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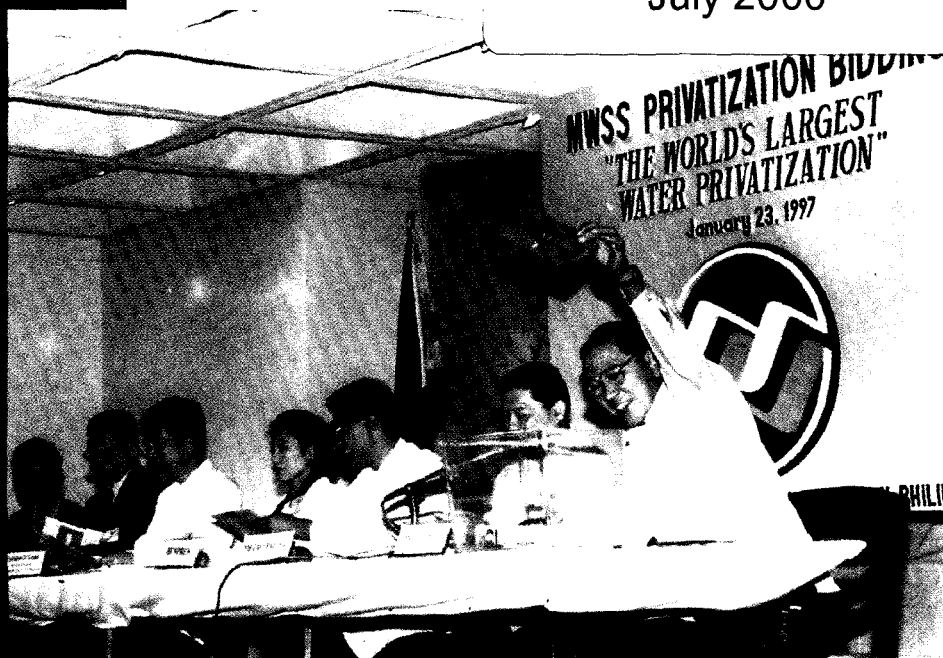
The Manila Water Concession

*A Key Government Official's
Diary of the World's Largest
Water Privatization*

MARK DUMOL

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July 2000



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The cover photo was taken on January 23, 1997, during the ceremony for the opening of the bids for the MWSS privatization. The photo shows the sealed bid envelopes being inspected by representatives of the Commission on Audit, the Development Bank of the Philippines, and the four bidders. MWSS Administrator Angel Lazaro III is also shown displaying one of the bid envelopes before dropping it into a transparent container.

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Foreword

In January 1997 the Government of the Philippines awarded two long-term concession contracts, handing over to private consortia the responsibility to operate and expand water and wastewater services in Greater Manila. With a combined population of 11 million in the two service areas and investment needs projected at \$7 billion over the contract period, the transaction was hailed as the largest water concession in the world. By tendering the contract competitively, the government was able to deliver an immediate benefit to customers: the winning bidders not only accepted contractual obligations to expand service coverage much faster than in the past, but they also offered large rebates on the tariffs of the incumbent public utility.

Mark Dumol was a key player in the government team that steered the Manila transaction. In this book, he tells the story of how the idea of a concession emerged and gained support; how the preparation effort was designed and launched; the main hurdles met and how they were surmounted; and the thinking behind some of the key contract features. Seeing through a water concession of this size is a challenging process, involving complex preparation and extensive stakeholder consultations, and it can be easily derailed by procedure or politics. Often—as in Manila—the government officials involved in preparing a concession have to learn by doing, since few countries have relevant prior experience. The learning curve can be daunting.

Mr. Dumol's objective in donating his time to write this book is to help fellow government officials facing similar challenges in other countries to be better prepared for some of the issues they will have to address, and to move faster on their own learning curve. Each case of utility reform is specific, but some principles are valid across countries: the importance of

sustained high-level political commitment; the need for a strong and dedicated government team supported by experienced advisors; the value of a transparent bidding process; and the need to communicate and consult broadly. While these principles are discussed in several more abstract publications, Mr. Dumol's book is unique in bringing them to life in this step-by-step, first-person account of a major transaction seen from the "boiler room." We hope that many practitioners will join us in finding the book useful as well as highly readable.

Vincent Gouarne
Manager, Water and Sanitation Division
The World Bank

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A very special citation to my mother Angelina and late Aunt Ludie who trained me in storytelling by having me narrate to them movies that I had seen.

Love and thanks to my wife Gigi, my son Tim, and my daughter Mary, who exercised a lot of patience with me during this process.

Most of all, I wish to thank the numerous people who helped make the MWSS privatization a success.

Acronyms and Abbreviations

ACCRA	Philippine law firm
ADR	Appropriate Discount Rate
BOT	Build-Operate-Transfer
CGE	Compagnie Generale des Eaux
COP	Committee on Privatization
CPI	Consumer Price Index
DPB	Development Bank of the Philippines
DOF	Department of Finance
DPWH	Department of Public Works and Highways
EO	Executive Order
IFC	International Finance Corporation
MWSS	Metropolitan Waterworks and Sewage System
NERA	National Economic Research Associates
NRW	non-revenue water
O&M	operations and maintenance
ODA	Official Development Assistance
OFWAT	Office of Water Services (U.K.)
PSP	private sector participation
PR	public relations
RORB	Return on Rate Base (system)
RPI	Retail Price Index
RTC	Regional Trial Court
TBM	tunnel-boring machine
TOR	Terms of Reference
TRO	Temporary Restraining Order
TWG	Technical Working Group
UATP	Umiray-Angat Transbasin Project

VAT	value added tax
WCA	Water Crisis Act
ZCWD	Zamboanga City Water District

Introduction

On January 6, 1997, the Philippine government accepted four bids for two concessions in the service area of the Metropolitan Waterworks and Sewerage System (MWSS), a government-owned and controlled corporation.

On August 1, 1997, the two winning bidding consortia fully took over MWSS operations.

The MWSS privatization was the largest of its kind in the world. It was estimated that over the 25-year life of the two concessions, some \$7 billion would have to be invested in MWSS by the winning bidders.¹

At the time of the bidding, I was the Chief of Staff of Gregorio R. Vigilar, the Secretary of the Department of Public Works and Highways and the concurrent Chairman of the Metropolitan Waterworks and Sewerage System. In this capacity, I was extremely fortunate to be deeply involved in this transaction, from conceptualization in mid-1994 up to the actual takeover in August 1997.

The MWSS privatization was, at the very least, an intense intellectual and emotional experience. We traveled into uncharted waters, and at every turn, we encountered obstacles that seemed impossible to overcome.

This book attempts to capture this experience. Intellectually, it tries to document our thought process as we executed the transaction. Emotionally, it tries to capture some of our excitement and our fears, especially as we approached the bidding date.

The Philippines—A Brief History

The Philippines is a developing country with a population of some 70 million people in a land area of about 300,000 square kilometers. The natives of the country are largely of Malay origin. In 1521, Ferdinand Magellan discovered the Philippines for Spain and, soon afterwards, Spain colonized the country.

In the late nineteenth century, the country staged a revolt against Spain and was largely successful in beating back the Spaniards. In 1898, the Filipino army had surrounded Manila and the Spaniards capitulated—to the United States of America.

The Philippines was a U.S. colony from 1898 until the Japanese occupation of the country in World War II. In December 1941, the Japanese army invaded the Philippines and occupied the country from that time until the United States liberated the country in 1945.

In 1946, the Philippines was granted full independence by the United States, and it governed itself under a democracy, patterned closely after the American system. In particular, the constitution gave strong powers to a popularly elected President.

In 1972, then-President Ferdinand Marcos declared martial law; he ruled as virtual dictator until 1986, when he was deposed. President Corazon Aquino, whose term ran from 1986 to 1992, succeeded him.

President Marcos built up a highly centralized government, which dipped its finger into many activities, including those that clearly should have been left to the private sector. The government owned and controlled commercial banks, hotels, construction firms, mining companies, and so on.

President Aquino adopted an opposite policy of limiting government involvement in commercial activities and of promoting the private sector as the real engine of growth through a market-oriented economy. These

policies were partly in reaction to the “strong government” policy of Marcos and partly because nearly all of Aquino’s advisers were from the private sector.

Aquino created the Committee on Privatization (COP), which was mandated to privatize hundreds of government-owned companies and other assets. From 1986 to 1992, the COP privatized about 122 government-owned and controlled corporations and generated about \$2 billion in revenues.

An equally important step during the Aquino administration was the enactment of a law (the “BOT Law”) that provided a legal basis and structure for the implementation of “Build-Operate-Transfer” (BOT) contracts. Under this groundbreaking law, the Aquino administration signed the first privately financed BOT power contract, the Navotas gas turbine power plant, which was financed and built by Hopewell Holdings of Hong Kong.

From 1992 to 1998, the president of the Philippines was Fidel Ramos who, among his many achievements, revived the economy and implemented a highly successful program of private sector participation in infrastructure. President Ramos built on the legacy of President Aquino and generated even more revenues through sales by the COP of government-owned corporations and assets. During the Ramos administration, the COP disposed of 132 government-owned and controlled corporations and generated approximately \$4 billion in revenues.

Unfortunately, while the Aquino administration restored democracy and established a strong legal foundation for a market-oriented economy, it did not build a single electric power plant, other than the Navotas gas turbine plant, mentioned earlier. Thus, from 1992 to 1993, the country suffered from brownouts lasting 8 to 16 hours a day. Selling generators suddenly became the most profitable business in Manila. The Central Business District was a virtual cloud of generator exhaust fumes. Climbing 20 stories or more to a meeting in the upper floor of a building became the latest exercise fad.

Faced with this huge crisis and needing to solve the problem as quickly as possible, the Ramos administration turned to the private sector once more. Making use of BOT arrangements, the private sector rapidly installed over 1,500 megawatts of electric power capacity. By the end of 1994, there were no more brownouts. No one believed that it could be done so quickly. It was like magic.

This dramatic experience with the power of private sector participation (PSP) in infrastructure was important because it proved to all—the executive branch of government, the politicians, the media, and the general public—that privatization works. This helped to lay the groundwork for the privatization of the MWSS.

The Metropolitan Waterworks and Sewerage System (MWSS)

The MWSS is considered the oldest water system in Asia, having been established as far back as 1878 to supply water to the city of Manila. Over the decades, its coverage area was gradually expanded to cover 14 adjoining cities and municipalities with a population of about 11 million people over 2,000 square kilometers. Roughly 10 million of its clients live in urban areas and occupy half of the coverage area. The remaining 1 million customers are in rural areas.

MWSS is a government corporation. Being a corporation, it can retain its revenues and spend these as needed, without the obligation to turn to Congress yearly for a budget allocation (though MWSS actually did turn to Congress often to seek for subsidies in the form of increased equity).² Being part of the government, MWSS was governed by the usual government rules, particularly with respect to procurement and personnel.

The MWSS had largely failed in its mission to provide water and sewerage to its coverage population. When the privatization of MWSS was conceptualized in 1994, MWSS was supplying water to only two-thirds of its coverage population for an average of only 16 hours per day. Out of the roughly 3,000 million liters per day (MLD) that it received from the Angat reservoir, about 56 percent was non-revenue water³ (NRW) and this figure had actually been worsening for more than a decade, in spite of numerous attempts to reduce it. With respect to sewerage, MWSS serviced only 8 percent of its coverage population.

The ex officio Chairman of the MWSS Board of Trustees was the Secretary of the Department of Public Works and Highways (DPWH). In June 1993, President Ramos appointed Gregorio R. Vigilar as DPWH Secretary and Chairman of the MWSS Board.

The appointment of Vigilante was a surprise to most people because, at the time, he was not a well-known public figure. It seemed that his main qualification was that, similar to Ramos, Vigilante was a graduate of West Point, the U.S. Military Academy. Initially, therefore, people thought that Vigilante was just a crony of Ramos.

In reality, Ramos had chosen Vigilante mainly because of his competence in implementing infrastructure projects and his reputation for honesty. Vigilante had vast experience working with the Philippine Army Corps of Engineers, with varied civilian government programs and offices, and with a very large private construction company. Equally important, he had an impeccable reputation of integrity. Vigilante was a professional who did his job. He knew how to implement large projects. All this was to prove indispensable in the privatization process.

The Philippine Democratic Framework

At the beginning of President Ramos' term, former Singapore Prime Minister Lee Kuan Yew visited the Philippines and delivered a stinging speech to a large gathering of top executives. In that well-publicized speech, he criticized the Philippine style of governance. Essentially, his thesis was that, in the Asian setting, it was not possible to have high economic growth coupled with the luxury of democracy. Instead, he advocated strong discipline among the people, instilled by a strong government.

This kind of thinking was prevalent at the time—the early 1990s. The Philippines was then the economic basket case of Asia. It was the exception to the rule. While all other countries around it were growing at rates of 8 to 12 percent per year, the Philippine economy was stagnant—and it was not uncommon to point to democracy as the culprit.

The societies of Singapore, Indonesia, and Malaysia, among others, did not have the freedoms provided by democracy. Their press was much less lively than that of the Philippines. Their politicians were less able to criticize the head of state, unlike in the Philippines where many legislators have the guts to deliver stinging attacks against the executive branch, including the President. Their courts had less power than the Philippines where courts have reversed even apparently pure business decisions.

Everyone in the Philippines has an opinion about anything. Everyone speaks his or her mind. And, if you are a government official, you have the obligation to listen to nearly everyone.

To outsiders, the Philippine environment probably appears chaotic—and it is. Yet, there is order within this chaos. There is reason behind the confusion.

There is strength in the need to obtain a consensus before important actions can be taken. The process may take longer, but you end up with a more thoroughly studied and robust transaction.

After the Asian/global economic crisis of 1997, some of the traditional thinking about the weakness of democracy seems to be changing. There now appears to be more appreciation of the value of a transparent economy and society in which people can voice their opinions. People seem to understand that there is a tendency for a democratic society to be more stable.

Early Offers to Privatize MWSS and the Decision to Privatize

The Malaysians' Offer to Privatize MWSS

About June 1994, President Ramos asked Secretary Vigilar to join him during a presentation by a private group on the possibility of privatizing the MWSS.

The group was composed of a Malaysian firm, in joint venture with Biwater, a British water company. President Ramos was extremely interested in the presentation and he instructed Secretary Vigilar to study the proposal and to give his recommendations. Ramos was so excited about this offer that, every now and then, he would call Vigilar over the phone, just to follow it up.

Essentially, the Malaysian firm wanted to purchase MWSS on a negotiated basis. They wanted the transaction to be government-to-government, and this would provide the basis for the negotiation.

On our recommendation, the President created an interagency committee to study the proposal. The Committee met several times and recommended that the offer be turned down, mainly because it was illegal to sell MWSS shares. Aside from this, we thought that it would be virtual suicide to negotiate such a large transaction and one that involved a commodity as political as potable water.⁴

At the same time, the proposal was actually very interesting. The proponents were promising to do a lot of things for MWSS. They would expand distribution services. They would provide new water supply sources. They would reduce leaks. They were going to solve all the problems. Could they really do all that they promised?

We analyzed the structure of a potable water system and we realized that there were remarkable similarities to power systems. Similar to power, there

was the bulk water supply (treatment plants), transmission lines (primary distribution pipes), and a distribution system (secondary distribution pipes). Our immediate reaction was that if the country could be so successful in solving the power crisis through BOT projects, could we not do the same with water? Could we divide the MWSS operations into distinct units that could be bidden out as BOT projects?

We thought we could use the BOT law to effectively privatize MWSS. We would request the President to extend the life of the Committee and expand its functions to the "pursuit of the MWSS privatization." Given the President's enthusiasm for the proposal, this recommendation would also be more positive than simply turning down the Malaysian firm's offer. The President was excited about privatizing MWSS and it was our duty to see what we could do about it. The President approved our recommendation to "pursue the MWSS privatization." We now had a mandate.

The President

Later on, we would always say that the MWSS privatization was the initiative of President Ramos. President Ramos was a great believer in private sector participation in infrastructure development. Throughout the MWSS privatization, all the way up to financial closure in August 1997, the President repeatedly asked Secretary Vigilar for updates on the MWSS privatization. He was on top of the situation and, when we needed his help, he was there.

Aside from his direct contributions to the advancement of the MWSS privatization, he was particularly indispensable in terms of making people aware of the water crisis and developing a consensus on the need to address it.

In June 1993, when Secretary Vigilar had just assumed office at the DPWH and the MWSS, he had a one-on-one meeting with President Ramos. The President talked to Vigilar about what he felt were the national priorities, particularly certain important provincial highways. This was expected. What surprised Vigilar, however, was that the President talked to him about the "water crisis."

At that time, no one except the President talked about the "water crisis." People simply were not aware about the problems in the water sector. The President pushed Vigilar to create awareness among the public. He convened "Water Summits," which brought together decision-makers from all over the country to talk about water.

I personally thought that these summits produced relatively little action. Nevertheless, they played the crucial role of making people understand that there were serious problems in the water sector and that we needed to do something. Specifically, people suddenly became aware that the level of

“Non-Revenue Water” of MWSS exceeded 50 percent. This was actually not something new. In fact, this problem had existed for more than a decade. Yet, it was only during the time of President Ramos that people were generally made aware of it.

Why did President Ramos want to publicize his problems? He seemed to realize that in order to reform the water sector, people needed first to be aware that reform was needed. He wanted to develop a consensus among the public that serious problems existed. This gave the President the leverage needed to undertake important reforms.

Later on, while we were working out the details of the privatization effort, it was necessary to secure a number of commitments, decisions, and so on, from various government agencies. In nearly all cases, I found that not only did the government officers cooperate, they were, in fact, enthusiastic about the project. Partly, this was because everyone realized the seriousness of our water problems. Partly, this was also because everyone in Metro Manila was suffering from the poor MWSS service.

Second Proposal to Privatize MWSS

In December 1994, we received another offer from Biwater to privatize MWSS. By this time, an expanded BOT Law had already been passed and Biwater claimed that its offer was an “unsolicited proposal” as defined in this new law. Their offer included several thick documents but contained essentially nothing other than their company brochures and propaganda material. Essentially, they said that they would hire consultants to determine the value of MWSS and then pay the government whatever that was. We did not take this proposal seriously.

Third Offer to Privatize

In September 1995, we received a third offer to privatize MWSS, on a negotiated basis, this time from a large local real estate firm, backed up by a conglomerate of multinationals. Naturally, we again refused their proposal and, instead, invited them to participate in the privatization bidding.

Particularly after seeing all the media attention we got from the MWSS privatization bid, we thought it was amazing that some people thought they could acquire MWSS on a negotiated basis. MWSS was too big and its business—potable water—was too political. As mentioned earlier, it would have been political suicide to attempt to privatize MWSS on a sole-source basis. We were absolutely convinced that it was essential to bid it out.

Early Research on Water Privatization

The Commercial Counselor of the French Embassy

About June 1994, I met Henri Fremon, the Commercial Counselor of the French Embassy in the Philippines. It was about this time that we had started looking into the MWSS privatization so I mentioned this to him.

It turned out that Fremon was a diplomat in Buenos Aires at the time of the privatization of the city's water system and he was able to share a substantial amount of information about this transaction. I was encouraged by the parallelism between Manila and Buenos Aires, particularly in terms of size, coverage, and inefficiency.

Fremon insisted that the Buenos Aires situation was worse than Manila's. For example, there were hardly any water meters in Buenos Aires. People were billed according to a formula based on their lot and house area, among others. Fremon told us about his household help who, during the summertime, would keep the tap running the whole night to cool down the house. Anyway, no matter how much water you consumed, you still paid exactly the same to the water company. Fremon also told us that there were many "ghost" employees in the water utility.

I was surprised when Fremon informed me that there were only five pre-qualified bidders for the Buenos Aires privatization and that, after two of the bidders joined forces and one was disqualified, only three bidders were left. It was only then that I realized that there were very few companies worldwide that were qualified to bid for a water concession as large as that of Buenos Aires.

If Buenos Aires could be privatized, why couldn't we do the same in Manila? The reasoning was simple: The quality of the work of the private firm would be assured by setting the prequalification standards so high that,

similar to Buenos Aires, very few companies, only the best in the world, would prequalify. The price of water would be determined by bidding, and we hoped we would experience the same phenomenon as in Buenos Aires, where the privatization actually resulted in the lowering of water rates. Politically, this seemed to be much easier than the toll roads we were negotiating at that time, since we were looking at substantial increases in toll rates. Which politician would object to better water quality at a lower price?

Fremon also told us about the system in Paris with two concessionaires, on each bank of the Seine River. This created a form of quasicompetition. I thought this was a great idea and that we could apply it with the Pasig River, which splits Metro Manila in two.

Initially, we were highly confident that it was going to be easy to privatize MWSS. 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.

Lyonnais des Eaux

About the same time, almost by coincidence, I met Gerard Meriguet, the local General Manager of Degremont, who explained that his parent company, Lyonnais des Eaux, was the privatization partner of the Macao and Buenos Aires water systems. In Macao, they had reduced non-revenue water from 44 percent to 14 percent in four years' time. In Buenos Aires, they had committed to invest \$4 billion, which was supposed to be the largest investment in a privatized water system ever. Actually, this was the first time we had heard the name of Lyonnais des Eaux, and we did have some initial apprehensions on the competence of any French firm that was not in the business of fashion or wine.

The information we received was impressive. We got the impression that water privatization was commonplace. We did not immediately realize that there were few actual precedents, particularly concessions.

Macao

About September 1994, Secretary Vigilar went to Hong Kong and Guangzhou, China, to observe the projects of Hopewell Holdings, on the suggestion of President Ramos. A few days before the trip, it occurred to me that Secretary Vigilar could visit Macao and observe the privatized operations of the water system. I called Meriguet and the visit was quickly arranged.

Secretary Vigilar had a one-day side trip to Macao, and he was extremely impressed with the operations of the water system, particularly the

compactness of the system, the SCADA (automation) technology, and the short time it took for the concessionaire to upgrade the system. He was convinced that privatization was the solution to the ills of MWSS.

The U.K. Model

In May 1995, on the invitation of the respective embassies, Secretary Vigilar visited France and the United Kingdom to observe, among other things, their water systems and toll roads. In June 1995, I visited the United Kingdom as well and did an extensive tour of water facilities in addition to the U.K. water regulator, the Office of Water Services (OFWAT).

We held numerous talks with U.K. water companies and investment bankers. Everyone showed a keen interest in a possible privatization of MWSS.

We learned much about how the U.K. water system was privatized by actually selling water companies. We thought that was a brave thing to do. We could not imagine ever selling a water utility in the Philippines to the private sector. It was just politically untenable.

It was also surprising for us to discover that a lot of consumers in the United Kingdom do not have water meters. It was even more surprising that the water companies themselves resist installing water meters for individual consumers. Since it is a temperate country, people probably use less water.

In the Philippines, not installing water meters was unthinkable. If this were done, everyone would start selling water to informal settlers.

Finally, it was interesting for us to see the piles of documentation that OFWAT produced on the numerous water utilities operating in the United Kingdom. To us, this seemed to be an extreme. In the Philippines, we could not imagine the value of having so many reports.

Buenos Aires Documentation

Also about this time, through one of the MWSS board members, we got hold of a copy of a pamphlet written by Emmanuel Idelovitch and Klas Ringskog (both from the World Bank) about the Buenos Aires privatization. The copy we got was probably a fifth-degree photocopy, terribly faded, but we treated it like a sacred document.

The pamphlet excited us even further. It gave more details about the transaction, and we became even more convinced that we could implement it in Manila. We were familiar with and liked very much the basic bidding procedure used in Buenos Aires. Bidders would actually submit two envelopes—a technical and a financial proposal. The technical proposal was evaluated on a pass-fail basis. The financial envelopes of all those who had

failed would be returned while the envelopes of those who had passed would be opened. The lowest or highest bidder, as the case might be, would automatically win. This system was transparent and objective.

The Need to Privatize

We had heard a lot of benefits derived from the Buenos Aires privatization. Aside from these, we felt that there were many more compelling reasons to privatize.

Procurement

With respect to procurement, MWSS had the habit of tying itself up into knots, to such an extent that it could not even sort out its biddings for janitors and security guards. These specific biddings were locked in so much controversy that awarding them usually took two years or more.

MWSS was also locked in a bidding controversy over large-diameter fiberglass-reinforced pipes, which was ending up in a multitude of court cases and was substantially delaying a multibillion-peso water supply project. This bidding took seven years to resolve, from 1992 to 1999.

A classic case involved the Umiray-Angat Transbasin Project (UATP), a 900-million-liter-per-day water supply project. This project was going to provide an invaluable, immediate benefit because the existing water supply shortfall was 700 million liters per day—a figure that did not include the huge number of people who were not connected to MWSS. The project involved the drilling of a tunnel to transfer water from the Umiray River to the Angat reservoir. The project was bidden out and won by an Italian-Filipino consortium for the price of about P2 billion.⁵

These types of tunneling projects invariably involve the procurement of a new tunnel-boring machine (TBM). These machines are typically made to order, and it takes more than a year to fabricate them. The winning contractor informed MWSS that they could procure two TBMs immediately,

although these were of a different size. The contractor offered to complete the job, using the two tunnel-boring machines, 14 months earlier but with an additional cost of about P500 million.

