

INSEAD

Economics and Management in Developing Countries

**Water Privatization in Manila, Philippines
Should Water be Privatized?**

A Tale of Two Water Concessions in Manila

Authors

CHIA Pei Lin Grace
CHUA CHIACO Karen
KIM FAT Clint
TEO Serena
TOH Kai Ling

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1. Introduction

1.1. *Water is an economic good*

“Water has an economic value in all its competing uses and should be recognized as an economic good.”
Dublin Statement, International Conference on Water and the Environment, 1992

The neo-liberal economic view of the world supports the notion that developing countries should involve the private sector in the provision of infrastructure such as water. The premise is that commercial incentives will encourage private water companies to seek the highest possible efficiency in order to maximize commercial returns and reduce possible losses from inefficiency and non-paying customers. This results in a water system that is more efficient and thus more economically-sustainable than many of the cash-strapped public sectors can achieve. By and large, this is also the view advocated by many international organizations. The World Bank provides structural adjustment loans as the core monetary means for such privatization reforms.

1.2. *Water is a public good*

“Water is a limited natural resource and a public good fundamental for life and health. The human right to water is indispensable for leading a life in human dignity.”
General Comment, United Nations Committee on Economic, Cultural and Social Rights, 2002

The countering view centers on the fact that water is essential for human survival and ought to be valued as a human right. Consequently, anti-privatization activists would argue that people have a right to have access to sufficient and clean water, and hence water should be provided free or subsidized.

In this paper, we discuss a specific water privatization case - the water privatization in Manila, Philippines in 1997 - covering the situations which led to privatization, privatization process and outcomes, before concluding with a discussion on what could have been done specifically in Manila, and more broadly in water privatization efforts.

2. Background of Philippines and Manila’s Water Services

2.1. *Brief Background of Philippines*

Philippines became independent in 1946, after 47 years of American colonial rule and more than 300 years of Spanish rule. Since independence, the political climate in Philippines has been characterized by instability, corruption, military conflicts between the state army and the minority groups of Muslim separatists. For many decades, the country struggled financially, and consequently it was the recipient of at least nine Structural Assistance Programs under the World Bank, in addition to other international fund programs, which led to a restructuring of the country’s economy.

The country’s GDP is driven by Services (54%), Industry (32%) and Agriculture (14%), and its main exports are electrical machinery, clothing, food and live animals, chemicals and timber products. GDP per capita is about US\$5,000 (CIA World Factbook, 2006). Philippines has a

population of 85.2 million people living on its 7100 islands. Unemployment rate hovers at about 7.9% currently. About a third of the country's population (28 million people) lives below the poverty threshold. In Manila, the country's capital, about 40% of the residents live in slums and squatter settlements. There is also high and widening income disparity in Philippines. The Gini coefficient, an indicator to show inequality between poorest and richest inhabitants, increased from 45.1 in 1988 to 48.7 in 1997.

2.2. *Water and Sanitation Services in Manila Pre-Privatization*

Water and sanitation services in Manila up to 1997 were provided by the public company, Metropolitan Waterworks and Sewerage System (MWSS). MWSS was struggling financially to service a debt of US\$880 million, and its operations were neither efficient nor effective. In 1997, MWSS' piped water connections only reached two thirds of household coverage, with the remaining one third relying on either vended water, own deep wells and/or private water works. Service levels were low with low water pressure and intermittent supply of 17 hours a day on average. MWSS suffered from very high NRW (non-revenue water) of more than 60% of water production, vis-à-vis 20-30% on average for developing countries and 7% in Singapore. MWSS was also considered over-staffed with 9.8 employees per 1,000 connections, vis-à-vis 7.7 in Jakarta and 4.6 in Bangkok. Please refer to *Table 1* for the comparison data.

City	Water Availability (hrs/day)	Water Coverage (population %)	Non-Revenue Water	Staff per 10,000 Connections
Singapore	24	100	7	2.0
Hong Kong	24	100	36	2.8
Seoul	24	100	35	2.3
Kuala Lumpur	24	100	36	1.4
Bangkok	24	82	38	4.6
Manila (in 1996)	17	67	61	9.8

Table 1: Comparison Data of Water Services¹

2.3. *Three Factors Which Led to Water Privatization in Manila in 1997*

Firstly, MWSS was under-performing and burdened by the large debts. It was obvious that the public company would not be able to invest in much-needed water system improvements. Secondly, in the mid 1990s, when state finances were wavering and debt loads were putting severe restraints on government spending, the country was stricken with what was perceived to be a looming water crisis due to the events that followed the El Nino. The crisis prompted the government then headed by President Fidel Ramos to take affirmative actions. Lastly, at that time, Philippines had a pro-privatization environment in terms of economic policy and legal system, no doubt a result of the pro-market reforms that had occurred since the introduction of structural reforms under the Structural Assistance Programs. The pro-privatization environment was further bolstered by Ramos' past success from privatizing the electricity sector which led him to believe that the same model could work for water.

¹ Sources: 1. Second Water Utilities Data Book: Asia and Pacific Region, Asian Development Bank: October 1996; 2. 2002 Annual Report, MWSS – Regulatory Office

Given these factors, water privatization was looked upon as a golden opportunity for the government to finally get rid of their economic burdens caused by an inefficient public utility and at the same time solve the city’s water and sanitation needs.

