at whatever cost and would have resulted in huge losses for the companies.

Aggressive dive bidding, or bidding at such a dangerously low level that will bring the company to operate at a loss, is not at all an irrational behaviour. That losses are incurred at the start of the contract, after all, need not be permanent. In general, the weaker the regulatory structure, the greater the propensity is for dive bidding. The greater role there is for non-formal political interference to play a role in economic decision-making, the greater the chance that the losses may be recovered, especially if the company is well connected politically. The more ambiguous the contract is (i.e. more rather than less 'soft targets'), the greater the scope for dive bidding. Thus, it is quite naïve to assume that companies will *not* engage in dive bidding. Blaming companies for bidding aggressively is like blaming a liar for telling a lie.

The onus of responsibility therefore in protecting all other stakeholders against dive bidding lies with the crafters of the contract agreement. The Ramos administration took steps to get the best possible advice -- by hiring the International Finance Corporation and its consultants. The assumption is that these consultants are 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, largely on hindsight, such advice giving is not rocket science. The consultants' best advice may still not be good enough.

The key evidence that dive bids were made in the tender for the Manila water concessions was that there were no incentives for the IFC consultants and government officials involved to reject a bid or call the process a failure if they suspected that dive bids were made. Their main implicit role is to conclude the bidding process -- rejecting a bid would have been unacceptable politically, and may potentially result in the executive losing its congressional authorisation to enter into a contract. As two University of the Philippines economists 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 percent higher than the earlier study made by the French consulting firm SOGREAH.
- Manila Water was optimistic that it can 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 results in further traffic problems for already-congested Manila. This also would have meant aggressive prosecution of water theft).
- Manila Water assumed that it would be able to secure yen-denominated project finance at a very low rate of 2.79 percent. (Which did not happen)
- It had a high gearing ratio of 87 percent. ([What is a 'gearing ratio' and what is a realistic gearing ratio?](#))
- Its capital spending in the first five years is low — at least 25 percent less than the amount earmarked by the other bidders.
- Its projected internal rate of return was set at 3.6 percent, whereas the other bidders had 9 to 11 percent.
- Cash flow will be negative in the first ten years — the company will 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 can 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 exist.⁵ The only technical study that could have been used — the one done by SOGREAH — clearly warned about the assumptions of the bidders.

The IFC review may not have been as thorough as it needed to be. Subsequent performance of the two companies showed how way 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 below projections, or 12 percent below expectations. In the case of Maynilad, it was PHP 2,789 million or 25 percent below

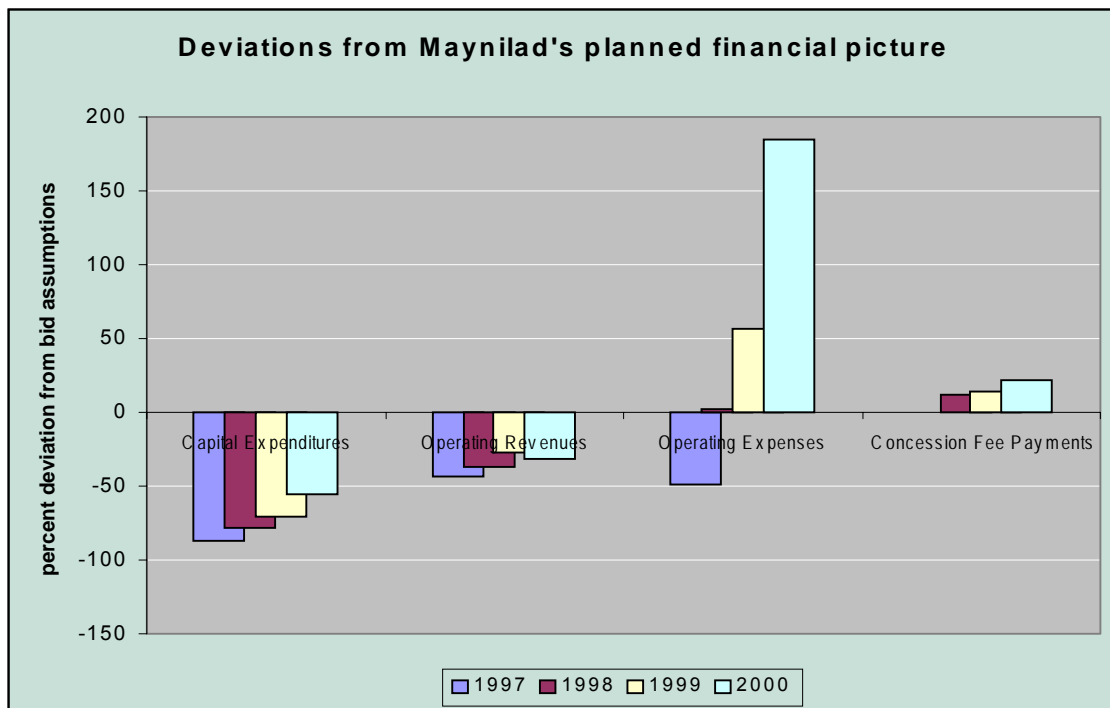
⁵ Had these studies been made, it could have warned not only the consultants but, more importantly, the regulatory office to be set up about the extent to which sales could decline as a result of the jump in tariff levels arising from the amendment to the concession agreements.