The contractor's offer made a lot of financial sense, considering that the water would be delivered 14 months earlier and the additional water the MWSS could sell during this 14-month period would more than cover the additional cost. This is aside from the social benefit of providing additional water to the public at an earlier date.

MWSS, however, could not approve the offer of the contractor because it would then be violating the procurement rules of the Asian Development Bank. Even without the anticipated Asian Development Bank objections, it was also doubtful whether the MWSS could approve the offer because doing so would open the MWSS to protests from the losing bidders.

Some of the major problems of government procurement procedures are the following:

- There is so much emphasis on transparency that decisions are often based on how a certain course of action could be perceived rather than on whether or not the course of action is correct.
- In order to strengthen controls, procurement procedures are often long-winded and full of red tape.
- Since the procurement procedures are so strict and extensive, they are open to protests from losing bidders—often on mere petty technicalities—whether or not these protests are justified.

It is useful to emphasize here that there is certainly nothing wrong with "transparency." On the contrary, transparency is one of the most important prerequisites to a successful transaction. What often happens in government, however, is that "transparency" exists in name only. There is an emphasis on form and a loss of concern over substance.

This obsession of the government with procedure results in a game of bureaucrats versus auditors. People try to look for loopholes in the procedures while the auditors try to plug them by making the procedures more and more complicated.

How often had it been our experience that we focused on the substance of having a fair and honest deal, of obtaining the best for the government both in terms of quality and price, only to end up being investigated for some obscure irrelevant procedure that was not observed?

And furthermore, how many government transactions meticulously follow procedure, yet result in projects that provide obsolete and overpriced equipment?

In the MWSS privatization, while we focused on transparency, we were fortunate not to have a fixed procedure to follow. We had no precedent. We designed our own procedure, which was not only patently transparent but

also resulted in a transaction that was grossly favorable to the government and to the general public.

Other procurement problems of government may be better illustrated through anecdotes of the privatized MWSS:

- Soon after the takeover of MWSS by the private sector, employees commented that all the fluorescent bulbs in the ceilings were now working because it was easier to requisition a ballast. Previously, you had to fill up all sorts of forms and it would take six months before the new ballast came.
- An officer of the privatized MWSS also observed that it took him two weeks to purchase some 30 service vehicles whereas before, he would be lucky if he could get these in six months' time.
- Within six months after the takeover, the concessionaires started to award large contracts for pipe replacement. In the old MWSS, this would have required a feasibility study, a loan approval by a multi-lateral financing institution, biddings for consultants and civil works, and then actual implementation. The old procedure may have required four years from the identification of the need to the actual work.

Personnel

It is well known that government has many constraints with respect to levels of salaries, motivation and firing.

At the MWSS in particular, while virtually all employees were career officials, the vital position of the Administrator, who was the Chief Executive Officer and Chief Operating Officer, along with all of the members of the board, were political appointees. At times, there were excellent Administrators and board members. At other times, the appointees were politically well connected but not all that competent.

Equally important, the Civil Service Commission granted the employees rigid job protection, which made it extremely difficult to reduce the number of employees. Thus, with 8,000 employees, the MWSS had 13 employees per 1,000 connections, which was two to five times more than what similar water utilities in the region had.

Salary levels were dictated by civil service rules. While the salaries of the MWSS rank-and-file were actually competitive compared to the private sector, the salaries of middle managers and those higher up were very low.

Again, the difference between the government and the privatized MWSS may be better illustrated through short anecdotes:

- Immediately after privatization, people commented that the employees were reporting to work on time and voluntarily working overtime.

- People have observed that the privatized MWSS has surprisingly few employees loitering in the corridors.
- According to one of the concessionaires, the very same leak-repair and meter-replacement teams, with the same equipment as before, increased their productivity by factors of three to four.

Financing

Being the sole stockholder of MWSS, the government was expected to support its equity requirements. Yet, the government had many other needs. Any government has nearly infinite needs. There was never enough money for the equity contributions that MWSS needed.

In accordance with its charter, all MWSS debt was fully guaranteed by the national government. Of course, these guarantees created a huge contingent liability in the books of the Department of Finance. Also, since MWSS was a government corporation, its debts were carried in the books of the national government, thereby contributing to the loan ceiling of the national government and limiting its capability to borrow money for other purposes.

Largely because of pressure from the Department of Finance, MWSS sourced its financing nearly exclusively from Official Development Assistance (ODA) agencies. This was long-term and often low-cost money, but it was not enough for the huge capital expense requirements of MWSS and it was slow in coming.

The ODA agencies demanded that MWSS be run like an ordinary company, which meant that it should earn profits. MWSS, therefore, always earned profits, but often at the expense of its operations and maintenance, particularly preventive maintenance.

Elephants Can't Fly

I personally felt that a large weakness of the company stemmed, conceptually, from its not having a real owner. Theoretically, the company was owned by the national government, which therefore played the role of the stockholders of a corporation. But who was the government? Being owned by the government is a nebulous concept. To the ordinary MWSS employee, it meant that there was no owner. There was a general attitude among the employees of trying to extract as many benefits as possible from the company with as little effort as possible. In board meetings, the best-prepared presentations were those that involved requests for increases in benefits. Other presentations, including those for critical projects, were often poorly prepared.

In summary, we felt that many of the problems of MWSS were inherent to the company, by virtue of its being owned and operated by the government.

During the privatization process, some people would comment to us that it was high time we privatized a government corporation that was as corrupt as MWSS. We told them that the problem was not corruption. We felt that even if the MWSS were run by saints, it would still be sorely inefficient because of the inherent weaknesses of government-owned and controlled corporations, particularly because of problems related to personnel, procurement, and financing. As Peter Drucker has said, you cannot make an elephant fly.

Much later, in May 1999, I visited Johannesburg, South Africa, as part of a World Bank mission to advise the city on privatization for its water utilities. South Africa is very different from the Philippines, but the problems with water utilities were exactly the same as those that we faced with MWSS—personnel, procurement, and financing. The solutions contemplated by officials were also the same—some form of private sector participation.

I think that in this world governments may differ greatly from each other, but they also have many similarities. I feel that if a country has reached a certain level of wealth, pays its civil servants competitive salaries, and has enough funds for equity requirements of government corporations, that country may directly run a water utility in an efficient manner.⁶ In the case of developing countries, however, we need to privatize.

Financing the Cost of the Advisers

The Need for Advisers

While we now had the germ of a concept, we did not know how to proceed. At that time, we were in the midst of negotiations for three major toll road projects and we had hardly any external advisers. We just did not know that these transactions were normally done with advisers. Secretary Vigilar and I both thought that we could privatize MWSS in the same manner—that is, by ourselves and without any external assistance.

After thinking about this for a while, however, I thought that the MWSS privatization was going to be more difficult than that of a toll road. Some of the areas that I thought were going to be tough were the limitations on foreign ownership of certain types of corporations, the need to lay off excess workers, and the restriction on the sale of MWSS shares (of course, in reality, there were probably a hundred other tough areas). One day I told Secretary Vigilar that we were probably going to need some advisers and he looked at me with a puzzled expression and asked why. We were both quite naïve about how difficult this transaction was going to be.

Later on, Secretary Vigilar agreed to hire advisers—but how does one go about securing an adviser and paying him or her? We had a vague idea of the terms of reference and we had no idea whatsoever about how much it would cost. It was clear to us that we needed advisers to help us secure advisers. This was a chicken and egg situation, especially because, being government, we had to procure the services of advisers through some form of transparent process, normally via bidding.

The problem was that we needed a set of Terms of Reference (TOR) to select our advisers and we didn't have a clue about this TOR. Therefore,

we needed advisers to prepare the TOR—and we didn't know how to go about procuring those. This is always the problem in water privatization and in many other cases of private sector participation.

French Assistance

It was about October 1994 and the only thought that came to mind was to ask Fremon to help us get a grant from the French government for the advisers. I talked to him about this and he said that he would try to help. He explained that, similar to Buenos Aires, we would need financial and technical advisers.

At that time, I had only a vague idea about how responsibilities would actually be divided between the financial and technical advisers but Fremon's advice was firmly etched in my mind: we needed two kinds of advisers, technical and financial. The advice was simple—and wrong. Many more types of advisers were needed, together with a lead adviser who would have overall responsibility.

Fremon started to work on securing a million-dollar French government grant. He worked hard and eventually got the grant. I think his argument to his authorities was simple. If the MWSS were to be bidden out, few firms would prequalify, and among those would be French firms. A French grant would help facilitate the bidding. It was, therefore, to the interest of the French government to give a grant.

The terms of the assistance were peculiar. It would be provided in kind, through actual consultancy work carried out by French consultants, and not in cash. This arrangement ensured that we would need minimal government approvals to accept the grant. We actually insisted that we were not to receive any cash. The Philippine government bureaucracy was such that it could take a year or longer for us to accept grants if these were provided in cash.

The French wanted to help push the process forward, but they were extremely careful to structure their assistance in such a way that no one could have basis to claim that this was done in order to favor French bidders. Thus, while the terms of the grant made it obligatory to hire French consultancy firms, it was ascertained that the chosen firms had no connections to any of the French water companies, particularly Lyonnaise and Compagnie Generale des Eaux (CGE). After obtaining our "no objection," the French government selected SOGREAH, a large engineering firm that specialized in water and that was not connected with any French water company.

Furthermore, the French government specified that the consultants would be involved only in the activities prior to actual implementation, in other words, bidding. Later on, in fact, we rehired the French consultants

to assist during the actual bidding and evaluation process. It was clear, however, that this was with Philippine government financing. No one questioned the decision.

The Search for Additional Grants

A lot of our time and effort early in the process was spent looking for additional grant financing for the consultancy fees, in addition to those that the French government had committed. We approached a number of potential ODA sources, including the World Bank, the Asian Development Bank, and the United Kingdom's DTI. We had limited success and found the process quite frustrating—back then, the aid agencies were not focused on water privatization or aware of its potential, and their grant processes were generally much too slow and bureaucratic to meet our calendar.

In the end, aside from the French government grant, all other sources failed to deliver, even though all of them had pledged to provide grant funding. I hear that donors have recently become more responsive to this need, but I wish they had been ahead of the curve when we privatized MWSS.

Bridge Financing

About May 1995, we struck on the idea of charging the cost of the consultancy to the winning bidders. Given the size of the contract, we were sure that this would not be a problem for the bidders.

In order to bridge the financing gap for the cost of the consultancy, we decided that MWSS would get a loan from a government bank. After the privatization was concluded, this loan would be more than fully covered by the \$10 million "Commencement Fee" that we charged to the winning bidders.

Finally, we thought of paying part of the consultancy fee through a "success fee," to be paid by the winning bidders only after the success of the transaction.

With the loan from the government bank, the \$1 million French grant and the success fee to be paid by the winning bidders, we had the funds we needed.

How to Secure and Finance Advisers

Governments generally need external advice for nearly all infrastructure projects involving private sector participation. The skills needed are highly specialized and often require some international experience.

This need seems even more amplified in the case of water sector transactions, which, in our experience, are generally much more complicated than those of other sectors such as power and roads.

Yet, the work of the advisers is so complicated that one would probably need the help of other advisers to draft the Terms of Reference (TOR) and to assist in evaluating the bids for advisers. But how do you procure the services of advisers who will help procure advisers? It's an endless chain.

Water utilities need some technical assistance to help them evaluate their problems, decide on their best course for privatization, and help them procure advisers. The utilities need the draft terms of reference and a budget. Without help, the utility is unable to progress. Our experience is that the easiest way to get this technical assistance is through multilateral agencies such as the World Bank and the Asian Development Bank.

Water Crisis Act

In February 1995, the House of Representatives started to push for the enactment of a "Water Crisis Act." This bill was being sponsored by top Congressmen who said that it would be similar to the "Power Crisis Act," which had led to the successful solution of the power crisis.

The key provision in the law was the granting to the President of the power to negotiate contracts for the water sector. Actually, we felt that this provision was not all that useful for MWSS because all the major MWSS projects were being financed by Official Development Assistance (the Asian Development Bank, WB, the Overseas Economic Cooperation Fund of Japan, and so on), and the lending institutions would never agree to have the implementation of their projects negotiated instead of bidden.

Aside from the authorization to negotiate projects, the bill also covered the reorganization of MWSS (essentially reducing the number of staff through an early retirement program) and the criminalization of water theft.

The proposed legislation was quickly passed by the Lower House. In the Senate, however, it encountered rough sailing. Later, we received feedback that the Senate wanted to delete the provision on negotiation. During this time, we started to think about how we could make this law work for us. One day, we struck on the idea of including in the bill the granting of authority for the President to privatize water utilities, including MWSS, and to negotiate BOT contracts, in lieu of an authority to negotiate standard contracts. This provision was approved as a compromise.

The Water Crisis Act (WCA) turned out to be extremely important for the MWSS privatization. In one sentence, almost as an afterthought, the law gave the President the authority to privatize MWSS. This authority was strong because it did not prescribe any particular procedure for privatization. We were free to create our own procedure.

We used the Water Crisis Act as our legal basis for privatization. The only conditionality attached to the President's power was that it had to be exercised within six months of the law's going into effect. Later on, this was interpreted by our lawyers to mean that the President had six months to *commence* (not conclude) the privatization process, and this interpretation was upheld by the courts.

In addition, the law gave authority for MWSS to retrench personnel, and this was used to reduce the number of staff prior to privatization, thus creating a much leaner organization and increasing its value for the bidders. This significantly contributed to reducing the price of the bids.

Finally, this law made the theft of water a criminal act, which was to prove extremely important after privatization. It meant that the current top officers of corporations who were caught stealing water faced the prospect of jail sentences. These corporations quickly entered into compromises with the concessionaires.

The Water Crisis Act turned out to be crucial for the privatization of MWSS. The original objective of this Act, however, was not the privatization. In fact, the MWSS privatization consisted of only one sentence in the Act. Yet, other provisions in the Act were helpful in this regard, particularly the granting of power to reorganize MWSS and the penalties for water theft.

The particular provision in the Water Crisis Act that was never used was the power to negotiate BOT water projects. Yet, this was probably well and good. It is true that the Philippine power crisis was solved through the implementation of BOT power plants. The problems in the water sector, however, are different from that of power. The power sector essentially had a problem of supply, which may be resolved through BOT power plants. The water sector typically is plagued by problems in distribution and it is not advisable to solve this through BOT water supply and treatment plants. You do not want to provide more water supply if you are losing nearly half of the water you distribute. You want to solve those leaks first.

I suppose that part of the problem lies in the nature of water distribution. Water pipes necessarily are buried. You don't see them. It's harder to maintain them. In electricity distribution, by contrast, distribution lines are normally above ground and are, therefore, easier to maintain.

I am convinced that usually, the problems in water utilities lie in the distribution and that, therefore, the solutions are reached by focusing on operations and management—for example, a concession.

The International Finance Corporation

First Contact

In the first half of 1995, the MWSS board was looking into the implementation of the Laiban Dam project, a major water supply project that was estimated to cost about \$1 billion. The board wanted to bid it out as a BOT project and this would be the very first BOT project bidden out by MWSS. The Board knew that it would need advisers; Board members asked Senior Deputy Administrator Bing Veroy for suggestions. Bing invited the International Finance Corporation (IFC) to come over. Bing told me that IFC was the only financial advisor that he knew.

In July 1995, an IFC team flew in to Manila and I had the occasion to meet the team, which was led by Scott MacLeod. Instead of discussing the Laiban Dam project, I peppered them with questions about what IFC was and what it did. Though I had previously heard about IFC, I was really not familiar with the organization.

I was surprised to learn that even though it was a multilateral body, it acted according to private sector rules. Together with IFC's vast experience in privatization transactions, the fact of their being a multilateral organization made them the ideal entity to hire as advisers. They would provide the transparency we needed for the bidding process because they were not identified with any particular country. Also, we could negotiate with them directly (since they were a multilateral group).

It was important for us to be able to quickly hire a set of advisers, particularly because we wanted to close the transaction way ahead of the 1998 elections. From experience, we knew that the selection process for advisers could take months and, in some cases, more than a year. The process

was inherently subjective, and therefore open to controversy. We never really knew whether we had hired the best advisers for the job or the best advisers for making proposals. We were only too glad to be able to negotiate directly with a set of competent advisers.

Up to this time, we had always had the vague assumption that, similar to Buenos Aires, there would be two sets of advisers—technical and financial. While speaking with the IFC representatives, I realized that it would be best to have one consultant with overall responsibility. The French consultants would report to IFC and this would resolve the issue of the French grant and the integrity of the bidding. No one would be able to question the integrity of a multilateral institution.

I explained to them that we were trying to privatize MWSS and I explained to them briefly where we were in that process. I asked them whether they were interested in becoming the lead adviser for this transaction. Naturally, they were interested.

It turned out to be quite fortuitous that we had decided to hire a single adviser to have overall responsibility. At the time it seemed to be mainly a way of solving the problem of ensuring that no one questioned the French grant. Later on, it turned out that the transaction was indeed so complex and required hiring so many consultants of such a variety of disciplines that it was indispensable to have an overall coordinator and lead adviser. We hired engineers, local lawyers, international lawyers, accountants, public relations (PR) specialists, economists, opinion survey specialists, and so on.

Later on, we learned that one of the weaknesses of the Buenos Aires transaction was precisely that there were two sets of consultants, with no one to coordinate their work. In fact, their work overlapped. For the MWSS privatization, our initial concept of hiring two sets almost became an example of trying to blindly imitate a transaction and, in the process, coming dangerously close to imitating the same mistakes.

Negotiations

I informed Secretary Vigilar about the meeting with IFC and he agreed that they looked like the right group to be the lead adviser. Secretary Vigilar presented to the MWSS Board the concept of hiring IFC as the lead adviser and then financing the contract with a French grant and a loan from a government financing institution. The Board approved the plan.

Scott came back quickly with Barry Walton of Halcrow. Barry had been directly involved in the privatization of the Buenos Aires water system. We discussed the first draft of the IFC contract. I thought that this was one of the big advantages of negotiating with a multilateral institution. We actually did not have detailed Terms of Reference for the consultancy. In fact,

we were not totally sure about what exactly we needed. We explained a bit what we thought the concepts behind the contract should be and we went straight to drafting the contract, which was then presented to the Board.

We also discussed concepts behind the MWSS privatization. At this early stage, some of our ideas were the following:

As Buenos Aires had done, we wanted to do a concession because it was clearly the most complete solution.

We liked the Paris model of having two concessionaires, although we realized that there were pros and cons to this.

We discussed the impact of the Laiban Dam and whether or not this should be included in the bidding parameters. IFC was worried that Laiban had such a big impact on the bidding that if its construction were part of the bid, the bid winner might be the company that best knew how to build a large dam such as Laiban, not the one that could operate MWSS best.

We wanted to impose strict prequalification standards in order to ensure that only the very best companies would prequalify.

We wanted to handle the bids in a way that was similar to Buenos Aires' approach. We would dictate the service targets. The bidders would submit their technical and financial proposals. The technical proposals would be evaluated on a pass-fail basis. The financial proposals would be based on the tariff, and the lowest bidder would win.

The MWSS Board formed a committee to negotiate with IFC. Scott came back for the negotiations and these proceeded very quickly.

In the end, I thought that IFC really earned every cent of the money we paid them. There seems to have been two major differences between MWSS and Buenos Aires—(1) MWSS was split into two zones while Buenos Aires was one, and (2) the tariff adjustment process for MWSS was much more detailed than that of Buenos Aires. These two variations made a huge difference and made the MWSS transaction much more complex.

The Contract

The MWSS Board quickly approved the IFC contract. We set November 10, 1995, as the signing date. The signing ceremony was held at MWSS. A portion of the ceremony focused on the \$1 million grant from the French government, and the French ambassador was present.

The press conference was a disaster; the focus was not on the significance of this project (which would generate some \$7 billion in investments by the private sector) but the consultancy fee of \$6.2 million. The next day, the big news was the "exorbitant" consultancy cost and how MWSS was wasting money for yet another study, instead of developing new water resources with the same money. Of course, in reality, it would cost \$200 million to

\$1 billion to develop new major water resources for MWSS, which is far more than the consultancy fee. Also, these fees were to be repaid by the winning bidders, so the government would actually not spend anything.

Yet, we were ill-prepared for the news conference, and that is a big mistake in any transaction of this size.

Appointment of Angel Lazaro III

In 1995, because of certain controversies, President Ramos decided to relieve the current MWSS Administrator. The President also asked the entire Board to submit their courtesy resignations.

President Ramos then asked Secretary Vigilar to submit his recommendations for changes in the Board, including the Administrator.

It was very difficult to find qualified persons who were willing to be Administrator. While many people, whom we felt to be unqualified, volunteered, none of those whom we ourselves selected was willing to be named Administrator. It was a hot seat. Nevertheless, we submitted a list of potential candidates to President Ramos, including Angel Lazaro III (Lito Lazaro), the brother of Delfin Lazaro, the former Secretary of Energy. President Ramos wanted Lito to be Administrator.

Lito Lazaro was the head of a private engineering consultancy firm. He had a Ph.D. in civil engineering. He was extremely well-respected in professional circles. The track record of his firm, which did a lot of work for DPWH, was outstanding.

We had a hard time convincing Lito to accept the job. He thought the MWSS job would lock him into a no-win situation. First, it would take a long time to improve the performance of the company, even while everyone would expect immediate miracles from him. If he did a bad job or took too long to fix the company, he would be booted out. If he did a good job, he would be asked to stay on and he would then get stuck with this thankless and poorly compensated job.

We convinced him to accept the job by telling him about the privatization plans, that he could stay on to privatize the company and then leave immediately thereafter. We explained that it would be prestigious for him

to solve the water crisis, in a similar way that his brother had solved the power crisis.

Lito's appointment was widely hailed because of his reputation for honesty and his heavy academic and professional qualifications. It was also perceived that the President appointed him in order to privatize MWSS, although that was never really made clear. Nevertheless, Lito played an important part in the privatization, which he supported.

The Legal Basis

Executive Orders 286 and 311

One of the first tasks of our consultant lawyers was to decide on the legal basis for the privatization. There were three options: the BOT Law, Proclamation 50 (which created the Committee on Privatization, geared mainly toward the sale of government-owned corporations), and the Water Crisis Act. It was decided that the Water Crisis Act would be used as a basis because it gave the President the authority to privatize, without mentioning any constraints.

The main problem with the Water Crisis Act (WCA) was that it gave the President a six-month deadline to privatize. Our lawyers, however, argued that this time period was not "mandatory" but "directory." This meant that the President had six months to *initiate* the privatization process, not *complete* it. This was the most logical conclusion because six months was obviously too short a time period to carry out such a complicated transaction as the privatization of MWSS. Nevertheless, this was an interpretation of the law. We looked into the records of the deliberations of Congress, relative to the WCA. There was no record of any discussion on the interpretation of the six-month deadline.

Our lawyers said that, in order to beat the six-month deadline of the WCA, the President needed to issue an Executive Order (EO) by December 7, 1995, or earlier. We could not understand why this EO was needed. If all we needed was proof that the President had initiated the privatization within the six-month period, we had the memos of Secretary Vigilar to the President, recommending approval of the IFC contract for the MWSS privatization, which the President had approved. These memos were issued from July to September 1995 and were well within the six-month period.

The MWSS privatization was not the only item in the WCA that had a six-month deadline. The WCA dictated that the reorganization of MWSS also had to be completed within six months.

The WCA had created a Joint Legislative-Executive Water Crisis Committee. One of the principal tasks of this Committee was the finalization of the MWSS reorganization plan. This plan anticipated the reduction in the number of MWSS employees from 8,000 to about 6,000 and it was complicated. It provided substantial changes in the MWSS organization chart. The Committee drafted an EO pertaining to the MWSS reorganization, and the deadline for this was the same deadline as the EO that IFC wanted.

The local consultant lawyers belonged to a prestigious firm called ACCRA. ACCRA gave us a draft EO and Secretary Vigilar talked to Executive Secretary Torres about the importance of ensuring that this was issued on or before December 7, 1995. However, when EO 286 came out, while there was some mention about privatization, this was relatively minimal. We were surprised.

Also about this time, Lito started meeting with representatives of MWSS employees. Labor was demoralized by the twin moves of privatization and reorganization. The employees said that there was no need to work because the agency would be privatized anyhow. Lito promised them that if they, by some sort of miracle, turned MWSS around (particularly in terms of non-revenue water), he would recommend that privatization not be pursued. Lito gave labor a target that was very difficult to achieve but was nevertheless a clear objective. The labor group was happy and they quieted down. Lito's targets were never achieved, but he did give labor a chance.