3. Overview of the Water Privatization Process

3.1. Privatization Model

The concession model was selected for Manila’s water privatization, in order for the Philippines government to tap into the private sector to relieve the government from water services and at the same time have the private companies pay off MWSS’ debts. Manila was then divided into 2 regions along river lines, as illustrated in *Figure 1*. This was done so as to avoid a monopoly, as well as allow regulators to check the performance of one concessionaire against the other.

With the split in regions came the issue of division of the debt. Eventually, it was decided that the West would take up 80% of debt as it was believed that the area was already fully developed with existing pipelines, whereas the East would take up the remaining 20% of the debt as the area was quite dispersed and a lot of capital would be needed. Due to the time pressure to implement water privatization, these decisions were made based on available documentation, without any actual investigation.



Figure 1: Split of Water Service Zone

3.2. Bidding Process

The Philippines government adopted transparent international bidding rules for the bidding process. For example, the bidding consortium should comprise a local company (“sponsor”) and an international operator, and the Filipino local companies had to be pre-qualified separately from foreign water operators, based on financial capacity, perceived know-how and experience with large projects. The bidding process took on a two-envelope system, whereby the technical envelope containing specifics was opened first and judged whether compliant or not, and if compliant, the financial envelope was opened and compared with other financial envelopes of compliant bidders in terms of tariff. The lowest tariff bidder won, but a single

Box A: Water Privatization in Jakarta and La Paz

Jakarta: A water privatization which has drawn comparisons with Manila’s case is that of Jakarta. In 1991, the World Bank provided loans to municipal water authority PAM Jaya to expand its network coverage. Suez and British water firm Thames each partnered with a local Indonesian company to run the Jakarta Raya water and sewerage system. Both local companies were linked to then-president Suharto and were awarded the concessions without any open bidding process.

La Paz: In La Paz, Bolivia, to win the concession contract in 1997, Aguas del Illimani committed to extend in-house water connections to virtually all unconnected households in the metropolitan area by December 31, 2001. What sets this contract apart from other agreements is its almost exclusive focus on extending the service area while maintaining a high level of service. Most contracts also seek to achieve other objectives, such as tariff reductions, which could conflict with service expansion goals.

consortium could only win one zone.

Based on the process, four pre-qualified bidding consortia emerged. The bid results are shown in *Table 3* and the companies which won the bidding process are described in *Table 2*.

Maynilad Water Services Inc (“Maynilad”)	Manila Water Company Inc (“Manila Water”)
Operates the West concession area covering 8 cities, parts of 2 cities and 7 municipalities.	Operates the East concession area covering 8 cities, parts of 2 cities and 12 municipalities.
Company shareholders include: Benpress Holdings Corporation (60%), the flagship company of the Lopez Group, and the French water giant Suez (40%).	Company shareholders then: The Ayala Corporation holding majority control of the partnership (51.1%) International Water Limited (USA), United Utilities (UK) and Mitsubishi Corporation (JPN). Today though, the Ayala Group owns 100% of Manila Water.
Concession agreement includes: Treating and distributing drinking water, bill collection and manage sanitation/sewerage services until the year 2022.	Responsibilities include: Treatment, distribution of drinking water, bill collection and management of sanitation/sewerage services until the year 2022.

Table 2: Winning Consortia

	East		West	
	Percentage of Prior Tariff	Bid Tariff (Pesos)	Percentage of Prior Tariff	Bid Tariff (Pesos)
Ayala-United	26.4	2.3169	28.6	2.5140
Aboitiz-CGE	62.9	5.2090	56.9	4.9941
Metro Pacific-Anglian	64.5	5.6638	66.9	5.8738
Benpres-Lyonnaise	69.8	6.1275	56.6	4.9688
Prior to Privatization	100.0	8.7800	100.0	8.7800

Table 3: Results of the Water Privatization Bidding²

Box B: Jakarta’s Privatization structure

Jakarta’s privatization model was similar to Manila’s – water services were divided into 2 zones (east and west) and concessionaires were awarded to separate companies to manage each zone.

While the concession agreement spelt out certain performance targets:

- It lacked formal regulatory or oversight mechanisms, e.g. PAM Jaya had no right to review financial reports of the companies, and the agreement did not spell out clear sanctions in the event the companies failed to meet performance targets;
- Payment by the water authority to the concessionaires was not linked to revenue they collected, but based on the water they supplied. As a result, the risk of cost recovery was de-linked from the companies’ profits.

4. Was Manila’s Water Privatization a Success?

4.1. Pre v/s Post Privatisation

As shown in *Table 4* below, both concessionaires had exhibited much improvement five years after privatization. Water coverage in 2002 reached 82% for Manila Water and 78% for Maynilad from 67% before privatization. Water availability rose to 21 hours from only 17 under MWSS. Improved water quality was another noteworthy positive development. Before privatization, quality of water (1997) did not satisfy the Philippine National Standards for

² Source: Dumol, 2000

Drinking Water. Both MWCI and MWSI viewed this problem seriously. MWCI became compliant since 1998, MWSI became compliant from 2000.

Efficiency likewise improved. Staff per one thousand connections fell from 9.8 to 4.1 for both concessionaires. This came about as headcount was streamlined. The total number of employees working for Manila Water and Maynilad was 49% less than that of MWSS.

