Water from a spring at Sitio Sapinit, Antipolo City, where residents have yet to enjoy a piped water system.

Photo by Rodillo Catalan

Originally appeared in a feasibility study submitted by MPA students to the National College of Public Administration and Governance, University of the Philippines in April 2011.
On August 1, 1997, water and sewerage service in Metro Manila, which used to be delivered by the state-owned and -operated Metropolitan Waterworks and Sewerage System (MWSS), was turned over to two private concessionaires. It was the largest water service privatization up to that point. It is now considered a singularly successful structural reform in the annals of Philippine political economy. This case study attempts to explain how and why it happened and to draw object lessons for future policy battles.

**Shifting the Boundary of the State**

The privatization of MWSS was a tectonic shift in the boundary between the state and market in the Philippines. Where state ends and market begins, a debate of great moment on the world stage in the 20th century (see, e.g., Yergin & Stanislaw, 1998, for a lively account) remains alive, and indeed, re-emerges as a very lively issue in the wake of the 2008 Global Financial Crisis. The years following the collapse of the Marcos regime in 1986 saw the start of a march, if somewhat spasmodic, toward greater reliance on the market. By contrast, the decade prior to 1986 experienced an even deeper level of state encroachment on the market. President Corazon Aquino (1986-1992), wanting to undo the trend, created the Committee on Privatization (COP), and mandated a return to private hands of hundreds of state-owned corporations and other assets. The COP privatized 122 government-owned and -controlled corporations (GOCCs) under Aquino. Also of great moment was the enactment of the Build-Operate-Transfer (BOT) Law, which was the legal basis for private sector participation in infrastructure projects. By the end of Aquino’s term (mid-1992), the Iron Curtain had evaporated and the market ideology was triumphant. President Fidel V. Ramos (1992-1998)—who enjoyed a vastly favorable tailwind both in ideology and financing—pursued state disengagement with more vigor and ambition.

The 1990s under Ramos saw a determined deregulation effort in the oil, transport, and telecommunications industries, which delivered substantial early harvests for consumers in certain economic sectors. Ramos secured from Congress the passage of the Electric Power Crisis Act to successfully address the crippling power brownouts that followed his inauguration. The
view that the state should disengage from economic activities where the market has a demonstrated superior competence—or as was more often the case, where the state has demonstrated unusual incompetence—had by then just been codified in the Washington Consensus (For further discussion, see Chapter 9 of this volume). The experience of MWSS privatization could not be told apart from this global tectonic shift in beliefs in favor of the market and global competition.

The Make-or-Buy Decision

Oliver Williamson, winner of the Nobel Prize in Economics (2009), introduced the make-or-buy efficiency rule (1975; 1985; 2002), which, while first applied to the delineation of the boundary between firms and markets, equally applies here: the natural economic boundary between the state and the market is determined solely by comparative competence. Where procurement of goods and services via the market is socially cheaper by reason of comparative competence, the state should buy from the market the good or service it is expected to provide. Where comparative competence favors the state, the state should then make. But what makes such common sense boundary rule compelling?

The answer advanced by Nicolo Machiavelli is competition and imminent threat. Enlightenment Europe was a motley continent of nation-states constantly at each other's throats, testing each other's political boundaries. The survival of any state was constantly challenged. How best to ensure survival? Machiavelli (1513/1909-14) observed in The Prince that where the survival of the state was the paramount end (which in his view justifies any means), a prince (ruler)

[...] should show himself a patron of merit, and should honor those who excel in every art. He ought accordingly to encourage his subjects by enabling them to pursue their callings, whether mercantile, agriculture, or any other [...] so that this man shall not be deterred from beautifying his possessions from the apprehension that they may be taken from him...or [...] from opening a trade through fear of taxes [...] (XXI, 9).

This was, as far as is known, the earliest recognition of the comparative competence of market actors in the creation of wealth and the value of property rights protection. Competition and Darwinian selection among states lead to an efficiently bounded, and thus prosperous, state.

The ruler is always confronted with the temptation to impose ever more
onerous exactions to fatten his treasury. But this blunts the flowering of private initiative, which is the engine of future economic growth. It is economic growth that will ensure the fiscal integrity of the state treasury. A state in chronic fiscal need is easy prey to its enemies. Machiavelli saw prosperity as the real warranty of political survival of the state and, by implication, of the ruler.

The view we embrace here is partly Machiavellian and Darwinian: episodes of the state ceding ground to the market are linked to global and inter-state competition, sometimes armed but mostly friendly, in the effort to improve one’s standing in the world. The threats to survival emerge in various guises, such as a fiscal bankruptcy, which show up when the ruler increasingly violates the efficient boundary rule (see, e.g., Cook & Fabella, 2002).

Using the same comparative competence lens, this case study offers an inquiry on how the MWSS privatization came about and how market regulation supplanted state ownership in water services procurement. It is the goal of this endeavor to ferret out the lessons that can be learned, the circumstances that can be replicated, and the pitfalls and missteps that can be avoided. We are especially interested in the footprints left by change agents. We will endeavor to add to the understanding already contained in some outstanding publications (see, e.g., Dumol, 2000).

The circumstances surrounding the episode are rather different from the other successful reforms. In normal episodes, a group outside the universe of formal policymaking advocates an idea for which it seeks buy-in from a champion or a set of champions operating inside that universe, who then wages trench warfare within the walls to get the idea accepted and operationalized into an executive order (EO) or a law (e.g., a republic act passed by Congress). In the case of MWSS privatization, the highest political authority—the president—appeared to have owned the idea right from the start. Thus, the struggle to engender the buy-in by a champion did not happen. His own awareness of the idea appeared to have been triggered by a series of overtures by private entrepreneurs interested in running MWSS for their own profit. What was interesting was the emerging milieu that made President Ramos and his advisers even entertain what seemed to be, at that juncture, such a preposterous idea.

The following are several important issues related to the privatization and regulation of water and sanitation services in Metro Manila that will be addressed in this chapter:

1. Was the gamble taken by the political authority in 1997 justified by the subsequent harvest?
2. Why was the dismal performance of the pre-1997 MWSS tolerated for so long?
3. Who were the main advocates of change and what strategies were employed to overcome the forces lined up against the reform?

4. Since this project required drawing in private sector players, how did the private players address the risks they faced?

Clearly, because of the nature of the case, standard tests of significance cannot be carried out. The issues are addressed in what is known as a “thick description” of reality, more historical and anecdotal, than a “thin description” associated with statistical tests. We will start with the performance of the enterprise five years after privatization.

**MWSS Privatization: Performance After Five Years**

On February 21, 1997, the concession contracts for the privatization of the MWSS were signed. On August 1, 1997, water supply and sewerage service management and operation in a service area with a population of 11 million, spanning 14 municipalities and cities, were turned over to two private concessionaires. MWSS became, by virtue of a Concession Agreement or CA\(^1\) (1997), the Regulatory Office (RO) tasked with regulating the activities of the concessionaires and the implementation of the CA.

The East Zone was awarded to the Manila Water Company, Inc. (MWCI hereafter), a consortium of four companies led by a Filipino entity, the Ayala Corporation, and three foreign partners, United Utilities, Bechtel, and the Mitsubishi Corporation. The West Zone was awarded to Maynilad Water Services, Inc. (MWSI hereafter), a consortium of two companies led by another major Filipino entity, Benpres Holdings Corporation, and a French foreign partner, Suez Lyonnaise des Eaux.

