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REVISITING PUBLIC-PRIVATE PARTNERSHIP IN INFRASTRUCTURE DEVELOPMENT: IMPROVING BOT GOVERNANCE

**Congressional Planning and Budget Department
House of Representatives**

EXECUTIVE SUMMARY

Infrastructure development entails the mobilization of huge financial resources. Given budgetary constraints, the government planned to tap the private sector to finance 27% of the P1.711 trillion investment requirement of the Comprehensive and Integrated Infrastructure Program. This move is also in line with the government's objective of encouraging private sector participation in infrastructure projects specially those with high financial returns.

The Build-Operate-Transfer (BOT) Law, which embodies the basic principle of public-private partnership in infrastructure development, has been cited as instrumental in increasing private investment in infrastructure (especially in power, telecommunications, airports and water utilities) in its initial years of implementation. Recently, however, the loopholes in the same BOT Law, which in many cases resulted in highly controversial and contested transactions, have been blamed for the declining trend of awarded projects under the BOT scheme. The BOT law is found to be unclear in areas like obligations of each party in a project; financial terms such as guarantees, subsidies or equity to be provided; and contractual provisions on risk allocation including assisting the project secure financing and ensuring its financial viability and sustainability.

Moreover, issues in the design and implementation of contracts (i.e. LTO-IT project, MWSS Concession, Independent Power Producers or IPPs) weighed down on BOT's perceived benefits. In fact, the Philippine experience on BOT projects highlights the risks and costs especially those that matter to the government and the public in general such as the rise of moral hazard problems, failure to increase efficiencies, and rise of contingent liabilities of the government.

In order to improve BOT governance, various literature have cited the need to implement the following: a) ensure a stable macroeconomic environment; b) develop capital markets as source of long-term financing; c) use ODA efficiently; d) develop and maintain efficient and effective regulatory bodies; e) improve on the BOT Law; f) improve on BOT contracts; and g) enact a Freedom of Access to Information Act.

Further, while there is a need to expedite the whole gamut of the BOT process, the proposal to decentralize the process to the line agencies and the local government units, which would in effect bypass the National Economic Development Authority-Investment Coordinating Committee (NEDA-ICC), would be an inappropriate policy response.

REVISITING PUBLIC-PRIVATE PARTNERSHIP IN INFRASTRUCTURE DEVELOPMENT: IMPROVING BOT GOVERNANCE

By Elsie C. Gutierrez and Manuel P. Aquino

OVERVIEW

Upgrading and modernizing the country's infrastructure are crucial in addressing the key strategic objectives of improving competitiveness and alleviating poverty. Infrastructure fosters employment opportunities and contributes to improving the incomes of the people especially in the rural areas. However, infrastructure development in the Philippines has not kept up with rapid population growth and urbanization. Further, the low quality of services has emerged as a key impediment to the economic competitiveness of the country.

The requirement for infrastructure development is huge. The World Bank has underscored the need to increase infrastructure spending from less than 3% to at least 5% of GDP (*Eijbergen 2006*). Under the Comprehensive and Integrated Infrastructure Program (CIIP) of the government, an investment requirement of P1.711 trillion or 4.45% of total GDP for 2006-2010 has been identified for infrastructure development. Constrained by its limited revenues, the National Government indicated that it would only be able to finance 44% of the CIIP's capital requirement and planned to tap 27% from the private sector. This is also in line with the government's objective of encouraging private sector participation in infrastructure projects especially those with high financial returns.

There have been expectations on the part of Congress to pursue policy reforms (such as the proposed amendments that would

enhance the BOT Law) that will foster a more conducive yet competitive environment for private sector participation through investment in infrastructure. There have also been parallel moves by the Executive to amend the implementing rules and regulations (IRR) of the BOT Law as amended to expedite the review, approval, and implementation of BOT projects.