Service Indicators	*Prior To Privatization	MWCI			MWSI			Total 2002	Gains
		Target 2001	Actual 2001	Actual 2002	Target 2001	Actual 2001	Actual 2002		
Population Served Based on Official No. of Water Service Connections (millions)	7.3m	4.26m	3.2m	3.4m	6.7m	5.3m	5.2m	8.6m	+18%
Official Number of Water Service Connection	779,380	378,670	352,982	369,699	574,590	577,637	573,194	942,893	+21%
Water Production (mid) Annual Average	2,800	1,234	1,724	1,658	2,257	2,417	2,363	4,021	+44%
Water Coverage (Based on Official No. of Connections)	67%	77.1%	76%	82%	87.4%	79%	78%	79%	+18%
Water Availability (hours)	17	24	21	21	24	21	21	21	+24%
No. of Staff	7,638	1,386	1,530	1,516	-	2,594	2,366	3,882	+49%
Staff per 1,000 Connections	9.8	3.7	4.3	4.1	-	4.5	4.1	4.1	-58%
Reported No. of Leaks	27,053	-	40,454	38,225	-	41,242	98,611	136,836	-
No. of Leaks repaired	20,585	-	39,688	37,461	-	38,508	92,189	129,650	-
Non-Revenue Water	61%	16%	48.29%	52.66%	31%	66.25%	68.68%	62%	-
Services Extended to the Urban Poor (Water Service Connections)	Water Improvement For Depressed Areas (WIPDA)	-	* 14,504	** 22,160	-	61,370	63,370	85,890	-

* with equivalent 50.549 household connections;

** with equivalent 63.910 household connections

Table 4: Water Service Performance³

Complaints and responsiveness was another area where the two displayed substantial progress. In 1996, the percentage of reported leaks attended to and repaired was 74%. It rose to 97% in 2002 for MWCI and 93% for MWSI for a combined 94% responsiveness. The two concessionaires also extended better services to the poor: both companies operated programs whereby in poorer neighborhoods, the

Box C: Pre- and Post-Privatization in La Paz		
Following privatization:		
	<ul style="list-style-type: none"> Water availability increased from 19 to 22.5 hours per day; Rate of new connections increased by two thirds; Increased sewerage coverage in La Paz by 30% in the first 3 years. 	
	Pre (1997)	Post (2005)
No. of water connections	152,000	234,000

³ Source: 2002 Annual Report: MWSS – Regulatory Office

costs of construction and affordability issues are reduced through cheaper small diameter pipes. Many consumers were also getting water sold in bulk by the companies to third parties, who were local firms.

On the flipside, the two concessionaires were charging much higher water rates than before. Water tariff before privatization stood at P8.78 per cubic meter of water. For MWSI, the tariff rose more than threefold from P4.96 in 1997 to P15.46 in 2002. For MWCI, the tariff rose from P2.32 to P6.75, a little less than threefold.

Non-revenue water (NRW) figures were also way below target. NRW refers to water that is unbilled due to leakage or theft. MWCI did better in reducing NRW, but MWSI fared worse compared to MWSS. Losses from NRW stood at more than half of billed volume, still very high by any standard. In fact, the target NRW for MWCI was 16% by 2002 and for MWSI, 30%.

Box D: Pre- and Post-Privatization in Jakarta

Only 20% of residents had piped water, with around 40% water coverage. Most Jakarta citizens bought water from local vendors, while the rich and industrial enterprises had their own artesian wells. Based on post-privatization statistics issued by the companies, water provision appeared to have improved.

	Pre-privatization	Post-privatization*	
		West	East
No. of water connections	327,433 – 428,764	290,524	320,282
Water coverage (% of population)	38 – 42 %	44%	61%
% of non-revenue water	53 – 57%	48%	50%

* Figures as of April 2002

Prior to Privatization	MWCI			MWSI		
	1997	2002	Rate Increase	1997	2002	Rate Increase
8.78	2.32	6.75	191%	4.96	15.46	212%

Table 5: Pre vs Post Privatization Tariff Rates⁴

4.2. Did privatization of water distribution in Metro Manila work?

If one goes by the numbers for water coverage, availability and quality, water privatization in Metro Manila seemed to have worked. However, water rates had risen dramatically during the same period. Hence, it was a subject of public debate whether the improvements were worth the hefty price increases suffered by the public.

Box E: La Paz as a success story (2002)

In La Paz, Policymakers increased the likelihood of improvements in low-income areas by

- (1) making contract objectives clear and easily measurable,
- (2) eliminating policy barriers to serving the poor (e.g. service boundaries that exclude poor neighborhoods, property title requirements).

The contract's quality and reliability standards were designed to ensure that Aguas del Illimani did not reduce service quality to increase profit. In 2002, La Paz was hailed as a success in 2002 by the World Bank.

4.3. Financial Performance of the Two Concessionaires (1997 to 2002)

As of 2002, the privatization experiment generated confusing results. Manila Water attained breakeven in the third year of operations and posted P553 million in 2002, while Maynilad was

⁴ Source: Source: MWSS Regulatory Office Rate Rebasings

still financially bleeding. Maynilad's 2002 financial statements showed that losses ran up to P1.4 billion, from only P618 million in 2000.

