



SECTOR OVERVIEW

Build Operate Transfer (BOT)- Private Investments in Public Infrastructure

If we build it, will they come?

In the early 1990s, the Philippines was living in a state of turmoil, not so much because of political unrest, but due mainly to inefficient public infrastructure. Productivity and consequently economic growth slowed down, particularly in 1992-93. No one, not even Metro Manila, was exempt from daily 12-hour power outages. In fact, the main problem then wasn't even power interruptions but the availability of power services throughout the country. Power services were simply inadequate. Only 60% of the population had access to electricity, and electricity rates were very high compared to other countries. The telecommunication sector was in the same situation. Density rate was very low, and a typical consumer needed to wait an average of 8.9 years to get a telephone installed. The transport sector, meanwhile, had to contend with bad roads, which in turn contributed to very high transportation costs. The water sector couldn't provide an adequate supply of water; some areas went without water for almost 22 hours a day.

Today, while we're no longer grappling with problems of crisis proportions, the state of infrastructure still leaves much to be desired. Overall, the country still has the poorest infrastructure compared to its Asian neighbors (see Table 1). The same table shows that the Philippines has the lowest road density and water transport infrastructure compared to Indonesia, Malaysia, Singapore and Thailand. Worse, the latest World Bank Competitiveness Ranking by the World Economic Forum placed the Philippines at number 54 out of

75 countries in the world in terms of overall competitiveness. We're 8th from the bottom in overall quality of infrastructure, only slightly higher than Vietnam and behind Thailand, Indonesia, and China.

Why is our infrastructure inferior to our neighbors? Simple: The government has not been sufficiently spending on infrastructure unlike our Association of Southeast Asian Nations (ASEAN) counterparts who spend roughly 5 to 6% of gross domestic product (GDP) annually on it. A study by Rosario Manasan [*Fiscal Adjustment in the Context of Growth and Equity, 1997*] established that capital investments were the first casualty of fiscal adjustments during the period. This is not unique to the Philippines, since in developing countries, infrastructure is always one of the first candidates for budget cuts.

The World Bank had once suggested that for every 1% rise in per capita income, a country needs to beef up infrastructure stock by 1% of GDP, another ideal that the Philippines could not attain. Using this peg, an estimated \$38 billion (B) to \$45B will be needed to meet the infrastructure requirements for 1995-2004. In fact, from 1986 to 1992, the official estimate of the National Economic and Development Authority (NEDA) placed the gap between programmed and actual expenditures for infrastructure at nearly P81B.

Table 1. Performance in infrastructure: rank of select countries

	Philippines	Indonesia	Malaysia	Singapore	Thailand
Overall infrastructure investment and development	47	40	18	1	25
Density of road network	45	37	38	2	42
Density of railroads	32	41	37	47	35
Number of passengers carried by air transport companies	39	51	22	20	19
Water transport infrastructure	46	41	22	3	38
Total indigenous energy production	25	5	6	49	25
Investment in telecommunications	9	29	7	14	42
Telephone lines per 1,000 inhabitants	47	48	38	21	16
Cellular subscribers per 1,000 inhabitants	43	48	33	19	45
International telephone calls	31	46	42	16	39

Source: World Competitiveness Report 2001: Key Economic Indicators of Developing Countries, ADB 2001

The BOT and other policy reform initiatives

Well aware of the gravity of the infrastructure problem and its effect on the country's competitiveness, the government, toward the last leg of the Aquino Administration, enacted the Build Operate Transfer (BOT) Law, which paved the way for the private sector to engage in infrastructure projects to help address the gap. The Ramos Administration also capitalized on this initiative to engage the private sector in infrastructure projects that the government could not unilaterally address.

The passage of the BOT Law or RA 7718, alongside several "market-oriented" policy reforms during the Ramos era produced the following results in the infrastructure sector:

1. The power sector saw several fast tract projects aimed at addressing the power crisis that significantly derailed the economy.
2. In the water sector, the privatization of the Metropolitan Waterworks and Sewerage System (MWSS) guaranteed a much-needed improvement in the provision of services.
3. The telecommunications sector witnessed the dismantling of the de-facto monopolist and this brought about a dramatic rise in telephone density.
4. In aviation and shipping, competition compelled players to improve their operations and offered consumers a wider range of choices in rates, service quality, etc. across different modes of travel.

The biggest private infrastructure projects were in telecommunications, roads, and transport in 1994 and in water resources development and flood control in 1997 [Bottleneck to Growth: Inadequate Infrastructure, Llanto, 2004].

There were also substantial private-sector investments in response to the power crisis in the early 1990s. However, the Llanto study observed that post-Asian crisis, private-sector participation in infrastructure went down, partly because of the crisis, and partly because of the lack of confidence in the country. Another study (Navarro, 2005) observed the same "lack of investor appetite" and disclosed that during 1999-2003, new private sector-funded investments in infrastructure has been dwindling every year (please see chart on BOT Center time series data). The study cited three factors that caused the decline, namely: (a) more developed middle-income countries have reached the end of the "private participation cycle", which explains why the trend prevails in other parts of the world; b) the financial crisis during the 1990s brought forth an environment of uncertainty; and c) several controversial transactions brought to the limelight the complex political economy of private involvement in public infrastructure.



Issues and problem areas

Further investigation reveals that the third reason Navarro cited was right on the money. In fact, the Navarro study recognized that many of these transactions were flawed in the area of contract design and implementation as manifested by numerous contractual disputes between the government and the private proponents in a number of BOT projects.