I still was not fully convinced why the EO was necessary, particularly after I explained to Atty. Lee Buchheit (our chief consultant lawyer) that we had all sorts of instructions from the President related to the MWSS privatization, within the mandated six-month period. Lee said that these documents of ours were internal to the DPWH. An EO was a public document that would serve as a record that the President had taken steps to privatize MWSS.

I thought that the strongest argument for the EO came from Ebot Tan, the ACCRA chief lawyer, who said that the EO strengthened the legal basis of the transaction. It may have been redundant, but in a transaction that was as important as this, it was better not to leave anything to chance.

If I could not be convinced about the necessity of the EO, I can imagine how others who were less familiar with the transaction felt. In fact, it turned out that a staff member from the Chief Presidential Legal Counsel's office was the individual who had decided not to pursue the EO because, like me, he had thought that it was superfluous.

Secretary Vigilar continued to talk to Executive Secretary Torres, but we were getting nowhere with the EO. Finally one day, Tuv Magsalin, the Chief

of Staff of the Executive Secretary, called me to arrange a meeting. We met at the Manila Hotel and it turned out that he simply wanted to know me and to discuss some of the many queries and requests that they had received concerning the DPWH.

I took advantage of this encounter to talk to Tuy about the draft EO. Tuy arranged for me to meet with his staff who were working on the EO. At about this time (February 1996), Chief Presidential Legal Counsel Tony Carpio was replaced by Atty. Rene Cayetano and all of Carpio's people disappeared, including the one who had been working on the EO. We had to work with the staff of the Executive Secretary instead.

They continued to argue that the EO seemed superfluous, but they were finally convinced by the argument that it would not do any harm to have the EO issued. I said that, considering the flak we were getting at the time because of investigations in Congress about some of our projects, it was better to be redundant. This seemed to convince them.

In March 1996, EO 311 was issued, almost exactly as ACCRA had prepared it. My specific contribution was to require that the privatization be approved by the President. I thought that a transaction as important as the MWSS privatization must obtain presidential approval, and I think that ultimately this did help strengthen the transaction.

IFC was overjoyed with the issuance of EO 311. At that point, I thought it was no big deal. Much later, whenever we explained the transaction and discussed the legal basis for the privatization, EO 286 and EO 311 were always mentioned. EO 311 was explicit about the desire of the government to privatize MWSS. It really was useful.

I was also right that the actions taken by the President relative to the IFC contract were definite proof that he had acted within the six-month period. In February 1997, when the Court of Appeals issued a temporary restraining order because of a petition questioning the legality of the privatization, the ACCRA lawyers informed the Court about the DPWH memos that the President had approved. These documents turned out to be important in convincing the Court that the President acted within the mandated period.

I think that, even without the issuance of EO 311, we probably would have been able to convince the Court that we had the legal basis to privatize MWSS, but EO 311 certainly made the explanation easier, providing an extra leg for us to stand on. In a transaction as important as this, it was extremely important to have many supporting legs.

I thought that another key to the issuance of EO 311 was the development of our personal relationships with the staff of the Executive Secretary. Instead of writing memos, we could call each other and speed things up. We could also explain things face to face, which was often absolutely necessary in such a complicated transaction.

The Bidders Question the Legal Basis of the Bidding

Sometime in October 1995, during formal meetings between IFC and one of the bidding consortia, the lawyer of the bidding consortium questioned the legal basis for the privatization. This was a red flag for us. In our mind, this consortium seemed to be getting ready, in case they lost the bid, to sue us in court and undermine the legality of the bidding. Of course, it was not entirely clear why they were bidding at all if they felt that we had no legal basis for accepting bids.

This left us with no choice but to ask all bidders to formally confirm that they believed in the legal basis of the privatization. We did not want any of the bidders to participate and lose in the bidding, and then take us to court. We felt that it was imperative to get this confirmation from the bidders prior to bidding, while we had an advantage over them. It is amazing how quickly bidders change after the bidding from being accommodating and friendly to suddenly confronting you with the slickest litigation lawyers.

Everyone readily gave the letter of confirmation except for one particular consortium. Our lawyers met with their lawyers on a Friday evening until 1 a.m. and were unable to convince them to sign the letter. The deadline for submission was Monday. It was possible that we would need to disqualify them if they did not give that letter, which would have serious consequences since we had only four bidders for two concessions. We did not want to lose one bidder and end up with three bidders for two concessions. To the public, this would have looked like a lack of competition; people would have started to question whether or not the bidders would connive to fix their bids.

We met with the dissident group on Sunday evening, the night before the deadline for the submission. It was a big meeting attended by our consultants and the bidder's top people.

Our lawyer started to explain once more the legal basis while the consultants of the bidder questioned him. After a while, as the questioning continued to drag on, I thought that there was something terribly wrong about the whole exercise. I said that the debate was all theoretical and that either position could be argued before a court of law. I said that it was the job of the bidder's lawyer to look for the legal basis to defend the transaction in case the bidder won.

I said that if we did not get that letter, we would disqualify them and their partner, which would probably destroy everything that we had worked on for so long but there was nothing we could do. I thought that these people would get scared of being disqualified because they had refused to submit a letter that was completely harmless. Sure enough, they acceded.

A couple of days later, we met with the representatives of this bidder again. This was a more relaxed atmosphere and we were able to explain in detail all the due diligence that we had done. We explained the history of the transaction, including the actions taken by President Ramos from the very beginning. We explained how EO 286 and 311 had come about. We explained the rationale for a particular Presidential directive that had created a Special Advisory Committee and that this Committee was indeed meeting regularly, was now in the process of approving the privatization strategy, and would later approve the Concession Agreement. We explained that we were going to get the President's approval, as required by EO 311, before we received the bids.

All of this was an eye-opener to the representatives of the bidder. Up to that point, they had not been given the entire picture. They were unaware of all the steps we were taking to make the transaction as legally tight as possible.

We took a great risk on our part by threatening to disqualify one of the bidders—and we were serious about this. We would actually have disqualified them if they had not submitted the letter that we requested.

We simply needed to stand by our bidding principles. If a bidder had doubts about the legal basis for bidding, he or she had no business bidding.

We took the high moral ground. In the end, actions such as these strengthened the transaction because the bidders understood that the government was sticking to the letter of the bidding rules.

We also wanted to be tough on the bidders so as to ensure that no one would question the deal later on in the courts. In fact, we asked all the bidders to sign a document stating that, after the bidding, the losers would not seek a court injunction on the bidding.

Participation of Foreign Firms

The Philippine constitution specifically mandates that all public utilities must be owned and controlled by Filipinos. Specifically, the concessionaire would need to be 60 percent domestically owned. Furthermore, it meant that the officers had to be Filipinos. This apparently was not the case in Buenos Aires where it was allowed to have foreign firms and foreign personnel run the water utility.

This provision was problematic. It was acknowledged that there was no local firm that was capable of properly operating MWSS. We needed a technology transfer from foreign firms. Yet, how could this transfer be effected if the foreigners were not allowed to run MWSS?

This was one of the first major issues that our consultants tackled. They tried all sorts of formulas by which the letter of the law would be followed while giving actual control of MWSS operations to foreigners. However, they kept bumping into provisions of other laws that made these arrangements illegal.

In the end, we decided to very carefully follow the provisions of the law, not only the letter but the spirit as well. We thought that with the high profile of this transaction, we were going to attract a lot of flak from the opposition politicians if we tried to employ a "trick" that would give actual control of MWSS to foreigners. We did not want to risk ending up in a court battle we could actually lose. We made it clear to all the bidders that the winning concessionaires would need to be 60 percent Filipino-owned and that management of the firm had to be in Filipino hands.

Furthermore, we felt that there were ways of transferring technology without violating the law. Foreign technical personnel could help MWSS, even if they were not officers. We thought that there were many solutions

to this problem and we decided to let the foreign firms and their local partners sort this out among themselves.

I think this makes a good example of how we executed this privatization effort. We identified our potential opponents and, like good chess players, we anticipated their moves—that is, their future objections. We acted with the assumption that someone was going to take us to court and question the legality of the transaction. We wanted to have the confidence to defend the transaction, no matter who questioned it in the future, and for whatever reason it was questioned. We did not want the transaction to even be “perceived” as violating the law.

Need to Reduce the Labor Force

One of the features of the privatization of the Buenos Aires water system was the reduction of the labor force. We understood that prior to privatization, the government reduced the labor force by 25 percent through an early retirement program and that after privatization, the concessionaire reduced the labor force by a further 25 percent.

We sensed that the reduction in the labor force was going to be a key feature of the transaction. One of our key objectives was efficiency and it was obviously going to be difficult for the private sector to inject efficiency if it ended up saddled with an overstaffed company. Based on Asian Development Bank data, MWSS was, in fact, one of the most overstaffed water utilities in the region. Singapore was up to four times more efficient in terms of the number of employees per connection.

Ordinarily, civil service rules would have made it difficult for us to reduce the labor force. Fortunately, the Water Crisis Act was the godsend. The Act provided MWSS with the legal basis to reduce its workforce. MWSS worked with labor and came out with an attractive compensation package. The package was so appealing that more than 30 percent of the employees accepted it.

After the early retirement program had been completed, we continued to negotiate with the MWSS labor union on the terms for the remaining workers. The resulting deal was actually even better than the initial retrenchment program. It stated that all MWSS employees would be terminated prior to the takeover by the concessionaire. As a result, all employees would be awarded tax-free severance pay for having lost their jobs. By contrast, the employees who took early retirement had to pay taxes on their severance pay.

After termination, the concessionaires would be compelled to rehire all employees on a probationary basis. Anyone who was not hired after six months would be given the full early retirement benefit, less what they had already received as severance pay.

Similar to Buenos Aires, we also provided that a certain percentage of the shares of the concessionaire companies would be offered to the employees through a stock-option plan.

The reduction in the number of employees was substantial. It gave the future concessionaires a much freer hand in running the business. The fact that all employees were going to start from scratch with the concessionaires also gave great comfort to the bidders. Finally, our being able to reduce the number of employees by 30 percent was another example of the political will of the government. I think that this significantly contributed toward soothing the bidders and reducing their perception of the risk of the transaction. Ultimately, all of these helped reduce the bid prices.

We strongly felt that the deal we struck was advantageous to labor, and yet it was acceptable to the bidders. Later on, left-leaning labor leaders would claim that the Concession Agreement was disadvantageous to labor but it was easy to disprove these claims.

The provisions on labor in the Concession Agreement had been carefully crafted, in full consultation with the legitimate labor union. Since the negotiations were done only between labor and our consultant lawyers, there was no one representing the bidders and, naturally, the provisions actually favored labor. Once more, the transparency of the transaction was an asset in defending it.

Need to Have Bids Lower than the Existing Water Tariff

One of the most attractive aspects of the privatization of the Buenos Aires water system was that the tariffs actually went down.

From the beginning, we felt that it was *essential* that the bids be lower than the existing tariffs. This way, we would have public support—and support from the politicians would follow. This was also the feedback we were getting from the politicians. They supported the privatization but insisted that the tariffs must go down.⁷

One of the essential intermediate objectives, therefore, was to ensure that the bids would be lower than the existing tariff. IFC was aware of this, although initially they did not want to set the present tariff as a cap for the bids. Nevertheless, a few months before the bidding, the MWSS Board decided that the bids must be capped at the present tariffs, so this condition was incorporated into the bidding rules. There was no reaction from the bidders so we sensed that they would not have a problem with it.

It was only toward the end of the process, just a few weeks before the bidding, that we started getting signals that the bids were going to be extremely aggressive. We were really not sure up to that point. I thought that if we got a 10 percent discount, we would be happy.

Since we were unsure what the bids would be, all sorts of things were done to drive the bids lower. For example:

- In August 1996, about five months before the bid submission, the water tariffs were increased by about 38 percent. This tariff increase was actually long overdue and would have been implemented, regardless of privatization. Nevertheless, it gave us a substantially greater chance that the bids would be lower.

More important, it conceptually set the tariffs at the correct level prior to privatization. This gave us a fair chance to prove that the bid tariffs would be lower than the current tariff because of the much higher efficiency of the private sector. This theory would certainly not work if the current tariffs were way below what they should have been or if utility operations were subsidized.

This tariff increase was actually ready for implementation by the MWSS Board in February 1996. Secretary Vigilant presented the proposed increase to the Cabinet and the President asked that the rate increase be postponed. He said that the timing was not right because the government had just implemented a controversial tax law.

Furthermore, President Ramos said that, prior to a rate increase, it was important that MWSS show the public that it was improving its services. MWSS, therefore, launched a visible campaign of leak repairs.

When the tariff increase was actually implemented, there was hardly any objection raised in the media. I thought that this was partly because of the MWSS leak repair campaign and the fact that, in absolute figures, water bills are not very large. Finally, we were fortunate that the tariff increase coincided with the visit of Thalia, a Mexican soap opera actress who had become so famous in the Philippines that, during her visit to the country, she was even given an audience by the President. The front pages were full of her pictures. The media got distracted. Public attention was diverted from the announcement of the rate increase to the arrival of Thalia.

This tariff increase was yet more proof to the bidders that the government had the political will to raise prices, with the result that the bidders were more comfortable, and their perception of the risks involved was reduced. Once more, this helped convince the bidders to bid more aggressively.

- The water and sewerage expansion programs were designed so that major capital expenditures commenced after five years. Initial focus would be on softer and cheaper measures to improve service such as replacements of meters and reducing water theft. Heavy investments were back-ended. This approach ensured lower initial tariffs; it also happened to be extremely logical for a new concessionaire to concentrate on measures that provided the same benefit for a relatively lower investment.
- An automatic tariff adjustment was incorporated in the fifth year to cover funding for sewerage investments at that time. This had the effect of reducing the initial tariffs.
- We made arrangements for the Board of Investments to grant six-year income tax holidays to each of the concessionaires.

- We arranged to have the concessionaires exempted from paying value added tax (VAT). Later on, however, after we opened the bids and discovered that the bids were extremely low, we no longer pursued this tax exemption.
- We arranged for the Department of Finance to provide a performance undertaking, effectively guaranteeing the most crucial commitments on the part of the MWSS. This was probably one of the most important features of the transaction. It gave a lot of comfort to the bidders and their bankers.
- In general, we feel that a major factor that contributed to the lowering of the bids was that the transaction was handled in a professional and transparent manner and that the government was serious in meeting its commitments. The bidders saw that the government had the political will to raise rates by 38 percent and to execute a labor reduction program that reduced the number of employees by about 30 percent. All of these reduced the risks on the part of bidders, making them more willing to accept lower rates of return.

So far, the people's immediate reaction to the MWSS privatization has been overwhelmingly positive; they often cite their substantially lower water bills. It makes a lot of political and economic sense to start off with a lower tariff. While it is not absolutely essential, it is nevertheless important for the success of the water privatization.

Splitting the Franchise Area into Two Zones

One of the first privatized water systems that we learned about was that of Paris. It was explained to us that Paris was split into two zones: the left and right banks of the Seine River. The two concessionaires were the two large French water companies, Compagnie Generale des Eaux and Lyonnaise des Eaux.

Intuitively, this model was appealing because of the quasi-competition that it fostered. Consumers could compare service quality of the two concessionaires. Each company would try to outdo the other.

In our first discussions with IFC, even before the start of their contract, we already conceptualized the grant of two concessions for MWSS. We said that, following the Parisian model, the concessions could be located along the left and right banks of the Pasig River.

During the actual IFC consultancy work, we learned that Buenos Aires was not split into two concessions because the implementers felt that this would entail too much work and would substantially delay the transaction. To us, this did not seem to be a good reason. Much later, we realized that there was a lot of wisdom in that Buenos Aires decision. A lot of work resulted from the split into two concessions.

In February 1996, IFC officially recommended that the MWSS franchise be split into two zones. The most compelling reason was giving the regulators more leverage in their negotiations with the concessionaires. There would be some benchmarks or comparisons between the two zones. Otherwise, we would have little basis to question costs of the concessionaire. This would also foster some sort of competition. Furthermore, it gave a safety valve so that in case one concessionaire got into financial trouble, the other concessionaire could take over.

IFC also analyzed the scenario in which there would be more than two concessionaires. However, it was clear that the complications arising from

this were not compensated by the incremental benefits of having even more concessions.

SOGREAH split the franchise into the East and West zones. Population was roughly equal (60:40 in favor of the West). Each had a well-developed and profitable core and an expansion area (Rizal for the East and Parañaque southwards for the West). There were relatively few interconnection points between the two zones. It appeared that SOGREAH had done a good job. The MWSS Board approved the IFC recommendation.

As the bid date approached, there was increasing concern about the possibility that the bids for the two zones would be widely different. It was felt that this would create a political problem since people on one side of the street would be paying a different rate from the people on the other side of the street.

When IFC ran their financial models on the concessions, it turned out that, all things being equal, the East zone would charge a higher rate. This was because the East required a higher per capita investment. Also, the East included the province of Rizal, many parts of which were rural. IFC felt that the bidders would favor the West Zone because it had a higher population and required a lower investment. I argued that this might not necessarily be the case because the Makati, Ortigas, and Fort Bonifacio Central Business Districts were all in the East Zone and this would make it more attractive, particularly for two bidders who were heavily involved in real estate. The bid results proved us correct.

IFC decided to try to balance the bids by skewing the repayment of debt toward the West Zone. IFC tried different ratios but up to a month before the bids, IFC could not come up with a final split of the debt. This seemed to be a big problem. Finally, I volunteered to ask the bidders themselves. IFC agreed and, informally, I requested each bidder to give its suggested split of the debt. The range of the splits suggested by the bidders was from 70:30 to 90:10. In the end, IFC decided on 80:20 (although in the Concession Agreement, the figure was 90:10, this was actually 80:20 because some of the debt would come in after financial closure and would be loaded in the East Zone).

At the same time that IFC was deliberating on the split of the debt, some of the IFC staff continued to be greatly worried that the bids would still be very different. They came up with all sorts of suggestions aimed at balancing the bids.

The biggest problem would be if one bidder would bid way too low. We did not expect this to happen, however, because of the provision in the Concession Agreement that the first rebasing would be held solely at the prerogative of government. This meant that anyone who bid too low would have to endure 10 years of negative cash flow before starting to earn money. We felt that 10 years was too long for any company. Therefore, none of the

bidding companies would low-ball its bid. Furthermore, all the bidders were well-known and were responsible bidders. We did not have any bidder with a reputation for wild bids.

If the bids were not going to be that far apart from each other, I felt that it would be better to keep them unequal. This would make people get used to the idea that the tariffs in the two zones were different. Even if the tariffs of the two zones were to be made initially equal to each other, they would eventually deviate over time, particularly after the rebasing.

I also thought that it was going to be very important that when the bids were opened, they would contain a single number and that anyone who saw the numbers would understand what the number meant and would immediately know who had won. Certain procedures being suggested would have required some computations before the winners could be announced and this lessened the transparency of the transaction.

During a dinner with Fremon, a few months before the bidding, I explained the bidding procedure to him, particularly the provision that no one was allowed to win both zones. If someone were to bid lowest on both zones, a procedure would follow whereby the government would be able to determine which combination of bids was the most advantageous. Fremon suggested that we could continue to follow our planned procedure but require the second-lowest bidder to match the lowest. I thought that this would be problematic, particularly if one of the bidders bid too low and the other bidders did not want to match that bid.

This was a common experience in the biddings for DPWH civil works projects. Many times, for some reason or another, we decide to award contracts to the second-lowest bidder, or the lowest bidder's contract is terminated and DPWH negotiates with the next lowest bidder. We ask this next lowest bidder to match the lowest bidder's price. Sometimes, the bidder agrees to match. At times, however, he or she is not willing to do so, preferring to give up the project than take it at such a low price. If we were to compel bidders to match the lowest bidder, this would create a huge uncertainty, which would adversely affect the way the bidders bid. However, I felt that if only one bidder were to take the entire MWSS concession, this would be a big mistake since that bidder would have a real monopoly and would hold us captive. We therefore did not accept Fremon's proposal.

In the end, in spite of all our analysis and the peculiar transaction structure that we had set up, what we feared would happen was exactly what happened: The winning bids for the two zones were so far apart that one was actually more than double the other. This discrepancy immediately became the target of the media and some politicians.

Many questions have been raised as to why there was such a huge difference in bids and whether the transaction could have been structured in a way that would reduce that difference.

Many theories have been espoused to explain the bid discrepancy but the only one that really makes sense to me is the "dynamics of a bidding." It is nearly impossible to accurately predict the result of a bidding, particularly one that is as complex as the MWSS privatization.

After experiencing the issues created by the two bids that were so far apart from each other, I thought it was imperative that the next privatization bidding involving two concessions should somehow have a mechanism to ensure that the bids were not too far apart from each other. It seemed to me that the best approach would be to keep the tariff at the same level and then bid on a payment to the government. This would ensure that the tariffs would be exactly equal, at least in the beginning. It would also allow the government to share, along with the customers, some of the monetary benefits of the transaction. Naturally, in the future, the tariffs for the two zones would surely start to vary but, at least, they would start off equal.

National Economic Research Associates (NERA) also had a proposal that would have ensured that the bids would be equal to each other. This required the bidders to submit a matrix of two columns for each zone. One column would correspond to the discount rate and the other column to a theoretical amount that the bidder would either pay to the other concessionaire or that would be paid by the other concessionaire. Matching bids would be those that would result in the same price for each zone, with the payment proposed to be received by one concessionaire being equal to that proposed to be paid by the other. MWSS would then determine which matching bids would result in the lowest composite rate. This procedure would work. It was based on solid economic theory. The problem was that it was too complicated. Each bid had to be a matrix. It would be very difficult to explain why one bidder won over another and this would reduce the level of transparency. We wanted the bidding process to be so simple that anyone could understand why one bidder won over another. This meant that the bid had to consist of a single number, with the lowest number winning.

Having said all of this, was the bid discrepancy really such a big deal? Aside from the noise created by some politicians, there did not appear to any really strong complaints in the end. I think the main point is that everyone's water bill went down, though some went down more than others.

The complications arising from having two concessions extend beyond the difference in the tariffs. These complications became clear after the awarding of the bid. The biggest issue was clearly the interconnection agreement, which will be discussed later. Another problem was the distribution of employees and the organization chart. It is not a simple thing to split a company into two. When a department of that company is split, the head of the department goes to one side and the other side is left with-

out a department head. Furniture and office equipment had to be divided as well.

Still another complication was the customer database. Previously, there was only one database, but this now had to be split between the two concessionaires and, in certain cases, it had to be physically verified that a customer belonged to one zone and not the other.

Another issue that cropped up was related to the water taken by the West Zone from the East. It appears that at one time this water was contaminated with a certain bacteria that caused a foul odor. The West Zone said that it had to increase the chlorine dosage of its water to compensate for the bacteria. The West concessionaire said that they did not want to receive water from the East and get blamed for the deficiencies of the other concessionaire.

These incidents are convincing the concessionaires to build completely distinct water distribution systems with a minimal number of interconnection points (or none). Technically, this is not ideal. If we consider the sewerage distribution system, this is even less ideal. Therefore, in the future, the MWSS concessions will have a certain degree of technical inefficiency. Will this inefficiency be offset by the efficiency spawned by competition?

It is probably too early to declare whether or not it was wise to split the MWSS coverage area into two zones. So far, it has certainly been proven that there are huge complications arising from this decision. The split has also been shown to be extremely useful in the evaluation of common petitions for price increases. The jury is probably still out on this issue.

Tariff Escalation Procedures

Tariff Escalation for Toll Roads

When we studied BOT toll roads, we realized that one of the most important aspects of the transaction was the procedure for tariff escalation. In particular, if we were to conduct a bid for a toll road and the bid were to be based on the initial toll rate, we had to make sure that the procedure for tariff escalation was fixed and objective. Otherwise, one bidder would bid based on a certain tariff escalation while another's bid would be based on another procedure, with the result that the net present values of their bids would vary significantly. For toll roads, therefore, tariff escalation was based on a formula that contained inflation and devaluation variables. These were objective factors. Therefore, tariff escalation would be the same for any proponent. There was no room for discretion.

It was easy to understand the proposed bidding procedure of prequalification, evaluating technical bids as complying or noncomplying, and then determining the winner to be the one offering the lowest tariff. The problem was that, after the bid, the procedure for tariff escalation had to be the same for everyone. Our experience was limited to that of toll roads and so we had in mind a formula that contained certain objective factors. We could not, however, figure out how to derive the formula for the MWSS privatization.

In the case of toll roads, the principle we followed for our initial projects was that the formula should result in tariffs that would give the same project rate of return, no matter what the value of the variables contained in the formula were. It was theoretically possible to derive the formula by creating a financial model of the project that reflected the effects of the formula's variables (in the case of our toll roads, devaluation and inflation)

on future revenues and outflows. This exercise, in itself, was quite difficult in practice. We spent months negotiating with toll road proponents on the appropriate toll escalation formula.

Dilemma of the MWSS Tariff Escalation Formula

For the MWSS privatization, we could not understand how a formula could be derived. The problem with the transaction was that it was so complex that its financial model was going to be equally complex—and subject to a large number of variables, including population growth, GNP growth, urbanization rate, and so on. We felt that it was going to be impossible to accurately capture how each of these variables influenced the rate of return.