In view thereof, this paper seeks to revisit public-private partnership in infrastructure development and to surface from various literature ways to improve BOT governance. Further, it posits that while there is consensus to expedite the whole gamut of the BOT process, the proposal to decentralize the process to the line agencies and the local government units, which would in effect bypass the National Economic Development Authority-Investment Coordinating Committee (NEDA-ICC), would be an inappropriate policy response.

PUBLIC-PRIVATE PARTNERSHIPS IN INFRASTRUCTURE DEVELOPMENT

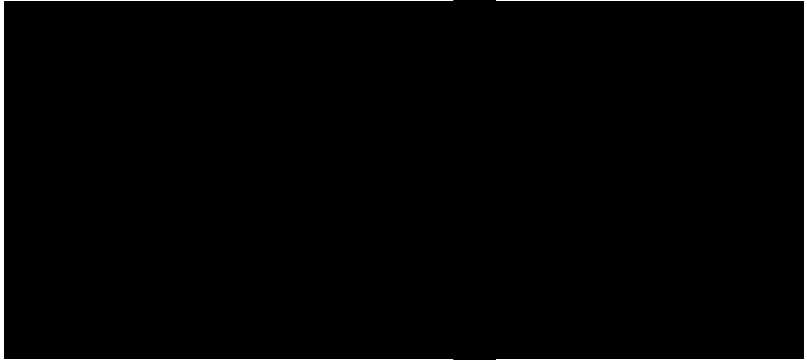
The passage of Republic Act 6957 (the Build-Operate-Transfer Law) and the subsequent amendments to this law under RA 7718 manifests the government's commitment to tap private sector expertise and resources in infrastructure. The basic principle is "user's pay" which means that the private sector bears the cost of financing the capital investments while the beneficiaries pay for the benefits of the project. The role of government is to regulate and, in some cases, provide subsidy, equity and guarantee performance.

According to Llanto (2004), the BOT Law was cited by the World Bank (2000) as instrumental in increasing private investments in infrastructure in the country because of the following reasons:

- Expansion of private sector participation in infrastructure development in sectors other than power, including telecommunications, ports, toll roads, airports, and water utilities;
- Easing of the requirement that all private sector construction contracts be awarded to companies whose capital was at least 60 percent Filipino-owned;
- Relaxing of the 60 percent Filipino ownership requirement for operating infrastructure projects;
- Grant of permission to implementing agencies to consider unsolicited project proposals and to negotiate proposals directly with the private sector under certain conditions.
- Access to official development assistance (ODA) since BOT projects are eligible for ODA assistance of up to 50% of the project cost. ODA may be an inevitable source of long-term funding to develop the infrastructure in most countries like the Philippines, where the financial market is not mature enough to provide necessary long-term finances; and
- Delegation of Congress' approval authority on infrastructure projects to the executive branch.

However, tapping the private sector for infrastructure financing may not be that easy. Recently, the country has been experiencing a lack of investor demand for infrastructure projects. Based on a time series data on awarded projects under the BOT scheme during the period

1999-2006, a declining trend in terms of new investments committed



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into substantial renovation of existing ones. For a “fiscally-stressed” government without sufficient resources for infrastructure investments, BOT tends to work well for new facilities that require substantial financing. For example, the cost of BOT projects in the Philippines could range from US\$ 1 million to as high as US\$ 7 billion.

Moreover, governments enter into BOT contracts to harness private expertise and resources in the financing, construction, management, and delivery of infrastructure services. If properly designed and implemented, BOT can also spread the risks in infrastructure projects with the principle of having the party that could more appropriately bear the risk to assume it (i.e. commercial or market risk should be with the private sector while political risks with the government).

The extent by which these objectives are being met can be gleaned from lessons emanating from three (3) cases of BOT and BOT-like projects in the Philippines. Note that issues in the design and implementation (including regulation) of contracts weighed down on BOT’s perceived benefits.