The literature enumerates several issues surrounding the design and actual implementation of the BOT law. These issues are briefly discussed below coupled with some issues that derail a liberalized environment in infrastructure in general.

Flawed contract design where public sector is made to assume completion risk. The long-term nature of most if not all BOT contracts has brought to fore what economists call “moral hazard” problems especially since long-term contracts, by their very nature, are necessarily incomplete (Navarro 2005). Some BOT/ BOO contracts, for instance the LTO-IT contract of 1998, revealed that there is no provision for liquidated damages when the contractor doesn’t finish the project on time. Completion delays translate to opportunity costs and the lack of a provision on liquidated damages won’t spur the contractor to complete the project on time. Other loopholes in contract design include a not so well-designed price adjustment mechanism in the case of the LTO project which again undermines what is supposed to have been a mutually beneficial transaction for both the private and public entities. (For a more detailed technical analysis of contracts design of some BOT/BOO projects, the reader can refer to Navarro’s study, *BOT Arrangements: The Experience and Policy Challenges*, 2005).

In a related meeting with Economic Policy Reform Advocacy (EPRA) Policy Review Group, Atty. Francis Lim, president of the Philippine Stock Exchange, mentioned the need to revise the BOT law to avoid another PIATCO from happening. The loopholes of the law, some vague items in the implementing rules, the violations of the law in the past, should all be revisited and addressed. In the Small Group Discussion (SGD) on BOT held by EPRA on November 2004, the participants mentioned that there were several cases in the past where the sanctity of contracts was not observed, and this lack of respect, which can be the root cause of several other related problems, should be addressed.

Regulatory institutions lack technical capabilities. In the Philippines, regulatory institutions, which automatically should have also expanded and strengthened their capabilities to keep up with the demands of the newly liberalized environment, do not do so. For

instance, in the case of telecommunications regulation, the National Telecommunication Corporation (NTC) was ill-equipped to regulate PLDT effectively (*Gavino: A Critical Study of Regulation of the Telephone Utility, 1992*).

In the same discussion group that EPRA conducted on November 2004, Antonino Aquino, President of Manila Water raised the same issue. Aquino called for specific guidelines as to the authority and responsibility of each government regulatory agency especially if a project cuts across various government offices. He cited their water project in Cebu, which was approved and endorsed by the pertinent national offices but was blocked by the local water utility agency in the area.

Related to this, the participants of the said discussion group agreed that there is a need to professionalize the regulatory bureaucracy. This means “re-educating” government officers and personnel holding key positions in regulatory offices (referred to by the participants as “middle management”) on their duties, values, and the significant role played by public-private partnerships as engines for growth. It is unfortunate that at times, some government employees do not even know the latest rulings and insist on applying old rulings in making decisions.

Is the economy conducive overall for long-term infrastructure investments? Time and again this question arises. It is a question that cuts across investment arenas, but more so in infrastructure because fixed investments in this area are huge and take a long time to recover. The country’s political and judicial institutions should ideally complement and not clash with the regulatory framework that had been initially created.

Financing Structure of BOT that results in a higher level of contingent liabilities for the government. Llanto and Soriano concluded in their study “Government Guarantees in Infrastructure Projects” (1997) that one attendant issue for the government that BOT schemes and its variants create is the growth in contingent liabilities that pose potential fiscal problems. The government, in its effort to encourage private sector participation, assumes a number of risks that the private party cannot, or is not willing to bear. This translates to a



rise in the government's guarantee exposure, or a contingent liability that merits proper management by the government. Sadly, the government lacks a comprehensive and detailed accounting and monitoring system to address this end. Moreover, most BOT projects are highly leveraged with a substantial foreign component. The foreign exposure again creates an additional risk that the government must be able to properly manage.

Prevalence of graft and corruption in infrastructure projects. An all-encompassing concern in many sectors, the issue of graft and corruption is more prevalent in infrastructure given the magnitude and long-gestation of the projects. There is much improvement needed in the systems and procedures surrounding infrastructure projects starting from budgeting all the way to post-mortem monitoring. Such procedural innovations are necessary to curb corruptive practices and help bring back investor confidence in the sector.

Future areas of study

The initial discussion on the BOT and surrounding issues/ bottlenecks during the SGD discussion resulted in an initial list of potential studies and projects that EPRA, in cooperation with the government and the private sector, can undertake. These potential joint undertakings with EPRA in the lead, although subject to more refinement and detailed discussions in the next SGDs to be organized in the future, are summarized below:

Capacity-building program. In response to the general sentiment that government employees seem to be technically deficient in many areas of BOT administration, a capacity building program must be designed and undertaken. In fact, a values-formation component should also be incorporated in this program. The specific audience should be middle managers from the government bureaus.

Studies on losses and costs of "projects not undertaken". Criticisms hurled at public infrastructure projects focus on their cost to the public (e.g., additional toll fees) or the obligations of government (like government guarantees), and cost to users/affected parties. The SGD participants agreed that it will also be beneficial to present the costs or consequences if such infrastructure projects are not at all undertaken, and there seems to be a dearth of analysis from this perspective. A particular case study



on the North Diversion Road, where the tolls have recently been increased and have elicited complaints from the public was suggested to emphasize the fact that for this particular case, "if the public doesn't pay, it is really the poor who suffer."

References:

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