Maynilad cited three main reasons for its financial losses:

- a) El Niño for reducing bulk water supply that Maynilad could distribute to its customers by 40%;
- b) The 1997 Asian currency crisis which had a negative impact on Maynilad's ability to service its share of the MWSS debts; and
- c) MWSS's breach of contract. El Niño and the 1997 Asian currency crisis prevented MWSS from completing vital water projects on time. The delay of the projects had an adverse effect on Maynilad's ability to supply water and generate revenues.

		2002	2001	2000	1999	1998	1997
MWCI	Operating Exp* / Operating Revenue (%)	67	78	82	86	106	109
	Operating Exp / Billed Water Volume	7.81	5.54	5.53	5.20	5.60	6.07
	Net Income/Operating Revenue (%)	21	11	8	8	-7	-9
MWSS	Operating Exp* / Operating Revenue (%)	131	131	101	126	132	128
	Operating Exp / Billed Water Volume	27.85	14.13	10.03	11.79	10.26	9.36
	Net Income / Operating Revenue (%)	-35	-35	-6	-29	-34	-28

*less amortization and depreciation

Table 6: Financial Performance Ratios⁵

On 7 February 2002, Maynilad issued a statement terminating its concession agreement with the MWSS, implying that the operations and management as well as the debts it assumed would have to revert back to the state-owned agency.

While Maynilad's reasons for its dismal financial results were valid, a deeper look into the issue revealed that Maynilad's explanation was only half the story.

4.4. Why was Maynilad losing heavily, while Manila Water was making money?

4.4.1. Differences in financing models

Both concessionaires were exposed to the pressures of currency devaluation, but Maynilad experienced considerable difficulty in obtaining loans to finance capital expenditures in the first five years of operations. The two concessionaires had adopted different financing models that most likely led to different outcomes.

Manila Water resorted to corporate finance by putting the assets of its owners Bechtel and Ayala Corporation at stake to obtain loans. The company also managed to capitalize on the reputation and good credit standing of its majority shareholder, Ayala Corporation, to draw funding from both local and foreign banks. Of course, having positive profits helped to open private loan windows for Manila Water.

⁵ Source: 2002 Annual Report: MWSS – Regulatory Office

Meanwhile, Maynilad used project finance or a limited recourse financing scheme to request for a US\$350 million term loan. This meant that the collateral on which the loan would be secured would be the receivables of the project itself. Maynilad's access to private loans also depended on its capacity to convince regulators to grant its rate rebasing and other requests. Furthermore, Benpres Holdings, its parent company, reported net losses of P353 million and P10.2 billion in 2001 and 2002. These factors made it all the more difficult for Maynilad to source funds abroad.

4.4.2. *Non-revenue water (NRW)*

NRW was 61% before privatization. As of 2003, Manila Water reduced its NRW to 52.66% while that of Maynilad deteriorated to 68.68%. Estimates showed that during the five years since privatization, Maynilad lost about P36 Bil in revenues to water thieves and leaks.

A possible reason for the difference in performance was the approach used by the companies in addressing this problem. Manila Water used the cooperative approach. This approach recognized that people wanted to pay as little as possible for their water such that they might even buy water from illegally tapped sources. Therefore, the firm provided water to poor areas where pipelines were shared by several households which in turn reduced the fixed installation cost. This reduction in lost water enabled the company to increase water delivery from 440 million liters a day in 1997 to 750 million liters a day. On the other hand, Maynilad took a threatening strategy. People who were caught for water theft were penalized. However, this monitoring and enforcement approach was not very effective. The success of Manila Water's approach highlights the importance of innovative approaches to enhance public buy-in to attain one's privatization goals.

4.4.3. *Management Styles*

a) *Territorial areas*

Manila Water instituted the territory management concept whereby the East Zone was hydraulically divided into 43 Demand Monitoring Zones (DMZs) which consisted of approximately 10,000 connections. The DMZs were further divided into smaller hydraulically discrete zones called District Meter Areas (DMAs) consisting of 1,000-2,000 connections. Each DMZ and DMA was individually metered. This enabled Manila Water to decentralize its operations and empower the areas' business managers to make important decisions. The concept enabled Manila Water to prioritize action on areas with high NRW. The setup also had a carrot-and-stick system that financially rewarded better performers and penalized laggards.

Maynilad claimed to be practising similar management techniques. Unfortunately, there was no planned strategy until April 2000, which appeared to have been meter replacement, mains replacement and leak repair in a reactive way. Again, such strategy was not implemented until November 2000 and lasted only until June 2001.

b) Employee Management

Manila Water revamped the entire management structure for the East Zone. It brought in only a very small core team and used the old staff to fill up their new organization structure. Its employees enjoyed annual 10% salary increases, contributing to improved worker morale.

Maynilad retained the same structure and introduced only upper management, at the Department level. The new managers were drawing salaries of P60,000/month or more while their counterparts who came from MWSS had the government rate of about P18,000. This was a key source of low morale and was a constraint for the integration of staff. Another managerial concern regarding Maynilad was the frequent change of top management. Since 1998, Maynilad already had three CEOs.