Another important point was that in the case of a toll road project, one knew from the very beginning what exactly one was going to build: namely, a toll road with certain features from one point to another. In the case of MWSS, none of the bidders knew exactly what they were going to build during the life of the concession. There were so many variables that the actual capital investment program was surely going to be very different from the bidders' initial plan. It seems that this was the experience in the United Kingdom—the actual investments differed wildly from those assumed when the companies were sold to the public.

I thought that the MWSS bid was like bidding to implement and operate 20 or 30 BOT projects over a 25-year period, except that you were not sure how many projects there were, how much they cost, or when they were to be built. This tremendous uncertainty made it impossible to apply a tariff escalation formula with objective factors, the kind that would apply to toll roads.

NERA Rate Rebasing Concept

Our economist consultants came from National Economic Research Associates (NERA). Almost from the beginning, NERA proposed to utilize a tariff escalation procedure that they called "rate rebasing." The procedure seemed to be similar to a "Return on Rate Base" (RORB) system except that the return was a "project return" (an unleveraged return). Similar to RORB, some expenses (for example, extravagant ones or extra expenses arising from inefficiency) could be disallowed. A key factor in the calculation was the determination of the value of the return. This was designated as the "Appropriate Discount Rate" and was defined as the prevailing rate for similar infrastructure projects in similar economies or countries.

When NERA first proposed the rate rebasing procedure, we seriously questioned this, particularly the fact that it appeared to practically *guarantee*

the return of the concessionaire. NERA said that it was not appropriate to allow the concessionaire to go bankrupt. We thought that this violated the very concept of bidding, and this all the more reinforced my belief that their concept was wrong.

We were uncomfortable with the NERA proposal for several reasons. First, it violated the principle of having an objective and uniform tariff escalation formula. Someone could bid with the idea of monkeying around later with the escalation procedure. Second, it was virtually a guarantee that the concessionaire would earn money. It removed the risk from the bid. Third, someone could bid low with the idea of recovering losses at the first rate rebasing period, five years hence.

In view of the above, we initially objected to the adoption of the NERA proposal and we kept objecting up until about October 1996, when finally, it seemed that all questions had been answered. Some of the considerations that made us agree to the rebasing concept were the following:

In order to avoid someone's submitting an unreasonably low bid, we established that the first rate rebasing (after five years) could be canceled at the sole option of the government. This meant that if a bidder bid too low, he or she would have to live with that bid for 10 years and suffer all the consequent losses during that period. We felt that this was sufficient to dissuade anyone from bidding too low.

The transaction was not devoid of risks for the bidders. For example, they were taking over the existing projects of MWSS, except for Umiray, without fully knowing about the problems of those projects. For each capital project, they would take on a construction risk. They also took on the risk that the Regulatory Office would disallow some of their expenses. All of this was aside from political risk.

Even if there were risks involved, it was clear that they were much more reasonable compared to a scenario in which the escalation formula was fixed. The argument here was that the risks were lower because the rewards were less. Water utility operators are regulated and it is not feasible to have them charge rates that would give them unreasonably high returns. This would be politically impossible. If the upside of their returns is limited, it is natural to expect that the downside should also be limited. Water is different. It is a monopoly. It is essential to life. It is highly political.

NERA Proposal to Use the Consumer Price Index as the Escalation Index

In conjunction with the rate rebasing, NERA proposed to escalate the tariff annually in accordance with the Consumer Price Index (CPI). This procedure was very similar to the regulation in England, except that there the tariff was escalated by the Retail Price Index (RPI) less a fixed percentage

(X) to account for expected efficiency gains, plus an adjustment (Y) to cover the cost of investing in wastewater treatment so as to meet European Union standards. The formula was $RPI - X + Y$.

I argued that CPI was not a very good basis for price increases. I repeated an observation that we had made with respect to toll roads. We felt that a good price escalation formula should be that which would maintain a proponent's rate of return, irrespective of inflation or devaluation. Our views in this regard had been strongly influenced by the sudden surge in inflation that the country experienced in 1995, as a result of a shortage and price increase in rice. The price of rice was a big percentage of the computation of the inflation index.

We argued that there was no direct correlation between the cost of water and the price of rice and that the concessionaires would earn a wind-fall if the price of rice were to unexpectedly increase. We felt that we needed to create a particular composite index that would probably consist of a certain combination and proportion of indexes for labor, chemicals, and power.

NERA came up with a procedure, which turned out to be awfully complex, for the determination of this composite index. NERA then argued for the adoption of a simple index whose increase would be pegged to inflation. It was easy to understand. It was easy to defend before the public. A composite index would have to be explained and there would always be some loophole that could be exploited by someone. NERA also explained that while, at times, actual cost increases of water would be lower than the inflation index, at other times it would be higher.

In the end, it was the concept of simplicity that convinced us to follow the NERA recommendation of an automatic tariff increase corresponding to inflation.

The "Appropriate Discount Rate" and Objectivity

There were a lot of concerns being raised about the "Appropriate Discount Rate" or ADR. The ADR was extremely important for the bottom line of the future concessionaires. Given the large investments involved, even a single percentage difference in the ADR could mean millions of dollars in increased or reduced profits.

The ADR was initially defined in a relatively loose manner as the prevailing rate of return for similar infrastructure projects. The ADR would formally be determined by the MWSS Regulatory Office.

The Department of Finance (DOF) was quite concerned about the subjectivity of the process for determining tariff increases and, in particular, the discretion of the Regulatory Office in determining the ADR. We agreed to tighten the definition of the ADR.

Specifically, we directed the bidders to reveal the discount rate that they had used in coming up with their bids, and we said that the regulator would have the option of using this number or any other discount rate that could be derived or imputed from their financial bid.

We said “imputed” because we felt that all bidders would indicate in their bid a rate that was much higher than the one they had actually used. They could do this by, for example, just increasing their assumed costs or by raising their assumptions on per capita water consumption. We felt that in some cases, it could be possible to detect the area in which the bidders had inflated or deflated their figures, adjust these, and then come up with the actual discount rate that they had used.

We also expanded the description about the way the ADR would be determined from the “prevailing rate of return for similar infrastructure projects.” The specific provision reads as follows:

In determining the Appropriate Discount Rate, the Regulatory Office shall apply conventional and internationally accepted methods, and in particular shall make estimates of the cost of debt in domestic and international markets, the cost of equity for utility businesses in the Philippines and abroad and shall make adjustments to such estimates to reflect country risk, exchange rate risk and any other project risks. The Regulatory Office, at its sole discretion, may consider the Concessionaire’s rate of return, either stated or implied in its bid, in determining the Appropriate Discount Rate.

I think it would have been difficult to find a more detailed, yet flexible, definition of the ADR.

The ADR as Project Return

The NERA consultants always recommended that the “Appropriate Discount Rate” (ADR) be the project return, or the “nonleveraged” return. The project return is the theoretical return on an investment made with pure equity.

In making this recommendation, NERA essentially had the same line of reasoning that led us to use project return in our evaluation of toll road proposals. When we first studied the financial models of toll road proposals, we realized the immense complication created by the financing. It was extremely difficult to analyze the models because we needed to validate the financing assumptions. We decided to evaluate the toll road projects based on an unleveraged return. This simplified the analysis tremendously and assigned the financing problem to the proponents.

In the case of the MWSS Concession Agreement, it was even more essential to use project return because, otherwise, the regulators would have needed to approve all of the financing transactions of the concessionaires. This would have tied up the concessionaires in bureaucratic knots.

The ADR and Retroactive Adjustments

Another significant discussion point was whether or not the ADR should be adjusted retroactively. It was already agreed that the ADR should be determined at each rate rebasing date. NERA wanted the ADR to be adjusted retroactively. We felt that the ADR should be fixed until the next rate rebasing date. This was based on the concept that the investments for every period up to the next rate rebasing were entitled to a certain ADR, 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 rebasing. Ordinarily, one would expect that the concessionaires would always want to have a higher ADR. Yet, NERA argued that in certain instances, it would actually be beneficial for the concessionaire to have a lower ADR. This situation arises when the Opening Cash Position is positive. This is true, and yet our argument for not retroactively adjusting the ADR is also valid, particularly when the Opening Cash Position is negative.

There is also an argument for a mixed solution. It may be argued that investments made during a certain period should earn a certain rate of return up to the end of the concession, while investments made at a later period may earn a different rate of return. More study surely needs to be done on this point, which is likely to require extremely complicated analysis.

The Regulatory Office

In the process of discussing the tariff escalation and the ADR, we learned about this proposed “Regulatory Office.”

The Regulatory Office was very important because of the partly subjective nature of tariff escalation, particularly the determination of the ADR. Conceptually, however, the need for the Regulatory Office seemed to naturally stem from the peculiar nature of water. Water is not just an ordinary commodity; it is essential to life, and highly political, as mentioned before.

It was essential to regulate the concessionaires, not only from the point of view of tariff increases but also with respect to all their obligations under the Concession Agreement, since many of those obligations had a direct impact on the health of the population.

Our consultants explained that in other countries such as the United Kingdom, an independent water regulatory office had been established. I was familiar with the U.K. regulatory setup, particularly OFWAT, the Office of Water Services. I had visited OFWAT in June 1995 and been impressed by the professionalism of their work.

Our advisers pushed initially for the creation of an independent Regulatory Office. It was argued that the Regulatory Office needed to be independent of both the concessionaires and the MWSS. They needed to judge on matters of dispute in a disinterested manner. An independent Regulatory Office, however, would require legislation and, given our tight timetable, there was no time for this. As an intermediate step, therefore, we decided to create a semiautonomous Regulatory Office within the MWSS.

The problem was doing this within the constraints of the MWSS charter. The MWSS was not originally intended to be privatized, all the less was it intended to have a Regulatory Office. If we created this office, it would necessarily have to be under the MWSS Board and, therefore, it would not

be independent. We went around this situation by inserting a clause in the Concession Agreement that the MWSS Board would “cooperate” with the Regulatory Office. It was not a perfect arrangement, but it has worked so far.

We recognized that the Regulatory Office would play an important role in making the concession work. Yet, we would have to create this office from scratch. One of the most difficult things for the regulator was to interpret the Concession Agreement, an extremely dense document. Even certain seemingly harmless words in the Concession Agreement actually had a deep meaning behind them. We decided to create a “how-to” manual for the Regulatory Office. With the help of our consultants, we created a manual that taught the regulators in detail nearly all that they had to do. The manual was probably four times the size of the Concession Agreement, but it was structured neatly and things were explained in great detail.

Takeover of Existing Projects

One of our principles for the transaction was that the takeover of MWSS had to be as total as possible. We did not want MWSS to be left with any residual projects other than the regulation of the concessionaires, the payment of existing loans, and the management of its assets, particularly non-operating assets.

During the discussions with the bidders in October 1996, the bidders raised the issue of the ongoing MWSS projects, particularly the Umiray-Angat Transbasin Project (UATP). Our position was that the concessionaires needed to absorb all ongoing projects. The bidders said that they would not accept responsibility for the UATP. The UATP was a critical project because it was the only major ongoing water source development project. Any delay would seriously affect the ability of the concessionaires to meet their service targets.

Furthermore, the UATP carried great risk because it was essentially a tunneling job and tunneling is always risky. You never know what kind of rock you will encounter when you tunnel. Depending on that, the task may proceed quickly or be seriously delayed.

The position of IFC was that MWSS needed to retain responsibility for all ongoing projects. They raised a common argument advanced by the bidders, which was that they could not accept responsibility for ongoing projects because they had not been involved in the project from the beginning.

We told IFC that this would be a disappointment because we would need to retain a substantial number of personnel in MWSS, at the same time that very few people would want to stay. The management of residual projects was clearly a temporary job, which would disappear as soon as the projects were completed. There would be no future in MWSS while the real and clear future lay with the concessionaires.

We suggested to IFC that we strike a compromise with the bidders. MWSS would absorb responsibility for the UATP, but we would request the concessionaires to absorb all the other projects. IFC argued that this was not logical. I said that I would personally talk to all the bidders and convince them in this regard. IFC agreed. I talked with the bidders and they were so happy about our agreeing to retain responsibility over UATP that they immediately agreed to absorb all the other projects.

I thought this was another example of how important it was for the government to be in control of the transaction. We insisted on our point and we got it.

Capital Expenditures toward the End of the Concession

At the beginning, one of our biggest dilemmas was the question of how to motivate the concessionaires to continue to make capital investments even toward the end of the concession period.

It was probable that in the last few years, the concessionaires would not want to make any capital investments because there would not be enough time available to recover these investments through tariff increases. This situation would obviously be detrimental to the MWSS.

Our solution consisted of providing for an “Expiration Payment” at the end of the Concession. This way, if a large capital expenditure was to be completed 10 years before the end of the concession and if this asset was normally amortized over 25 years, we would adopt the same 25-year amortization with respect to the concessionaire’s return on investment. At the end of the concession, there would be 15 years remaining to be amortized and the net present value of this amount, at that time, would be paid by the government to the concessionaire.⁸ Naturally, our idea was that toward the end of the concession, we would bid out the succeeding concession and establish that the winning bidder would shoulder the “Expiration Payment.”

This was a tidy solution. It not only gave an incentive to the concessionaires to continue capital investments up to the end of the concession, it would also help to ensure that tariff increases would be gradual.

Ownership and Use of Assets

From the very beginning, we preferred not to transfer ownership of assets to the concessionaires.

The concessionaires would be granted the rights to the use and usufruct of MWSS assets, except cash and receivables, at no cost to the concessionaire, provided that the service targets in the Concession Agreement were met. The concept was simple, but there were some technical difficulties in a few areas, largely because of government auditing requirements.

The first issue was related to assets that were not essential to the running of the business. MWSS had huge real estate properties, some of which were highly valuable. We determined that MWSS would retain ownership and use of these assets. In fact, it was agreed that these assets would, in principle, be sold by MWSS and the proceeds would form part of a buffer fund in case of default.

The second issue was related to the inventory of consumable items. Conceivably, MWSS could minimize the purchase of these items prior to the takeover, so as to conserve its cash. At the same time, if ownership of the inventory were to be transferred to the concessionaires, they could, in theory, sell the inventories and make money on day one. The value of the inventories was substantial. We resolved this problem by mandating that at the end of the concession, the concessionaires would turn over to MWSS at least an equal value of inventories, adjusted according to CPI, that they had initially received.

The last issue was related to movable properties such as vehicles and equipment. This was similar to the consumable items in the sense that the problem involved the disposal of assets. Since ownership was retained by MWSS, it was determined that the concessionaires could use these assets,

commit to maintain them in reasonably good condition, and then return them to MWSS when the assets reached the end of their useful lives.

Some of these issues may seem minor relative to the size of the entire transaction, but they were important to us because they could have led to accusations that we had given undue advantage to the bidders.

Consequences of Termination

Much time was spent discussing termination procedures, particularly the consequences of termination. This was an important stage for the bankers.

In our discussions, we adhered closely to the provisions that we had set in some negotiated toll road contracts. The key principles in those contracts were the following:

- In case of government default, the government should compensate the proponent the amount that the proponent would have expected to earn, as declared in the financial model submitted to the government, which formed part of the proponent's contract. In any given year, this meant that if the government were to default, the government would have to assume the loans of the proponent and, in addition, pay the proponent, at the end of each year, the net income after tax that the proponent had expected to earn for that year.
- In case of a default by the proponent, the creditors of the proponent would take over and name a new proponent, who would likewise assume the liabilities of the previous proponent. This would cause the least disruption to the toll road services and the least trouble to the government.

The provisions that we set in the MWSS Concession Agreement followed the same principles but were modified to reflect the unique character of the transaction. The specific provisions were the following:

- In case of government default, similar to the toll roads, the government would assume the loans of the proponent. With respect to the expected future net income, however, there was a large difference between toll roads and the MWSS concession. In the case of toll roads,

the capital investment was substantially defined from the beginning and incurred at the onset of the concession. In the case of the MWSS privatization, the amount of capital investment was much less clearly defined and it was spread over the entire 25-year concession period. The Concession Agreement provided, therefore, that the concessionaire would be compensated for its actual investments up to the early termination date, in accordance with the appropriate discount rate as determined by the Regulatory Office and as defined in the Concession Agreement. Furthermore, it was agreed that instead of paying the concessionaire over the remainder of the concession period, the government would give the proponent a single payment, provided that this could be in the form of a promissory note.

- In case of a default by the concessionaire, similar to the case with toll roads, the creditors of the concessionaire would take over. However, a water concession, particularly the size of MWSS, is much more complicated than a toll road and therefore the creditors might be unable to find a substitute concessionaire. In that case, the MWSS would take over the concession and pay the concessionaires only 70 percent of the discounted value of the assets to be taken over, and only to the extent of the value of the outstanding loans. This provision was extensively discussed. If the banks were unable to find a new concessionaire, they did not want to be left without anything. The banks argued on the basis of “unjust enrichment” that the MWSS should not simply take over the assets of the concessionaire without any form of compensation whatsoever. The government, in turn, did not want to completely bail out the banks and effectively guarantee the loans.

Joint Venture Agreement

It was clear that the two concessionaires would have to create some form of joint venture to handle common facilities, particularly the facilities that were upstream of the treatment plants. What was not clear was the form that this "joint venture" would take.

Initially, we had a lot of discussion with IFC on the appropriate form of joint venture, an extensive description of which was then produced by IFC. The problem was that each bidder had such a different idea of the joint venture that in the end, everyone agreed to leave the details to the two winning bidders. They could sort it out later.

There were, in fact, not too many problems in coming up with the actual joint venture arrangement between the East and West concessionaires. It was not a problem to leave this matter for the winning bidders to decide on, particularly because there were no financial repercussions. The problem was the interconnection agreement, which had a huge financial impact and which did cause problems, as will be seen later.

Trip to Buenos Aires

Sometime in April 1996, the World Bank broached the idea of organizing a trip to Buenos Aires. We had actually been thinking about this possibility from the very beginning of the transaction, but, with so many other things to take care of, it had never been actively pursued.

From all the reports we had received, the Buenos Aires transaction was highly successful. We thought that it would be great if key people involved in the MWSS privatization could actually meet people who had been involved in the Buenos Aires transaction.

When we decided on the composition of the contingent, we took a great risk. Aside from MWSS top and middle management, we decided to send members of Congress and the labor union leaders. We were not really in control of what would happen in Buenos Aires, but we gambled that the trip would have a positive result.

In the end, the trip turned out to be highly successful. The contingent met with numerous officials and all of them were happy with the privatization. The happiest were the labor union leaders. Their counterparts in Buenos Aires explained that even if so many jobs were apparently lost with the privatization (due to retrenchment), all of those jobs and more were recovered in the private sector. The concessionaire generated a lot of new business, most of it for other companies in the private sector.

It seems that this trip was key to securing labor's support of the privatization. They saw that the results in Buenos Aires were positive. They also saw that the MWSS privatization itself was transparent.

Handling the Media

Hiring a Local over a Multinational Firm

Given the liveliness of the Philippine press and their strong influence on public opinion, we thought that it was going to be quite important to properly manage the media. Thus, the IFC contract included a provision for a public relations (PR) firm.

IFC hired a prestigious multinational firm. Their representatives looked quite professional but did not strike us as being “street smart.”

Immediately after signing the contract with IFC, we had a mini-crisis on our hands because the media did not seem to appreciate the significance of the MWSS privatization at that point. The bigger story was the \$6.2 million IFC fee. A lot of articles came out about the fee and soon thereafter, we had politicians criticizing the “exorbitant” transaction.

We asked our PR firm to respond to the articles, but it took them forever to react. In the end, we had to do the press release ourselves. Over the next few months, there seemed to be very little that the PR firm was contributing to the process. There were few positive articles appearing in the media about the privatization. On the contrary, we faced a steady stream of negative articles. Specifically, certain members of Congress criticized the privatization and got media coverage. One newspaper came out with a series of articles attacking the transaction, including the track record of IFC.

Finally, we decided to replace the multinational PR firm with a small local firm. We felt that the staff of the local firm were more experienced and had more creative minds.

The local PR firm did its job well. Over a six-month period, they came out with a solid parade of positive articles, which appeared in the major

newspapers, including provincial newspapers. Positive news was also being heard on the radio. The tactic was mainly to explain the transaction and its potential benefits. We included positive reports on the experience in other countries.

Later on, after the opening of bids, some politicians and members of the media criticized the transaction and tried to drum up public opinion against it. They were largely unable to muster support. In part, this was probably due to the many months of lead time that we had, which allowed us to send out numerous press releases and build our own constituency.

The “Bidding War”

One of our worries was that there were only four bidders for two concessions; we thought there was a possibility that people would claim that the bidding was going to be rigged. In order to preempt this, we drummed up the rivalry between two of the local firms—Ayala and Metro Pacific—and the image of an upcoming “bidding war.”

Later on, when a prominent Senator started talking about the “bidding war,” we knew that our press releases had been effective. The press liked the idea of having a corporate battle of giants and this suited our purpose as well. How could people say that the bidding was rigged if the bidders were cutting each other’s throats? Little did we know that this “bidding war” was real.

Ayala was owned by one of the richest families in the country. They own substantial land and have built up a huge corporate empire. Yet, during the last few years prior to the MWSS bid, they had lost three of the largest real estate bids ever held. Metro Pacific was one of the companies that had beaten Ayala, which had led to serious corporate rivalry between the two.

Later on, as the bidding approached and particularly after the bidding, the MWSS privatization story took a life of its own. It became too big and we were no longer able to control the press releases coming out. Nevertheless, even at that point, all the work that we had done over many months, coming out with press releases, was extremely useful because much of the research that the media did was based on our own press releases of the past.

The Media and Transparency

Our media campaign also helped keep the aura of transparency. It was not a transaction that was being hidden from public view. All the important aspects were being explained to the public through the media, months before the actual bidding. Later on, this was actually cited in an editorial of a local newspaper, which correctly pointed out that the transaction took

two years to prepare and its details were amply covered in the media for many months.

One aspect of the transaction, which we played up in the press, was the elaborate security surrounding the custody of the bids. The security was purposely exaggerated, not only to protect the integrity of the bids but, equally important, also to strengthen the aura of transparency and professionalism. The media was going to play an important part in forming public opinion on this transaction so we made sure that they saw the complex security measures and transmitted this to the public.

We considered the media an extremely important player because they were our main link to the public. We were doing the right things and we wanted to make sure that the public knew that. With such an important transaction, it was essential to influence public opinion to gain support. Later on, after the bidding, when the politicians suddenly took notice, they quickly realized that the public supported the transaction—and therefore they ultimately supported the privatization as well.

Transparency

In the Philippines, it is common for procurements to be mired in controversy.⁹ Large procurements, in particular, almost surely result in protests by losing bidders and sometimes end up in Congressional inquiries, court cases, graft investigations, and so forth. The bottom line is that the transaction can drag on for months or even years. In our experience, one of the most important ways to avoid controversy in procurement is to emphasize transparency.

One of the things that attracted us the most to the Buenos Aires transaction was the bidding procedure, which specified the submission of separate technical and financial envelopes. The technical envelopes of the bidders would be examined and declared complying or noncomplying. Subsequently, the financial envelopes of the noncomplying bidders would be returned while those of the complying bidders would be opened. The lowest bid (on the tariff) won.

The basic advantage of this procedure was objectivity. There was no “points system” giving higher points to better technical proposals. Those bidding systems were open to a lot of corruption because of the inherent subjectivity of the “points.” We felt that a transaction as large as this would succeed only if it was perceived to be fair.

We were also influenced by the success of the bidding for Fort Bonifacio (a very large real estate sale by the government). Everyone admired this transaction. None of the politicians had criticized it. The reason was that it was perceived to be above suspicion. The winning bid for Fort Bonifacio was very high and, therefore, advantageous to the government. The opening of the bids was done through their flashing on projector screens—one screen per bid, in the full view of the media—which seemed to be mainly drama but did help create an aura of objectivity and transparency.

We were worried about the possibility that the losers could take us to court and get the transaction stuck for years. We had a few examples of this at DPWH and there were a few other high-profile transactions in the Philippines that had stalled in the courts for years. It was extremely important, therefore, to handle the transaction in such a way that it would be difficult for anyone to sue. In this regard, we believed that the courts, whether they admitted it or not, were also strongly influenced by media.

We had to document all our moves. Each step had to be not only transparent, it also had to be perceived as being transparent. We followed this principle to the hilt.

While designing the transaction, there were many suggestions to change the Buenos Aires method of bidding on a single number, but we rejected all of those. We wanted a single number that, when seen, automatically determined the winner.

As a corollary to the "single-number" requirement, we decided that the financial models would be submitted with the bids, but they would not be opened until 30 days after commencement. The problem was that if the models were immediately available, losing bidders could try to find a way of getting hold of copies of these and then try to prove that their bid, in conjunction with their financial model, was more advantageous to the government. The problem with this is that once you try to analyze a complex financial model, you can produce nearly any subjective conclusion that you wish, and take it to court from there.

