

## CO-OPRIVATIZATION, NOT RATE HIKE, THE ANSWER TO MAYNILAD'S WOES

AS MAYNILAD APPEALS to the public's emotions on the choices between having water and no water at all, we at the Freedom from Debt Coalition are challenged by a more sober view. It is the issue of choosing between granting special favors to vested interests, and giving the consumers their due—which is a rightful share, not only of the costs and economic burdens, but the prospective benefits for their sacrifices.

Maynilad Water Services Inc. is desperately seeking an increase in its water rates because of its severe liquidity and bankability problems. By avoiding procedures for a rate hike set out in the Concession Agreement between Maynilad and the MWSS, and with the help of no less than former Chief Regulator Rex V. Tantiogco, Maynilad on 8 June 2001 signed a Memorandum of Cooperation (MoC) with the MWSS. The MoC would have allowed Maynilad to accelerate the recovery of its foreign exchange losses and subsequently impose a rate increase amounting to P4.75. It also agreed to a scaling down of Maynilad's performance targets as provided in the Concession Agreement. It also agreed to lower the billed volume from the levels in Maynilad's financial model (on which basis it won the bid for the west zone), to actual levels.

To the Freedom from Debt Coalition (FDC), the MoC was a pure and simple case of *dagdag presyo, bawas serbisyo*. In particular, lowering the billed volume to Maynilad's actual volume would in effect reward Maynilad for its inefficiency and mismanagement, since the latter account for a significant part of Maynilad's current high levels of non-revenue water and therefore low billed volume. Fortunately (although no doubt to Maynilad's dismay), President Gloria Macapagal-Arroyo thumbed down the MoC.

There are now, it seems, three proposals being pushed as possible solutions to the problems of Maynilad. On the one hand, the MWSS Board would like to implement the MoC it entered into with Maynilad, give or take a few variations. For another, Maynilad through Benpres executive Christian Monsod is urging the MWSS and the Arroyo government to accept its version. This, we understand, would enable Maynilad to automatically recover *prospective* foreign exchange losses—again, a departure from the framework of the Concession Agreement. Finally, we understand that a Cabinet committee formed to find a solution to the problems of Maynilad has a third proposal crafted with the assistance of Ms. Gloria Tan Climaco.

Whatever agreement the MWSS Board finally decides on must be one that has to be defensible by no less than the President herself. This is especially since the Finance Secretary, Jose Isidro N. Camacho, who must affirm any amendment to the Concession Agreement (and we believe all three proposals require such amendment), must inhibit himself from this process as Maynilad was his client just prior to his appointment to the President's Cabinet.

Indeed, the last thing the President would like to see is a decision rewarding Maynilad for its inefficiency. But that is precisely what all three proposals plan to do.

### **Maynilad's tight financial fix**

The FDC believes that negotiating with Maynilad for a workable and reasonable solution to its problems is *not* about giving them the cash they need through a price hike. A truly viable solution must deal with the need to infuse additional cash equity into Maynilad, and the need to urgently address inefficiency and mismanagement of Maynilad.

A careful review of Maynilad's tight financial situation is in order, and we believe that such a review will clearly show that a rate hike does not adequately solve Maynilad's problems. It will merely bail out Maynilad—as well as the Lopezes who through their holding company, Benpres, guaranteed Maynilad's loans.

To repeat, Maynilad's main financial woes are liquidity and bankability. Liquidity is about having enough cash to meet current operating expenses. Bankability is about having enough equity (i.e. leverage) to enable one to borrow in capital markets to upgrade existing capacity and expand it.

Both liquidity and bankability are undermined when a company such as Maynilad experiences mounting net losses. Net losses mean revenues are inadequate to meet expenses and debt service, which puts a strain on the company's cash resources instead of bolstering it. Furthermore, net losses eat into stockholders' equity because they reduce retained earnings of the company. This further weakens the firm's bankability.

Since the start of its operations in 1997 Maynilad is anticipating accumulated losses of P4.1 billion by year-end, with its biggest annual loss of P2.4 billion having been incurred last year. The losses stem from two major factors: revenues are weaker than expected, while costs are bigger than expected.

Maynilad's main rationale for a tariff hike is the fall in peso value from P26:\$1 to P50:\$1, which has greatly affected Maynilad's costs. It claims it has incurred P2.7 billion of foreign exchange losses as a consequence of the Asian financial crisis and the succeeding devaluation of the peso. According to Maynilad officials, this has greatly magnified peso payments on its dollar loans, bulk of which it inherited from MWSS.

While no one could have anticipated a fall of the peso from P26:\$1 to P50:\$1 by end-2000, the concessionaires were expected to anticipate some fall in the exchange rate say from P26:\$1 to P35:\$1 in 2000. They would also have been expected to be ready to respond to capital calls by bringing in additional equity or by tapping credit lines if the peso fell. Maynilad's proposed solution, however, of a quick recovery of at least 95% of the forex losses, unfairly passes on to consumers the bulk of the burden for the unanticipated peso devaluation.