The only true test of a policy change is the welfare outcome for the targeted beneficiaries. In the case of providing water services, it is reflected by the price and quality of the service delivered. Low price is no consolation when the service is unavailable when needed or unusable when available. This was the normal state of affairs in the Philippines when a state-owned and -operated enterprise acted as service provider. Price and quality have to be combined and analyzed in tandem. The levels of analysis used here are post-privatization outcomes before the start of the first rate-rebasing exercise versus (a) pre-privatization standards, (b) regional standards, and (c) targets set by the CA at the commencement of concessions.

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\(^1\) “CA” here means Concession Agreement. It is different from the “CA” mentioned in other chapters, which refers to the Court of Appeals.
Regional Comparison: Efficiency Indices

Table 4.1 gives a snapshot of the water service performance in the Southeast Asian Region based on the most recognizable indices before privatization (1996) and post-privatization (2002) for Manila and the two concessions.

Table 4.1. MWSS Performance: Pre-Privatization (1996), Post-Privatization (2002), and other Asian Water Utilities (1996)

<table>
<thead>
<tr>
<th>City</th>
<th>Water Availability (hours/day)</th>
<th>Water Coverage (% of population)</th>
<th>Non-Revenue Water2</th>
<th>Staff per 10^3 Connections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>24</td>
<td>100</td>
<td>7</td>
<td>2.0</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>24</td>
<td>100</td>
<td>36</td>
<td>2.8</td>
</tr>
<tr>
<td>Seoul</td>
<td>24</td>
<td>100</td>
<td>35</td>
<td>2.3</td>
</tr>
<tr>
<td>K. Lumpur</td>
<td>24</td>
<td>100</td>
<td>36</td>
<td>1.4</td>
</tr>
<tr>
<td>Bangkok</td>
<td>24</td>
<td>82</td>
<td>38</td>
<td>4.6</td>
</tr>
<tr>
<td>Average ('96)</td>
<td>24</td>
<td>96</td>
<td>30</td>
<td>2.6</td>
</tr>
<tr>
<td>Manila ('96)</td>
<td>17</td>
<td>67</td>
<td>61</td>
<td>9.8</td>
</tr>
<tr>
<td>Manila ('02)</td>
<td>21</td>
<td>79</td>
<td>62</td>
<td>4.1</td>
</tr>
<tr>
<td>MWCI</td>
<td>21</td>
<td>82</td>
<td>53</td>
<td>4.1</td>
</tr>
<tr>
<td>MWSI</td>
<td>21</td>
<td>79</td>
<td>69</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Sources: McIntosh & Yñiguez (1997); MWSS Regulatory Office (2002).

The message was unequivocal. The improvements in water availability (from 17 to 21 hours), water coverage (a 12-percent rise), non-revenue water (NRW) (a 2-percent fall), and staff (a 58-percent reduction) over the pre-privatized outfit were dramatic. The chasm in water service performance between Manila and other Association of Southeast Asian Nations (ASEAN) cities’ average—so glaring before privatization—was at last beginning to close, although the gap was still considerable in NRW, water coverage, and staffing. However, the gap was expected to continue narrowing. It is unlikely that Manila will ever catch up with the front-runners despite privatization,

2 Non-revenue water (NRW) does not bring in revenue due to leaks, theft and illegal connections, or improper metering. It is also free water used for standpipes, cleaning reservoirs, or fighting fires (ADB, 2007).
since the closure of the remaining gap requires substantial improvement in governance, where the Philippines remains weak. In general, the performance of the market and market players is greatly influenced by the quality of governance.

For example, the presence of sizeable illegal settler communities raises the cost of water service. The high cost of prosecution due to long delays and judicial leniency makes water theft less forbidding. Indeed, water theft was made a criminal offense only with the National Water Crisis Act of 1995 (Republic Act [RA] No. 8041 or RA 8041).

**Regional Comparison: Price**

Figure 4.1 shows the regional price per cubic meter of water in 2002. The MWCI and MWSI rates are based on pre-rate rebasing rates as of March 2002. The new tariffs put Manila in the middle of the pack as to price, trailing only Hong Kong and Singapore.

![Figure 4.1. Water Cost (US cents/cubic meter) based on 30 cubic meter monthly bill.](source: Rivera (2003b).

**Performance vs. Pre-Privatized Standards**

We now move to the analysis of water service performance of pre- and post-privatized MWSS. Table 4.2 gives the water service performance of
MWCI and MWSI for 2001 and 2002, the 2001 benchmark targets, and pre-privatization standards.

Based on pre-privatization standards, the combined performances showed much improvement: water coverage (18-percent rise), staff per 1,000 connections (58-percent fall), water availability (hours, 24-percent rise), and number of staff (49-percent drop). On NRW, MWCI did better but MWSI did worse. Both performed much better in extending services to the urban poor (83,000 connections). On sewer coverage, MWCI did badly and MWSI did better. Starting in 2000, both MWCI and MWSI brought their water quality into compliance with the bacteriological requirement of the Philippine National Standards for Drinking Water (PNSDW).

### Table 4.2. Water Service Performance for 1966, 2001, and 2002

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population served based on official no. of water service connections (millions)</td>
<td>7.3</td>
<td>4.26</td>
<td>3.2</td>
<td>3.4</td>
<td>6.7</td>
<td>5.3</td>
<td>5.2</td>
<td>8.6</td>
<td>18</td>
</tr>
<tr>
<td>Official no. of water service connections</td>
<td>779,380</td>
<td>378,670</td>
<td>352,982</td>
<td>369,699</td>
<td>574,590</td>
<td>577,637</td>
<td>573,194</td>
<td>942,893</td>
<td>21</td>
</tr>
<tr>
<td>Water production (mid) annual average</td>
<td>2,800</td>
<td>1,234</td>
<td>1,724</td>
<td>1,658</td>
<td>2,257</td>
<td>2,417</td>
<td>2,363</td>
<td>4,021</td>
<td>44</td>
</tr>
<tr>
<td>Water coverage (%) (based on official no. of connections)</td>
<td>67</td>
<td>77.1</td>
<td>76</td>
<td>82</td>
<td>87.4</td>
<td>79</td>
<td>78</td>
<td>79</td>
<td>18</td>
</tr>
<tr>
<td>Water availability (hours)</td>
<td>17</td>
<td>24</td>
<td>21</td>
<td>21</td>
<td>24</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>24</td>
</tr>
<tr>
<td>No. of staff</td>
<td>7,638</td>
<td>1,386</td>
<td>1,530</td>
<td>1,516</td>
<td>-</td>
<td>2,594</td>
<td>2,366</td>
<td>3,882</td>
<td>49</td>
</tr>
<tr>
<td>Staff per 1,000 connections</td>
<td>9.8</td>
<td>3.7</td>
<td>4.3</td>
<td>4.1</td>
<td>-</td>
<td>4.5</td>
<td>4.1</td>
<td>4.1</td>
<td>58</td>
</tr>
<tr>
<td>Reported no. of leaks</td>
<td>27,053</td>
<td>-</td>
<td>40,454</td>
<td>38,225</td>
<td>-</td>
<td>41,242</td>
<td>98,611</td>
<td>136,836</td>
<td>-</td>
</tr>
<tr>
<td>No. of leaks repaired</td>
<td>20,585</td>
<td>-</td>
<td>39,688</td>
<td>37,461</td>
<td>-</td>
<td>38,508</td>
<td>92,189</td>
<td>129,650</td>
<td>-</td>
</tr>
<tr>
<td>Non-revenue Water (%)</td>
<td>61</td>
<td>16</td>
<td>48.29</td>
<td>52.66</td>
<td>31</td>
<td>66.25</td>
<td>68.68</td>
<td>62</td>
<td>-</td>
</tr>
<tr>
<td>Services extended to the urban poor (water service connections)</td>
<td>-</td>
<td>14,504</td>
<td>22,160</td>
<td></td>
<td>61,370</td>
<td>63,370</td>
<td>85,890</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes:  
* a With equivalent 50.549 household connections.  
* b With equivalent 63.910 household connections.