financial model expectations, although the company explains this as 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 hunch, and instead merely crossed their fingers.

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 therefore were 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 pesos shy of what it was instructed to assume. Could this have been a mistake, or a deliberate effort to make the company's financial position look better so it can avail of project financing? Also, if this were detected early on when the bids were being considered, is this not sufficient ground 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 have risen beyond the expectations found in its financial model. Its lenders would not approve a term loan of \$350 million that it needed to fulfill 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 P26:\$1 to P50:\$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 percent of the foreign indebtedness of the MWSS. Maynilad had to nearly double its peso payments on the dollar loans it assumed. (Alunan 2001).⁶

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 company argued, is 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 USD 350 million Maynilad is applying for unless the MWSS-RO allows 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 will not meet these obligations, risking the event of forfeiting its performance bond, which places the company in an even more *un-credit* worthy 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.

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 Benpres Holdings (the Lopez company that is the majority owner of Maynilad) was highly leveraged and was bleeding due to bad performance of other affiliates, a call on the guarantees on the bridge loans it had would have acted as the proverbial last straw that would cause Benpres to default on its loan obligations. In other words, government could not allow Benpres to go under because of its size, which would have potentially disastrous effects on the economy. There is no clear indication though of

⁶ 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 percent.

exactly how a Benpres default will 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 diametrically 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 credit-worthiness and cash flow of the firm. A different diagnosis and explanation is possible. The evidences to support this argument are the following:

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

There is a major difference in the financing mode adopted by Maynilad in contrast to Manila Water. This may also account for the difficulty encountered by Maynilad in securing its term loan of \$350 to finance its investment plans in the first five years. Maynilad used a *limited recourse financing* scheme for its \$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 comes to rights of third parties (e.g., creditors) to 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 \$350 million term loan. In the meantime that the limited recourse financing could not be clinched, Maynilad had to secure bridge financing backed by the equity of the French and Filipino partners, and by simply postponing 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 one other 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 4369 million. Actual operating expenses for this period was PHP 6259 million, or 43 percent more. This study has not been able to access sufficient information to fully explain the overestimation of costs. However, it learned from Maynilad's disclosure in a May 28, 2001 meeting with Public Works and Highways Secretary Simeon Datumanong that the pipe network is actually much longer 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 Benpres Holding Company (BHC) as well as from LDEP for bidding and start-up costs. There also was a technical assistance and service agreement with both BHP and LDEP. Maynilad also paid charges for guarantee fees related to loans and standby letters of credit guaranteed by BHC and Suez Lyonnais des Eaux (SLDE). Then, there was an Interim program 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 program 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 they can. However, there are certain accounting procedures that cleverly passes 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 means 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 would be cost-minimising would have to be used sparingly when the procurement relationship is with affiliate companies. The recent literature on corporate governance, especially in countries like Indonesia and the Philippines, testifies to the widespread practice where related transactions cause some parts of a conglomerate to prosper while others are allowed to go bankrupt.

c) Maynilad overestimated revenues

In its financial model, Maynilad expected revenues totalling PHP 7255 million for the years 1997 to 1999. Actual revenues were only PHP 4729 million, which is 33 percent way off target. This serious underestimation is clearly seen in 1997, way before the effects of the Asian financial crisis set in. Maynilad expected to collect PHP 1316 million in 1997; actual collections that year were only PHP 751 million, which is 43 percent way 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 program and therefore on its revenues. These claims are only partially correct. Addressing physical losses needs a lot of capital expenditures 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 suspect 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 credit worthiness or its ability to raise funds through means other than the \$350 million term loan.