They could have hedged against a then possible further depreciation if they had held on to the foreign currencies infused by foreign equity. Moreover if Maynilad had incurred losses from foreign denominated loans, why did it continue to borrow as such when the foreign markets then were volatile? It is a poor management judgment call whose cost is now being passed on to consumers.

Maynilad furthermore claims its revenues are weak because it is not able to recover its foreign exchange losses soon enough, putting a strain on its fund for capital expenditure. Its inability to spend on capital outlays further inhibits it from lowering its non-revenue water and expanding its income-generating base.

While these claims are partially correct, FDC does not fully concur with them. For one, not all of non-revenue water (NRW) is due to physical losses. Data of the World Bank from various countries show that loss of revenues due to physical losses is generally less than losses due to ineffective monitoring by the water concessionaire. "Lack of accountability and managerial incentives to deal with the problem have been offered as the main factor to explain" why programs to reduce NRW are largely frustrating experiences. In other words, Maynilad's NRW, which has been increasing—from 60% in 1998 to 66% last year—rather than decreasing (as projected in its financial model), could still be reduced, with better management. At present, for every three cubic meters of water it produces, Maynilad earns from only one. This situation is clearly unsustainable.

For another, Maynilad's financial model underestimated by P3.9 billion the amount of concession fee payments it had to make to the MWSS, justifying its submission of a lower tariff bid than its competitors. Having won the bid, Maynilad cannot now try to recover what had been, either deliberately or neglectfully, understated. Besides, the Concession Agreement clearly says that any mistakes in the financial model are for the account of the concessionaire concerned. FDC can only interpret an accelerated recovery of forex losses as an endorsement by the MWSS board of Maynilad to charge consumers for mistakes it had made in the financial model—contrary to the Agreement.

A high NRW also means higher costs in the production and delivery of water. This is because in order to earn from one cubic meter of water, Maynilad has to spend to produce three cubic meters. This is costly for consumers especially if the resulting cash flow problem leads to an amendment in the Concession Agreement that would impose new financial demands on consumers. (Under the Agreement the concessionaire cannot claim lost revenue as a ground for an Extraordinary Price Adjustment or EPA.) A World Bank study explains how lower NRW could significantly reduce costs and raise revenues for Maynilad:

- “1. A reduction of physical losses translates into less water to be produced, treated and pumped. This results in the postponement of expansion of capacity, which eases the financial pressure to finance new works. Less water produced also translates immediately into cost savings in operations, due mainly to savings in energy and treatment costs (chemicals). All of these savings could be passed on to the consumer.
- “2. A reduction of commercial losses results in more water being billed, and in additional revenues for the utility. It has also been shown that water metering and adequate rates reduce wasteful consumption. Therefore, total consumption is likely to decrease and will yield lower production and corresponding cost savings.” (Guillermo Yepes, “Reduction of Unaccounted for Water,” Washington DC: The World Bank, 1995, p.3)

Maynilad's high costs of production and operations can also be attributed to its high personnel expenses for foreign consultants and management contracts. These expenses are denominated in US dollars, adding to the stress on Maynilad's expenses when the peso devalues.

The cumulative losses of Maynilad are eating into its equity. Between 1999 and 2000 there was a conversion into equity of liabilities due to stockholders. While this served to offset the deterioration of Maynilad's capital base by P1B, it did not stop the erosion. Being a non-cash infusion of equity, it did not also improve Maynilad's cash position, which continued to deteriorate in 2000.

However, a cash equity infusion resolves both liquidity and bankability problems. The owners of Maynilad are offering to put up additional equity in exchange for a tariff increase. But the crux of the matter is that a cash equity infusion, if significant and substantial, would render the company creditworthy as well as capable of absorbing a long-term recovery of its costs *without necessitating* an accelerated recovery of forex losses.

Granting that Maynilad could not have fully anticipated the peso devaluation and therefore could not be made to fully account for this, it still cannot be denied that many of Maynilad's problems were created by its own management and business decisions.

### **Government's Convenient Solution: Bail out Maynilad**

Although it may appear sensible to consider a one-time assistance to Maynilad, the situation cannot justify a bailout. There should be no special treatment for Maynilad.

The various elements of the proposed settlement with Maynilad all tend to protect Maynilad's

stockholders and favor Maynilad over its customers. This is nothing but a bailout of Maynilad and its institutional investors. This is not a lasting and just solution to the problem of Maynilad, but a convenient way out for its owners and managers.

Front-ending forex losses with a tariff hike, together with postponement of service obligations and early rate re-basing, makes Maynilad bankable and spares Benpres from delivering on its loan guarantee to Maynilad. (Benpres had earlier guaranteed the payment of Maynilad's bridge financing.) But this is lopsided against consumers. Avoiding a call on its guarantee of its affiliate's loan should not pose a real problem to Benpres—unless it never had the money in the first place. Besides, Benpres has been collecting a guarantee fee from Maynilad, that Maynilad would no doubt recover from its customers in the west zone.

Furthermore, billed volume must **not** be based on actual volume of Maynilad since its inefficiency and mismanagement account, at least in part, for present high non-revenue water and therefore low billed volume. At the same time, billed volume based on financial model may also be unrealistic. A reasonable downward adjustment may be one based on Manila Water's experience.