The difference between labor and management relations was apparent, with Manila Water employees and management having better working relationships.

c) Operational efficiency

Compared to pre-privatization, efficiency gains were achieved by both concessionaires as they prioritized efforts to cut on operational costs. The performance of the two companies however differed quite significantly. One could attribute this to the difference in the situations within which they operate (e.g. condition of pipes, etc.), but there were certain aspects of their operations that could offer calculated explanations why one concessionaire performed better than the other. For example, Maynilad spent more on a cubic meter of water compared to Manila Water. Personnel costs for Maynilad were on the high side as well. It took twice as much time for Maynilad compared to Manila Water to respond to reported leaks, perhaps a big factor why Manila Water was able to reduce its NRW.

	MWCI	MWSI
Personnel cost/employee (in Pesos)	312,000	409,000
Operational cost/m ³ (in Pesos)	4.05/m ³	10.45/m ³
Average time to repair leaks	4 days	11 days

Table 7: Operational Efficiency of the Concessionaires⁶

4.4.4. Corporate Culture

The parent company of Manila Water, the Ayala Corporation is the foremost property development company in the country. It has interests in banking and financial services, mobile telecommunication and electronics equipment manufacturing. The interesting common facet of Ayala Corporations' varied activities is market competitiveness as the preponderant determinant of success. Its corporate culture was oriented decidedly to excel at market competition.

⁶ Source: MWSS-RO rebasing study

Maynilad's mother corporation, Benpres Holdings, is also into property, telecommunications and banking. But the core business of Benpres Holdings is in the power sector (distribution and generation) which is one of the most heavily regulated businesses since it is largely monopolistic. Thus, market competitiveness cannot be said to be the preponderant selector of winners in this sector. That the Lopez Group also strategically owns ABS-CBN, a TV network giant, only serves to reinforce its lobbying clout in the eyes of many. It is noteworthy that in the last May 2004 presidential elections, two contenders for vice-president of the Republic were long-time broadcasters of the TV network. Hence, the corporate culture that developed in the Benpres Holdings and (presumably) bequeathed to Maynilad was one steeped in the management of the state-market interface.

4.4.5. *Luck of Draw? Or Lack of Due Diligence?*

Manila Water's cognate assets as the premier real estate developer in the country were located largely in the East Zone. This might actually have prompted Manila Water's winning very low and "seemingly bid" entry (P2.32 per m³) in the original auction. While luck was involved, Manila Water did stack the deck in its favor by bidding more aggressively for the East Zone.

As the next lowest bidder, Maynilad was awarded the West Zone. The West Zone, while having the lion's share of the underground assets, was recognized to suffer from greater NRW or water loss due to (1) much older water-main and pipe connections and, thus, greater extent of leakage due to wear-and-tear, and (2) greater extent of water theft, illegal connections and free public water outlets due to heavy concentrations of squatter communities. Indeed, the bid information showed the pre-privatization NRW for the East Zone to be 44% and 60% for the West Zone.

However, an argument can be made that Maynilad did not do its due diligence properly. It is interesting to note the winning bids differed markedly between the winners, creating the tariff gap. The bids suggested that Manila Water was slightly aware of the differences in favor of the East Zone, but that Maynilad was either unaware of or had underestimated the true difference in the conditions of the two zones.

There were two big differences:

- a) The pre-agreed distribution of MWSS foreign debt (\$1 billion), 80% of which was assigned to the West Zone and 20% to the East Zone was known but only slightly got reflected in the winners' bids;
- b) It was generally held that the pipes in the West Zone would be much older and had higher tendency to spring leaks under increased water pressure but the extent of this was hazily known;

The tariff adjustment mechanisms (EPA and rate rebasing) provided for by the concession agreement seemed to make due diligence less urgent, as one can always claim ignorance later.

In the initial phase, corporate culture did seem to matter. Manila Water's due diligence pointed in the right direction. Maynilad's did not. A case can be made that Manila Water got lucky when it got the East Zone. It can, however, be also argued that Manila Water made its own luck. Its bid did reflect some of the actual conditions, while Maynilad's did not.

5. Manila's Water Privatization Today

5.1. *New ownership of Maynilad*

Following Maynilad's statement terminating the concession agreement, the International Appeals Panel stepped in to arbitrate the dispute and declared that the concession fees owed by Maynilad should be paid. Faced with mounting debts, Maynilad filed for corporate rehabilitation. Under the plan, Maynilad would undertake a debt-to-equity swap and Maynilad's debt to MWSS would be converted to a 84% equity stake. MWSS held a bidding process for the sale of this stake, which attracted investors including Manila Water. The stake eventually went to Metro Pacific Investment and DMCI Holdings. Maynilad also announced last month that Deutsche Bank and Singapore financing firm will take over Lyonnaise's stake in the company. Maynilad posted positive net profits in 2005 and 2006, and its new owners have expressed their hope that the firm will get out of rehabilitation by this year.

Box F: Epilogue to the Jakarta privatization: A story of Crises, Costs and Constitutionality challenges

Post-privatization, as riots spread during the Asian economic crisis, Suez and Thames executives fled from Indonesia. After intervention by French and British diplomatic officials, they returned, but their Indonesian partners withdrew. The concession agreement was then re-negotiated; the new agreement provided for establishment of regulatory body and PAM Jaya to have access to companies' financial records.

As part of efforts to restructure the water sector in Indonesia, a new Law on Water Resources was passed in 2004. In considering water as an economic good, the law provided for private sector participation in water resource management and quality improvement. However, it met with opposition from the public and NGOs, and in June 2004, a group of legal aid foundations and NGOs filed a lawsuit, arguing that the Law contradicted the constitution and was unconstitutional. While this action was eventually dismissed by the Indonesian Constitutional Court, it showed the degree of public discontent with the privatization process of Indonesia's water resources.