World Bank data from various countries show that loss of revenues 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 explain⁷ why programs 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 meters of water it produces, Maynilad earns from only one. Yet it has to use up resources for storing, purifying and pumping not just for one cubic meter of water but for three. The same problem can be seen in sewerage; Maynilad is able to bill 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 (P26:\$1) reference rate 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 concessionaire to pay unanticipated forex costs on any given year up-front. The concessionaire 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 their credit rating and qualify for the USD 350 million loan they are 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 "securitization". 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 securitizing revenue from water tariffs is that the company will have to collect the tariffs first. 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:\$1 to P50:\$1 by end-2000, the concessionaires were expected to anticipate some fall in the exchange rate, from P26:\$1 in 1996 to P35:\$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 equity⁸ as needed or by tapping credit lines if the peso fell.

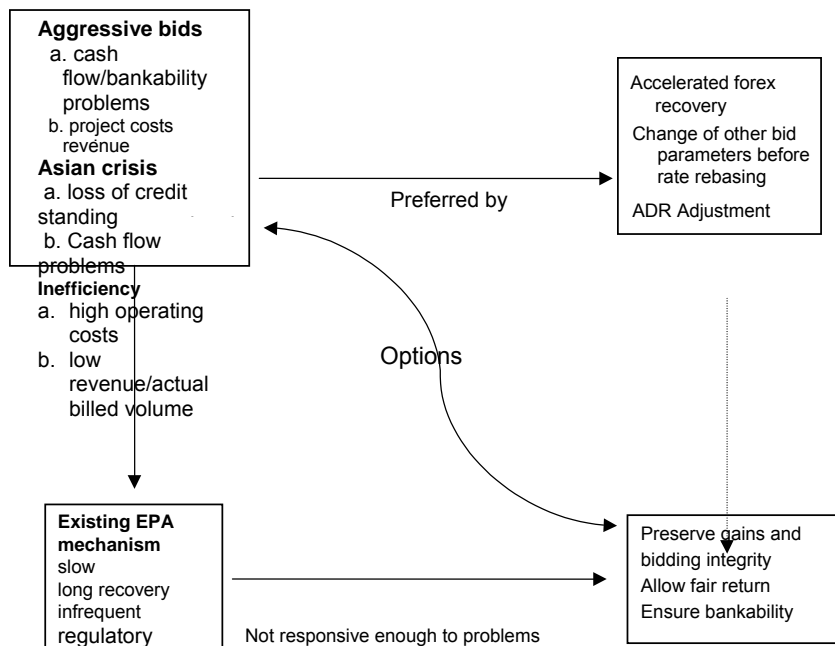
⁷ Yepes, Guillermo (1995) Reduction of unaccounted for water : the job can be done! Working Paper. The World Bank

⁸ In a meeting with the Secretary-General of the NEDA, Mr Dante Canlas (October 4 2001), right before he was to give official acknowledgment to 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 they

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

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. The appropriate discount rate determines the interest rate that consumers must pay for the deferred recovery by the concessionaires of costs that are approved during EPA petitions.



The appropriate discount rate or ADR implicit in the original bid was 5.2 percent. Manila Water wanted this raised to 18 percent but the regulators refused. The dispute was brought to the Appeals Panel (a body created under the terms of the Concession Agreement) and it led to a grant of a new ADR at 9.3 percent. 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. As the Maynilad issue brewed, Manila Water was granted a provisional implementation of the final awards granted by the Appeals Panel.

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 controversial ruling favoring 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.

Things got even better for Manila Water when later on, the MWSS Board acting through the Office of the Government Corporate Counsel⁹, unilaterally withdrew its own petition from the Court of Appeals, without even consulting or even notifying its co-petitioner, the Regulatory Office. 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.

In greater detail: in the 1998 EPA 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 (ADR – appropriate discount rate) of 18 percent be used in cash flow calculations and 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. [\(Please check statements here carefully. How many petitions were made, and to which body?\)](#).