We now view the evolution of the water tariff through five years. Table 4.3 gives the tariff trajectory for MWCI and MWSI. For MWSI, the tariff on cubic meters of water rose more than threefold from P4.96$^3$ in 1997 to P15.46 in 2002. This table also shows, together with the dates, the motivation behind the adjustment, e.g., Accelerated Emergency Price Adjustment (EPA) and Foreign Currency Devaluation Adjustment (FCDA). For MWCI, the tariff rose from P2.32 to P6.75, a little less than threefold.

<table>
<thead>
<tr>
<th>Period</th>
<th>Average Tariff (peso/m³)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MWCI</strong></td>
<td></td>
</tr>
<tr>
<td>1997-1998</td>
<td>4.96</td>
</tr>
<tr>
<td>1999</td>
<td>5.80</td>
</tr>
<tr>
<td>Jan 1 – October 19, 2001</td>
<td>6.58</td>
</tr>
<tr>
<td>Accelerated EPA – October 20, 2001</td>
<td>10.79</td>
</tr>
<tr>
<td>FCDA (Jan – March) 2002</td>
<td>15.46</td>
</tr>
<tr>
<td><strong>MWSI</strong></td>
<td></td>
</tr>
<tr>
<td>1997-1998</td>
<td>2.32</td>
</tr>
<tr>
<td>1999</td>
<td>2.61</td>
</tr>
<tr>
<td>2000</td>
<td>2.95</td>
</tr>
<tr>
<td>January – March 2001</td>
<td>2.95</td>
</tr>
<tr>
<td>Provisional implementation of final award (April 2001)</td>
<td>3.22</td>
</tr>
<tr>
<td>Accelerated EPA – November 2001</td>
<td>4.22</td>
</tr>
<tr>
<td>FCDA (Jan – March ) 2002</td>
<td>6.75</td>
</tr>
</tbody>
</table>


The tariff trajectory appears to be in a steep rise for two reasons: (1) the initial tariff was the winning bid, which was extraordinarily low (P2.32 for MWCI and P4.96 for MWSI versus the pre-turnover tariff of P8.00); and (2) the five years under scrutiny were indeed very turbulent, being beset by the Asian financial and currency crisis (heavy depreciation of the peso and considerable reactive inflation) and the El Niño phenomenon, which reduced water supply.

$^3$ Foreign exchange rate was P44 to US$ 1, as of December 2010. See [http://www.xe.com/](http://www.xe.com/) for the latest rate.
Thus, compared to the pre-privatization tariff of ₱8.00, the MWCI 2002 tariff per cubic meter of water was still low, while the MWSI 2002 tariff was about twice as much. But given the turbulence in those years, it is inconceivable that the tariff—were there no privatization—would have stayed at ₱8.00 per cubic meter, while the quality of service would have remained dismal.

**Water Quality**

The quality of piped water determines its use. Poor-quality water is not potable and, if drunk, can cause illness. For potability, poor-quality piped water has to be boiled properly, or a bottled alternative has to be procured, both of which are costly. A low official price only disguises the real high cost of piped water. This is a case where the benefits of MWSS privatization are patent. Table 4.4 gives the bacteriological quality of piped water from 1997-2002 by concessionaire.

Water quality is gauged by the number of coliforms, specifically fecal coliforms. Note first that the number of determinations (tests) increased almost ten-fold in the case of MWCI and eight-fold in the case of MWSI. This reflects the seriousness with which the concessionaires view water quality. For MWCI, the number of determinations containing coliforms fall from 7.0 percent in 1997 to 0.3 percent; corresponding percentages for MWSI were from 5.0 percent to 0.7 percent. Note that the pre-privatized quality (1997) did not satisfy the PNSDW, which requires that at least 95 percent of samples taken during the year be coliform- and E. coli-free. MWCI became compliant in 1998; MWSI in 2000. Water quality was an undeniable harvest after price!

**Table 4.4. Bacteriologic Quality of Water in the Distribution System**

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MWCI</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total no. of determinations</td>
<td>6234</td>
<td>6040</td>
<td>5586</td>
<td>5104</td>
<td>4652</td>
<td>639</td>
</tr>
<tr>
<td>No. containing coliforms</td>
<td>21</td>
<td>25</td>
<td>19</td>
<td>36</td>
<td>91</td>
<td>45</td>
</tr>
<tr>
<td>% containing coliforms</td>
<td>0.3</td>
<td>0.4</td>
<td>0.3</td>
<td>0.7</td>
<td>2.0</td>
<td>7.0</td>
</tr>
<tr>
<td><strong>MWSI</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total no. of determinations</td>
<td>7549</td>
<td>8793</td>
<td>8577</td>
<td>8742</td>
<td>6520</td>
<td>910</td>
</tr>
<tr>
<td>No. containing coliforms</td>
<td>52</td>
<td>41</td>
<td>45</td>
<td>267</td>
<td>205</td>
<td>43</td>
</tr>
<tr>
<td>% containing coliforms</td>
<td>0.7</td>
<td>0.5</td>
<td>0.5</td>
<td>3.0</td>
<td>3.0</td>
<td>5.0</td>
</tr>
</tbody>
</table>

*Source: MWSS Regulatory Office (2002).*
The problem with quality is related to property rights issues on the one hand and the previous MWSS neglect on the other. Aqueducts of raw water supply from the Balara Treatment Plant were occupied illegally by squatters. On top of that, manholes and auxiliary structures were left grossly untended. These at once resulted in contamination and allowed privately profitable illegal connections to be installed. The theft and the asset neglect were probably part and parcel of the illegal income supplements of some MWSS personnel, which were well known. MWCI did two things that further reduced the scope of water theft: (a) it closed manholes and upgraded its assets to make illegal connections more difficult, and (b) it installed proper water service connections to these communities. This proved crucial for water quality improvement as the same time that it reduced NRW.

Complaints and Responsiveness

Responsiveness is another important dimension of service. Table 4.2 shows that in 1996, the percentage of reported leaks attended to and repaired was 74 percent. It rose to 97 percent in 2002 for MWCI and 93 percent for MWSI, for a combined responsiveness of 94 percent. Leaks contribute to NRW and erode the bottom line. The bottom line was never a concern for the state-owned and -operated MWSS, whose leadership was not rewarded for increasing revenue. This is a clear example of the importance of a “residual claimant” that comes to play with privatization. This responsiveness may also explain the increased number of complaints regarding leaks (from 27,000 in 1996 to 132,000 in 2002).