We wanted a bidding procedure that was so objective that, even if one wanted to cheat, it would be nearly impossible. We wanted to deal with all bidders in a fair manner. We wanted them all to have equal information. We wanted to encourage each of them to pursue their bid.

It was also important to be fair because, later on, we knew that there were going to be two losers and we did not want them to complain that we had not dealt with them in an equal manner.

In determining the procedures for the custody and the opening of the bid envelopes, we exaggerated to an extreme degree. Equally important, we also made sure that the media were aware of all the extraordinary precautions we were taking.

All this resulted in the universal perception that the transaction was completely beyond reproach. Before the bidding, some of our opponents were trying to create the impression that the transaction was a scam. Later on, none of their voices could be heard. Everyone acknowledged that the transaction was completely fair.

The Approval Process

Early Thoughts

Given the uniqueness of this transaction, in the beginning we were not exactly sure what the approval process would be. We did not attempt to fully settle this issue immediately. We had a few concepts and then we let events evolve.

It was clear that the President would need to personally approve the most important aspects of the transaction and, initially, we thought that this could be handled through memos from Secretary Vigilar—this was wrong. Also, it was clear that the MWSS Board would have to approve the transaction structure because MWSS would be the signatory to the Concession Agreement.

The MWSS Privatization Committee

One question mark was the role of the MWSS Privatization Committee. As mentioned earlier, this Committee had been created to study a specific proposal, but its function was later expanded to include the pursuit of the MWSS privatization. This was done because we wanted to privatize MWSS and we needed a vehicle to lead the process, but it was very difficult to trust MWSS itself. The highly convincing argument was that an agency itself would not be objective in relation to its own abolition.

Thus we initially envisioned that the Committee would play a large role in making the initial approvals for the privatization structure. The more important of these would be endorsed to the MWSS Board and the most important would be further endorsed to the President. It was unclear,

however, which specific aspects of the transaction could be approved at what level.

When Dr. Lazaro took over as MWSS Administrator, we gained stronger MWSS support for the transaction. The first major meeting of the Committee was in early February 1996, when IFC presented the initial ideas for the transaction structure. We were not happy with the way the meeting proceeded. The comments and questions from the Committee members seemed to be quite shallow. We sensed that this was not the way to go. The composition of the Committee was not right. As a consequence, that February meeting turned out to be the last meeting of the Committee. We simply did not call for a meeting anymore and the Committee was allowed to die.

Instead of using the Committee, IFC consulted directly with the MWSS management and staff through a series of conferences. They also consulted with me a lot and I, in turn, consulted with Secretary Vigilar. This was a much more efficient procedure and it effectively became the first layer of approvals.

The MWSS Board

The MWSS Board handled the second layer of approvals. This was tricky because the Board needed to approve many documents, including the privatization strategy and the entire Concession Agreement, which was a lengthy and difficult document to digest.

The MWSS Board did an impressive job of approving the various IFC recommendations. This was all the more impressive considering that the Board was not a rubber stamp. The members carefully studied the IFC recommendations and voiced their opinions.

In spite of the obstacles, the MWSS Board met its deadlines.

The Special Advisory Committee

Executive Order 311 directed that the MWSS privatization be approved by the President himself. Essentially, we felt, this meant that the President needed to approve the privatization strategy (or structure) and the Concession Agreement, both of which were voluminous and dense documents.

President Ramos would never approve such documents without the endorsements of the concerned agencies and staff. This was in consonance with his style of "complete staff work." We realized that the President could endorse the documents to numerous agencies and, if this process were not properly managed, the documents could get stuck in these agencies for months.

In order to expedite and control this process, we decided to create a “Special Advisory Committee” to the President, composed of all the government agencies that were expected to endorse the privatization documents to the President. Through the Office of the Executive Secretary, we arranged for the President to issue Memorandum Order 365, creating a “Special Advisory Committee” (“Advisory Committee”) headed by the Executive Secretary and with the following members: the Chief Presidential Legal Counsel, the Secretary of Justice, the Chief Government Corporate Counsel, the Secretary of Finance, and the Secretary of Public Works and Highways.

The Advisory Committee was mandated to provide *legal* advice to the President on matters related to the MWSS privatization. We wanted to make sure that its powers were limited to legal matters, because otherwise, it would start second-guessing the MWSS Board on technical issues.

After the MWSS Board, the next level of approval, therefore, became the Advisory Committee—and thereafter, the President. Later on, we realized that the creation of the Advisory Committee was another key decision. It was another proof of the transparency of the transaction. Besides, we realized that any of these offices could later throw a monkey wrench into the transaction by questioning some of its aspects. By involving them in the process, we substantially broadened the ownership of the transaction. Most important, however, all the Advisory Committee members provided useful inputs to the Concession Agreement.

Since the Advisory Committee was composed of high-level people, we created a Technical Working Group (“Working Group”), which we envisioned would do most of the nitty-gritty work. We arranged to have regular briefings conducted by the IFC team for the Working Group. The Working Group members were all competent and responsible. Yet, the approval process was slow.

The Working Group decided that the only documents the Advisory Committee needed to approve were the Privatization Strategy and the Concession Agreement. Soon after its creation, the Advisory Committee held a meeting, after which the rest of the meetings were held by the Working Group. The Working Group started to discuss the Privatization Strategy and there did not appear to be any major points of contention.

It took many months before the President finally approved the Privatization Strategy. First, the Working Group members approved it. Next, the Advisory Committee members themselves, all of whom were Cabinet Secretaries, approved it. Finally, the President approved it. Given the high ranks of the signatories, it was quite understandable that the process would take a long time.

We soon realized that we needed the Advisory Committee’s approval of the Concession Agreement before the bidding. Ideally, we needed

Advisory Committee approval at least a month before the bidding. The Agreement was one of the most critical bidding parameters. The bidders would not be able to make an intelligent bid without the approved final draft of the Concession Agreement. Furthermore, we wanted the bidders to sign off on it in advance so that immediately after the notice of award, we could sign the Concession Agreement ourselves.

One of the reasons for the difficulty in getting the Working Group approval of the Concession Agreement was that we were trying to get MWSS Board approval and Working Group approval simultaneously. Theoretically, the MWSS Board should have approved the Concession Agreement and then endorsed this to the President through the Advisory Committee. We didn't have the time for this sequence of approvals, so the MWSS Board finished their deliberations on the Concession Agreement about December 5, 1996, at the same time that the Working Group was deliberating on the Concession Agreement. We just provided the Working Group copies of each updated version of the Agreement. While this seemed confusing, in fact there were only a few changes toward the beginning of that month.

It was not a simple matter to get the endorsement of the six members of the Working Group. Each person had his or her own concerns and these needed to be addressed one by one.

Our consultants worked extremely hard on the concerns raised by the Working Group. They met individually with each member of the Working Group and sorted things out. By December 20, 1996, they thought everything was in order.

But everything was not all right. There continued to be some serious concerns from some Working Group members. I had to work with each of the members through the Christmas season. We were literally working on the privatization while other people were partying.

In the morning of December 24, Secretary Vigilar and I were in our offices working. I was trying to contact people, but no one was in their offices. I needed six signatures from the Working Group. Suddenly, I pitied myself and sent this e-mail to everyone at IFC:

*'Tis the day before Christmas
And everywhere we call,
There is no one around,
Looks like all work has stalled.*

*Even IFC's on holidays,
But not so my boss,
We will be busy working,
Making letters and poems.*

*Please make my day,
I call out and say,
I need six more signatures,
Ministers!—Please don't be away.*

Merry Christmas to all!

The poem was a great hit at IFC although I am not sure that they realized I was quite serious about my self-pity. Scott wrote me an enthusiastic e-mail, saying that he loved my poem and that he would frame it as a memento to this outstanding transaction!

We got the final approvals from the Working Group on December 26, after which Secretary Vigilar started to personally call each Advisory Committee member, so as to get their signatures before the January 6, 1997, bid opening deadline. We got all the signatures of the principals before the New Year but we still needed the President's final approval.

On January 6, 1997, barely two hours before the submission of bids, I received word that the President had finally approved the Concession Agreement. We had made it, but just barely. We never told the bidders about this. They may have panicked otherwise.

The Committee on Privatization (COP)

One of the members of the Working Group of the Advisory Committee was Chris Legaspi of the COP. Chris was always very supportive of the transaction and, from the very beginning, she kept suggesting that we course the transaction through the COP. Initially, we objected to this idea, primarily because the COP was concerned mainly with the sale of government-owned corporations, not privatization through the granting of concessions. We said that our legal basis was the Water Crisis Act, not Proclamation 50.

Sometime in October 1996, Administrator Lazaro attended some public hearings at the House of Representatives, which questioned, among others, the legal basis of the MWSS privatization. Congressmen started to raise the issue of whether or not the six-month period prescribed in the law for the privatization had already lapsed. We started to worry that this could become the Achilles' heel of the project.

It was at this point that we decided to explore the possibility of getting COP approval in addition to all the other approvals we were obtaining. This would give a second legal basis to the transaction. It was a redundant approval, but it would further strengthen the transaction. We talked to Chris Legaspi and discovered that the procedure consisted of a preliminary approval by COP of the main features of the transaction, prior to actual bid-

ding and then a second approval by COP after the bidding, subject to the final approval by the President.

On October 18, 1996, I joined the IFC team in a two-hour presentation to the COP. Immediately after the meeting, the COP Chairman informed us that they had approved the transaction, subject to certain conditions, which were not difficult to comply with. It was very encouraging to get this kind of quick and solid support.

The Prequalification, Bids, and Awards Committee ("Bid Committee")

We needed to adopt a procedure for the evaluation of bids, the recommendation for awarding the bid, and the actual awarding of the contract. Again, we had no precedent, but the procedure we adopted was based on normal government procurement procedures.

By virtue of Executive Order 311, the President himself had to approve the award of contract. This corresponded to the head of the "agency" typically approving awards. In this case, the "agency" was the national government, which owned MWSS and the head of the national government was the President.

Similar to other procurements, we decided that a Bid Committee should recommend award of contract and endorse it to the approving authority, in this case the President. The composition of this Bid Committee was most naturally the MWSS Board itself. Obviously, it was appropriate that the highest decision-making body within MWSS recommend approval of the total transfer of MWSS operations to the private sector. We arranged, therefore, for the Board to constitute itself into a Bid Committee.

The Technical Working Group of the Bid Committee

A Bid Committee normally has a Technical Working Group that handles the staff work and submits its recommendations to the Bid Committee. We arranged for the Technical Working Group to be chaired by Administrator Lazaro, but its other members to be composed of IFC staff.

The Technical Working Group was essentially made up of engineers and finance people. For the technical evaluation, the engineers were probably going to be the key Technical Working Group members because they were most likely going to be the ones to recommend the rejection of any technical bid. In order to minimize potential complaints against the integrity of the technical evaluators, we arranged for the three main nationalities involved in the bidding to be represented among the Technical Working Group engineers. There was Jerome Esmay of the United States, Barry

Walton of the United Kingdom, and Lionel Huet of France. Conveniently, these were also the three main engineers who had worked on this transaction, representing, respectively, the IFC internal staff, the IFC special consultant, and the main technical consultant of the transaction. The three engineers did their work in a highly professional manner and, later on, there was no serious question raised about their competence or integrity. Yet, it was quite funny that the three of them continuously clashed. One would never think that engineers, who are supposed to be objective, could act exactly like economists, never agreeing on any of the points—or at least always initially arguing over every single one of them.

Since we had decided to run the transaction through the COP, we also decided that the MWSS recommendation of award would be coursed through the COP.

Finally, within the Office of the President, we made sure that both the Executive Secretary and the Chief Presidential Legal Counsel endorsed the recommendation of award.

The procedure we followed was without precedent. However, it closely followed the structure of government procurements and, in fact, went beyond the typical procedures. We wanted to go for overkill as far as procedure was concerned, even if this made the approval process more tedious. What is most impressive is that in spite of this deliberateness on our part, the transaction was executed very quickly. The bidders were extremely happy with the speed of the transaction. It significantly reduced their transaction costs.

Contract Negotiation and Signing

After the approval of award by the President, the next logical step was going to be contract negotiation and signing.

Contract negotiation is always a touchy matter, particularly when it is done after a competitive bidding process. One is open to court suits from losing bidders if it is perceived that the negotiations have resulted in a more favorable contract for the winning bidder. The best procedure is to have a contract agreed upon with all bidders even before the bidding. The bidding is based, therefore, on a common pro forma contract known to everyone.

This procedure would have been much easier if the bidding was for a project with many precedents. In this case, we had no precedent, neither in the Philippines nor in the world. Nevertheless, it was much cleaner to do it in this manner.

We completed contract negotiations prior to the bidding. After we received a copy of the President's approval of the award of contract, we signed the prepared contract, literally a few hours afterwards.

Summary of the Approval Process

In summary, the three main approval processes were the following:

PRIVATIZATION STRATEGY

- MWSS staff
- MWSS Board
- Committee on Privatization
- Technical Working Group of the Special Advisory Committee
- Special Advisory Committee
- President of the Philippines

CONCESSION AGREEMENT

- MWSS staff
- MWSS Board
- Technical Working Group of the Special Advisory Committee
- Special Advisory Committee

BID AWARD

- President of the Philippines
- Technical Working Group of the Bidding Committee
- Committee on Privatization
- Chief Presidential Legal Counsel
- Executive Secretary
- President of the Philippines

The Bidders

The International Water Operator

From the beginning, we realized that there would be few bidders and that the constraint on the number of bidders would be the number of prequalified international water operators. There are very few private water operators with the size of operations that would approximate MWSS.

We expected the two large French water companies to bid—Compagnie Generale des Eaux (CGE) and Lyonnaise des Eaux. We also expected several British water operators to bid, particularly Thames Water and Northwest Water (a subsidiary of United Utilities). Aside from these, we were not sure who else would bid. We felt that Anglian Water and Severn-Trent, both British companies, had a chance to prequalify but we were not sure.

Since Biwater had twice offered to purchase MWSS, we expected them to try to prequalify, but they didn't even attempt it. We also looked at the size of their operations and we seriously doubted that they were qualified to take over MWSS.

We desperately wanted to have as many bidders as possible, all the more so since we had decided to split MWSS into two concessions. We were extremely worried that if there were only a few companies in the running, people would think that the bidders would connive with each other, and the credibility of the bidding would be damaged. Furthermore, what if the bidders *did* connive?

Initially, we had only three international water operators—the two French companies and United Utilities of the United Kingdom. We tried hard to convince Thames Water, but it seemed that they had recently lost

a lot of money in their international water contracts and so they had decided to cut back on international operations.

There was an attempt to prequalify Australian Water, which was a very large water operator owned by the Australian government. We decided against prequalifying them because this would have been counter to our objective of privatization. We would have been shifting ownership from one government to another. Furthermore, from a national security point of view, we thought that it would have been difficult to accept that a foreign government actually controlled the drinking water of your capital city. Finally, we thought that any adverse action against the government-owned firm in the future might have unwanted diplomatic repercussions. In the end, Australian Water still joined, but only as a partner of Anglian, not as the "International Water Operator."

There were also attempts to prequalify companies with expertise solely in sewerage, which would bid together with companies with expertise in water distribution. This did not actually manage to push through and it was probably better this way. We thought that handling a combination of two international water operators, both of which were indispensable for the job, was going to be too complicated.

It was fortunate that Anglian Water decided to join the bidding. With Anglian, we had four bidders for two zones, giving each bidder a 50 percent chance of winning. Without Anglian, we would have had three bidders for two zones.

Very early in the process, there were attempts to combine some of the international water operators. People rationalized that the transaction was too large and the risk had to be spread. We thought that some people just wanted to reduce the number of bidders to two and then negotiate two contracts. Because of this possibility, we set a requirement that no firm that was prequalified by itself could enter into a bidding consortium with another firm that had also been prequalified by itself. This condition actually destroyed CGE's plan to use, as their bidder, United Water, an Australian firm that was a joint venture between CGE and Thames Water. The problem was that both CGE and Thames Water were strong enough to prequalify individually.

Later on, we marveled at what Margaret Thatcher had unwittingly created. She had privatized the U.K. water system in 1989 and accidentally built the only serious competitors to the two large French water companies. The 1989 U.K. water privatization had created 10 large water operators and, aside from the French companies, these were probably the largest in the world. If Mrs. Thatcher had not privatized the British water systems, it would have been very difficult politically to execute a privatization of a water system in which the only qualified operators were French. However, since the French companies seem to be the main winners of

water privatizations, these companies should probably be the ones giving plaques of appreciation to Mrs. Thatcher.

I think it is a matter of concern that we had so much difficulty in finding prequalified international water operators and in convincing them to bid. There are many large water systems in the world that can be privatized, but there are only a handful of firms that are qualified to handle these. The fear here is the reduction in competition, possible collusion, or even the perception of collusion, and the possibility that a cartel may be formed.

With respect to the MWSS privatization, we are pretty certain that there was intense competition among the bidders. We are not certain, however, that this strong competition will continue to be seen in future bids.

Hopefully, more large private companies in the future will enter this field and compete.

The Local Lead Firm

An international water operator entering our bid needed a local partner. In fact, given the laws of the country, the local partner was actually going to be the majority owner of the utility (60 percent minimum) and principal manager of the water system. In other words, the local partner was supposed to run the show.

We had two initial problems in convincing local firms to join the bidding. The first problem was that no local private firm knew the water business. The only privately run water systems were mainly in subdivisions and industrial estates and these were relatively small. The international water operators themselves resolved this problem. Each of them gave extensive briefings to the management of the local firms and convinced them that the water business was good business. In good times and bad times, people needed to drink water. It was absolutely guaranteed that you would always have customers. The customers paid in cash and this would provide a generous cash flow over 25 years, the life of the concession.

Our second problem was the perception of many companies that the required equity would be in the range of \$1 billion. This was way off the mark. While the total estimated investment was in the range of \$7 billion, the estimated equity was in the range of only \$200 million, and this was for the two zones. The equity per zone was even less and this would be split between the local and international companies. Most of the investment was actually going to be sourced from the cash flow. Later on, when I explained this to the owner of a relatively large local firm, he was extremely surprised and suddenly became very eager to participate. Can you imagine having a significant share in a company that provided water to Metro Manila for only \$10 million? This was not only good business, it was also power. After Benpres won the concession for the MWSS West Zone, Asiaweek named

their patriarch, Mr. Genny Lopez, one of the 50 most powerful men in Asia. In large part, I believe this was attributable to their having won the MWSS concession. Water is power.

Largely as a result of our experience with the construction contracts of the Department of Public Works and Highways (DPWH), we wanted to ensure that there would be one dominant Filipino firm. In some DPWH contracts, there were up to six joint venture partners. The thing that often resulted was that the partners would fight, to the detriment of the project.

We were afraid that the same thing would happen in MWSS. If the equity for the Filipino firms had been thinly spread over too many partners, this would have resulted in many disputes among the Filipino partners. If this resulted in chaos for short-term construction contracts of the DPWH, one can imagine what would have happened with a 25-year concession. Because of these concerns, we dictated that there had to be one dominant local lead firm with at least 20 percent of the equity.

Our concerns were probably well-founded. The local equity of the two winning bidders was each taken by only one Filipino firm—Benpres for the West and Ayala for the East. Some of the bidders involved with the losing consortia would later complain that part of the reason for their having lost was that there were too many companies involved in their consortia and it was difficult to get a consensus.

The Prequalification Process

The first stage of the prequalification process consisted of our sending letters of invitation to nearly all major Philippine companies and to embassies. IFC took care of sending letters to all major international banks and water companies. All companies that submitted letters of intent (more than 70 of them) were given a brief document with a general description of the planned transaction.

The next stage was the prequalification of individual Filipino companies and international water operators. We did not want to prequalify them together because the Filipino company could have been disqualified, thus resulting in the automatic disqualification of the international water operator as well. Our constraint was that we had only four international water operators. By contrast, there were seven local firms that qualified as the local lead firm.

The final stage was the prequalification of the complete bidding consortia and, at this point, the firms were virtually assured of prequalification since the local lead firm and the international water operator had already been prequalified.

The prequalification process extended all the way to December 1996, just one month prior to the bidding. Yet, very early on, in May 1996, we opened

the "data room." This room contained numerous documents about MWSS that could be studied and photocopied. Interviews and field trips were also officially organized. All of this was made available for a fee of \$25,000. Companies that felt extremely confident about prequalifying paid the fee. It was important for us to open the data room early so that the bidders would have more time to do their due diligence.

The final prequalified international water operators and local lead firms were as follows:

1. International Water (composed of United Utilities of the United Kingdom and Bechtel Corporation of the United States) and Ayala Corporation;
2. Lyonnaise des Eaux (France) and Benpres Holdings;
3. Compagnie Generale des Eaux (France) and Aboitiz Equity Ventures;
and
4. Anglian Water International (United Kingdom) and Metro Pacific Corporation.

Bid Submission

Meeting the Deadline

Even before the IFC work started in November 1995, we had targeted the submission of bids for the end of 1996.¹⁰ The schedule was tight but we thought that it was doable. Furthermore, the sooner we completed the transaction, the farther away it would be from the 1998 elections and the smaller the chance that it would become a political football.

The schedule for the submission of bids was tighter than that for Buenos Aires. Our advantage was that we had the Buenos Aires experience to fall back on. The big disadvantage was that we were splitting the MWSS coverage area into two concessions and this resulted in huge complications.

In May 1996, I met with a contingent from Lyonnaise des Eaux. At that time, we were about to complete the conceptual phase of the bidding and we were entering the implementation phase. One of the Lyonnaise des Eaux officers told me that the conceptual phase was easy while implementation was the real challenge. He said that the actual bidding would probably be delayed by a year. This seemed to be a fairly common view. Nearly everyone thought that problems would crop up and cause substantial delays. Hardly anyone believed that we could meet our deadline.

IFC felt very strongly about meeting the deadline for bid submission. They felt that the credibility and prestige of both the government and the IFC were at stake. They pushed themselves to the limit. For example:

In October 1996, they held daily discussions with MWSS on the draft of the Concession Agreement. In the evening and up to early in the morning of the next day, they would send faxes to the lawyers in New York, aside from talking with them by phone. By early in the morning of the next day, the revised drafts were faxed back from New York to Manila.

We showed the draft Concession Agreements to the bidders and asked them for their comments. The bidders responded with a stack of comments a few inches thick. I thought that it would take a few weeks to integrate all these comments. In fact, the IFC team, largely through hard work and not sleeping much, completed the work in less than a week's time.

I myself was not sure that we would be able to meet the deadline. Experience said that all major biddings experienced some inevitable delay. Something would crop up. In July 1996, over dinner, Scott asked me what I thought our chances of success were. I said that we had a 90 percent chance of success, but that the major question was when we would complete the transaction. At that time, I correctly predicted that the major opponents of the privatization would be the proponents of BOT projects for MWSS. These companies had spent a lot of money to prepare their proposals, which would then largely be set aside because of the privatization. They had the resources needed to delay the privatization. I said that initially, the BOT proponents would use the media and Congress and, later on, they would use the courts. This turned out to be precisely what happened.

As late as November 1996, I thought that we could be delayed by up to a month. Most important, we had to get the Advisory Committee to approve the Concession Agreement.

I thought that the Advisory Committee approval was the critical milestone. Not only was the Advisory Committee composed of very important people whose signatures would be difficult to get, we also needed to get those signatures during the Christmas break. Finally, the Technical Working Group of the Advisory Committee was composed of tough negotiators.

All of these obstacles were real and serious. In retrospect, it was almost miraculous that we met our deadline in spite of all the problems.

It was in November 1996 that we decided to move the schedule for submission of bids from December 31, 1996, to January 6, 1997. The problem was that if we received the bids on Tuesday, December 31, 1996, these bids would immediately be deposited in a safe and would probably not be opened till Monday, January 6, the first real working day after the Christmas and New Year holidays. We felt that this was unfair. We were asking the bidders to work through the Christmas vacation. Many of the people preparing the bids were foreigners and they would be away from their families during Christmas. Yet, after the bids were to be submitted, we would not immediately act on these bids. We felt that it was better for the bids to be submitted on January 6, because then we would immediately evaluate the bids.

Custody of the Bids

A few weeks before the scheduled submission of bids, the bidders started to raise concerns about the security of the financial bids while the techni-

cal bids were being evaluated. This seemed to be a real concern with everyone.

In order to address these concerns, we floated the idea of depositing the bids in a vault of a government bank, specifically the Development Bank of the Philippines (DBP). The bidders liked this idea and so did the bank. We called the bank and arranged to have not only the custody of the bids at their building, but also the submission and the opening of bids.

The bidders were paranoid about the confidentiality of their bids. One particular bidder prepared its bid the day before submission on a yacht sailing along Manila Bay, far away from any electronic eavesdropping devices. On the bid date itself, the consortium finalized the bid numbers in a secure room in a bank, but whenever someone wanted to mention the bid amount, that individual never said the figure aloud. He communicated by writing it on a piece of paper and showing it to everyone else in the room.