LTO-IT Build-Operate-Own (BOO) Project. Projects using ICT have unique features relative to other infrastructure projects. For example, the Database Infrastructure and Infrastructure Technology Project of the Land Transportation Office involve the design, customization, construction, complete installation, testing, commissioning and operation of the entire IT system of the agency. The LTO’s build-operate-own project was signed on March 1998 at a time when there were no existing policy guidelines specifically for the ICT sector—the Investment Coordinating Council’s guidelines for the

review and approval of BOT projects in the ICT sector were crafted only in 2002.

This seeming lack of preparedness on the part of the government was obviously reflected in the design of the contract. In fact, Navarro (2005) noted that certain provisions or the lack of them in the LTO-IT contract had been disadvantageous to the government and the end-users. Such provisions include lack of liquidated damages provisions, lack of clear risk sharing arrangements between the government and the proponent, variability of the weights used in the parametric formula, and the lack of credibility of the threat of early termination as penalty in the event of default because of regulatory capture.

MWSS Concession Contracts. The operations of the Metropolitan Waterworks and Sewerage System (MWSS) were turned over to two private entities in August 1997 through concession contracts. The service area was divided into two zones –the east and west. Manila Water Company, Inc. won the bid for the east zone and Maynilad Water Services¹ got the west zone.

While there have been some improvements in water provision, certain problems encountered in the concession agreements were deemed attributable to lack of a comprehensive government policy statement covering all the critical issues of public and private operated water supplies, e.g. tariffs, tariff structure, service levels, serving the poor, transparency; lack of a regulatory body to monitor the implementation of the above policies since regulation was by contract, which made the regulator merely a contract administrator; lack of agreement on tariff and cost recovery issues; bidding based

¹ The Maynilad Water Services Concession was eventually taken over by the DMCI-Metro Pacific.

on the lowest tariff did not reflect the scarcity of the resource; and lack of punishment for non-performance of the concessionaires(*Costin 2005*).

Philippine Independent Power Producers (IPPs). IPPs entered the Philippine market in 1988 with EO 215 authorizing private generators to build plants and supply power to both the National Power Corporation (NPC or Napocor) and local distributors (e.g. MERALCO), effectively ending NPC's monopoly in power generation while maintaining the state monopoly on transmission.

In 1993, the Electric Power Crisis Act authorized the Executive to negotiate IPP contracts on a fast track basis until April 1994. Woodhouse (2005) noted that in terms of addressing the power shortage, this law was an immense success with several thousand megawatts of generating capacity installed in the country in the first 18 months. It was also observed that despite the general hesitation of investors regarding the status of rule of law and corruption, investors have readily responded to legal incentives (such as the EPCA and BOT Laws) and to the favorable terms of the contracts signed by Napocor during the early years of the IPP program.

The prevalence of BOT contracts in IPPs as opposed to other forms of public-private partnership arrangements results from the fact that the "transfer" element of the project makes the project eligible for a sovereign guarantee. It was indeed common for projects to shift all risk except construction and operation to the government off-taker. Woodhouse (2005) cited the common risk elements (market risk, fuel risk, foreign exchange risk, escalation clauses, sovereign guarantees) in BOT projects in the Philippines are heavily borne by the off-taker, if not passed on the consumers.

RISKS AND COSTS OF BOT PROJECTS MATTER

The Philippine experience on BOT projects evinces the risks and costs, especially those that matter most to the government and the public in general:

- **Creation of monopolies and the rise of moral hazard problems.** The length and complexity of BOTs make these contracts difficult to design. As explained by Navarro (2005) long-term contracts are necessarily incomplete, or at least, that it is difficult, if not entirely impossible because of bounded rationality arising from information asymmetries and limits of computational capabilities. This fact often negates the positive effects of the initial competition. For example, most BOTs have to be renegotiated once they are underway and these negotiations are essentially conducted in the absence of competition. Moreover, moral hazard problems in implementation of contracts may be expected such as construction delays and extensions, tariff adjustments and imposition of additional fees. Thus, even with BOT, the Philippines ended up with the highest tariffs on water and electricity in the region.
- **Failure to increase efficiencies.** BOT generally involves only one facility, which limits private sector's ability to help optimize system-wide resources or efficiencies. For example, the LTO-IT project encountered significant delay in 2002 in the implementation of the computerized licensing system because license plate manufacturing backlog stood at around 87,000 plates. The district offices could not give the plates to vehicle owners who had already paid for these because the Central Office could not cope up with the demand. As a consequence,

even with the presence of computerized systems in the district offices, these offices resorted to manual operation.

- **Rise of contingent liabilities of the government.** Because BOT generally involves dealing with many parties, huge amount of money and long period of time, policymakers have realized that private investors look for various credit enhancements such as guarantees and subsidies (e.g. off-take arrangements in the power sector) for risk capital to be deployed. Perception of various risks that could undermine the infrastructure projects' financial viability has been used to justify the provision of even comprehensive guarantees that provide cover not only from fundamental risks such as political and regulatory risk, foreign exchange risk, site availability risk and others, but also from market or commercial risk.

The determined effort by the government to bring in the private sector through solicited and unsolicited projects, joint venture and concession agreements, has given rise to contingent liabilities. These liabilities could pose as a serious threat to government's fiscal stability. As of 2006, about P569.93 billion in contingent liabilities have been registered in the books of the government.

To address the risks associated with BOT (i.e., moral hazard, failure to increase efficiencies and rise in contingent liabilities), one has to deal with the sources of these risks. Factors that have been cited as sources of risks in BOT projects are as follows:

- **Lack of capacity at project preparation stage.** Currently, many implementing agencies (IAs) still lack the capacity for project identification and preparation, thereby resulting in the inconsistent

application of Section 4 (Identification of Priority Projects) in the BOT process. It has opened up opportunities for the private sector to crowd out projects that ought to be in the priority list and jurisdiction of the national government. As a result, a large number of unsolicited proposals are being submitted to government agencies for endorsement to the NEDA. Many of these unsolicited proposals, however, are mere attempts to circumvent the law and to avoid competitive bidding through lobbies to delist some projects from the original priority list of the government (*Canlas et.al. 2006*).

- **Lack of capacity at project evaluation stage.** Most IAs experience difficulty in moving projects from identification to the approval stage. At the evaluation stage, their weak technical, financial and legal capacity to evaluate proposals, especially unsolicited ones, tends to delay project processing and the approval of the NEDA-ICC.
- **Incomplete BOT Law.** A primary statute like the BOT Law should contain the broad enabling framework for a given sector or activity. It should identify the primary roles, functions, powers, duties and rights of government agencies responsible for project preparation and implementation as well as oversight over the implementing agencies (*Llanto 2007*).

At present, the BOT Law is unclear in areas like obligations of each party in a project; financial terms (including guarantees, subsidies, or equity to be provided if the project is eligible); and contractual provisions on risk allocation, including assisting the project secure financing and ensuring its financial viability and sustainability. For example, neither RA 7718 or its IRR clearly

specify what is an indirect government guarantee for unsolicited BOT project. As a result, private proponents have been able to justify that the assumption of full or partial responsibility of the obligations of the private proponent to the lenders by any other government institutions other than the national government is acceptable.

- **Inefficient and ineffective regulatory bodies.** The private sector has often claimed that pricing policies have become “highly politicized” because of the lack of independence of regulatory agencies from political interference. This discourages private investors because of concerns in recovering their costs and generating profits, thus, creating uncertainty about future income streams and magnifying the risks perceived by private investors. The lack of accountability will also perpetuate arbitrariness in decision-making and potential abuse of regulatory power. Experience showed that the inability of the government to support BOT projects with cost-recovering tariffs creates an incentive for government guarantees (*Llanto 2004*).