Service to the Poor

Both concessionaires devised a program to provide water service connections to the urban poor. This activity was incentives-compatible because water loss is associated with illegal occupancy, and thus, urban poverty. As observed in the case of MWCI, hand-in-hand with a crackdown on illegal connections and the tap-proofing of the aqueducts and connectives, legal water connections now were made available in these areas. Table 4.2 shows that by 2002, MWCI had provided 22,160 connections, while MWSI had provided 63,370 connections to poor households, thus making billed water available even to squatter areas. This reduced the opportunity for water syndicates to steal water, thus reducing NRW. The combined new connections to poor areas were 9 percent of total service connections. Previous provisions of water by the state to squatter communities, when available, took the form of public outlets, access to which was, in theory, free. But in practice, water was ferried by water carriers for a fee. Where even this was not provided,
trucked water was the only resort, and this meant that the effective cost of water ran at least three times the official tariff.4

Collateral Benefits

The first collateral benefit was macroeconomic: suddenly, MWSS was no longer a fiscal burden to the economy. Just as suddenly, the exploitation of the majority subsidizing Metro Manila residents disappeared. The continuous availability of good quality water impacted the intensity of private coping activities that caused substantial negative externalities. For one, the acquisition of privately financed and owned deep wells, which directly tapped the water table diminished, at least according to anecdotal evidence (artesian well service used to be a thriving industry). Residents acquired water pumps that ensured sufficient water flow in those precious few hours when tap water was available (of course, the incremental water access by residents was a prisoner’s dilemma game: with everyone fitted with pumps, nobody got an advantage; power and capital were just wasted). Business establishments spent a lot of money putting up auxiliary systems to ensure continuous availability. These negative externalities have now been mitigated. The quantification of these collateral benefits had yet to be done, but it should be substantial.

Evaluation

The growing pains that the MWSS privatization experienced through the first five years were numerous and daunting. But in the end, it is the outcome that either celebrates or damns this momentous shift in the boundary between the state and the market in the Philippines. Would Metro Manila water users have been better served without privatization?

There is no question that substantial efficiency gains in numerous areas have been realized. There are fewer staff members per 1,000 connections, and better water availability and coverage. NRW remains too high, although it has improved for one concessionaire. There is no doubt that the ownership effect and incentives compatibility are working their magic here. The gains in water quality are especially telling. Water procurement as a source of corrosive rent-seeking has clearly diminished. The view that water service has become a regular private business with its superior standards is momentous.

Water tariff, too, is now subject to intense scrutiny by a combination of private and public entities combining to form the regulatory environment.

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4 In some waterless areas, rationed water costs 20 to 60 times more than utility water per liter. In unserved areas in Antipolo City, for example, truck-rationed water cost P50 per container (150 liters), as of January 2011.
This means more thorough accountability to the public. The burden now lies with the private concessionaires to prove that water tariff adjustment petitions are backed by prudent expenses. Even with the tariff adjustments, water tariffs are still lower than they would have been without privatization, especially when implicit state subsidy is removed. The latter is due to the public recognition of debt liabilities via the concession fee. The contribution of the concessions to fiscal integrity in terms of concession fees is estimated at ₱100 billion. It must be recognized that MWSI stopped paying the concession fee in 2001 in violation of its contractual obligation. But that is another story.

Did the gamble pay off? The numbers are unequivocal in their answer: yes.

**The Old Order: Why Was the Pre-1997 MWSS So Robust?**

There are two interesting angles whence to view the MWSS privatization. One is to view the experience as a case of a contractual and regulatory game focusing on incentives of players, their actual behaviors during the episode, the response of regulators, and the eventual outcomes. The second angle is to view the episode as a game of social change—the supplanting of one stable equilibrium by another. The object of the second is to inquire into how the various interests either converged on or were induced to coalesce toward—or at least to refrain from opposing—the emergence of a new equilibrium. This means looking into the circumstances that changed the payoff matrix governing the behavior of players in the old equilibrium. The process that led to the emergence of a new equilibrium and the intervention of various change agents is the interest of this chapter.

Water is a basic commodity, and thus is highly politicized. Water service pricing in Metro Manila—where crucial political decisions are made, compromises are reached, and where social unrest is most feared—could make or break a political leadership. This was a crucial consideration in the determination of the old equilibrium.

**A Bad Stable Equilibrium: The Pre-Privatization MWSS**

The MWSS was a GOCC, and thus was subject to the usual Commission on Audit (COA) rules on procurement and the Civil Service Law governing the hiring and firing of manpower. As a GOCC, it could also contract foreign currency borrowing, blessed with automatic sovereign guarantees for infrastructure development. Otherwise, investment was financed by official development assistance (ODA). Needless to say, its water tariffs were set with one eye on the preference of political authorities who hire and fire the members of the governing MWSS Board of Trustees. By 1997, the MWSS dollar debt was at
US$1 billion, and it periodically sought and received fiscal subsidy from the government ("increased equity" in official guise) to service its debt.

Its performance as a water utility was dismal (see Table 4.1). MWSS was plagued by the usual problems associated with state-owned and –operated enterprises. There was little or no accountability. It operated with a soft budget constraint where the state treasury was the ultimate guarantor. Severe over-manning shared with other state agencies was not a surprise. That a pre-privatization retirement program accepted by about 30 percent of the work force came about without any decline in water service tells of over-manning. MWSS had 9.8 employees per 1,000 connections, over thrice the Asian regional average of 2.6. Water was available only 17 hours a day on average versus 24 hours in other SEA cities. Its NRW was 61 percent of total, twice the regional average of 30 percent. Its coverage was 67 percent of total population, a full 30 percent less than the regional average. Still and all, poor performance was seldom a trigger for meaningful reforms in the Philippines. It was a stable, low-level equilibrium.

The pre-privatization MWSS was thus a mess. Its water service was remarkable more for the interruptions than availability. Its US$1-billion debt was a fiscal burden due in part to its dismal NRW performance and due to the lack of political will to adjust rates. Incentives toward greater efficiency and sustainability did not exist. And yet it persisted.

The unspoken dominant political attitude back then was, “Don’t raise the tariff; reduce the service quality.” This attitude is, of course, very politically clever and is the counterpart of a “slow boil.” Service erosion can be sold as equal sharing of pain. Reducing service hours to a district by four hours hits both the posh subdivisions and squatters of the district. Raising tariffs, on the other hand, hardly reduces water use by the rich but should considerably reduce or shut off that of the poor! This form of water rationing is in keeping with the general populist tendency at work elsewhere in the polity and consistent with the nominal equity norm.

Politicians were, and still are, especially comfortable with it. They did not have to confront a noisy opposition to tariff adjustments. Quality erosion did not inspire as much opposition. Water tariff was dirt cheap and subsidized by taxpayers in general. The masses—unable to see beyond nominal equity—appreciated the low tariffs. The rich, on the other hand, could afford powerful water pumps and water storage facilities, and if need be, artesian wells to maintain 24-hour service. This was also a case of the Mancur Olson effect: the noisy minority (Metro Manila residents) forcing transfer to themselves via subsidized water from the disorganized majority (the rest of the nation).

This rule had, however, a massive downside for some, and increasingly
for all. (a) For those still uncovered by the service (39 percent of the Metro Manila population), there was no money available to extend the service, which meant they continued to pay through the nose for water (up to four times the official tariff for trucked water). For those without a piped system, water was accessed from communal faucets through costly water carriers. (b) Those entities that required water on a 24-hour basis had to provide their own continuous supply: costly pumping equipment and storage installations, which raised the cost of doing business.

Thus, the nominal equity norm was served at the expense of substantial operative inequity. Other problems followed. The non-availability of water for a great many people created demand for illegal connections that raised NRW. The proliferation of private deep wells worsened the common resource problem associated with the underground water table. The system was headed to a crisis, but on tiptoe. Everyone who had the wherewithal had time to adjust, to develop his or her own defensive scam. Before long, vocal vested interests emerged to defend the system, however abysmal. Continuous quality corrosion did not grate as much as price adjustments.

The MWSS Board, whose membership was appointed by the political authority, often as a form of political patronage, internalized the authority's tacit preference, and went along as the safest path to retirement or to other juicier positions. It did not matter that the system incurred an ever-rising deficit; it faced a soft budget constraint where the state treasury was the ultimate guarantor.