Arrival of IFC

During the Christmas break, from December 21, 1996, to January 1, 1997, no one from IFC was in Manila, although work on the privatization, particularly the approval by the Advisory Committee, continued. The first IFC representative to come was supposed to be Partho Sanyal, who was expected on January 2, and the next was Luc Dejonckheere who was supposed to come on Sunday evening, January 5. Luc was the more senior IFC officer.

I sensed that this was not right. Something was going to happen on the weekend before the bid submission. Something always happened. Later on, Lee Buchheit, the principal international lawyer of the transaction, commented that this deal was like an Indiana Jones movie. Something unexpected always happened and you kept thinking that the deal was dead, but at the last minute, the problem would be resolved.

It was tough to ask Luc to come earlier and disrupt his vacation, but business is business. Luc advanced his trip and arrived on Friday morning, January 3. This turned out to be an important decision. Without Luc and Partho around during the weekend, we may not have been able to sort things out. We always anticipated the worst scenario, and so we were always prepared.

Planning the Procedures for Bid Submission

On January 2, we met with personnel from the Development Bank of the Philippines and the MWSS auditor to plan out the arrangements for the submission and custody of the bids. The following day, we held another meeting, this time not only with the bank personnel and the MWSS auditor but also with Luc and Partho, as well as representatives of the four bidders. We

wanted these preparations to be transparent to all, including the bidders themselves.

Our principle was that the security measures must be exaggerated so as to protect the integrity of the bids and, more important, so as to project an image of transparency and professionalism to the media. Thus, we would have double seals on the bid envelopes, a seal on the safe door, two people who were needed to open the combination of the safe, four sets of chains and padlocks on the door to the room containing the bids, with the keys held by the four bidders. Finally, the room containing the bids was within a big vault inside the bank. We wanted to make the bids so secure that even Houdini would not be able to steal them.

January 4, 1997—The Temporary Restraining Order

At 7:30 a.m. on Saturday, January 4, Secretary Vigilar called to inform me that a Temporary Restraining Order (“Restraining Order”) had been delivered to his residence at 8 p.m. the previous night. The Restraining Order was issued by the Executive Judge of Manila, based on a petition by a group led by the proponents for a BOT water supply project for MWSS. Secretary Vigilar said that the Restraining Order was effective up to Tuesday, January 7, and that the case would be raffled out at 8:30 a.m. on Monday, January 6. There was little more news available. This was totally devastating.

I immediately called Luc and told him about the Restraining Order, that the bidding had to be suspended and that he needed to inform all the bidders. The problem was that no one knew when the bidding could be held. I also called our local lawyer, Atty. Ebot Tan, to inform him of the news and to tell him that we would probably need to meet later in the day. He said that he would assemble the litigation team of his law firm, ACCRA, to join up with us. At 8:30 a.m., Scott MacLeod called from Washington, sarcastically saying that he had heard the good news. I said that there was nothing we could do.

At about 11:30 a.m., Administrator Lazaro called to say that a Cabinet Secretary had called him to a lunch meeting with our opponents. This was big news. I thought the easiest way to work this out was to talk to the opponents and ask them to withdraw.

Our opponents wanted to implement a certain water supply project, even without a “take-or-pay” provision. We felt that their proposal was unrealistic because we did not believe that one could finance a \$1 billion BOT water supply project without a “take-or-pay” provision. However, this was a risk for the proponents and it posed no risk to the government.

I asked Lito to emphasize to our opponents that we had no problem with their proposal and that I was willing to meet with them. Furthermore, I was willing to arrange for them to meet with the IFC team who also had no prob-

lem with their proposal. I emphasized that all bidders had been informed about their proposal and everyone said that it was all right for them to proceed, provided there was no “take-or-pay” provision.

At this point, I realized that there was a slight chance that, somehow, we could still pull through and hold the bidding as originally scheduled. I called Luc and told him to tell all bidders to proceed as if there were no problem, because there was a chance that we could pull this off.

I was hoping that something favorable would come out of Lito’s meeting with our opponents. However, Lito called me at about 3 p.m. and said that the principal opponents had not appeared. Some high-level government officials were the only ones who had shown up. They had told Lito that the privatization was being attacked on its legal basis and had arranged for him to have a meeting with the opponents the following morning.

The information that the court suit targeted the legal basis of the privatization was vital. One of our biggest problems was that we did not have a copy of our opponents’ petition to the court. It was impossible for us, therefore, to prepare our response to the court on Monday. We sensed that our opponents had to be confident about the strength of their court case since they saw no reason to hide the basis of their suit. It was like announcing a checkmate in three moves. They thought that there was nothing we could do. They were gravely mistaken.

We met with the litigation lawyers at 4 p.m. The IFC team was there. Atty. Tan came with a whole bunch of the litigation lawyers led by Atty. Francis Lim. I explained to them the information that Lito had given me. Atty. Tan gave them the materials he had about the legal basis. I explained a bit about the background. We talked until 6:30 p.m. The lawyers said that they would work on the response the following day.

January 5—The Day Before

The following morning, I was on pins and needles waiting for a call from Lito on his meeting with our opponents. Lito finally called at midday and explained that our opponents had agreed to allow the bids to be submitted because, in any event, only the technical bids would be opened and the financial bids would be opened on January 23. In return, the group requested that we have President Ramos call a meeting with them, to be attended by Secretary Vigilar and Lito as well; they wanted the President to sign some order at the meeting, binding Secretary Vigilar to implement their project. In the meantime, they promised not to have the Restraining Order served. They did not seem to realize that the Restraining Order had already been served.

Finally, our opponents asked that we work it out so that none of the winning bidders be allowed to bid against them for the implementation of their

project. I said that we could not impose this on the bidders because we had no legal basis to do so. However, I also said that this should not be a problem and that this could probably be worked out with the bidders because the bidders seemed to be indifferent to this project, provided there was no take-or-pay commitment.

I then explained to Lito that, in fact, the Restraining Order had already been served. Lito was surprised. I asked him to try to contact our opponents and explain this to them.

I called Luc and we discussed the situation. I said we needed to meet all the bidders and ask them about their reaction to our opponents' request regarding the bidders' not bidding on the opponents' proposed water supply project. Furthermore, I said that it was probably opportune to meet with the bidders face to face after all of the confusion of the past day. We set the first meeting for 2:30 p.m.

We first met with the Anglian group. They had no problem with the recent turn of events. They were willing to give the letter committing not to bid for the water supply project of our opponents.

Before meeting with the Ayala group, Lito called to tell me that our opponents had called: They had just found out that, in fact, the Restraining Order had been served, but they would allow the bids to be submitted anyway.

We then met with the Ayala group, and they were very tough. They refused to sign the letter. They said that this amounted to blackmail and that if they acceded to this, when would it end? I said that the request did not compromise the bidding, and that we would not compel the bidders to sign the letter because we had no basis to request this, but if they did agree to sign, this would be a positive step toward solving the problem.

At the same time, I explained that we had some of the best litigation lawyers in the country ready to fight in court on Monday and that Secretary Vigilante had solicited the assistance of the Chief Presidential Legal Counsel and the Solicitor General. The Ayala group seemed to be satisfied with this explanation.

At this time, a top government official who was in contact with our opponents called me about the submission of bids. I told him that I understood that the bids were to be received and we could evaluate the technical bids but that the financial bids would not be opened until agreement had been reached between the two parties.

He said that we could receive the bids but we should not open the technical bids. I asked him if our opponent was willing to withdraw the case because, otherwise, the bidders might not be willing to even submit the bids, given the strict wording of the Restraining Order, which prohibited us from doing anything "related" to the bidding. He said that our opponent would not withdraw the Restraining Order but that there was no problem in simply receiving the bids. He said that he himself would be present dur-

ing the submission of bids to give comfort to the bidders. I thought that his proposal was not going to work; none of the bidders was going to trust him.

The last group we met was Benpres (we still could not contact Aboitiz). They were concerned about not being able to submit the bids on schedule. They tossed an idea of submitting the bids to the government bank and then to a third party (another bank). This idea, however, was discarded because it would appear that the bidders were colluding with each other.

At this point, I suddenly realized how important it was for the bidders to just submit the bids. People had been working for so many months. They had missed their Christmas and New Year's vacations. If the bids were not submitted, the bidding teams, which included many expatriates, would stay in Manila until the submission date, whenever that would be. The trouble was that up to the submission date, you could continue working and refining your bid. You would know that the other bidders were probably doing this and so you yourself would feel pressured to continue working.

Someone from Lyonnaise des Eaux then came out with the idea that we should not, in any way, give an opening to anyone to say that we had defied the court by submitting the bids. Too much work had been done and it was better to wait for a court order lifting the Restraining Order than submitting the bids and risking being found guilty of contempt of court. I thought that this was a very important observation and everyone immediately agreed to it.

We decided to call all the bidders to a final meeting at 7 p.m. wherein we would summarize everything that had been agreed upon—basically that we would fight the Restraining Order and that we would not have the bids submitted unless we got a court order reversing the Restraining Order. We also told everyone to be on call for a meeting with a half-hour notice.

At 8 p.m., we met with the chief MWSS lawyer. At 9 p.m., we met with the litigation lawyers. At that time, they had already prepared some preliminary written pleadings for the judges, based on what we surmised was the complaint. Their work was very impressive. It was thorough and had been accomplished over 24 hours, by lawyers who initially had little knowledge of the transaction. It was also completely accurate, in spite of the fact that we had no copy of the actual complaint. Everything was guesswork, based on the little information that our opponents had provided.

I explained to the lawyers the background behind the proposed water supply project. The lawyers needed to do some more work on the pleadings. We finished the meeting at 1 a.m.

January 6—Bid Submission

The following day, I went to the office very early to get a copy of the approval by President Ramos of the privatization strategy and sent this to

the ACCRA lawyers who were at the office of the judge who had issued the Restraining Order.

Throughout the morning, we received intermittent reports from the lawyers. The lawyers of the opposing side were not there—this was a welcome development although, later in the day, the judge called the lawyers and they appeared. The case was raffled out and given to Judge Maliaman. All the initial information on Maliaman was positive. He was a professional, close to retirement, worked very hard, and so on.

At 10:30 a.m., we received word that Maliaman had declared that the Restraining Order had expired the previous day and that there would be a summary hearing at 1:30 p.m. We called all the bidders to give them the news. It looked like we were pushing through!

At 2:30 p.m., we finally got confirmation that Maliaman had definitively declared, in writing, that the Restraining Order had expired. The law states that a Temporary Restraining Order (TRO) of a lower court (as in this case) is valid for a maximum of three days. The Executive Judge who had issued the TRO interpreted this three-day period to exclude the weekend. Maliaman ruled that the life of the TRO included the weekend and, therefore, it was valid only from Friday up to Sunday. While we had won on apparently a mere technicality, our lawyers said that the judge was probably also persuaded by their extensive and persuasive arguments on the substance of the case. We informed the bidders again about this official ruling. Later that same afternoon, we received copies of Judge Maliaman's actual order. I thought that this was a great vindication of the Philippine justice system.

I arrived at DBP at 3:30 p.m. Metro Pacific had been there since 3 p.m. Shortly thereafter, the Aboitiz group arrived. Ayala and Benpres came much later. Everyone was in a very cheerful and celebrating mood. We had won. We could submit the bids. Everyone, particularly the expatriates, could go home and celebrate a belated Christmas.

I was surprised to see a lot of press around. We had not invited anyone from the press, but they had come anyhow; apparently we had hyped this up pretty well.

We had not really prepared for any ceremony, particularly because we were so busy trying to fight off the Restraining Order. We worked out the ceremony quickly. The proceedings went off without a hitch.

We had met our target. We had received the bids at exactly 5 p.m. of January 6, 1997. Against all odds, using all the resources we could muster and working as hard as we could, the Restraining Order had been lifted.¹¹

Bid Opening

The Evaluation of the Technical Proposals

The bids consisted of the financial proposals, which were placed in a safe, and the technical proposals, which were opened the day after the submission of bids.

From January 7 to January 20, the Technical Working Group (TWG) of the Bidding Committee evaluated the four technical proposals. This evaluation included clarificatory meetings with each of the bidding groups.

At the end of this process, the TWG informed the MWSS Board (the "Bidding Committee") that all technical proposals had met the minimum requirements. On January 22, the MWSS Board declared that all technical proposals were complying.

Preparations

The financial bid opening was obviously going to be the event that would attract the widest media coverage. At that moment, barring any unforeseen problems in the future, the public would immediately know the winners. We expected the opening to be attended by many foreigners and the international media. We needed to take advantage of this and project the transparency and professionalism of the project.

The most dramatic bidding that we had ever seen before was that for Fort Bonifacio, wherein the bids were simultaneously flashed on different screens, through overhead projectors, one bid for each screen. Our advisers, however, weren't really excited about this idea. They proposed bid rules that were boring, and that had no drama or imagination. It consisted of the

normal bidding procedure wherein Administrator Lazaro would call out the bids one by one and these would be posted on a board.

We talked to a lot of friends about the procedure and most people liked the Fort Bonifacio style. The point was the immediate capture of emotions. After the bids were flashed on the screen, there would probably be a pregnant pause of two seconds during which the bidders would try to quickly check who had submitted the lowest bid, after which the supporters for one bidder would be jumping up and down while the others' faces would be aghast. By contrast, in calling out the bids, the emotions are spread out over time.

In the end, we decided on the Fort Bonifacio style. We wanted drama in the bid opening. This was the biggest water privatization in the world and it had been done in an extremely transparent manner. It was an international event and media from all over the world would cover it.

We needed to explain the bidding rules to the audience, particularly the media. We decided that we would do so through a video presentation. We got a local group to do the video and they turned in a good job.

January 21

On January 21, 1997, two days before the bid opening, we met with representatives of the bidders, the Development Bank of the Philippines, MWSS, and IFC. We had prepared a five-page detailed description of the procedures for the ceremony. Similar to the bid submission procedures, the bid opening was going to be characterized by transparency.

The vault containing the safe in which the bids sat would be opened in the presence of the bidders, IFC, and the Commission on Audit. The bidders would unlock each of their padlocks, which had prevented entry to the room with access to the safe. The safe would be wheeled in to an auditorium, accompanied by security guards.

The safe was to be set in the front of the room and the combination was to be opened by an officer of the bank and the MWSS Administrator. Then, an IFC officer would open another cabinet inside the safe, where the bid envelopes were kept.

The bid envelopes were going to be brought by the representative of the Commission on Audit from the safe to the stage. They were going to be inspected by all bidders. The envelopes were to be placed in a glass container, in the full view of the audience. After the ceremonies, all bidders would be given the opportunity to inspect the bids, so as to determine that the bids flashed on the screens were those that had been actually submitted by the bidders. All the bidders agreed to the procedures and appeared to be quite happy.

January 22

On January 22, the day before the opening of the bids, the group that secured the court Restraining Order came out with a big media assault. There continued to be attacks in several newspapers against the legality of the privatization. It was announced that the labor union had joined them in their court case; it did not help their case, however, that the person who filed the supplementary case was the one who had lost the labor union elections earlier. A columnist once more attacked the transaction and asked President Ramos to stop the bidding. All of this told us that there was a real possibility that a Restraining Order would be served.

In the morning, the MWSS Board declared all the technical bids to be complying. In the afternoon, while I was at DBP inspecting the venue for the bid opening, I received a call from Administrator Lazaro. He was extremely worried. He had received word that a Restraining Order was going to be issued.

I called Secretary Vigilar and gave him the news. I then went home and waited with dread for the Restraining Order to come. The last time, it had arrived at 8 p.m. at the residence of Secretary Vigilar. At 9:30 p.m., I called Secretary Vigilar and he said that no Restraining Order had come as of yet. Yet, we could not rest.

January 23—The Big Day

This was the big day. I woke up at 4 a.m. and could hardly sleep anymore. I was worried to death about the possibility that a Restraining Order might be served at the last minute.

The press releases in the morning mainly announced that all bidders had passed the technical bid. The more interesting news was that the judge had said that he could not make a decision because he had not yet received the memo from MWSS.

A huge number of people arrived, many of them foreigners, and they had started coming in before 9 a.m. Ultimately, we ended up with some 400 guests. A lot of media were also coming in, ultimately maybe 70 to 80 journalists. This got me all the more nervous that a Restraining Order might be served. The embarrassment would be tremendous. I just wanted those bids to be opened because I felt that the discounts were going to be huge and that this would make big news and effectively stop all of our critics.

At exactly 10 a.m., we commenced with the national anthem, followed by an invocation. The video was impressive. Secretary Vigilar gave some brief remarks, meant to thank everyone, particularly all the bidders. This speech was important. We wanted to be able to thank all the bidders and

make them all feel good, prior to opening the bids. After the opening, two of the bidders would not be very happy anymore.¹²

The show started. The safe was rolled in by three utility personnel, all well-dressed, accompanied by security guards and representatives of the four bidders, the Commission on Audit, IFC, MWSS, and the bank. The safe was positioned in the center, just before the stage.

After the procedures for opening the safe were followed, the bidders accompanied the Commission on Audit representative upstage, bringing the sealed bids. Seals were inspected by all and everyone was satisfied that none of the bids had been tampered with. The bid envelopes were deposited in a large transparent plastic container, clearly visible to everyone. The bidders came down from the stage. All this elaborate ceremony was very important, first to ensure that no one had any doubts about bid tampering, and second to give an aura of transparency.

The bids were opened and penciled in. During the days before the bid opening, I was thinking to myself that some big problem would arise when we opened the bids. This intuition was based on the fact that nearly every imaginable obstacle had occurred. I started discussing this with IFC and we came to the conclusion that one of the bidders may have submitted a qualified bid (a bid with preconditions), which would result in an automatic disqualification.

What had raised our concern about the financial bid of one bidder was that it was unusually thick. The bid was supposed to be only a few pieces of paper and, in fact, everyone else's financial bid was a thin envelope. We thought that this particular bidder may have submitted many documents that outlined conditions for their acceptance of the award—in other words, a qualified bid that would merit automatic disqualification.

In anticipation of this possibility, we asked Atty. Tan to inspect each bid so as to ensure that all bids were in order. We also arranged that in case Atty. Tan were to question a bid, the MWSS Board would immediately meet in an adjacent room and decide on the matter right away. We had to be prepared for anything.

When we opened the suspect bid, we discovered why it was so thick. They had encased their bid in lead, so as to protect it from being seen, even by X-rays. Thankfully, no one submitted a defective bid. That was not the surprise.

All eyes were glued on the DBP officer who was writing the bids down and people were trying to guess what the bids were, based on the way her hand moved. Toward the end, Ebot started talking to Lito and they both looked worried. I sensed that there was a problem. With all the bids opened, everyone came down from the stage. The atmosphere in the room suddenly changed. People started getting restless. There was a sudden hum of noise.

The projector screens were raised. The security guards positioned themselves at the two sides of the screens. We tested the projectors to make sure they worked. Lito mounted the transparencies for the West Zone. The tension was tremendous. Secretary Vigilar pushed the button and everyone immediately saw that the Ayala group had bid 28 percent while the others were in the 50–60 percent range. It was kind of shocking. Ayala started to whoop it up amidst a deafening silence from everyone else who were all in some kind of shock. Then, there was lots of noise and movement. Everyone was suddenly on a cell phone. Everyone was talking to everyone else. The media converged on the various business personalities. It was kind of strange seeing all these disciplined, quiet, and elegant people in the audience to suddenly lose control.

I was floored. The bids were all so low. I never expected this but the Ayala price looked like a mistake. I thought it was the discount, not the coefficient. I thought Ayala would admit their mistake and this would be a big mess.

After maybe five minutes, we proceeded to the East Zone. Knowing that Benpres was second in the West, I knew that if Ayala submitted the lowest bid for the East and Benpres was second, Benpres would automatically win one of the zones. Yet, some more drama and excitement was coming. Again, a silence just before the bids were flashed. The bids were flashed. After a few seconds, the Aboitiz group cheered because Ayala was again number one while they were number two. Aboitiz had realized that they could win.

After a few seconds digesting this, I rushed to our three evaluators. Within a few seconds, they unanimously said that Benpres had won. However, it took almost two minutes for them to display the data on the big screen. During this time, people were still confused as to who the winners were.

Finally, the screen came up and confirmed that Benpres had won the West. After a minute or so, the evaluators gave Secretary Vigilar a piece of paper containing the names of the winning bidders. He then officially announced the winners and total pandemonium erupted.

Ayala was the runaway winner for the East Zone, where they desperately wanted to win because of their numerous real estate projects in that area.

In the West, the percentage bid of Benpres was 56.5922 while the percentage bid of Aboitiz was 56.8800. The difference in their bid prices was totally insignificant. To a certain degree, one could say that Benpres (Lyonnaise des Eaux) beat Aboitiz (Compagnie Generale des Eaux) by pure luck.¹³

Everyone was on a cell phone at this point. Reporters and cameras were all over the place. Everyone was interviewing everyone. Everyone seemed

to be in a state of shock at seeing such low bids and, particularly, the very low Ayala bid. We checked with the Ayala group and they confirmed that the numbers were not the discount but the coefficient. Everyone I talked to was aghast at the Ayala bid.

The MWSS Board met and the meeting took ages. They called in the representatives of Ayala to confirm that they had not made a mistake in writing down their bid, that is, that they had bid the coefficient and not the discount. The board finally appeared and confirmed that they would recommend award of contract to Ayala and Benpres.

The following day, the results of the bidding were the headlines in the three largest newspapers—*Manila Bulletin*, *Star*, and *Inquirer*. It was funny how their headlines reflected their slants. The *Bulletin* was upbeat (“Bid results ensure lower water prices”), *Star* was neutral (“Ayala, Benpres win MWSS bidding”), while the *Inquirer* was controversial (“2 Big Empires Bag MWSS bid”). We expected the transaction to be big news, but we never thought that it would make the headlines. Largely, the news was positive. Everyone was happy at the prospect of paying lower tariffs and receiving better service.

Court of Appeals' Temporary Restraining Order

From the MWSS, the bid documents were forwarded to the Committee on Privatization (COP). The COP initially asked for additional documentation from MWSS. The approval was postponed until January 31, when the COP finally endorsed the award to the Office of the President. While the COP was discussing the award of contract, the Court of Appeals issued a 20-day Restraining Order on the award. The following day, the Restraining Order was the headline in five newspapers.

Over the next few days, the headlines were about President Ramos and Atty. Cayetano, the Chief Presidential Legal Counsel. The President vowed to fight the Restraining Order, using all of the government's resources. Cayetano slammed the courts for interfering with the prerogatives of the Executive Branch. Later, the President even called for a change in the Constitution so as to limit the powers of the judiciary.

The petition at the Court of Appeals came from the same group that had obtained the Restraining Order at the lower court. Their petition was much better prepared than the first. It was 22 pages and much better informed, mainly because of the information that we ourselves had provided to the lower court. Yet, it was basically a rehash of the original petition. Their main argument was that the six-month period for the privatization had lapsed.

The government's response was submitted on February 6, with a lot of contribution from Atty. Cayetano and his staff. The hearing was conducted on February 14 and we were well represented.

We gave the court copies of the memos that Secretary Vigilar had sent to President Ramos about the MWSS privatization, within the six-month period after the Water Crisis Act—memos documenting actions by President Ramos that clearly furthered the MWSS privatization. Even just a few days after the passage of the Water Crisis Act, President Ramos had

taken actions that advanced the privatization effort. The justices mentioned that the Constitution itself had prescribed certain target dates for doing certain things, but those targets had not been met.

On February 19, the last day of the Restraining Order, the Court of Appeals lifted it and remanded the case back to the lower court. The Philippine justice system had worked again.

Our opponents filed a motion for reconsideration, but this appeared to be halfhearted. They never really pursued the case anymore. It seems they realized that they did not have a chance of winning.

Approval by the President

The Court of Appeals lifted the Restraining Order on Wednesday, February 19. We were concerned that our opponents might submit an appeal to the Supreme Court and would get a Restraining Order from there. That kind of Restraining Order had no time limit—it could last forever. We told the winning bidders, therefore, to be ready for a quick signing as soon as we obtained the President's approval.

On Friday, February 21, close to noon, we got word from the Office of the President that President Ramos had approved the MWSS privatization bid. We decided to sign that very night. We called Benpres and Ayala and they concurred. The ceremony was set for 7 p.m. The biggest problem was to get the lawyers to pore over the signing documents and make sure that they were the same documents that had been previously approved.

The signing went through without a hitch. Literally within a few hours after the approval of award, we had signed the largest water privatization contract in the world. There was no extra negotiation on the contract provisions. All of that had been done before the bidding.

The Media and the Political Battle

A Frenzy

Over the next two weeks after the opening of bids, the bidding was the biggest news item. The bidding was the headline in several newspapers over several days.

The media and the politicians fed each other. Seeing the media interest in the transaction, the politicians started to make statements about it. In turn, the media gave publicity to their statements. On February 3, 1997, Raul J. Palabrica wrote in the *Philippine Daily Inquirer*:

Like ants attracted by the smell of sugar, some congressmen and senators view the projected privatization of the Metropolitan Waterworks and Sewerage System as an issue they can exploit to advance their political interests.