IMPROVING BOT GOVERNANCE

Collaborative efforts of the stakeholders in infrastructure development—Congress on policy reforms and oversight, multilateral agencies and lending institutions on financing and oversight, constituents and NGOs on monitoring, and essentially the government agencies and private investors on efficient and effective project planning and implementation—will help secure the Filipinos’ growing demand for infrastructure services and enhance the status of the Philippines as an attractive infrastructure investment destination,

worthy of private sector participation. In particular, there is need to raise the level of acceptance for BOT projects through improved BOT governance, which poses a great challenge to the government. Various literature (*Canlas 2006; Llanto 2004, 2007; Eijbergen 2006, 2007; CPBD 2006; etc.*)² on BOT indicate clear cut measures to achieve this.

- **Ensure a stable macroeconomic environment.** To build the confidence of private investors in infrastructure, the government needs to maintain a stable macroeconomic environment and continue with economic and financial reforms that will deepen the financial and capital markets. Infrastructure projects are vulnerable to currency and maturity risks, sources of uneasiness to the private investor.
- **Develop capital markets as source of long-term financing.** The maturity structure of bank liabilities cannot simply match the long gestation of infrastructure projects, hence the need for the development of long-term peso debt finance. This will also take care of currency risks that arise because infrastructure projects generate revenues in pesos while the loan exposure is denominated in foreign currency.
- **Use ODA efficiently.** Official Development Assistance (ODA) is a vital source of financing for infrastructure projects now that the focus is on local infrastructure. Thus, there is a need to develop LGU's capacity to use ODA funds, tap private sector expertise and resources through instruments like bond flotation, and identify and manage local infra project.

² Please see references.

- **Develop and maintain efficient and effective regulatory institutions.** The past experiences with BOT implementation indicate the need for efficient and effective regulatory governance. Efficient regulation is critical in achieving agreed service and performance standards, protecting consumers from excessive tariffs, enforcing contracts, and controlling corruption. Regulatory agencies should be independent and accountable. Improved regulatory governance should also involve the rationalization of the infrastructure bureaucracy by separating policy, regulatory and implementation functions within each sector (water, telecom, roads, etc).

- **Improve on the BOT Law.** The BOT Law should be transformed into the principal framework for public-private partnership in the Philippines with the following features:
 - Importance of competitive bidding. It should highlight competitive-bidding (as opposed to unsolicited proposals) as the central tenet of government procurement policy because it enables the government to get value for its money.

 - Capacity building of IAs. The BOT should also provide legal recognition to the importance of building Public-Private Partnerships' (PPP) implementation capacity at all levels of government and raising overall project quality. The framework should emphasize the importance of building and rebuilding capacity for project design and implementation within an implementing agency.

ON AMENDING THE IMPLEMENTING RULES AND REGULATIONS OF THE BOT LAW

There have been moves to amend the BOT-IRR in order to expedite the review, approval, and implementation of BOT projects. While there is consensus to expedite the whole gamut of the BOT process, the proposal to decentralize the process to the line agencies and the local government units, which would in effect bypass the National Economic Development Authority-Investment Coordinating Committee (NEDA-ICC), would not be the appropriate policy response.

Under the current framework, the oversight agencies bear the responsibility of project review and approval while line agencies are responsible for identifying and preparing project proposals (*Llanto 2007*). The delay in the approval process stems in part from the poor project preparation/feasibility studies. As such Eijbergen (*2007*) argues that the "IRR should reflect an upfront rigorous project preparation and appraisal by sponsors, line agencies and oversight agencies". Such is not meant to slow down but (rather) to accelerate the process (*ibid.*).