There was no incentive for government agencies like the MWSS to behave otherwise. Multilateral lending institutions and private loan syndicators were given implicit or explicit sovereign guarantees for their loans, the best possible arrangement for creditors in least developed countries (LDCs). They were not penalized by escalating inefficiency and losses, and had no incentive to monitor the use of the loans.

The MWSS workers were protected by a maze of civil service rules, and thus have virtually airtight or permanent security of tenure. Their ranks tended to be bloated by accommodation of political jobseekers. They were paid little, but were expected to do little.

The mess represented by pre-privatized MWSS was sustained by indefinitely postponing remedies and reckoning into the future. The losers either could not find a voice or were hampered by a public good market failure: the cost of protest was private but the benefit was public. Among the former was the taxpayer-at-large who subsidized water for Metro Manila users. The business sector—still largely dominated by domestic market-oriented players—could pass on the high cost of business to consumers. The sectors
that competed in the world market, burdened by higher cost of business, did not yet constitute a viable political force. Finally, information on viable alternatives was not available to the highest decisionmakers in case they were curious. State ownership of basic service provision was the inherited norm.

The pre-privatized MWSS was a manifest, stable, low-level equilibrium with all the players pursuing their best interests, given the rules of the game and the observed payoffs. The winners were sustained by an Olsonian dynamic, where the losers (i.e., the general public), finding resistance too individually costly and the benefits of successful resistance too diffuse, went passively along (Olson, 1965). The payoff structure left little room for change.

This old order does not surrender its grip without a radical change in the payoff matrix of the game. Since the internal forces cancel each other effectively in a stable equilibrium, the shock has to come from the outside. But from where?

Globalization and the Winds of Change

President Ramos was the undisputed father and champion of MWSS privatization (see next section for an elaborate account). But whence came the inspiration and conviction? Ramos came to power in 1992 following the collapse of the Iron Curtain, symbolizing the triumph of the market ideology. We contend that the post-1989 globalization provided the ingredients and wherewithal for this (at about 1993, still contrarian) view. We elaborate below.

The Allure of Privatization: Fiscal Deficits and Global Competition

The 1990s was a singular decade for globalization in East Asia. Massive foreign investment—both portfolio and equity—and the radically altered geo-economic landscape, changed the perceived opportunities of players and the payoff structures. One over-arching concern was the perennial problem of fiscal deficit. The political authority—confronted by severe fiscal constraints—began in the early 1990s to embrace privatization and deregulation as a way to reduce demands on the national treasury (Cook & Fabella, 2002). These were also the growth-driving policies identified by the Washington Consensus and were, in no small way, pushed by the multilateral banks. Reinforcing the emerging conviction, its efforts in telecommunications and transport deregulation were beginning to bear tangible harvests.

Another over-arching influence was the compelling claim of globalization as a door to progress. To secure the country’s place in the emerging global economy, the cost of doing business had to be reduced. Increasing awareness of Von Thünen competition (see, e.g., Fabella, 2000), where rival locations
compete for hovering *smart capital* on the basis of non-traded complementary factors—e.g., hard and soft infrastructure and worker skill—made basic services salient. You could not provide these conditions if you were perennially in the fiscal red. Globalization forced the authorities to recognize a crisis where once there was just dismal water service. Other globalization-related factors helped bring the situation to a boil:

(a) *The Tiger Economy aspiration of the Executive Branch.* The Ramos administration assumed power after the success of the “export platform” idea—made salient by the Japanese Direct Foreign Investment (DFI) to East Asia in the wake of the Plaza-Louvre Accords yen appreciation—was recognized. Tiger economies were then recognized as having ridden the export superhighway and attracted direct foreign investment (World Bank, 1993). The dismal performance of MWSS could only serve to discourage export competitiveness and DFI. You could not compete in the global marketplace with bad infrastructure. You could not provide the proper infrastructure if you were in a chronic fiscal mess.

(b) *The growing recognition of the traded goods sector,* especially the export sector, as an engine of growth was palpable in the rhetoric of the day, and its clamor for competitive cost of doing business was being heard in the decision circles. Indeed, then-Senate President Edgardo Angara made a competitive exchange rate the subject of his plenary speech to the 1994 Economic Summit, where he called for the upward adjustment of the exchange rate from ₱25 to ₱35 per US$ in the wake of the massive devaluation of the Chinese yuan. That it was widely attacked and eventually ignored showed that the support for the export sector did not yet extend beyond rhetoric.

(c) *Expansion of the information set of the political powers I: The role of overtures by foreign players:* Around 1994, a Malaysian firm, together with Biwater, a British water service provider, proposed the privatization of MWSS by direct purchase. In late 1994, Biwater also presented its own bid as an “unsolicited proposal” under the BOT Law. In 1995, a third negotiated bid offer was received, this time from a large real estate firm in a joint venture with a foreign group (Dumol, 2000). The information set of the authorities thus expanded on two counts: (1) these bids revealed clearly the existence of possible, financially able, interested parties in the privatization of water; and (2) at least one viable alternative mechanism to state water provision, the straight purchase and ownership by a private group.
(d) **Expansion of the information set of the political powers II (Successful templates):** The Buenos Aires and Macau Exemplars were most salient. Lyonnaise des Eaux, a French water company, and the partners in the privatization of the Buenos Aires and Macau water systems, reported to key figures on the performance of those projects. NRW fell to 14 percent from 44 percent in Macau. In Buenos Aires, water tariff actually fell. In both cases, the winner was determined by a competitive bid (Dumol, 2000). President Ramos and Department of Public Works and Highways (DPWH) Secretary Gregorio Vigilar became sold on the idea. Together with then-MWSS Commissioner Angel Lazaro and a contingent of stakeholders, especially MWSS labor, Vigilar visited Argentina for a first-hand look. Visits to France and the UK were also organized. That the model had been tried and had succeeded outside of the Organization for Economic Co-operation and Development (OECD) ambit was especially compelling.

(e) **Electric Power Crisis Act as template:** President Ramos enjoyed enough political capital with Congress to enact the Electric Power Crisis Act of 1993, which gave the president the power to negotiate BOT contracts for power supply and generation to address the crippling power crisis in the early 90s. This underpinned the successful address of the power crisis.

(f) **National Water Crisis Act of 1995:** After the success with the power crisis, Congress readily passed the National Water Crisis Act, which gave President Ramos the power of negotiation in the water sector and privatization of water utilities. It additionally gave MWSS the power to retrench personnel and made theft of water a criminal act. This law also gave the president a six-month mandate to privatize the sector.

(g) **Procurement of supply and capacity via the new BOT Law:** This had proven successful not only in solving the power crisis, but also in the procurement of new capacity in a way that entailed substantially reduced immediate fiscal burden.

(h) **Multilateral agencies** were eager to lend technical assistance and advisers to prepare the ground. The International Finance Corporation (IFC) was especially crucial as technical adviser.

(i) **Lee Kuan Yew:** The much-publicized public flogging of the Philippine telecoms infrastructure by visiting Singapore Senior Minister Lee Kuan Yew shattered the national tolerance for bad service in general, and supplied no small amount of impetus for deregulation at that time.
The confluence of events by the mid-1990s made the political authority singularly bullish toward reform, rendered the public receptive, and put potential objectors on the defensive. The grip of the old ethos was loosening.

A Happy Confluence of Events

Clearly, the clinching of the privatization of MWSS was a milestone in Philippine political economy. Few, if any, would have bet that in a little over two years, from June 1995 to August 1997, the turnover of management and operation of such a large and complex system would really come to pass.

While privatization of some sort had been ongoing from the late 1980s through the early 1990s, most cases were either straight sale of state assets or greenfield BOT contracts. None were as politically sensitive or as complicated as drinking water in the capital city.