5.2. *Tariff Reductions*

MWSS has issued a directive to Manila Water and Maynilad to reduce water rates by April 2007 to reflect the stronger peso. The water regulator said that it expected Manila Water and Maynilad consumers to save P.28 and P.30 per cubic meter for their water consumptions respectively. In response, both Manila Water and Maynilad announced that their water tariffs would be reduced by approximately P3 per m³ from April to June 2007.

Box G: End of Water Privatization in La Paz

In 2002, La Paz was regarded by the World Bank as a successful example of pro-poor water privatization. On 10 Jan 2005, however, discontent over prohibitively expensive hookup fees and the failure to expand water service to El Alto boiled over. Citizens of El Alto took to the streets en masse to demand that their water system, privatized in 1997 under World Bank pressure, be returned to public hands.

3 days later, Bolivia's president issued a decree canceling the water concession which had been led by the French water giant Suez and an arm of the World Bank itself.

6. Key Learning Points from Manila's Experience

6.1. *What Went Well*

6.1.1. *Attempts to Build Consensus*

The water privatization process received high-level support, with President Ramos himself a great believer in the project. Since 1993, President Ramos had helped to build consensus among decision makers and the public on the need for MWSS privatization. Before the bidding process, the government team also sought as much as possible to consult key stakeholders, for instance, MWSS employees, labor union, key Senators and members of Congress. The team also conducted a massive information campaign to reach out to all MWSS consumers. The bidding process was thus relatively well received by stakeholders.

6.1.2. *Planning and Expert Consultation*

The government team behind the water privatization process began their research as early as June 1994, learning from the experiences of other countries. Acknowledging their own inexperience, they hired external consultants to advise them on the process, including International Finance Corporation (IFC) as the overall coordinating consultant, SOGREAH – a French engineering company as process consultants, and National Economic Research Associates (NERA), as economic consultants.

6.1.3. *Transparent Bidding Process*

From June 1994 onwards, the Philippines government had received several offers to privatize MWSS, including from Biwater - a Malaysia-British joint venture, and a large local real estate firm backed by a conglomerate of MNCs. The government refused their proposals and instead invited them to participate in the bidding process, which they took pains to ensure was conducted in an open and transparent manner.

6.1.4. *Managing Potential Adverse Impact of Privatization*

The government team and its consultants anticipated and pre-empted several problems which could have arisen from water privatization, including:

- Avoiding backlash on foreign ownership by adhering to the Philippines constitution that mandates that all public utilities must be owned and controlled by Filipinos, whereby 60% of the concessionaires must be domestically owned, and the officers had to be Filipinos.
- Managing the reduction of labor force with an attractive compensation package which was so appealing that more than 30% of the employees accepted it. This had the effect of helping to reduce the bid prices as well.

6.1.5. *Fostering Quasi-Competition*

By splitting Manila into two concessionary regions, the government helped foster quasi-competition whereby consumers could compare service quality of the two concessionaires and each company would try to outdo each other. The government would also have more leverage

in their negotiations with the concessionaires. Furthermore, it provided a safety valve so that in the scenario that one concessionaire got into financial trouble, the other could take over.

6.1.6. Allowing Flexibility in How Consumers are Served

The Concession Agreement allowed considerable freedom in how the connection targets are met. Firstly, the contracts do not specify the input requirements for concessions. Secondly, the contracts do not define coverage as those with a standard household connection. Instead, coverage targets can also be met by alternative providers within the concession zone. This has helped the expansion of services to poorer households. The two concessionaires engaged on a program of system expansion, whereby in poorer neighborhoods, the costs of construction and affordability issues were reduced through cheaper diameter pipes. Many consumers were also getting water sold in bulk by the companies to third parties which were local firms. This strategy has allowed the concessionaries to supply those consumers who would otherwise have been unprofitable had the company served them itself via direct connections.

6.2. What Could Have Been Done Better

6.2.1. Due Dilligence

The government team (and the bidders) should have invested more efforts in performing due diligence such that they could better assess the commercial viability of the bids. For instance, the technical and operational data provided for the West Zone proved to be very inaccurate. Major elements such as the length of the distribution network were greatly understated – the bid documents stated that the length was 2534 kilometers but later turned out to be 3880 kilometers. The government also had no sound studies to help measure water demand for Manila and ascertain the feasibility of non-revenue water reduction. This meant that the government did not have the requisite knowledge to question the low bids, and the unrealistic financial forecasts and service targets predicted by the bidding companies.

Furthermore, the huge differences in the management style, efficiency and financial performance of the two companies give rise to questions on whether the government could have better assessed the competitive qualities of the firms before awarding the bids.

6.2.2. Debt Allocation

The process to determine the debt allocation between the two regions could also have been more rigorous. IFC toyed around with different ratios but up to a month before the bids, still could not come up with a recommendation. The government team thus informally requested each bidder to give its suggested split of the debt. The suggested range was from 70:30 to 90:10 (West:East). In the end, IFC decided on 80:20 (although the Concession Agreement stated 90:10, the split was actually 80:20 because some of the debt would come in after financial closure and would be loaded onto the East Zone). Maynilad's adverse performance was later attributed in part to the debt burden they had to shoulder, which exposed them to huge foreign exchange losses.