With the 1998 elections barely 15 months away, the privatization plan is heaven-sent for members of Congress who entertain presidential, vice-presidential and senatorial ambitions.

There seemed to be three principal issues being raised by media and the politicians:

1. Many people thought that the transaction was too good to be true. There must be have been some provision that was concealed from the public and that was grossly advantageous to the bidders or disadvantageous to the public.
2. People raised the issue of the overwhelming political and economic power held by the Lopezes and Ayalas, which needed to be held in

check. Otherwise, these families could abuse this power. The problem with this argument was that it was highly speculative. The Lopezes and Ayalas did not have recent histories of abusing their economic power. Besides, some newspaper editorials correctly pointed out that if the largest water privatization in the world was being carried out, you would expect that only the largest companies in the country would have the resources to participate in the bidding.

3. People questioned the disparity in rates between the East and West zones. In particular, people tried to raise the pseudo-issue that Forbes Park, the classiest subdivision in Metro Manila, was in the East zone, which was charging less than half of the fee in the West zone. The disparity, therefore, favored the rich.

Many people actually raised this issue and declared the bidding to be "seriously flawed" because of the tariff disparity. One Senator even encouraged the public to go to the Supreme Court and question the disparity in rates as a violation of the doctrine of equal protection under the laws.

No one went to the Supreme Court and not too many people, except for a few politicians and columnists, really seemed to care.

I think there were several reasons for people's apparent indifference to this issue. The first is that the amount of an individual water bill is relatively small; many people do not have an idea how much it is. People are more concerned about the availability of water and its quality.

Many households in Metro Manila do not have running water round the clock. Sometimes, the water flows at very odd hours, for example, at 2 a.m. Many others are not even connected to piped water from MWSS. They rely on water tankers that vend water at up to 10 times the MWSS rate. Furthermore, it is inconvenient to have to deal with the water tankers, get them to fill an elevated water tank, close the valves, and so on. On January 27, 1997, Ducky Paredes wrote the following in *Malaya*:

As a water consumer, I used to live in an area where the water could come on only from 10 p.m. to 4 a.m. Sometimes, the water would be only for two hours. There were days, even when no repairs were being done, when there would be no water at all. In my present residence, I have water about sixteen hours a day.

Together with other water consumers, I dream of the day when I can have water at my faucet 24 hours a day. Obviously, as long as the government continued to distribute the water, this was an impossibility.

With the award of the Eastern and Western Sectors to private developers, not only will this happen in the next ten years, we will also be paying much less for our water. **While there is a difference in water rates between the two sectors, this does not matter to me as a consumer as long as water will be available from my faucet every time that I need it** [emphasis added].

In fact, if I had to pay twice the current rates for that, I would gladly pay.

Likewise, on February 4, 1997, Dahli Aspillera wrote in *Malaya*:

Good luck, water privatization. Start by increasing the salaries of the good employees, and firing the lazy. Your management may finally bring water to the faucets at home in Barangay Kapitolyo in Pasig. Because the family has been without daytime water for the past decade, the children had never seen water come out of their home faucets. One housemaid has the two-hour chore at midnight to fill drums, pails, bottles with water. The faucet flows only between midnight and 4 a.m. in most of Baryo Kapitolyo. MWSS, you know that. Did you care?

Metro Manila residents have also become more and more concerned about the quality of their water. Many have bought water filters and many more boil their water before drinking. When Lyonnaise des Eaux was preparing a BOT proposal for the rehabilitation and operation of the La Mesa Treatment Plant, their representatives met with me and explained that the laboratory instruments at La Mesa, which were used to gauge water quality, were in error by a factor of up to 40 percent.

People did not seem to make a big thing out of the price disparity. Even after the actual takeover of MWSS on August 1, 1997, no one made an issue out of this. People always commented on how low their water bills were but they never complained that their neighbor had gotten a bigger reduction in his or her water bill than they had.

It was quite significant that hardly anyone made any accusation about graft and corruption. This was especially surprising, considering the amount of the transaction and the propensity of media and politicians in the Philippines to make this kind of accusation. This seemed to be largely a result of our striving to project an image of transparency.

More important, the transaction was indeed clean and all the bidders, including the losers, acknowledged this. One of the bidders ended up being bitter and looked for all sorts of reasons why it should have won but

it never accused the government or the government's advisers of favoring any specific bidder.

Too Good to Be True

Much of the reaction to the transaction must have been summarized by the statement of a particular Congressman a day after the opening of bids. Many months before the bidding, he had already started sending press releases containing his comments on the MWSS privatization and making privileged speeches in the House of Representatives. He had a lot of good intentions and was a good economist but, probably owing to his unfamiliarity with the water sector, some of his suggestions were a little unrealistic.

On the day after the bidding, he was quoted in the newspapers as saying that the MWSS privatization was "too good to be true. There must be a catch somewhere." He was not the only one to say this. Several other politicians made similar comments.

Given this attitude, many politicians and reporters tried to look for the "hidden provision" in the Concession Agreement that was the secret for the ability of the bidders to submit such low rates. Some of these revelations were almost ridiculous:

- One newspaper headlined a Senator's claim that MWSS was deceiving the public about the tariffs being fixed because, in fact, the tariffs could be increased with inflation and devaluation.
- Another newspaper headlined that water tariffs could be raised without conducting public hearings (which is exactly the way it had always been for MWSS).

Other politicians declared that they would closely scrutinize the contracts, with many focusing on the treatment of labor.

Senate Hearings

There were at least three Senators who delivered speeches questioning the MWSS privatization and asking that this be scrutinized in a public hearing.

The Senate hearings were held on February 5 and 11. At the first hearing, there were numerous members of the media present. Unfortunately for them, the hearing was relatively boring. The Senators asked tough questions and Secretary Vigilar, Administrator Lazaro, and the representatives of the bidders answered them squarely and satisfactorily.

At the next Senate hearing, there were very few media representatives. The Senators seemed to lose interest and there were no more hearings after that.

Positive Media Reaction

Not everything was negative. In fact, the overwhelming response of the print media was quite positive. Some quotes from columnists and editorials:

Beginning next March, water rates in the metropolitan area will be drastically reduced. That is just the most visible public benefit derived from the privatization of the notoriously inefficient Metropolitan Waterworks and Sewerage System.

As a public enterprise, the MWSS is a dinosaur that has miraculously survived the ice age. Bound by our archaic civil service rules, it retained more people than it needed. As a government institution, it was prone to corruption—a carcass that was prey to racketeering contractors.

The service that the MWSS delivered was, to put it lightly, bad. It was inefficient and never had enough money to fix the leaks and to install new water technologies that would improve delivery and collection efficiencies.

Worse, the MWSS required constant infusions of public subsidies in order to keep it, well, afloat. Subsidies for the MWSS are inherently unjust. The money comes from all taxpayers, including those who do not benefit from MWSS service. Those in the Manila area who pay taxes that go to subsidies for the water utility and yet have to buy expensive water by the bucket from those who ration it are the severest victims of this injustice.

Despite the subsidies, it now turns out that MWSS water has been overpriced. The public has been, all these years, paying for gross inefficiency and atrocious corruption.

Last Thursday, the bidding process for the two sectors of the MWSS system was completed. The bidding rules were quite simple: the bidder that offered the lowest water rates won the concession—although no single company may operate the two systems and defeat the intent of introducing competition among the water service providers.

One winning bidder offered to bring down water rates to a fourth of the prevailing tariff. The other offered to bring it down to half [the] present prices.

The public will not only enjoy lower water tariffs. The public purse will also be spared the wasteful task of subsidizing an inefficient enterprise.

On top of those, about \$7 billion will be infused into our economy in the form of investments in new water technologies to improve distribution and collection efficiencies, deliver water to

more residents and upgrade the sewerage system. The national budget would not have that amount to spare for water service alone.

Beyond merely complying with the rules, it is to the interest of the new concessionaires to rapidly improve service in order to deliver more water to more people with the least wastage. Only by doing that can they recover their huge investments while maintaining the lower water tariffs that won them their bids.

Such is the joy of the privatization program. It not only unburdens government of fiscal dinosaurs, the program also induces investments, improves service and restores justice to the way we do things.

The final significance of the successful completion of the MWSS privatization program does not lie in cheaper water and more efficient service. It lies in the larger probability that the public will accept privatization of more utilities as a modern and logical way of doing things.

By averting the depletion of public funds by way of subsidies to special interest groups and inefficient enterprises, more money will now be available to government to finance programs that are tightly focused on assisting the truly disadvantaged and vulnerable groups in society. The money saved from relieving government of the task of subsidizing the MWSS may, for instance, now be used to expand the pro-poor programs of the Department of Health and the Department of Social Welfare and Development.

MWSS Administrator Angel Lazaro must be congratulated for a truly heroic act: putting together a credible privatization process that abolishes his own job. His best reward will be the freedom to return to the private sector where things are always done more rationally.

Contrary to the ignorant claims of demagogues, the privatization program is truly pro-poor.

That is its ultimate joy.

*"The Joy of Privatization," Editorial,
The Manila Standard, January 26, 1997*

Before legislative hearings and court restraining orders ruin the privatization of the Metropolitan Waterworks and Sewerage System, there are two things that must be emphasized. One is that all the requirements of the public bidding were complied with. Another is that the MWSS whose core operations started more

than a century ago, had more than enough time to improve its service, but it bungled royally. In what is supposed to be the nation's premier region, the MWSS has managed to provide water to only 65 percent of 11 million consumers for an average of just 16 hours a day. Its antiquated, leaking pipes cause regular outbreaks of diseases including cholera. It is time to give the private sector a crack at it.

"A Need for Safeguards," Editorial,
The Philippine Star, January 28, 1997

The unfounded fears about privatization have been plumbed to exhaustion. It is now clearer in the public mind that privatization works.

The bidding process for the MWSS—now subdivided into two service sectors—has been completed without a hitch. This is by far the biggest water privatization project that has been successfully pulled off—and the other countries will be closely watching this experience.

The results have been accepted by a water-consuming public that is quietly convinced that no other arrangement could possibly be worse than the present service. Many families depend on water rationed by the bucket which costs many times more than even prevailing water rates. It is the poor that bear the greatest economic burden of bad water service.

The fact that water rates will go down after March this year is actually a minor add-on attraction. Tens of thousands of households in the metropolis would be happy just to have ample water service.

With privatization, a more just regime of attributing real cost to real beneficiaries will finally come into place.... Privatization will solve all the inanities we have woven into our collective lives through those years we allowed our politicians to pander to populist whim.

"Privatization Works," Alex Magno,
The Manila Standard, 28 January 1997

What is emerging in the competitive, privatization-driven business environment fostered by the Ramos economic strategy is that old and new money are competing aggressively, that oligarchies old and new are taking advantage of this business climate, and old wealth is becoming more creative and imaginative in the

deployment of their assets in the face of competition and challenge.

Amando Doronila, *Philippine Daily Inquirer*, January 24, 1997

The most welcome and biggest blessing for Metro Manila's 10 million people from the Ramos government this year is the privatization of the Metropolitan Waterworks and Sewerage System.

Vic del Fierro, Jr., *Isyu*, January 25, 1997

Aside from the print media, the MWSS privatization was the topic in nearly all the major talk shows and investigative shows on television for the next two weeks. Practically all the shows were supportive of the privatization.

One investigative show featured a woman—who was originally interviewed in January 1995—with all sorts of containers for water because she never knew when MWSS water would come or not. At the end, they showed her again, this time at the present, and she still had the same containers. She said that all she wanted was water.

Another investigative show documented how a squatter family bought water at a peso for five liters—or P200 per cubic meter. These people had to use a pushcart to fetch the water downhill and then struggle back to their house uphill.

It was largely Administrator Lazaro who represented the government during the talk shows and he came across very well. He was prepared and honest.

The positive media reports were reflective of the overwhelming dissatisfaction of the public with the MWSS service. They also showed a deep understanding of the rationale of the privatization program, particularly the need to remove subsidies for public utilities. We felt that much of this was attributable to the vastly successful BOT power program. People appreciated the value of privatization—it had restored the lights. Couldn't it restore water as well?

Closing Date

Delays

Over the next several months, we worked on the activities required prior to closure. Closure was originally scheduled for May 7, but this was quickly postponed because of the inability of the auditors to complete their closing audit before the deadline. The next target date was June 30.

There were a huge number of things to be done prior to closing. The books had to be audited. The employees and the properties had to be divided between the concessionaires. Even the split of parking slots became a problem. The database of clients had to be split. An interconnection agreement had to be signed. We needed a performance undertaking from the Department of Finance. We needed a clear opinion by the Bureau of Internal Revenue on whether the concessionaires ought to pay value added tax. We needed a legal opinion by the Office of the Government Corporate Counsel.

Unfortunately, our agreement with IFC did not include their assistance for activities after the signing of the Concession Agreement. This was a huge mistake. Progress was very slow and this was hurting MWSS.

In April or May, we started getting worrisome reports. MWSS employees were not particularly motivated to work. Everyone was waiting for the privatization to take place. It was like a hiatus.

We were told that NRW had probably increased from 56 percent to 62 percent because no one wanted to repair leaks. The leak repair teams would need to requisition equipment before they could go out. This equipment would then be the accountability of the concerned personnel. However, anyone who had an accountability would not be able to get his

or her terminal pay. Therefore, no one wanted to get equipment and no one repaired leaks.

Starting in June and July, many employees spent most of their time fixing up their accountabilities. The problem was that, technically, everyone was going to be terminated. In order to receive your termination pay, you would need to get all your clearances. This meant that you needed to get innumerable signatures from people who themselves were also trying to get their own clearances.

Receivables had gone up drastically from P1.2 to P1.8 billion, again probably because people were not motivated to work.

We should have put more resources into accelerating the actual turnover of operations. It is not good for a privatized agency to remain in a kind of limbo for too long. Yet, there were really so many problems associated with having two concessions that one wonders whether or not it is realistic to expect to close faster than we did—a little more than five months after signing the Concession Agreement. One other problem with having an extended period before closure was that MWSS was a lame duck during that period. The Concession Agreement mandated that MWSS could not make any major decisions during this interim period without the agreement of the concessionaires.

At the same time that we wanted the concessionaires to take over as soon as possible, the Concession Agreement did not contain any provision that would have allowed us to compel the concessionaires to take over immediately. The absolute deadline in the agreement was September. Unfortunately, there were a lot of loan amortizations due before September and, therefore, the Benpres group, which was going to pay 90 percent of the debt, was not particularly motivated to take over the operations before then.

Finally, IFC sent Michael Oraro to help out. He was ideal for the job. Things moved a bit faster at that point, but it was still slow because there were so many complications arising from the split into two concessions.

In order to accelerate the turnover, one of the things we did was to organize a 45-day “parallel run.” Both concessionaires would actually put their people in place. The personnel and the properties would be split. However, the final decisions would still be made by the existing senior MWSS staff. This actually turned out to be a wise decision. It is not easy to split a monolith. Lots of kinks were ironed out during the parallel run.

Turnover

The turnover ceremonies were held on August 1, 1997, at Malacañang Palace (the Presidential residence), with the President of the Philippines as witness. Up to the evening before the ceremonies, there was still no agreement between Benpres and Ayala on their interconnection arrangements.

In fact, the last legal documents were finalized about three hours *after* the turnover ceremony. It went down to the wire.

Everyone was there for the ceremonies. Top executives flew in from abroad. The President was very happy, particularly because he could announce the lower water tariffs.

Interconnection Agreement

The Source of the Problem

In a letter to the National Water Resources Board, which was an attachment to the Concession Agreement, Administrator Lazaro said that MWSS was being privatized through the establishment of two concessions and that each concession would be "allocated" half of the raw water from Angat. At the same time, the bidding documents stated that 60 percent of total demand was in the West and only 40 percent in the East. Therefore, a portion of the water allocated to the East would need to be transferred to the West. It was impractical and inefficient to totally segregate the East from the West. While SOGREAH had divided the zones to provide a minimum number of interconnecting pipes, it was too expensive to totally eliminate the interconnections.

In view of the above, it was necessary for the East and West concessionaires to have some form of interconnection agreement and the most important part of this agreement was the pricing of water transfers between the two zones. A November 1996 draft of the Concession Agreement provided a detailed procedure for determining the pricing. It classified water transfers as either "permanent" or "incidental." "Permanent" water was priced on the basis of direct cost, while "incidental" water could be priced according to retail pricing. "Permanent" water was a fixed steady volume of water that was considered to be "owned" by the other zone but that passed through the first zone for economic or engineering reasons. "Incidental" water referred to any extraordinary requirement.

The final version of the Concession Agreement, however, omitted this procedure and merely said that the two concessionaires needed to come to an agreement. The Concession Agreement went into detail on the pricing

of water transfers *after* the completion of the Umiray project but did not provide for the details *prior* to its completion. This omission, together with the above-mentioned letter to the National Water Resources Board, caused major problems.

Disagreement

Benpres wanted to pay Ayala only for the treatment cost, which they estimated to be P0.40 per cubic meter. Ayala wanted Benpres to pay much more and was talking about opportunity costs. Initially, the figure Ayala gave was close to P10.00 per cubic meter. Ayala and Benpres worked out the details of the interconnection agreement and agreed on everything except price.

About two weeks before the scheduled takeover, Ayala finally made its offer of about P5.45 per cubic meter. Benpres said that the price was way too high. Up to the very last day before the takeover of MWSS by the two concessionaires, Ayala and Benpres were unable to agree on a price. In the end, all they agreed on was to disagree and to submit themselves to arbitration.

Arbitration

About the second week of September, the arbitrators held their first meeting, in the presence of Ayala and Benpres representatives.

The arbitrators invited Scott and me to join a succeeding meeting. Scott's testimony was surprising.

It appears that the first draft of the guidelines on interconnection pricing was prepared by SOGREAH, which was an advocate of charging a tariff corresponding to the cost of "permanent water." This draft, however, was reviewed by an IFC technical expert who objected to the SOGREAH concept. He said that if the East were to charge only cost, the West concessionaire would have no incentive to invest in developing new raw water sources. He said that the tariff should be higher than simply a reimbursement for the treatment cost. Both sides argued their cases well and, since this conflict could not be resolved, it appears that some relatively junior lawyer decided to change the wording of the Concession Agreement and leave the price up to the two concessionaires. In other words, when the Concession Agreement was drafted, IFC was really unsure about the right way to handle interconnection pricing.

On October 2, we learned that the arbitrators had made a decision and it was P1.80 per cubic meter. It was a compromise amount. I thought that the arbitrators had done a good job. They had listened to both parties and come out with a compromise figure.

It was unfortunate that the Concession Agreement contained a gap on the interconnection arrangements. Yet, given such a complicated transaction and the fact that this was a precedent, one was almost certain that something was going to be overlooked. A combination of highly unusual circumstances resulted in an error that was extremely difficult to detect prior to the bidding.

Labor Opposition Prior to Closure

The dominant labor union at the MWSS was the KKMK and its leader was Prudencio Cruz. We had brought Cruz, along with two of his deputies, to Buenos Aires where they were impressed with the benefits that labor had received with the privatization. We had negotiated the labor conditions primarily with them and produced a Concession Agreement that was highly favorable to labor.

Yet, there were other labor leaders in MWSS, two of whom were left-leaning. Both of them opposed the privatization and they were often quoted by the media; they also appeared in TV talk shows after the bid opening. Nevertheless, their positions were quite weak and very few commiserated with them. There was no cause for commiseration with this minority. The Concession Agreement contained more than adequate provisions for labor.

As the takeover date approached, however, they found a new and legitimate gripe. Congress had passed a Salary Standardization Law, which increased the salaries of the MWSS employees. The increase was effected in October 1996. However, the MWSS employees discovered that the other government employees had gotten their increase much earlier—in February 1996. The MWSS employees started to lobby for their salary increase to be made retroactive to at least July 1996. Naturally, such a proposition received the support of all employees and many started to join noontime demonstrations. Soon, these demonstrations received media attention and this emboldened the labor leaders even more.

Then, other gripes started to pile on, particularly a demand that the concessionaires make all employees permanent immediately instead of having them go through a probationary period.

The MWSS Board was considering the petition of the employees. The law said that the salary increase could be made effective as long as the agency concerned had the available funds. However, while management claimed that funds were available, the Board was not fully convinced and it continued to study and deliberate on the matter.

Suddenly, on June 30, some 100 to 200 employees put up a picket line outside MWSS and blocked the other employees, telling them not to go to work. No vehicles were allowed inside the compound. The strikers were intimidating the other employees and were therefore disrupting operations. The strike was illegal because they were government employees and because they were employees of a vital public utility. We needed to act strongly. Otherwise, the strikers would continue to escalate their actions.

Secretary Vigilar told Administrator Lazaro to prepare notices that anyone who continued with the strike would be immediately suspended. Vigilar then told Lazaro to prepare suspension notices so that anyone who disobeyed would automatically be given these notices the following day.

Secretary Vigilar called the Secretary of the Department of Interior and Local Government to request antiriot policemen. He called the Secretary of the Department of National Defense to ask for the assistance of the Army Engineers, in case we needed to call them to take over the MWSS operations. He called the Labor Secretary to get advice on the strength of our legal position. The Labor Secretary confirmed that we had a very strong position and that the strikers' actions were illegal.

On Thursday, July 3, the MWSS Board held its regular meeting at a hotel and confirmed the instructions of Secretary Vigilar to Administrator Lazaro that we should take tough action against the strikers. Soon, notices were posted warning everyone to report to the office right away, under penalty of suspension. At the same time, antiriot policemen were brought in and we had the Army Engineers on standby in case they needed to take over operations.

Sure enough, the strike immediately fizzled away. Management asked the supervisors to list the names of all those who were absent; show-cause letters (some 2,400) were sent to all of these, asking them to explain why they were not to be suspended. The idea was that anyone who gave practically any excuse whatsoever was to be forgiven.

Following the advice of the Department of Labor, MWSS filed a case with a Regional Trial Court (RTC) in Quezon City, requesting a temporary restraining order and an injunction against the strike. The main basis for the petition was that the employees were government workers and were employed in a vital public utility. The objective of the court case was to have a stronger basis for arresting strikers. After some hearings were held, the RTC granted us the injunction.

In retaliation, the defiant labor leaders filed a petition with the Supreme Court, asking that the privatization be declared illegal. Their petition was extensive (81 pages), but it was weak because it was based on ideology. One of its syllogisms went like this:

- The electricity distribution and telephone companies are presently privately owned.
- When you do not pay your electricity or phone bill, you are disconnected.
- If MWSS is privatized and you do not pay your water bill, you will be disconnected.
- Therefore, we should not privatize MWSS.

The logic was absurd. The Supreme Court threw out the petition, without comment, with a one-page decision and remanded it to the lower courts.

This had been a classic show of political will within the constraints of a democratic society. We showed tolerance to the protests by the labor leaders but once they started to violate the law and to disrupt operations, we acted swiftly and strongly. We could not tolerate blackmail.

The Timing of the Bidding

Looking back, one can see that the bidding was correctly timed. There were some essential elements that came in just at the right time.

The right people were there. President Ramos was an outstanding leader who fully supported privatization and, in particular, the MWSS privatization. Secretary Vigilar was at the forefront of the water agency and was a persistent fighter. He had a lot of experience in handling large transactions. Administrator Lazaro was honest and competent and had no desire to hold on to his position. In fact, he wanted to complete the privatization as soon as possible so that he could return to the private sector. And, on the side of the advisers, we had Scott MacLeod who did a very thorough job and worked himself and his team to the limit.

The privatization occurred after the country had solved a severe power crisis through the implementation of privately financed BOT power plants. This gave greater credibility to privatization and it also made the government and the public more familiar with the nuances of privatization.

The Water Crisis Act was approved just as we started the privatization process. This gave us the strong legal basis for the transaction.

In the private sector, the transaction occurred at a time when there was intense competition among both local and international bidders. This probably contributed greatly to the low bid prices.

The bidding was held about 16 months before the national elections. If it had been delayed by a further six months, it may have become a political football and would have never been completed.

The bidding took place some five months before the start of the Asian financial crisis. Even with the financial crisis, the transaction could probably have been completed, but the bidders would have wanted more

guarantees and this would have caused a delay. Furthermore, the bids would have been higher.

How much luckier can you get? Yet, I've always thought that those who work very hard are often lucky.

The Service Targets, the Financial Model, and the Low Bids

The service targets specified in the Concession Agreement are as follows (figures are in percent):

<i>Year</i>	<i>1996</i>	<i>2001</i>	<i>2006</i>	<i>2011</i>	<i>2016</i>	<i>2021</i>
Water Service	67	87	98	98	98	98
Sanitation	0	39	40	36	33	29
Sewerage	8	7	15	26	38	54
Sanitation and Sewerage	8	46	55	62	71	83

The process of finalizing the service targets was an iterative one. Our advisers drew up three alternative sets of service targets, from a conservative to a moderate to an aggressive scenario.