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 bid¹⁰ [\(Solon and Pamintuan 2000\)](#).

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 of Maynilad. The resolution of the regulatory office says the following: “the regulatory office deemed it appropriate to use 5.2 percent as the ADR over other claims, which is consistent with its bid price of P2.32 per cubic meter... Any other figure to substitute 5.2 percent will effect changes (higher or lower) on the petitioners bid price. This means that the use of any other bid price such as 15 percent will result in two scenarios 1) a change in the bid price 2) a negative net present value.”

The MWSS-RO claims that if the ADR were raised to 15 percent (close to Manila Water’s petition) and the bid price was at P2.32 pcm, the project’s net present value is negative P3,638 million. This means that the project costs (operating expenditures, return on capital, etc.) are greater than the revenues generated. For the project revenues to cover project costs the bid price had to be at P2.86 pcm on the second year.

Manila Water won with an implied 5.2 percent ADR, which is one crucial factor for its very low bid price. Others bid using an explicit ADR assumption nearer 10 percent, 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.

⁹ The MWSS board could not produce a resolution justifying this move and empowering the office of the government corporate counsel to withdraw the petition.

¹⁰ One notes 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.

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 “have 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 percent and Manila Water won with a rate of return of 5.2 percent. 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 amendment number one’s granting of the accelerated EPA on the foreign exchange loss recovery to Maynilad, which was subsequently applied to Manila Water as well .

The matter that remains extant in the courts — whether the arbitrator was within his powers to propose an ADR when the East zone was primarily asking for it to render judgment on what the correctness of the procedure of ADR calculation by the RO is only one twig in a tangled branch of problems relating to the ADR. Other issues raised by Dumol on the ADR are even more problematic. ([Again, please try to rephrase this paragraph so it comes across more clearly](#))

These problems could have been avoided had the Concession Agreement from the very beginning 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 well into the scheme laid out by the company, whether knowingly or unwittingly. For instance, never did the authorities involved in the negotiations entertain 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 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, to which the Lopezes have developed close relations¹¹, 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 concessionaire from exactly the problems in unanticipated foreign exchange losses that Maynilad experienced. There was a mechanism in the Agreement for an Extraordinary Price Adjustment (EPA). The proper sequence of the EPA process is for the concessionaire 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 the 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 Agreement, the translation of the arbitration panel decision into a new MWSS BoT resolution authorising implementation is ministerial.

Going through the mandated EPA process, however, will not suffice to solve Maynilad's cash and credit-worthiness 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 March 8, 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 P2.3 billion (or is it P2.7 billion) losses in foreign exchange.

¹¹ Beaver Lopez, a scion of the family, was married to Estrada's daughter, Jackie Ejercito, in 2000.

At this time, it became evident that chief regulator Rex Tantiogco had become an advocate for the Maynilad proposals. Tantiogco 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 used in running the now defunct Energy Regulatory Board.

Tantiogco 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 their 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 their petition that was signed by seventy congressional representatives of the Lower House of Congress. Maynilad also sought and got 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 an urban poor advocate sister Christine Tan.¹²

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 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, the consumers and the concessionaire. 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 is 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 meeting,¹³ 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. Mr. Boris defended Tantiogco'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 Tantiogco was undermining the independence and the integrity of the regulatory office by taking on the role of an advocate for rules and rate increase petitions, which the RO is later on obliged to interpret and implement. It is the duty of the RO to validate the concessionaire's claims and check the petitions for their conformity to the concession agreement.

¹² 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 their petition and to neutralize potential opposition.

¹³ Meeting with Yves Boris, Mr. Rafael Alunan and other Maynilad officials sometime in April 2001 together with staff and officers of the Freedom from Debt Coalition.

The MWSS Trustees initially did nothing. The President told them of her desire to find solutions that do 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 March 7 cabinet meeting. With this intervention, the amendment route was also closed.

The cabinet cluster on social services¹⁴ (which includes the Public Works and Highways Secretary who sits ex-officio as chair of the MWSS Board of Trustees) 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, 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 decision. These irregularities, with the far-reaching consequences that they have, 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 reorganization 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 literature and has many referents in Philippine reality. 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 to 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 consonant with his positive view of the chief regulator's actions, Yves Boris said that he thinks 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 events happening today 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-

¹⁴ 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.