The privatization came through by a happy—if perhaps unique—confluence of events. In the mid-1990s, with the power crisis a vivid memory, foreign exchange turned from chronically scarce to abundant. Japanese banks were especially eager to lend at hitherto unknown low rates. Foreign investors were spoiling for any and every profit toehold in the *Pacific Century*. Dumol (2000) views this as luck when he observes the timing of the endeavor: “How much luckier can we get!”

The strong buy-in by the President of the Republic, the choice of a very able team to complete the job, and the constant monitoring of the process were crucial ingredients for the success of the MWSS privatization. But the buy-in itself was triggered by a confluence of events that made the idea compelling and promising: (a) new information on emerging alternatives to state procurement and provision provided by globalization, (b) the existence of private players willing and able to finance the project, (c) the impetus from the undiplomatic and frank Lee Kuan Yew, (d) the demands of the traded goods sector for lowering the cost of doing business, (e) the emerging orthodoxy regarding the export platform path, and (f) the desire to reduce the claims on the state treasury. Finally, the recent successes in telecoms deregulation and BOT procurement in the power sector eased the way for the more difficult privatization of water service via a concession contract. The government, however, needed to address the reluctance of the private sector to sign a 25-year contract with the government. We now, therefore, turn to what the government did to ease the entry of the private players.
How MWSS Privatization Was Won: Oppositors and Dumb Luck

This account depends largely on Mark Dumol’s “The Manila Water Concession: A Key Government Official’s Diary of the World’s Largest Water Privatization” (2000). As chief of staff to one of the key players in the game, Secretary Vigilar of the DPWH, Dumol occupied a front-row seat in the crafting and nurturing of the process that led to the clinching of the holy grail of MWSS privatization.

The Chronology of Events

Following Dumol, we constructed the following chronology (Table 4.5):

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>June</td>
<td>President Ramos broaches the idea of a ‘water crisis’ to newly appointed DPWH Secretary Vigilar</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ramos meets with investors proposing to purchase MWSS by a negotiated deal; gets excited with their promised water service overhaul; forms an interagency committee to study proposal.</td>
</tr>
<tr>
<td></td>
<td>July</td>
<td>Ramos creates the MWSS Privatization Committee; research starts</td>
</tr>
<tr>
<td></td>
<td>December</td>
<td>Biwater submits an ‘unsolicited proposal’ under the expanded BOT Law</td>
</tr>
<tr>
<td>1995</td>
<td>June</td>
<td>National Water Crisis Act passed</td>
</tr>
<tr>
<td></td>
<td>July</td>
<td>The French Government approves a grant of $1 million to finance the technical feasibility study of the privatization project</td>
</tr>
<tr>
<td>Year</td>
<td>Month</td>
<td>Event</td>
</tr>
<tr>
<td>--------</td>
<td>----------------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>1996</td>
<td>January</td>
<td>Ramos creates the MWSS Privatization Committee; research starts</td>
</tr>
<tr>
<td></td>
<td>September</td>
<td>MWSS 4 SALE!</td>
</tr>
<tr>
<td></td>
<td>November</td>
<td>Investor register interest</td>
</tr>
<tr>
<td></td>
<td>March</td>
<td>Investors provide data for due diligence</td>
</tr>
<tr>
<td></td>
<td>July</td>
<td>MWSS approves the privatization strategy</td>
</tr>
<tr>
<td></td>
<td>August</td>
<td>Bidders are pre-qualified</td>
</tr>
<tr>
<td></td>
<td>Oct. to Nov.</td>
<td>MWSS meets bidders for pre-negotiation of contracts</td>
</tr>
<tr>
<td></td>
<td>December</td>
<td>MWSS approves pre-qualified bidders</td>
</tr>
<tr>
<td></td>
<td></td>
<td>MWSS issues tender documents</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ramos approves privatization strategy</td>
</tr>
</tbody>
</table>

A large local firm backed by multi-national corporations tenders a negotiated privatization proposal, which is also rejected.

Development Bank of the Philippines (DBP) approves a loan to further finance the cost of hiring the lead adviser for the project.

MWSS hires the International Finance Corporation (IFC) as lead advisor on the project for $6.2m.

The French Government approves a grant of $1 million to finance the technical feasibility study of the privatization project.

A large local firm backed by multi-national corporations tenders a negotiated privatization proposal, which is also rejected.

Development Bank of the Philippines (DBP) approves a loan to further finance the cost of hiring the lead adviser for the project.

Investors register interest.

Investors provide data for due diligence.

MWSS approves the privatization strategy.

Bidders are pre-qualified.

MWSS meets bidders for pre-negotiation of contracts.

MWSS approves pre-qualified bidders.

MWSS issues tender documents.

Ramos approves privatization strategy.
<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>January</td>
<td>Ramos approves CA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CA opposition mounts legal challenge</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bidders submit their bids</td>
</tr>
<tr>
<td></td>
<td>January 23</td>
<td>Court of Appeals issues TRO</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Court of Appeals lifts TRO</td>
</tr>
<tr>
<td></td>
<td>January 31</td>
<td>MWSS opens bid documents</td>
</tr>
<tr>
<td></td>
<td></td>
<td>MWSS endorses award recommendation to COP</td>
</tr>
<tr>
<td></td>
<td>February 21</td>
<td>COP endorses recommendation to Ramos</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Ramos approves award of contract</td>
</tr>
<tr>
<td></td>
<td>August 1</td>
<td>Government and winners sign CA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Winners take over their respective concessions</td>
</tr>
</tbody>
</table>

Source: Dumol (2000).
Major Change Agents

Ramos was, in no uncertain terms, the principal of principals in the MWSS privatization project. The other players all agreed that the project was the President’s very own baby. In June 1993, Ramos met with the newly appointed DPWH secretary and broached, among others, the idea of confronting what he called the “water crisis,” which was unexpected, since a water crisis was not yet part of the popular discourse. Apparently, the dismal performance of water service morphed into a crisis in Ramos’s mind. This prompted Secretary Vigilar to convene a series of water summits, which created a consciousness of the water problem. The crisis view was being hawked. It was not that people were unaware of the water problem; they just thought there was nothing that could be done. They did not think it a crisis, but a predicament that had to be lived through and managed with local remedies (water pumps, water storage, plastic buckets, etc.). But what could be done about it in the long run? In June 1994, Ramos entertained a private group of investors (representing a Malaysian firm and its partner, Biwater) interested in purchasing MWSS outright on a negotiated basis. To this meeting he invited Vigilar, who was tasked to study the proposal. The follow-up calls from Ramos showed his excitement at the prospect. The inter-agency committee set up to study the matter rejected the proposal on the belief, most common at that time, that potable water was too politically incendiary to be passed on to private hands. Besides, how does one sell an agency whose value is unknown, and perhaps unknowable? But the proposal left its mark; the proponents painted a picture of a completely transformed water service. The privatization bug had bitten.

That Vigilar was the secretary of DPWH was a godsend for the project. He was a no-nonsense bureaucrat who cut his teeth in the Philippine Army Corps of engineers and in seeing through large infrastructure projects with dispatch and honesty. He was a can-do man. President Ramos set out to make him a true believer in water reform. He sent the secretary on visits to projects abroad, one of which turned out to be Macau, which had seen a successful privatization of its water service. In May 1995, Vigilar visited France and the UK to see their water projects and toll roads. Vigilar came out of these trips a proselytizer for water privatization. There is nothing like actual operating templates to focus the mind.