Each set of service targets was matched to capital expenditure and operations and maintenance (O&M) budgets that were drawn up with a lot of help from the engineers. These figures were fed into a complex financial model that produced, as a bottom line, the initial tariffs. If these tariffs were too high, it was back to the drawing board. This financial model was very important because it determined that the service targets were commercially viable.

IFC presented its final product to the MWSS Board—the conservative, the moderate, and the aggressive scenarios. The degree of aggressiveness was dictated essentially by the projected speed of implementation of the sewerage program. The Board chose the aggressive scenario, which would

obviously end up with higher tariffs. Yet, the Board felt that sewerage was so important to the metropolis that these higher tariffs were justified.

Our advisers never officially told us their forecasts for the bids. Nonetheless, a few days before the opening of bids, I participated in a friendly betting session with several of our top advisers on our predictions for the winning bids. The range of forecasts was from a low of 60 percent to a high of 85 percent. Obviously, everyone was terribly wrong. The winning bids turned out to be much lower.

What happened? I don't think there is any single explanation for the low bids. I think it was the result of a combination of several factors, including:

- The confidence of the bidders that their technology would drive their costs down; and
- The aggressiveness of both the international and local bidders, all of whom very badly wanted to win the bidding.

If this bid were to happen again, I seriously doubt that we would get the same level of low bids.

How Do I Privatize My Local Water Company?

There have been many attempts to produce some kind of "How to" book that would teach governments how to implement privatization projects. My feeling is that these attempts have been largely highly intellectual but probably not effective. Particularly in the case of water privatization, the task seems to be so difficult that one can easily get overwhelmed. In drafting a "How to" book, you can end up either overwhelming the poor civil servant or oversimplifying the problem.

Having said all of that, what would be my advice to civil servants trying to privatize their local water utility?

Define the Problem

While it is often proposed to implement BOT water supply projects for utilities, this is often not the right solution to the problem. In our experience, the root of the problem often lies in the operations and management of the water utility, not the water supply.

List the Constraints

This is not a perfect world and each country, each city, each utility has its own unique constraints.

In the case of the MWSS, for example, our main constraint was time. We needed to complete the transaction before the campaign for the next presidential elections started. This constraint meant that we did not have the time to enact new legislation. We needed to work within the existing laws.

In some other cases, the constraint may be an extremely strong labor union that is opposed to any management takeover by the private sector.

A strong and important constraint may be the legal basis for privatization. You need not be a lawyer to determine this, but you need to read the law.

Identify the Preferred Privatization Option and Its Broad Characteristics

There are many publications that list and describe the various privatization options, and there are not many of these options.

When one knows the available options for dealing with the defined problem and confines oneself within the identified constraints, it is normally not difficult to determine the appropriate privatization option. Many times, it is quite apparent. There is usually no need to go through a lengthy and complicated decision tree to arrive at the preferred option.

Even before the start of the formal advisory process by IFC, we had a pretty good idea of what we wanted (a concession) and its broad characteristics. This saved a lot of time and effort.

Hire a Lead Adviser

Now that you have a good idea of what you want, you usually have no clue about how to proceed. The moment has come to hire help. Privatizing a water utility is complicated work. One needs special skills and knowledge. Furthermore, one needs time.

Often governments try to implement projects through some form of inter-agency committee. These committees may work only if they are there to *oversee* a project. If the committee tries to actually implement the project, the project normally fails, mainly because no one has the time to devote to it.

In other words, you need to get advisers with special skills and knowledge, and with the time needed for the privatization.

With regard to the selection of advisers, I think that it is most important to select a firm that has actually implemented some form of water privatization and to make sure that the particular project manager selected by the firm has likewise had solid experience in water privatization.

In most cases, your advisers will need to have a variety of skills and this can only be obtained through the use of several consulting firms (accountants, economists, engineers, and so on.). In this case, I find that it is so difficult to coordinate all these consultants that it is essential to designate one firm as the *lead* adviser, with full overall responsibility for the project.

Manage the Work of the Adviser

Even though the adviser's role is indispensable, it is essential that the government always retain control over the process.

Advisers do not implement privatization. The government does it.

Some advisers have a tendency to try to fully control the process. This is often a simpler arrangement for them. While this may be simpler, however, it is also ineffective. The government is the client. The client needs to

own the project. The client, and only the client, knows what he or she needs and wants.

And when the inevitable investigations come from Congress, the Ombudsman, the courts, and so on, the advisers will no longer be there. Only the civil servants will be around to defend the transaction.

In this regard, one needs to strike a fine balance. While it is undesirable for the advisers to want to totally control the process, it is also incorrect for the government to start dictating everything, without listening to advice.

The transaction is a partnership. There needs to be mutual respect between client and adviser.

Design the Approval Process

The approval process for a privatization transaction is very important. In many cases, there is a lot of leeway in the approval process, namely, regarding who will be involved, the scope of approval of each person, the sequence of approval, and so forth.

I find that there are a few key principles that must be kept in mind:

1. The determination of the appropriate approving authorities must be in consonance with the legal basis for the privatization. If the law specifies a particular approving authority, the law needs to be followed. Yet, the law often does not state who needs to review the transaction and recommend approval, which is equally important, if not even more important.
2. All government officers who must review the document must be involved in the approval, preferably in one single committee. While we do not want to skip any person or office who should be included in the approval process, we also want to have some form of control over the process by creating a single approving committee. In the case of MWSS, this role was filled by the Special Advisory Committee.
3. We should define the scope of approval by each person or entity. In the case of MWSS, all technical matters were the responsibility of the MWSS Board, legal matters were the responsibility of the Special Advisory Committee, contingent liabilities were the area of the Department of Finance, and so on. We confined each approving party to a particular area.

Develop a Consensus

Not everyone should be involved in the approval process. Otherwise, the transaction would never be finished.

Yet, as much as possible, nearly everyone should be consulted during the implementation of the transaction. Prior to the bidding for MWSS, we

consulted with all employees, particularly the labor union. We held meetings with key Senators and members of Congress. Most important, we conducted a massive information campaign that reached out to all MWSS consumers.

Impose Strict Prequalification Requirements

The international water business is relatively new and there are not many players. If a country makes the mistake of allowing unqualified bidders to participate in a privatization, that transaction may be doomed from the very start.

It is very important to ensure that only the very best international companies participate in the bid. If this is done, you are practically assured that the winning bidder will accomplish its work in a professional manner.

Design a Transparent Bidding Process

All bids should be conducted in a transparent manner. In the case of water, I think this is even truer, because of the political nature of water.

The process must not only be transparent. It must also be perceived as transparent. I found this to be crucial to the success of the MWSS privatization. There were a lot of groups that were looking at the transaction with microscopes, and many people were predicting failure. Many asserted that the bidding was going to be rigged, that such a big transaction could not possibly be clean, and so on. Yet, try as anyone might, they could not accuse us of any impropriety. I felt that this was largely because of the transparency of the whole privatization process.

Postscript

Ninety-eight percent of the water supply of Metro Manila presently comes from the Angat Dam, and at exactly the same time that the concessionaires took over water operations (August 1, 1997), the Angat Dam (and the entire country, for that matter) was affected by the biggest drought since the completion of the dam in 1968. From December 1997 until December 1998, the water supply from Angat Dam to MWSS was reduced by some 30 percent. This was in spite of the fact that no water from Angat was released for irrigation, thus effectively doubling the available water for MWSS.¹⁴

Also at exactly the same time, the Asian financial crisis struck, thus causing the national currency, the Philippine peso, to devalue by some 60 percent. Nearly all of the MWSS debt is in foreign exchange so this devaluation automatically increased MWSS debt service requirements by 60 percent. This was a substantial figure, considering that in 1998, debt service was about \$100 million.

The drought and devaluation impacts were so big that, in the case of one concessionaire, total revenues were insufficient to cover even the debt service requirements.

Yet, water tariffs were not increased at all in 1998, and they went up by only about 15 percent in 1999.

The unprecedented drought and devaluation caused huge problems, but, in accordance with the Concession Agreement, these problems were fully absorbed by the concessionaires, not the government.

With regard to the drought, this caused huge operational problems for the concessionaires; they had to resort to water rationing, which in turn required a lot of manual manipulations of valves and the delivery of water by tanker to communities that had completely lost their supply. This prob-

lem was tackled well by the concessionaires and there was hardly any criticism from the public in spite of the obvious inconveniences caused by the drought.

With regard to the cash flow problems caused by the Asian financial crisis and the reduction in water sales, the concessionaires used their financial muscle to meet all of their financial obligations. All MWSS debt servicing was fully covered by the concessionaires and all salaries were paid on time.

In spite of these problems, the concessionaires not only continue to exist, they are also both financially strong.

Considering these facts alone, aside from other benefits that MWSS and its consumers have experienced, we feel that the results of the privatization, to date, have been extremely positive.

Notes

1. All dollar amounts in this paper are U.S. unless otherwise noted.
2. Standard national government line agencies are required to turn over all of their revenues to the National Treasury, unless the agencies are specifically allowed by law to retain a portion of their revenues. The budget of the line agencies is then obtained through the annual General Appropriations Act, which is passed by Congress. It is a big advantage, therefore, to be a government corporation. Yet, Philippine government corporations continue to be saddled with many constraints.
3. "Non-revenue water" (NRW), sometimes also called "Unaccounted-for water" is the difference between the total volume of treated water that is produced at the water treatment plants and that which the company is actually able to bill. The main causes of NRW are usually physical leaks, defective water meters, and theft.
4. I have often said that in the Philippines, given its peculiar political and social environment, there are certain things that even the President cannot do. One of these is to negotiate projects as large and as politically sensitive as the privatization of the Metropolitan Waterworks and Sewerage System.
5. The Philippine currency is the "peso" and its symbol is "P". As of end-1999, 1 U.S. dollar was approximately equal to 40 Philippine pesos.
6. Obviously, this is a very controversial statement, given that the United Kingdom has privatized nearly all its water systems and many U.S. cities are in the process of privatizing theirs. Nevertheless, internationally, there are water utilities that are owned by the state and that are well run. These utilities seem invariably to be in developed countries.
7. In 1995, there was an attempt to privatize (as a concession) a medium-sized water utility in the Philippines called the Zamboanga City Water District (ZCWD). International advisers were utilized and much preparatory work was undertaken. Unfortunately, the transaction was never pushed through. There were many reasons for this failure, but I think a major reason was that the water tariffs of ZCWD were among the lowest in the entire country. They were so unrealistically low that it was estimated that a private concessionaire would need to charge more than double the current tariffs. I never really understood why, among the more than 500 water utilities in the country, the one with one of the lowest tariffs was chosen as the first to be privatized.

8. Section 9.4.4 of the Concession Agreement states the following: “In the event that the Regulatory Office determines, at any time from and after the second Rate Rebasing Date, that the Concessionaire shall incur significant capital expenditures in carrying out the Concessionaire’s responsibilities under this Agreement which (in the judgment of the Regulatory Office) should not be recovered through immediate rate adjustments, the Regulatory Office may propose to the Concessionaire that this Agreement be amended to provide for the payment to the Concessionaire on the Expiration Date of a lump-sum amount designed to reimburse the Concessionaire for all or a portion of such unforeseen capital expenditure (the “Expiration Payment”).

9. Some people joke that in the Philippines, there are only two kinds of bidders, the winners and the “cheated”—or at least, those who either imagine or claim that they are cheated.

10. At that time, we joked that the bidders would not have a very pleasant Christmas and New Year holiday because they would be busy preparing their bids. We said that this was going to be the problem of the bidders, not ours. In the end, the bidders did spend most of the Christmas season preparing their bids. However, we ourselves ended up working very hard during the holidays. There was probably just as much work for the government side as for the bidders.

In retrospect, it was probably not a good idea to schedule the submission of bids at the end of the year.

11. Some of the bidders were working on their bids, refining their numbers, all the way up to the last minute. They worked with their investment bankers and were on the phone with their international partners. They used extremely complicated financial models. Yet, when it came down to the final figures for their bids, some of them were more superstitious than scientific.

Out of the 43 digits that were used for the bids, 13 (or more than 30 percent) were the number “8,” which is a lucky number for Chinese.

The sum of the digits of one of the bids was a lucky number. The same bidder’s bid for the other zone was double this sum—intended to be doubly lucky, perhaps. Unluckily, this bidder lost.

12. The day after the bid opening, we held a meeting with a group from one of the losing bidders. They had told Scott that they wanted to meet with us in order to get clarifications, which would help them explain to their respective boards why they had lost.

They came with a new lawyer who turned out to be someone they had brought to spice things up. They initially asked us some purely technical questions on the basis for the formula that was used when one bidder had bid lowest in both zones.

After we answered and they were satisfied with our response, they pressed us to give them a copy of the technical bids. They said that they had heard rumors that one of the technical bids was faulty. They wanted to examine the bids to see for themselves that there was no problem.

This was dangerous. If we gave them the technical bid, they would surely find some reason, no matter how farfetched, to declare that one of the winning bids was noncomplying.

Their lawyer was very smart and kept pressing our own lawyer, accusing him of all sorts of things. Then, their officers would stop the lawyer and say in a kind voice that all they needed was some information that they could use to explain

things to their bosses. It struck us as a completely scripted good guy-bad guy scenario. Everything just bogged down when we insisted that only the MWSS Board of Trustees could authorize the release of the documents.

That same day, two lawyers from a losing bidder parked themselves the whole day in the office of the MWSS Administrator, being nice to the secretary and trying to convince her to give them a copy of the technical bids.

Giving out the technical bids would have been dangerous because this would have been a violation of the confidentiality of the technical bid submissions, as pledged in the bidding rules. It would have resulted in all bidders asking for copies of the technical documents of all the rest of the bids. Everyone would have found fault with the others' bidding documents and chaos would have ensued.

We hung tough and refused to give in to the intimidation. We were correct. We had nothing to hide. We had simply followed the bidding rules. In the end, they gave up.

13. The bids were as follows:

<i>West</i>	<i>Percent bids</i>	<i>Peso bids</i>
Ayala-International Water	28.6333	P2.5140
Benpres-Lyonnaise des Eaux	56.5922	P4.9688
Aboitiz-Compagnie Generale des Eaux	56.8800	P4.9941
Metro Pacific-Anglian Water Int'l	66.8998	P5.8738
<i>East</i>		
Ayala-International Water	26.3886	P2.3169
Aboitiz-Compagnie Generale des Eaux	62.8800	P5.5209
Metro Pacific-Anglian Water Int'l	64.5080	P5.6638
Benpres-Lyonnaise des Eaux	69.7888	P6.1275

14. Angat is a multipurpose dam. Roughly half of the water is used for MWSS drinking water while the other half is utilized for irrigation. The dam is also used to generate electricity.

Chronology of Events

1994

July President Ramos creates MWSS Privatization Committee. Initial research done

1995

June Congress passes the "Water Crisis Act"
July French government approves grant for technical aspect of privatization study
September Local bank agrees to finance remaining cost of privatization advisory contract
November 10 MWSS engages IFC as the lead adviser for privatization

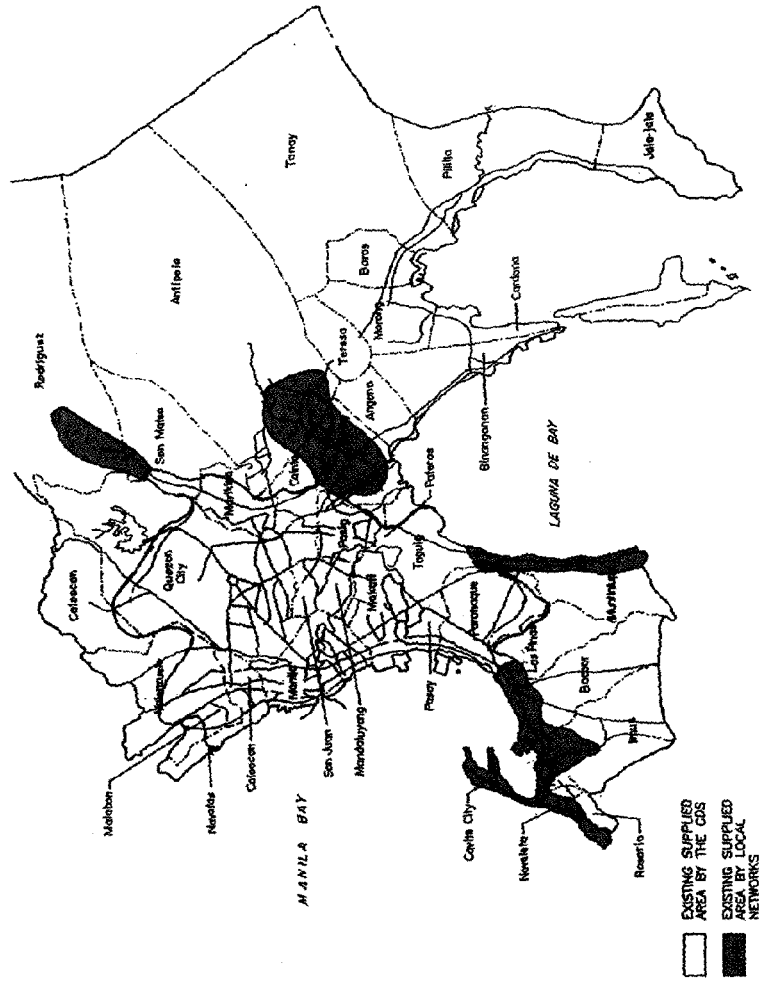
1996

March Registration of interested investors
May "Data room" opened to interested companies that pay the fee
July MWSS Board approves privatization strategy
August Start of formal prequalification of bidders
Oct./Nov. Prenegotiation of contract with bidders
December Final approval of prequalified bidders
Final tender documents issued
President Ramos approves privatization strategy

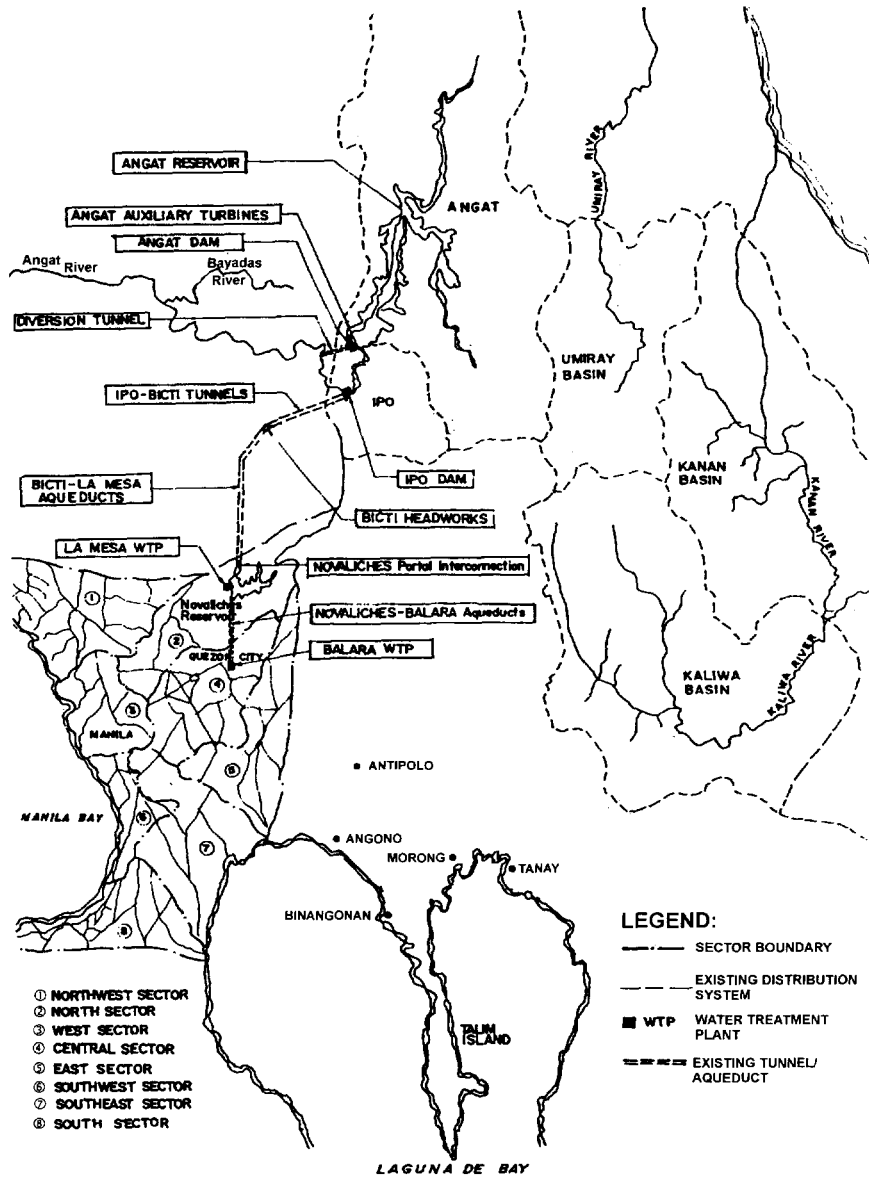
1997

- | | |
|-------------|---|
| January 6 | President Ramos approves Concession Agreement
Submission of bids |
| Jan. 7-22 | Evaluation of technical bids |
| January 23 | Opening of bids
MWSS Board endorses recommendation of award to
Committee on Privatization (COP) |
| January 31 | COP endorses recommendation of award to President
Ramos |
| February 21 | President Ramos approves award of contract
Concession agreements signed |
| August 1 | Concessionaires take over operations |

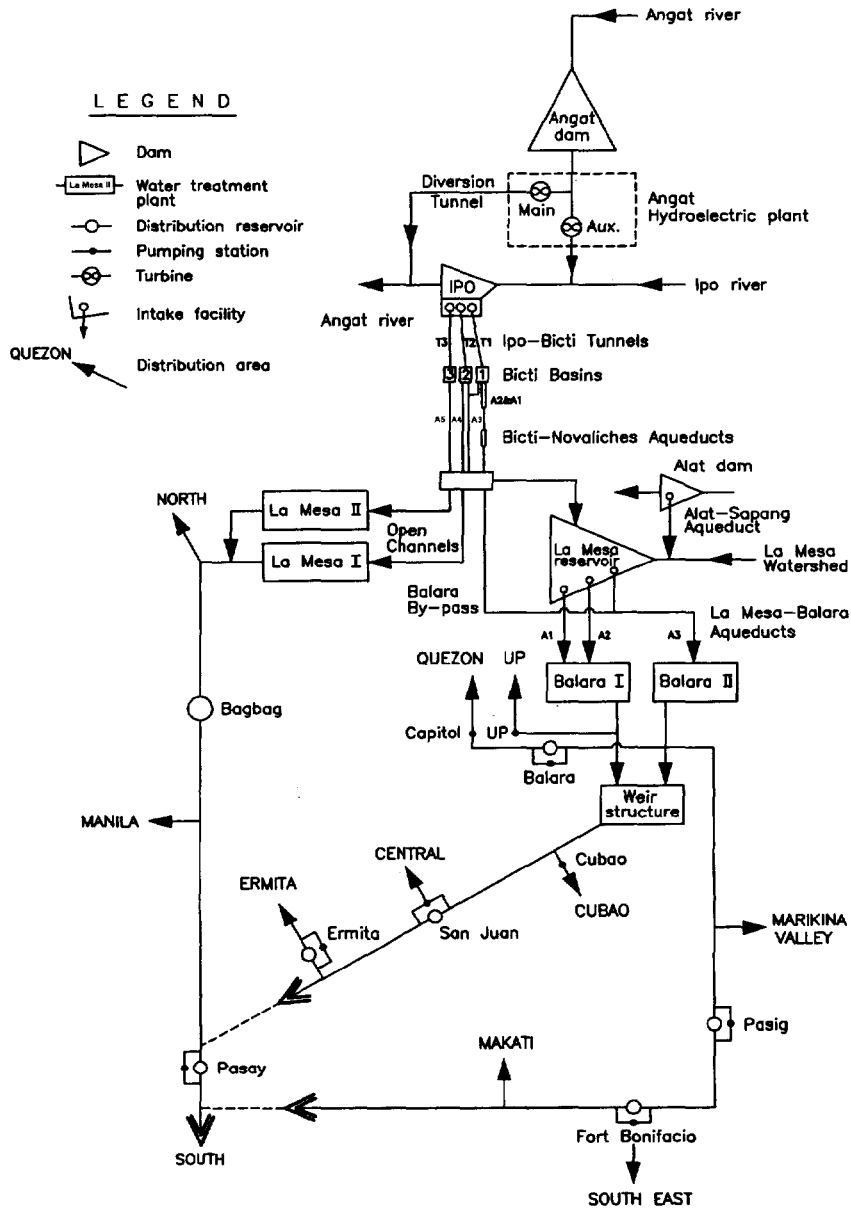
Map B. Existing Supplied Area within MWSS Franchise



Map C. Existing Manila Water Supply System



Map D. The Water Supply





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