6.2.3. Bidding Mechanism

The bidding process appeared to have encouraged unrealistically low bidding by the companies. One possible solution could have been to use a second-price auction where the lowest bidder would be allowed to operate at the price quoted by the second lowest bidder. This would encourage bidders to bid truthfully because it gives them profit for doing so and they would not benefit from making aggressive bids.

6.2.4. Safeguards Against Opportunistic Behavior

The government could have done more to safeguard itself against opportunistic behavior of the companies. The government team had rationalized that no bidder would bid overly low because of the provision in the Concession Agreement that the first rebasing would be held solely at the prerogative of the government. Furthermore, they had faith that all the bidders were well-known and responsible bidders. They did not anticipate that the companies would try to re-negotiate the terms of the Concession Agreement shortly after the bids were awarded. The government later made many concessions to the operators, including a revised appropriate discount rate (ADR) in favor of Manila Water in 1998; and the amendment of the concession agreement in 2001 to accommodate “unforeseen” needs of both operators through various rate adjustments mechanisms⁷, which led to increased water tariffs for consumers. The government also tolerated Maynilad's failure to pay concession fees; as well as both companies' failure to meet performance targets. The government was perceived as being over-forgiving towards the companies, choosing to “rescue” the companies from their faulty bidding assumptions, rather than risk bankruptcy. This lack of political will on the part of the government to impose penalties on the companies shifted the risks to consumers and the government; thus reducing incentives for the companies to get their act together and improve efficiency.

6.2.5. Honest and Credible Regulation

Related to the above, the water regulatory framework in Manila left much room for improvement.

- a) The amendment of the Concession Agreement was tainted by hints of corruption. Of the 5 Regulators consisting the Regulatory Office, two Regulators complained about the irregularities that were apparently actively abetted by the Chief Regulator himself. These two Regulators were apparently harassed and their salaries withheld.
- b) The Regulatory Office also lacked the capacity to evaluate the actual performance of the concessionaires, being dependent on the numbers submitted by the companies; as well as the ability to hold the companies accountable for failing to comply with the performance standards.

⁷ These rate adjustment mechanisms included:

- a) Accelerated Extraordinary Price Adjustment (a-EPA) of P4.21/m³ for recovery of Maynilad's past foreign exchange losses;
- b) Foreign Currency Differential Adjustment (FDCA) of P4.07/m³ for the recovery of accrued foreign exchange losses or gains starting 1 January 2002, subject to quarterly review of the MWSS Regulatory Office, arising from the servicing of foreign-denominated MWSS debts (shouldered by concessions fees) and concessionaire loans;
- c) Special Transitory Mechanism (deferred implementation) for other foreign exchange losses not covered by a-EPA and FCDA; and
- d) a mandatory rate rebasing in 2002, which among others, would seek to correct flawed business assumptions of the concessionaires.

- c) The Regulatory Office was a creation of the Concession Agreement and in this arrangement, consumers had no legal right to intervene in regulatory processes and there were no provisions for transparency except for token public consultations before price hikes.
- d) Furthermore, the political leadership appeared to observers as being susceptible to lobbying by the powerful local firms and multinationals which were awarded the water concessions.

6.2.6. *The Politics of Water Privatization*

“Everyone in the Philippines has an opinion about anything.”

- Mark Dumol, a member of the government team behind the Manila water privatization process

As early as 10 November 1995, the government team had their first taste of the politics behind water privatization - the press conference held to announce the appointment of IFC as consultant for the project was a disaster – attention was fixated on the “exorbitant” consultancy cost of US\$6.2 million which MWSS was seen to be wasting on yet another study, rather than developing new water resources. Although IFC hired a prestigious multinational PR firm, the government was faced with a steady stream of negative articles which did not abate until the firm was replaced by a small local firm. The local firm did a much better job and public opinion was generally positive just before and during the bidding process, aided no doubt by the public’s exasperation with the under-performing MWSS. However, the snags in the implementation process reversed public opinion, generating many criticisms from the media, public and NGOs on increasing water tariffs and the inability of the water concessionaires to meet performance targets.

Pricing, in particular, was an extremely political subject which the government was ill-equipped to handle. The companies had sought relief from the devaluation of the peso during the Asian Financial Crisis by renegotiating their contracts and passing through the foreign exchange losses to consumers through price increases. While this was part and parcel of the cost-reflective pricing principle underpinning privatization, the communication process was handled very badly. Consumers not yet accustomed to the idea of water as an economic good viewed this “concession” as the government giving in to blatantly opportunistic behavior by profit-seeking companies.

7. **Looking into the Future: To Privatize or Not to Privatize?**

“We had no inkling whatsoever of the tremendous obstacles we were going to face.

If we had known the difficulties, I do not know whether we would have proceeded.”

- Mark Dumol, a member of the government team behind the Manila water privatization process

7.1. *The Standard MBA Answer: It Depends*

With the current public backlash and depressed investor outlook, is water privatization a viable option for countries seeking to provide better infrastructural services? It would seem that there is now a reversion towards public provision. However, it is highly unlikely that governments can be more successful in the future in infrastructural provision, encumbered as they are by

- a) irrational pricing policies to please voters;
- b) lack of arm's length accountability;
- c) use of these public companies for political and self-interested motives;
- d) lack of fiscal resources and
- e) lack of know-how, efficiency and profit-seeking inclination.