Decentralizing the process by allowing line agencies and local government units not only to identify and select projects but also to review and approve projects submitted to the NEDA-ICC may result in the emergence of conflict of interest (*Llanto 2007*). He contends that the government should revert to the current process whereby the review and approval stages are delegated to oversight agencies while the project identification and preparation to line agencies. The solution lies in not doing away with the role of the NEDA-ICC but reviewing the pass system to accelerate the BOT process and ensuring the integrity and independence of the NEDA-ICC itself (*Aquino 2007*). Llanto (*ibid.*) further recommends that in order to shorten the approval process, the endorsement by the implementing agency of a BOT project should already constitute a "first pass" approval while an ICC approval will be the "second pass."

Further, diluting the BOT process through liberal decentralization could open the gate valve for loopholes, such as laxity in project review and approval and the possible proliferation of some problematic unsolicited proposals and contracts that may be disadvantageous to the public if the NEDA-ICC were simply reduced to some sort of "clearinghouse" for projects and if the provision pertaining to priority projects, which have reference to the MTPDP and MTPIP, among others, were deleted. (*Habito; Llanto; Aquino 2007*).

If ever the BOT-IRR or the law itself were amended, there should be provisions that will enhance transparency in BOT contracts. The Congress and the NEDA-ICC (as oversight institutions) should both be provided with copies of the contracts and not simply mere reports on the salient features of the contracts, and with penalties levied for non-compliance in a timely manner (*Aquino 2007*). The lack of transparency in these contracts has actually been a major factor in the delay in the implementation of some projects and, worse, in the failure of the country's investment promotion efforts, particularly in attracting private sector participation in infrastructure development.

- Sanctity of contracts. The government, particularly the judiciary should affirm the sanctity of contracts. The law must affirm government's binding commitment to honor and defend contractual rights and obligations. The law must also counter ruinous attack on contracts—especially after a relatively long period of time has elapsed since the contract was signed—by limiting options to annul contracts on procedural grounds.
 - Operational IRR. Policymakers should ensure the formulation of a substantive and operationally efficient IRR. The provisions in the BOT Law that can be relegated to the IRR are as follows: advertisement of project opportunities, financial criteria for identifying winning bids, liability of bidders, bidding procedures, circumstances under which direct negotiations may be entered into, and repayment scheme.
- **Improve on BOT Contracts.** A successful and sustainable BOT contract should reflect the convergence of the interest of the government and the public, the proponent and the lender. To attain a fair at the same time attractive contract terms, the following should be incorporated:
 - Effective performance securities. Prescribe rules or principles in setting liquidated damages for “under-performance” during operation. If it is the company's fault, it must bear the risk arising from it by paying liquidated damages and by allowing the erosion of its returns once the liquidated damages are exhausted.

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- Improved guidelines on attendant liabilities. Guidelines based on valuation methods of project asset and/or future earnings for determining compensation in the event of early termination may be formulated, rather than the government automatically assuming all of the terminated project's attendant liabilities.
 - Clear interpretation of the parametric formula. Disallow an interpretation of the parametric formula weights as variable weights. By fixing the weights in the parametric formula used in the BOT contracts, moral hazard problems such as increasing fees and including additional fees for corollary services are lessened.
 - Recovery-based tariff to help generate financial resources for system expansion and improvement.
 - Effective monitoring of project proponents. Lessen the incentive for companies to take on more risks (i.e., through higher debt) by resolutely monitoring the winning bidder's actual investment behavior. This could be done by requiring companies to submit to the BOT Center their audited financial statements (that which is also passed annually to the SEC).
- **Enact A Freedom of Access to Information Act.** To have sufficient information and disclosure in the project cycle ensures that stakeholders' expectations are realistic, and that contract and financial terms are fiscally feasible and attainable. It would make public the obligations that government has towards the service provider and towards consumers. It would also reduce perceptions of impropriety of corruption surrounding Public-Private Partnership transactions and contracts, contributing to the

maintenance of integrity and stability of contractual agreements in the long-run. Lastly, transparency facilitates the dissemination of good practices in PPP and allows all parties to design better and more incentive-compatible contracts in the future.

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