RO should not initiate action only after damage has taken place and the concessionaire will therefore need to petition for reparation or relief.

The problem for Boris and Alunan is that the MWSS-RO was split on this issue. Tantiogco thought that it was the role of the regulatory office to propose modes of relief 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 in the formulation of new rules that address unanticipated contingencies. She is also convinced that Tantiogco was giving undue advantage to the concessionaire¹⁵. She much preferred that the regulatory office avoid making an endorsement on the salience of rate increases or service obligation postponements that either party to the contract (the MWSS and 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 will later have to render judgement on.

The chief regulator's activism did not seem to bother members of the MWSS Board of Trustees. After all, they consisted mostly of political appointees. The Board did not have the professional staff with the acumen for considering technical options that can best abide with the intent 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 a long history of legal judgments serves to define what is and is not acceptable conduct does not exist. Overstepping one's prerogatives and the flouting of what may seem like cumbersome procedures may indeed result from zeal in one's work as partisans of Tantiogco would claim¹⁶. But too often, this was merely a poor excuse for getting around the fact that institutional consensus on the substance of a policy cannot be extracted. A graft case has been filed by a citizens' group against the chief regulator on the grounds that his action that were against regulatory procedure tended to unduly favor the concessionaires.

Ultimately, Rex Tantiogco was not able to carry the day for the concessionaires. The five-man regulatory body could not decide by 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 decisions¹⁷. 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

¹⁵ These allegations find some documentary substantiation in a corruption case that has been filed against Tantiogco — Labajo versus Tantiogco.

¹⁶ Discussion with MWSS regulatory staff on the occasion of the public hearing on the auto-CERA petition on March 20, 2001.

¹⁷ 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.

proposals affecting rate increases. Established regulatory procedures¹⁸ 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 meter 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 Agreement, and supplants some of the original Agreement's provisions. The MoC in many ways is no different from the original automatic currency exchange adjustment (auto-CERA) proposed by Maynilad. Both 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 Alunan, and by the MWSS administrator, without any prior formal MWSS Board authorization. Then, the Memorandum itself prescribed a particular amount of tariff rate increase, rather than procedures that the regulatory office will use as its guidelines for making rate increase computations. Members of the cabinet cluster itself was 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 regulators for finance and for legal affairs maintained that the MoC is not consistent with the Concession Agreement and with previous rate increase resolutions issued by the MWSS-RO. Using the concession agreement as their frame, both regulators issued memoranda disputing the legality and implementability of the rate increase.

Ultimately the correct procedure was followed. The Concession Agreement was first amended so that rate increase determinations consistent with the rules can 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 Agreements¹⁹

¹⁸ Documented as MWSS regulatory office manuals of operations.

¹⁹ The first amendment to the concession agreement between Maynilad and the MWSS is largely summarized 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).

Because the regulators for finance and legal affairs stood their ground, both government and Maynilad were 'forced' to drop the Memorandum of Cooperation and instead negotiate amendments to the Concession Agreements. 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 \$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 when rate re-basing is implemented by January 2003, based on a framework that will be drawn up in early 2002, one which they can then use as a reference for the term loan contract.

Financial closure on the \$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, it 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 draw-down 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 originally scheduled, partly because of time lost due to the delay in achieving financial closure on the term loan. According to Maynilad president 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 further raise the bill that households pay very significantly²⁰. 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 ninety days upon signing of 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).

²⁰ Discussions with ADB Private Sector staff on 19 October 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 draw-down 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 government declaring “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 can 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 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 (the FCDA) reduces efficiency.*

If Maynilad were still in the position where it were required to wait for many years before it can recover or reimburse unanticipated foreign exchange costs, it will reduce its use of industrial inputs that require the expenditure and borrowing of foreign exchange. But with the original lengthy period of waiting now removed, there is a complete *and immediate* pass through to the consumers today of foreign exchange costs. In effect because of the FCDA, Maynilad and the other concessionaire will have no incentives for economizing 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 for the operation of 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 maximized 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 concessionaire 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.

e) 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 the National Economic Development Authority 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 recovered²¹. Prudence and efficiency, however, can mean many things to many people. What one may regard as imprudent and risky venture may be regarded by another as a wise and necessary investment. The concessionaire 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.