When it was clear that MWSS privatization was the way forward, Ramos wangled from Congress the passage of the National Water Crisis Act, which granted the president the time-bound power to privatize water utilities, the power to reorganize MWSS, and the criminalization of water theft—meaning that chief executive officers (CEOs) of companies caught stealing water could go to jail. This was to prove crucial in clearing legal objections to the project.
and making potential bidders confident that they could collect the tariffs if they won the contract.

It was also clear that the current leadership of MWSS would not be best positioned to abolish it, and this called for a new administrator. Ramos chose the highly respected Dr. Angel Lazaro III, but the latter balked for good reason. MWSS was a quagmire of failed procurement projects. Lazaro ran a successful consulting firm and thought rightly that he would be caught in a no-win situation. This was clearly an instance of good quality and well-intentioned people fleeing from the snake pit of state bureaucracy. It was a job trying to convince him to accept, and he did so only on the condition that he would be allowed to exit right after the concessions were handed over to the winners. Lazaro was to prove crucial in giving the effort credibility and in taming the forces within MWSS that were viscerally opposed to privatization.

**External Forces**

It is said that bad equilibrium cannot be upended without new impulses flowing from the outside to change the equation. External forces that could be viewed as globalization dividends also weighed in the process of water privatization. These served to expand the information set and the expertise fund. The privatization offers coming from 1993 to 1995 were very pivotal in convincing the authorities that the water problem had at least one way out: privatization. They also brought to the authorities’ attention the existing LDC templates in Macau and Buenos Aires. The World Bank manuscript on the Buenos Aires privatization by Idelovitch and Ringskog (1995) were especially cherished by those tasked to push the agenda and seeking to change other peoples’ minds on the matter. Errors committed during the early 1990s could also be avoided.

Even after the authorities became convinced that privatization was promising, going about it was unknown territory. Experts had to be identified and terms of reference had to be drafted, and this cost money and seed financing. Here, the French Embassy came through with a grant of US$1 million for the financing of the technical feasibility study of the project. It also arranged for the visits of point persons to France and French water projects elsewhere. The UK Embassy also arranged visits by relevant project personnel to England for a look-see. When the IFC team to advise on the Umiray-Laiban Dam BOT Project came over in July 1995, the idea of the IFC becoming the principal adviser of the MWSS privatization was brought up. The MWSS Board approved the IFC advisory contract on November 10, 1995. This proved to be central in the design of the bidding and the drafting of the CA, which were highly technical undertakings.
Identifying Opponents and Preempting Objections

An undertaking as large and unfamiliar as this will encounter many obstacles and objectors along the way. Each of these is sufficient to derail the whole enterprise. This is especially pronounced in a third-world country with a fractious brand of politics.

Legality and Challenges

As mentioned, the passage of the National Water Crisis Act was momentous as a legal basis for the project. The merit, as well as the drawback, of the enabling law was the time-bound provision: the President was given six months to privatize. The advocates interpreted this as six months to initiate the process, not to complete it. This was subject to challenge in court. To preempt the opposition, the President had to issue an EO to that effect on or before December 7, 1995.

Executive Order No. 286, or EO 286, was issued on December 7, 1995 to beat the deadline of process initiation, but the mention of privatization was minor. A stronger EO seemed called for, showing presidential approval of the MWSS privatization. In March 1996, EO 311 was issued to the effect. As expected, prior to the bidding proper in January 1997, a temporary restraining order (TRO) was served by a Manila city judge in favor of a group wanting to implement a major water supply project, which feared being orphaned by the progress of the MWSS privatization.

Judge Inocencio Maliaman, who presided on the TRO case, declared the TRO expired on a technicality interpretation. This allowed the bidding to proceed. Before the end of January 1996, and after the winners had been determined, another TRO was issued, this time by the Court of Appeals. The contention was that the six-month period had elapsed. Here the EOs issued were material in convincing the court that the CA was being honored. If the opponents raised the legality issue to the Supreme Court, it would have languished for years and stopped the process in its tracks. This showed how tenuous the process was and how dumb luck played a role.

Preempting the Political Challenge

When the winners and their bids became headline news, the reception was euphoric, in view of the promised huge reduction in water tariff. But as usual, there were nitpickers and gadflies. The first salvo was that this was “too good to be true,” and so there was a catch somewhere that would cost the public dearly. Three senators questioned the contract, but their objections were simply and effectively addressed. Going through the CA with a fine-
toothed comb did not reveal any anomaly. The whole process was zealously transparent and designed to be so to preempt future challenges. There was no challenge from the losing bidders, who were themselves involved in the process of drafting the contract. And of course, the huge reduction in the tariff was the nonpareil evidence of correctness in the eyes of a public so used to political double talk. This was the outcome of the reassurance game played by the state to reduce the risk facing the bidders (see, e.g., Fabella, 2010) before the actual bid. The experience shows the wisdom of meticulous transparency and anticipating objections even before they arise: in other words, thoroughness.

**Preempting MWSS Labor Challenge**

MWSS had 8,000 employees—13 employees per 1,000 connections—which was two to five times the workforce of comparable Asian cities. The Civil Service Law gave state employees rather rigid protection. How did one whittle down this number so as to attract bidders to tender? This was Lazaro’s challenge. The National Water Crisis Act passed in June 1995 authorized the reduction of the MWSS workforce. The employees viewed Angel Lazaro’s appointment as the signal to privatize, and they were restive. To calm the field, Lazaro met with the workers and proposed to them a set of criteria, which if met, would forestall the privatization. The standards proved too tough to be met, but the initiative brought the workforce into the conversation, which proved important. Lazaro then managed a retrenchment program consisting of: (a) a generous package for early retirement, which was accepted by 30 percent of the workforce; and (b) a generous program accepted by the remaining workers: termination prior to takeover with tax-free severance pay and rehiring by new owners on probationary basis. Those not rehired (another 25 percent) were given full retirement benefits less severance pay. The government shouldered the cost of retrenchment. The CA carefully detailed the obligations of the concessionaire in respect to the rights of the workers. This reduction in the workforce would play a big part in the willingness of the private sector to play.

**Lessons**

Time would vindicate the faith and hard work of the advocates of MWSS privatization (see first section of this paper). It would be the largest water service privatization in the world and would make Manila a stopover for parties curious about or interested in water privatization. It also made one of the concessionaires a world player in water service privatization.
Ensuring the Low Tariff Outcome: Addressing Private Business Risks

It is clear that what muted opposition to the MWSS privatization was the sizeable reduction in the tariff contained in the winning bids. Without this reduction, the adverse reaction might have led to the derailment of the project. The team tasked to privatize was very conscious of this need. We are therefore interested in how this came about.

**Credible Commitment and Signaling Game.**

Since this water privatization enterprise involved drawing in the private sector in an embrace that would last decades, the government had to signal a new order of business. Dealing with the Philippine state was known to be fraught with uncertainty, and businessmen shun incalculable risks. To see the project through under such a time constraint (it had to be locked up before the 1998 presidential elections and the end of President Ramos’ term, the limit set by the National Water Crisis Act), the government undertook two crucial steps:

1. It raised the tariff rate per cubic meter of water by 38 percent from about ₱5.00 to about ₱8.00 five months prior to actual contract closure; and
2. It offered a generous early retirement plan for employees, which reduced the work force by 30 percent.

These actions had the following effects: (a) they made the intended concessions more attractive to bidders and, more importantly, (b) they constituted a manifest political will signaling a departure from business-as-usual—which meant that the state, as a counterparty, cannot be relied upon to deliver on its contractual obligations as it is prone to sway with the fickle political wind. A state that, by contrast, can risk public opprobrium by raising tariffs to this extent and can whittle down the workforce by this much (thanks to the National Water Crisis Act)—both unheard-of events—can be trusted to follow through. These actions were clear proxies for a *credible commitment* that reduced uncertainty and led to lower tariffs (see e.g., Fabella, 2010). Thus, one important source of business risk—the state as an unreliable counterparty that holds all the aces—was addressed.