Providing Maynilad with a mechanism to recover prospective foreign exchange losses such as AUTOCERA would likewise make Maynilad bankable **but for all the wrong reasons**. First, it assures creditors that even when Maynilad is inefficient, consumers will be made to foot the bill. Second, it evades regulatory review and raises the risk that imprudent inefficient operations will nevertheless be rewarded. There is also the danger that "management that is accountable to private investors may make decisions favoring management even if it may be inimical to the interests of consumers and, perhaps, even government: for example, passing on the burden of corporate taxes to the subscribers." A final danger has to do with social inequity: "the privatized utility has the power to pass on the costs of facing financial difficulties to the consumers but corners all the benefits to itself when the economy recovers." (Joffre Balce, "People-Powered Economic and Financial Reforms: Co-privatization," monograph, 2001) FDC strongly cautions against the setting up of an AUTOCERA or other similar mechanism.

A bailout of Maynilad through an accelerated EPA and AUTOCERA is clearly unacceptable. Aside from setting a precedent to grant similar concessions to Manila Water as well as to other local water districts in the privatization pipeline, and additional concessions to Maynilad in the future, a bailout accords Maynilad with special treatment and opens the gates of abuse.

In seeking a resolution to Maynilad's petition, government should ensure that Maynilad is not being favored over others. Logically, a principle that should be applied is one that determines the level of assistance that would be needed by a hypothetical winning bidder in the west zone, whose cash flow problems and credit worthiness are not affected by inefficiency and mismanagement. The solution should be the fairest to all concerned, which includes losing bidders and, most especially, consumers.

However, there is another option that government could take that would make an accelerated EPA and AUTOCERA unnecessary. This is what we call **Co-privatization**.

### **A Counter Proposal: Co-privatization**

Co-privatization is a mechanism that would enable consumers to buy into Maynilad and participate in its ownership. Instead of simply paying more for a water rates increase without getting anything in return, *consumers would develop their stake in Maynilad and eventually benefit from it not only as consumers but also as owners*.

Equity infusion by consumers could still come in through an appropriate charge in their monthly

water bill, but this no longer enters the books of Maynilad as revenues but as equity, with a commensurate increase in cash holdings. Co-oprivatization is *an alternative way of generating cash* from consumers that is at the same time *long-term capital*, over the basic principle of simply charging them a price that they can bear and afford.

*Co-oprivatization would likewise be beneficial for Maynilad* without placing undue burden on the consumers. First, Maynilad would obtain the cash it needs for capital expenditures and operations without necessarily raising tariffs. Any increase in tariffs would be processed through the EPA mechanism already provided in the 1997 Concession Agreement. Second, Maynilad's capital position would be beefed up enough to improve its creditworthiness. This would enable Maynilad to procure medium to long term loans. Third, since capital is cheaper than credit, Maynilad could even save on interest in the long run.

Another important aspect of Co-oprivatization is that it would *strengthen Maynilad's accountability to consumers*. Because consumers will no longer be just consumers, but also part-owners, they will have greater access to information on how Maynilad is being managed. Furthermore, consumers will have a greater say on how Maynilad is being run. Maynilad's institutional investors and managers would have to perform efficiently and effectively, or face the possibility of the dilution of their holdings in Maynilad in favor of their consumer-turned-owners.

A consumer buy-in is a workable and reasonable option that the GMA administration must seriously consider. In the final analysis, a democratization of Maynilad's ownership could even lead to better management, improved services, and greater accountability and efficiency.

“Co-oprivatization bears a promise to address all the elements necessary to make a utility not only viable but equitably beneficial to all stakeholders through participatory democratic processes. This means neither that the burden to the consumer will be lighter nor the risks of entrepreneurial or financial losses will be less than privatization. The point is that it equitably spreads burdens in difficult times, shares benefits in turnarounds and has a more stabilizing effect on macroeconomic fundamentals.” (Joffre Balce, “People-Powered Economic and Financial Reforms: Co-oprivatization,” unpublished, 2001)

In addition, there are clear *macroeconomic benefits* of a large-scale application of co-oprivatization, as follows:

- Development of capital markets, with the introduction of new debt instruments and the emergence of a mass base of investors
- Creation of a base of forced savings as millions of consumers regularly and reliably plunk equity on the basis of their consumption
- Emergence of management discipline tools to check institutional management and investors (failure to perform efficiently and effectively results in dilution of their position and control)
- Real possibility of a diminished fiscal burden with greater consumer accountability.

Co-oprivatization is a viable option and it deserves to be tried. Only recently the board of the Development Bank of the Philippines, in approving a loan extension to Maynilad, expressed its interest to explore other possibilities for Maynilad including co-oprivatization. The Freedom from Debt Coalition urges the board of trustees of the MWSS to do the same.

In the final analysis, the option is *not* between having water and the more expensive anti-poor alternative of having no water. It is now a matter of economic justice, of equitably sharing the risks and benefits of a precious commodity and becoming more pro-poor and pro-people than ever.