Consequently this mechanism mandating the MWSS-RO to examine the concessionaires' capital expenditures may actually be necessary. It may be the only means available for controlling the above-mentioned import-intensiveness and foreign loan intensiveness of future operations and investments of the concessionaires. [\(Can we restate this paragraph, it is confusing?\)](#)

(Question: According to Dumol, the bidding was a two-step process. Bidders submit two bids -- a technical bid and a financial bid. The technical bids are evaluated first, to look at the feasibility of the plans. Only those whose technical bids are approved will get their financial bids to be opened. Does this have a bearing on what you are saying here?) NO. Dumol was describing the competition for the franchise at a time when no regulatory office existed while the discussion here refers to the post-privatisation disciplining of those who won the franchises.

Conclusions and Recommendations

Until today, the two companies, the MWSS and donors like 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. Private sector participation (PSP), they argue, is desirable because of the infeasibility of public utility reforms. The PSP option chosen — a

²¹ Discussion with NEDA deputy Director-General Perpetuo Lotilla.

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 private sector participation 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 bidding process is not rocket science. Mostly on 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:

- 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 time frames is the principal mechanism to install discipline in the companies. But the threat of delayed rate re-basing may not always be deemed to be credible by bidders,²² 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 similarly work 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. As the regulatory set-up improves, higher investments from sponsors can be reduced.
- It is important for government itself to clarify right at the very beginning that they 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 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

²² 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 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 rebasing there appear 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.

delivery could be jeopardized 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). Applying the idea of second-price auctions means that bidders will be asked to make their lowest bid for a beginning basic water price per cubic meter 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 bids.²³

The Manila bidding process looked neat and proper at 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 DoF 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 have intentionally made, these officials claimed that 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 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 put 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

²³ 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.

privatisation of its kind in the world and an impasse would have sent a wrongly timed message to the world.²⁴

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 amendment²⁵. He was obviously aware of the valid objections to the amendment but claimed that the objection brought forward have all been taken into consideration and that a judgement call had to be made. The considerations that seemed paramount to them were the following:

1. Benpres (the Filipino counterpart within Maynilad) 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 (\$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 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 limited-recourse financing scheme that Maynilad was trying to close. But the government wanted to maintain the arrangement where quasi-competition can be established between the two different 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. One reason why this must be so 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 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 contract 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

²⁴ The Department of Finance was also at the forefront of trying to entice foreign investors in the privatization of the National Power Corporation. One must recall that the Omnibus Power Bill was the first legislation signed into law by President Arroyo.

²⁵ Interview after October 1,2001

immobilizing other capital that they have sunk 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, 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 government may 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 groups.²⁶

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 of these risks can be drawn up that the project company can decide to insure, as against those that it simply chose to retain and try to cope with 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 plan. Bidders will naturally have different appetites for risk. In order to make competitive bids, some bidders will forego insurance contracts or will chose 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:\$1 in 1996 to P35:\$1 by 2000, the company was 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 will 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 penalized 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*.

²⁶ 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 can be found. One notes 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.

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 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:\$1 to P35:\$1. Hence, the *force majeure* could be assumed from devaluations above P35:\$1. There is probably no way of operationalizing this idea that will not invite dispute. But it is possible that there may be certain benchmarks that have an intuitive appeal.

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 credit worthiness and fulfill its contractual obligations. These were the outlines of an extremely workable strategy.²⁷

Another possible approach then 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 they collect in this rate raising will need to have a different accounting treatment — these collections will 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 also have been possible to compel Maynilad to raise and risk more equity, either from its French sponsors or the Lopezzes. This new equity can 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 can 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 Lopezzes. This is desirable if one supposes that the French, because of the reputation they have to protect, rather than the Lopezzes, have the greater stake and capability in making the project succeed.²⁸

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 Lopezzes 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.

²⁷ 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.

²⁸ In this set-up consumers potentially acquire the capability to exercise a swing vote when there is disagreement between the Lopezzes and the French.

Still there is another alternative that both 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 later on claim back these contributions 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 some 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 busted 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 behavior 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 water systems.

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 maximized is not the profit of the firm but the profit of a bigger corporate grouping.

