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Universal Service Coverage After the Crisis?

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Manila Water Privatization: Universal Service Coverage After the Crisis?

By Jude Esguerra

Summary:

The first five years of the operations of the Metro Manila Water Concessions brought disappointing results. Investments and promised efficiencies did not materialize. The original bid tariffs were revealed to be unrealistic and there were indications of this even at the onset. The Asian financial crisis contributed to the difficulty of achieving performance targets in both concessions, but that only constitutes a small part of the explanation for the failures.

The rate re-basing exercise in 2002 marks a crucial turning point. The East Zone Concession was given a new lease on life through significantly raised tariffs; as a result it has become bankable and confident of achieving its scaled down targets. The West Zone Concession company remains unbankable and awaits corporate rehabilitation.

The bankability of the concessions is the most important factor in achieving the promised universal service coverage in water supply. The paper shows that bankability was made difficult by the inability of the bidders to assess *ex ante* the true state and potential productivity of concessionaire assets. It was also made difficult by the knowledge of the bidders that renegotiation is likely in case profits are negative and by the existence of many vague provisions in the contract that seemed to provide windows for political bargaining over contract terms and rules. It is not obvious that there was a way to avoid these information problems, especially in the much cases such as the older West Zone Concession with its many unplanned settlements.

The East Zone Concessionaire, however, has also introduced innovative engineering and social methodologies for extending services in urban poor communities of Metro Manila. These approaches move towards mitigating the plethora of commercial risks and costs encountered in bringing services to poor communities of informal settlers. The guaranteed returns on investments and the subdued incentives for making a profit that have been designed into the original concession contracts bid well for the willingness of the East Zone Company to venture into poor communities. The bankability of the East Concession business plan may that was made possible by the early resetting of tariffs and performance targets may yet nudge the Concessionaire into service expansion practices that were unthinkable during the first five years of financial difficulty. Many limitations remain – key among these are i) the high costs of connections, especially in areas that are not yet in the current business plan of the concessionaire ii) the need to properly calibrate and regulate the tariffs imposed by the East Concession through its bulk sales to mini-distribution systems and iii) the need to address the uncertainty in the cost recovery among pioneer, third-party providers in areas that the concessions will not be able to serve in the medium-term period.

Manila Water Concessions: Universal Service Coverage After the Crisis?

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Background

In January 1997 then Philippine President Fidel Ramos successfully induced four private water companies to bid for the right to operate and invest in two 25-year water concessions covering two-halves of Metro Manila and towns in the nearby provinces of Rizal and Cavite. To date this was the biggest and perhaps the most ambitious effort in the world to induce private companies to operate and invest in a public water utility. Metro Manila alone had 11 million inhabitants at the time of the bid.

From a system where piped connections were accessible to only two-thirds of the population, the concession contracts specified the achievement of near universal water service coverage during the first ten years even as the population was growing rapidly and was expected to double within 30 years. Improvements in water pressure, water quality and in the number of hours of service per day were also specified in the contracts. Sewage and sanitation services over the life of the contract were also expected. New raw water sources were to be developed and financed through the water tariffs. Total investments over the 25-year life of the contract were expected to reach US\$7 billion. The concessionaire inherited the income stream of the MWSS, but they also inherited the historically accumulated indebtedness of the public utility.

The winner in the East Zone offered a basic rate that was one-fourth of MWSS tariffs. The winner in the West Zone bid a basic rate that was about one-half of the prevailing MWSS tariffs. The overall impression in policy circles was that the bids reflected the private sector's confidence in their ability to improve over the performance of MWSS¹.

The scope for efficiency gains in the Metro Manila Water Works and Sewerage System (MWSS) seemed apparent in the level of Non-Revenue Water (NRW), which in 1995 officially² stood at 55 percent. With 8,000 employees, the public utility was also believed to be overstaffed. The fact that one-third of the population still had no access to piped water also meant that there were significant economies of scale that were yet to be realized³.