President Ramos’s complete embrace of the project—manifested by his constant hovering presence throughout the run-up, dismantling hurdles along the way, and making the necessary phone calls—was the last straw that broke the back of the old equilibrium.
Risk Associated with Information Scarcity.

The two years it took to privatize MWSS resulted in potential gross miscalculations, both by the state and the private players. Due to the shortness of the run-up period, there was no time to set up a properly legislated regulatory infrastructure for water. The Regulatory Office was itself set up as part of the CA. It had no statutory independence from the political principal. MWSS morphed, by virtue of the CA, from a water and sewerage service provider to a regulator. If it failed badly in the first, how could it succeed in the second? Additionally, the requisite expertise to regulate water utilities was conspicuously absent. While expertise could be quickly outsourced at a price (e.g., UPecon Foundation and Thames Water, who were hired as consultants), could it suddenly realistically excise the very source of its previous failure—political interference—from its decisions? This would become a big issue later.

How was this risk addressed? The CA provided for disputes over claims to be adjudicated by an appeals panel consisting of three members: (1) one nominee from the concessionaire; (2) another from the regulator, MWSS; and (3) one international expert nominated by the foreign chambers of commerce. This would take the Philippine courts, noted to be fickle, out of the dispute resolution. This was yet another confidence-building measure.

There were other potential pitfalls that would test the adjudication platform. One is the exchange rate and the concession fee obligation of the concessionaires to service dollar-denominated debt. Most East Asian countries were—throughout the 1990s—battling without much success the appreciation of their currencies. If the direction of peso movement were to be forecast based on the previous 10 years, it would have been appreciation. The peso had appreciated from about P26.00 to P25.00 per US dollar in the mid-1990s. The noise from the Central Bank of Philippines leadership was “depreciation over my dead body.” Exporters in Cebu Province burned the Central Bank governor’s effigy for his “strong peso policy.” So, the betting was that the peso would continue to appreciate. It went the other way in the Asian financial crisis of 1997.

Due diligence was made more tenuous by the extremely bad record keeping of the old MWSS. Bad or missing records are systemic in most state institutions where corruption is rampant. But in the mid-1990s, and due to the shortness of the decision period, that risk of inadequate due diligence could be glossed over. The nature of the business meant that due diligence was heavily biased toward type I errors: adjudge healthy and deal with a tumor later if it arises.

How were these risks addressed? The CA provided potential relief in the form of price adjustment mechanisms that could compensate for downside
surprises: *emergency price adjustment* annually and *rate rebasing* in perhaps five (optionally) or certainly 10 years. These would serve to reimburse the concessionaires for costs prudently incurred. This meant that there was less risk of a “winner’s curse,” the danger that the winners might have been so optimistic as to render the business unviable. This had risks for the regulator. Indeed, the authorities were concerned that, due to these relief windows, bidders could plunge and try to recoup in the rate-rebasing exercise. In a world characterized by severe path dependence and first-mover advantage, getting a toehold—however tenuous—was the usual strategy. Plungers, of course, would need to have very deep pockets to sustain losses for at least five years (if lucky), or worse, 10 years. This meant that the privatization rules were biased in favor of players with deep pockets that might not necessarily be the most efficient operators. There is risk to plunging; even when the claims are truly meritorious, there always is the danger that large tariff adjustments will become politically unpalatable and may be vetoed. Plungers can also exploit the weakness of the system by reneging on deliverables and not getting punished due to regulatory weakness. Again, the appeals panel could be brought to bear if disagreements arose.

Finally, and as a *coup de grâce*, the Department of Finance (DOF) issued a *performance undertaking* guaranteeing that the government would respect its obligations in the contract. This was no small gesture, according to insiders.

**And They Came.**

The moves to reduce the risks for participants succeeded in attracting bidders. Table 4.6 gives the bidding consortia and their other interests.

**Table 4.6. Pre-qualified Bidding Consortia**

<table>
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<tr>
<th>Pre-qualified Consortium</th>
<th>Business Interests</th>
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<tbody>
<tr>
<td><strong>Local Sponsor</strong></td>
<td><strong>International Operator</strong></td>
</tr>
<tr>
<td>Metro Pacific Corporation</td>
<td>Anglian Water International (UK)</td>
</tr>
<tr>
<td>Ayala Corporation</td>
<td>North West Water (UK)</td>
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</tbody>
</table>
The Ayala Group was heavily into real estate, telecommunications, manufacturing, and banking. The Benpres Group was into power generation, power distribution, telecoms, and most of all, media via the giant ABS-CBN group. Their calculations may include considerations of cognate interests within the conglomerate as affected by the ownership of the water company. No matter. The authorities probably preferred that the winning bids be infected with the winner’s curse—that is, so optimistic that the business was not viable.

**The Die Is Cast.**

In a sense, however, this might have been unavoidable. The size of the resources involved meant that only very large Filipino business groups could participate, and this is a very small set in an LDC. Capital market and institutional imperfections additionally ensured this to be a small set. That the Philippine Constitution mandates a 60-percent Filipino participation meant that foreign players could not participate and win on their own, which exacerbated the situation.

The designers of the privatization project were aware of the dangers. They were also aware that if it did not go through before the hard legal deadline, it might never go through. The gamble had to be taken, and the political authorities never hesitated. And the gamble paid off.
Summary and Conclusion

The privatization of MWSS was clearly a triumph of the principle of comparative competence—the private sector proved more competent at the delivery of water and sewerage services than the state. How it was clinched is a parable for those seeking to whittle down the compass of incompetence and inefficiency in a weak-governance environment. Where the state is weak and therefore easily hijacked, it is much better to cede territory to the market. In the terminology of Williamson (1985), it is well advised to just buy from the market. A classic objection may be interposed—weak governance environments also tend to produce weak markets characterized by market failures, so the state may have no alternative but to make. In the story just told, globalization made a difference by strengthening the hand of the market, providing new information, new templates and expertise, and new partners and sources of financing for local private business.

The MWSS privatization showed how precarious the journey to success can be. This observation is even more salient, since the project was owned right from the beginning by the President, who enjoyed considerable political capital. That political capital got translated into the National Water Crisis Act of 1995, which the President extraordinarily leveraged when it came to water procurement. Without this enabling law, it would have been difficult for the project to clear the labor objections to privatization. It could have stumbled and gotten scuttled at several junctures along the way. In one instance, progress depended on an interpretation by a judge which amounted to a mere technicality. Had the legal question of the validity of the award been raised to the Supreme Court, the delay would have been fatal. Luck did play a part.

Choosing the right people to manage the project was crucial. They had the right credentials and were viewed as having no hidden agenda that would cast doubt on the enterprise. They, in turn, had staff members who were idealistic and committed to the pursuit of the holy grail. The team—realizing its own technical limitations—recruited the best help available in the world, which, when availed of further, gave the enterprise added validity. Recognizing further that the state was viewed as an unreliable and risky partner, the team enshrined transparency as a rule of procedures, which muted potential objections and preempted legal challenges. It opened the regulatory environment to inputs from the market players. Additionally, it employed effective signaling and credible commitment devices to attract and induce aggressive bids from the private bidders. The response was so enthusiastic that the outcome justified itself in the eyes of the public. In the end, fortune favored bravery and thoroughness.
References