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

-end-

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Appendix A: Rate Re-basing

There are three ways through which the concessionaire may get adjustments of rates: the adjustment based on the consumer price index, CPI, the adjustment to reflect specific changes to the circumstances under which the concessionaire operates and there is a detailed list of grounds for such extraordinary price adjustment (EPA) petitions.

The third mode - 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 skillful 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 customers, but with 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		
Manila Water Co., Inc. (MWCI)		
1997	46	386
1998	41	404
1999	42	696
Total	129	1486
Maynilad Water Services Inc. (MWSI)		
1997	263	578
1998	263	51
1999	263	418
Total	789	1047
Operating Revenues		
Manila Water Co., Inc. (MWCI)		
1997	636	421
1998	1120	990
1999	1423	1310
Total	3179	2721
Maynilad Water Services, Inc. (MWSI)		
1997	1316	751
1998	2651	1662
1999	3288	2379
Total	7255	4792
NRW%		
Manila Water Co., Inc. (MWCI)		
1997	44	45.2
1998	31	38.8
1999	22	39.8
Total	97	123.8
Maynilad Water Services, Inc. (MWSI)		
1997	57.4	63.3
1998	47.9	60.5
1999	42.0	67.0
Total	147.3	190.8
Operating Expenses		
Manila Water Co., Inc. (MWCI)		
1997	738	459
1998	998	1057
1999	1029	1209
Total	2765	2725

Maynilad Water Services, Inc. (MWSI)		
1997	1202	959
1998	1612	2222
1999	1555	3078
Total	4369	6259
Concession Fee Payments		
Manila Water Co. Inc. (MWCI)		
1997	287	97
1998	400	360
1999	361	591
Total	1048	1048
Maynilad Water Services, Inc. (MWSI)		
1997	862	866
1998	1941	2265
1999	1670	1978
Total	4437	5109
Capital Expenditure²⁹		
Manila Water Co., Inc. (MWCI)		
1997	494	253
1998	590	820
1999	606	1098
Total	1690	2171
Maynilad Water Services, Inc. (MWSI)³⁰		
1997	1344	176
1998	3313	701
1999	5194	1504
Total	9851	2381

²⁹ If these required tradable purchases, then one notes 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.

³⁰ 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 Secretary 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 are also multiple and, again, credit worthiness 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 in the MWSS board, Ms. Joji Cruz, it is very difficult to say that such and such portion of the decline in expected revenues or rise in operating expenditures was due to inefficiency while the other part was due to low capital expenditures. The undeniable fact however, is that amendment one to the concession 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.>

M E M O R A N D U M

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**

SUBJECT : 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 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 issues³¹ that must be dealt with separately, and (2) the inclusion of a flexibility provision³² 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)

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

³²Researcher'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: i) postponement of sewerage investments beginning year 5 ii) 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 percent or P0.04	10.70 percent or P0.25	12.53 percent or P0.29	P2.61
2000	0.0 percent or P.0	5.70 percent or P0.15	5.70 percent or P0.15	P2.76
01 Jan - 31 March 2001	2.43 percent of P0.07	4.30 percent or P0.12	6.73 percent or P0.19	P2.95
Provisional Implementation of the Final Award by the Dispute Panel (ADR)			9.28 percent or P0.27	P3.22
A-EPA - 12 November 2001	31.08 percent of P1.00	0 percent P0.00	31.08 percent or P1.00	P4.22
2002	2.66 percent or P0.08	6.80 percent or P0.21	9.46 percent or P0.29	P4.51 +FCDA
Jan-March 2002 FCDA			49.60 percent 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 percent or P0.31	10.70 percent of P0.53	16.94 percent or P0.84	P5.80
2000	0 percent or P0.00	5.70 percent or P0.33	5.70 percent or 33 centavos	P6.13
01 Jan - 19 Oct 2001	3.09 percent of P0.19	4.30 percent or P0.26 centavos	7.39 percent or 45 centavos	P6.58
20 Oct 2001	63.98 percent or P4.21	0 percent of P0.00	63.98 percent or P4.21	P10.79
2002	2.37 percent or P0.16	6.80 percent or P0.45	9.17 percent or P0.60	P11.39+FC DA
Jan March FCDA			35.78 percent or P4.07	P15.46