¹ Tariffs were raised by 38 percent five months before the bids were made, to ensure that 'privatization' would not result in a sudden tariff increase.

² The concessionaires argue that the NRW was much higher, probably 11 percent higher. The accounting turns on assumptions about pressure management practices of the public utility.

³ Although it may also be true that certain diseconomies will also emerge because populations densities can turn out to be lower in the unserved areas. The costs of new water sources can be significantly higher than before, based on the assumption that the first sources that were tapped were the ones that were more productive and closer to the Metropolis.

The East Zone contract was won by a partnership of United Utilities, Bechtel⁴ and the Ayala Corporation. The West Zone concession was won by a partnership between Suez/Ondeo and Benpres Corporation. In each case, due to Constitutional limits on foreign ownership of utility companies, the majority owner of the project company is a Filipino corporation. Vivendi and Thames also made a bid for the concessions.

Regulatory Roles and Rules

A pool of consultants led by the International Finance Corporation provided the advice that permitted the Philippine government to craft the details of a contract attractive to private investors that, among other things, 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 (MWSS Regulatory Office – MWSS-RO) via the contract 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 concession arrangement 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 that included expansion of service coverage and the maintenance of the assets of the utility. The latter would of course require large sunk investments from the concessionaires.

The tariff-setting rules that would reimburse the concessionaires provide incentives for increased efficiency. From the first rate rebasing onwards, tariffs are adjusted every fifth year so that the return on investment does not exceed the fair return initially stipulated in the contract and thereafter aligned with market returns during succeeding rate re-basing exercises. However, if the concessionaires are able to earn higher profits as a result of increased efficiency and effort, the contract allows them to reap these rewards. At the end of the five-year cycle, a readjustment of tariffs ensures that consumers also benefit from the concessionaire's efficiency gains. On the other hand, if a company does not achieve profitability targets or if profits are negative, it suffers the consequence but rate rebasing corrects this problem periodically. The basic base rate is automatically adjusted for inflation every year. The concessionaires may petition for adjustments in the basic rate to cover unanticipated costs arising from sharp devaluations, changes in laws which affect cash flow, *force majeure* – a total of eleven grounds for extraordinary price adjustments.

⁴ In 2004 Bechtel gave up its ownership shares East Zone company. Aside from the majority shareholder Ayala Corporation, the major shareholders are United Utilities and the International Finance Corporation.

If a particular ground for tariff increase is accepted by the Regulators, the concessionaire will be compensated over the remainder of the concession period through a tariff increase. Unanticipated costs arising from newly legislated health or environmental standards, for instance, are examples of specific grounds for tariff escalation through the extraordinary price adjustment mechanism. Unanticipated high rehabilitation costs, such as may arise from inaccurate asset records handed over by the government before the auction, are also ground for extraordinary price adjustments. But then again compensation for the unanticipated costs would happen over the life of the concession. The project company will have to raise money from creditors and its shareholders in the meantime. If a concessionaire disagrees with the tariff adjustment recommended by the Regulator to the MWSS Board, disagreements may be appealed through international arbitration.

In effect, the Concession Agreement provides three grounds for changes to the tariff rates: a) inflation – which allows for increases to the standard rates annually depending on the consumer price index b) Extraordinary Price Adjustments (EPA) – that are adjustments to standard rates which may be initiated once a year to capture the financial effects of certain unforeseen events to the concessionaires c) Rate re-basing – which is a resetting of the rates and a revision of the bid parameter once every five years, although the contract says that the first review is on the tenth year unless the Regulator chooses to implement it on the fifth year. The first amendment to the concession agreement introduced a fourth mode – contract amendment.

If legitimate grounds for price increases threaten to push the prices up, the concessionaires and the MWSS can choose to negotiate for a relaxation of some of the performance targets and investment plans.