However, in this climate of bleak market sentiment, governments should not rush into privatization, considering that they may not find many potential bidders who are well-qualified to make the privatization a success. Governments should be especially mindful of the fact that the planning and implementation process needs to be carefully thought through to avoid potential pitfalls such as opportunistic behavior of bidders; and adverse PR on pricing and water supply to the poor.

7.2. *If Privatize, What To Watch Out For?*

If the governments choose to go ahead with water privatization, what are some of the key factors they should consider?

The process is key:



There are certain general principles which would apply across jurisdictions:

- a) *Policies*
 - i) Governments should carefully think through the *upstream policies (sector economics)*, including the level of government (municipal, state or national) responsible for the privatization project; and how many utilities there should be, bearing in mind the merits of competition versus the need for economics of scale and coordination.
 - ii) Governments will also need to decide on *service economics policies*, including service standards, tariffs and subsidies. It is important to find the right balance between the service people would like and their willingness and ability to pay for it. Furthermore, the mode of payment, either directly by consumers or indirectly through subsidies from taxpayers, should be considered. Engineering and financial studies could be used to generate various cost-quality options, coupled with consultation with the people on which they prefer. Subsidies for the poor should also be considered.

In addition, governments need to determine *risk allocation*, ie what risks and responsibilities to transfer to a private firm. Common risks include exchange rate risk, collections risk and policy risk (ie governments change the rules of the game unexpectedly). Various options could be considered, including concessions, divestitures, lease-affermage contracts and management contracts.

b) *Regulatory Frameworks*

It is critical to set up systems to manage the implementation process, including an independent regulator empowered by statute to make a decision binding on the utility. The regulatory agency must be competent and independent of the operator, government and consumer. It should be aided by a toolkit of incentives and penalties to align operator performance to desired objectives and targets.

c) *Company and Financing Access*

The government must carefully select a good operator through a transparent bidding process. As the Manila case showed, differences in company performance can make or break a privatization initiative.

A related factor which could impact on operator viability is the availability of local capital markets to provide long-term local currency financing and hedging opportunities against exchange rate risks.

d) *Politics*

Finally, the politics of water reform is potentially the most challenging aspect of privatization. There is a need to build consensus through public education and consultative mechanisms. In addition, governments need to ensure transparency in award and oversight of privatization schemes, as well as manage any potential adverse impact of privatization, for instance through compensation for the retrenched, subsidies to mitigate the impact of water tariff increases on the poor, and articulate environment requirements for the operator in the contract.

However, there is no fixed formula to ensure success. It would appear from the Manila experience that even if all the right boxes appear to be ticked, there needs to be strong consideration of how to address highly contextualized problems and issues.

For instance, Manila has a strong and vibrant civil society which prides itself on free speech and activism. This, combined with the fact that many people still see water as a public good, turns water privatization into an extremely politically charged issue. How should the government take this into consideration when planning their privatization approach?

Manila has also chosen to adopt a two-concessionaire approach, which surfaces unique questions on fair division of debt, as well as fairness of benchmarking since the two regions have very different geographic features, demographic profiles and infrastructural conditions. Perhaps the West Zone concessionaire was set up to fail from the outset?

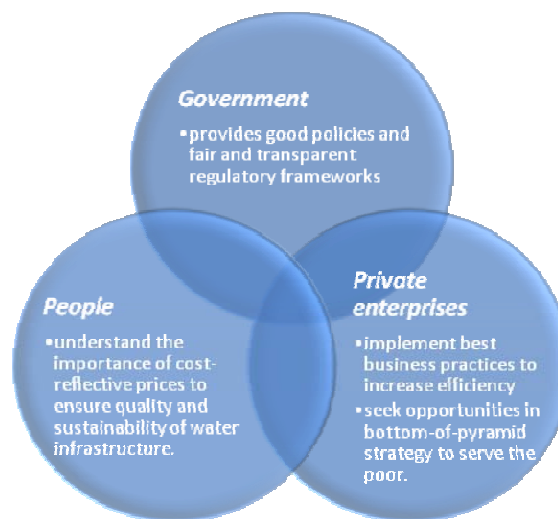
The Manila privatization project was also touted as the largest in the world. Could the government have considered a phased approach to experiment with a smaller area before applying the learning to scale up the privatization process? While the phased approach would definitely make the privatization process more manageable, it could also surface issues relating

to disparities in water access, quality and pricing across privatized and publicly-served areas; as well as challenges in regulation and enforcement.

Being sensitive to local conditions can also give rise to local innovations, such as how the concessionaires worked with local companies to expand access to the poor. New paradigms should also be explored – for instance, instead of adopting an enforcement approach, Manila Water used the cooperative approach to attract people to use their water supply through the sharing of pipelines amongst several households.

8. Conclusion

To conclude, water privatization is not the bitter pill that some make it out to be, nor is it the panacea to all the government's woes in water provision. While privatization can indeed generate significant welfare gains to people by tapping on the private sector's know-how and efficiency, it is extremely difficult to navigate the multitude of challenges to achieve a successful privatization. As we learn from the successes and failures of past privatization experiences, we are seeing a trend where privatization works best if the three key stakeholders of the process play their part:



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