The concessionaires have a large degree of autonomy as to what kinds of investments they will make in order to achieve the performance targets. There are explicit performance parameters and information requirements concerning the condition of the water utility's assets, these are a response to the problem of long-lived, non-transferable and not-easily-observable assets that the franchisee may not have sufficient interest to maintain properly throughout the contract's duration. In addition, asset reports are needed so the Regulator can identify assets that are frivolous and unrelated to the concessionaires' capacity to perform.

The MWSS-RO may also impose penalties and call on the concessionaires' performance bond depending on whether the MWSS-RO deems the concessionaires' performance to be unsatisfactory. Many details of the regulatory set-up have not yet been defined, even after the private companies have started operating. Performance criteria in the contract continue to be operationalized. The stakes involved in writing the fine print of the regulatory framework can be high.

Over all Performance 1997-2002

Overall neither concessionaire went close to fulfilling targets set out in their original bid documents. Both concessionaires claim population coverage based on a count of 9.2 persons per connection.

Table 1. Performance Water Supply Coverage 2001 (Percent)

| MWCI | | | MWSI | | |
|--------|-----------|---------|--------|-----------|---------|
| Target | Estimated | Claimed | Target | Estimated | Claimed |
| 77.1 | 65 | 84 | 87.4 | 76 | 84 |

A joint technical working group comprised of the concessionaires and the MWSS Regulator derived the figure. This 9.2 multiplier per connection was, however, used for all municipalities within the service area irrespective of population density. This has most likely led to a significant overestimate, resulting in instances such as in the city of Makati where the population claimed to have been covered exceeds the actual population (Landingin 2002). Corrections on the claims in Table 1 above were initially made by the Regulator based on advice from an expert demographer. Better methodologies and databases are being developed to address this problem (ADB 2003).

Although progress is disappointing at best, the 50% increase in billed volume over four years is a significant achievement. The two- and three-fold increases projected by the concessionaires at the time of the bids were, also in retrospect, quite unrealistic (UpeCon, 2002). During the first five years, the East concessionaire was able to bring Billed Water Volume up to 70 percent of its target. The West concessionaire achieved a billed volume that was only half of what it anticipated for the period.

It should be noted that achievement of service coverage targets is the most important strategy for reaching the poor. This is evident from the fact that alternative service providers (in areas where the utilities pipes have not yet been installed) have a clientele that has a disproportionately high number of households with incomes below the poverty line (WPEP).

The very serious shortfalls in capital spending (three quarters in the case of MWSI and nearly three-fifths in MWCI), which cannot possibly be attributed either to cost saving or elimination of unnecessary projects, must also be seen as a further indication of poor performance by the concessionaires, as well as a major failure of one of the main objectives of the concessions. The consequence of this inability of the concessionaires to deliver the promised investments has gravely affected service delivery. Under the best scenario of post-2002 performance by both concessionaires, close to 700 thousand people will be affected by these past failures in terms of a deferment of service target coverage by several years (see annex a and annex b).

Contrast in Efficiency Between the Two Concessionaires

An assessment of operational efficiency was made by consultants of the Regulator in 2002 using data from submissions by the two concessionaires. By comparing actual

OPEX (operations expenditures) to bid OPEX, adjusted for actual price and volume⁵ changes, it was seen that the East Zone Concessionaire was able to meet the efficiency level comparable to the underlying efficiency assumption in the bid model. It was able to achieve this by exceeding its total OPEX forecast in the bid. However, because the most important driver of unit cost reduction is the Billed Water Volume (BWV), which turned out to be significantly lower than the bid forecast, unit production costs turned out to be significantly above bid forecasts for the years 1997 to 2002. On the other hand, the West Zone Concessionaire was unable to achieve similar efficiency gains in its operational expenditures. In fact, while Billed Water Volume for the West Zone Concessionaire turned out to be only about half of the bid forecast, actual operational expenditures even exceeded forecast expenditures. Billed water volumes for the East Zone reached about 75 percent of their levels forecasted in the original bid. The overall impact on revenues of missed billed water volume was P4 B in the East Zone and P15 billion in the West Zone.

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