

Case Study Infrastructure Privatization In The Philippines

The Mandaluyong Public Market

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INFRASTRUCTURE PRIVATIZATION IN THE PHILIPPINES: THE MANDALUYONG PUBLIC MARKET CASE STUDY

by

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INTRODUCTION

This incorporates Mandaluyong's "BOT". On behalf of the Philippine Government, I would like to thank USAID's Regional Housing and Urban Development Office based in Jakarta for nominating me to address this regional conference on "Infrastructure Financing: Implementing Financing Options." This morning, I will present a case study of a market project in support of our "Infrastructure Privatization in the Philippines" using the Build-Operate-Transfer (BOT) approach. Modesty aside, the Philippines' BOT implementation experience in the power sector has been hailed by the international financial community as the most successful program in the world because of the speed with which we have been able to lay the groundwork for the policy and project environment to make BOT work. But our success story involves more than the power sector. The Philippines has other success stories. One such story is in local public markets.

BACKGROUND: REASONS FOR SELECTING THE FINANCING OPTION

In 1991, the main public market of the City of Mandaluyong in Metro Manila was destroyed by fire. Very little of the market remained after the fire, since most of the structure was made of wood. The market was located on 7,500 square meters of land along Kalentong, a main public transit route and one of the busiest roads in Mandaluyong.

Mandaluyong therefore needed to rebuild the public market, but knew that they would have a difficult time financing it, for two reasons. First, local interest rates at the time were quite high, approximately averaging 18% per annum. Mandaluyong estimated a new public market would require some P50 million in loans, which meant considerable debt service. Second, social concerns relating to public markets meant that Mandaluyong could not rely too much on raising charges to stall owners to cover debt service, since the stall owners would have to pass on the increased costs to their low-income customers.

Mandaluyong therefore decided to build the public market through a Build-Operate-Transfer arrangement, as the law (RA 6957) had just been passed at the time. The winning proposal, after a few months of bidding and negotiations, was for a P300 million (now P450 million) 7-storey commercial center called The Marketplace, broken down as follows:

The Marketplace

6th Floor ← Movie Houses
5th Floor ← Bowling Lanes
4th Floor
3rd Floor ← 2-storey Parking Lot
2nd Floor
1st Floor ← Commercial Shops and Department Stores
Ground Floor ← Public Market and Street-front Stores

Description of Contractual Arrangement: The winning bid came from Macro Founders and Developers, Inc. (MFD), a business consortium organized specifically for this project. The actual proposal is a combination of two BOT concepts: a Build-Transfer (BT) arrangement with a Develop-Operate-Transfer (DOT) component. The DOT is a contractual arrangement wherein some of the positive externalities of an infrastructure project are granted to the project company, say, by giving them the right to develop adjacent property (which increases in value due to the project). In this case, the infrastructure project is the public market.

For the BT arrangement, MFD builds the public market structure, and then transfers it over to Mandaluyong. Mandaluyong then constructs the stalls inside the market. Fifty percent of the stall construction is to be financed by Mandaluyong, the rest by the stall owners. (Mandaluyong made this decision jointly with the association of the stall owners.) In addition, Mandaluyong plans to take care of stall fee collection, while it contracts out to MFD the maintenance and security of the public market. (Under Philippine law, whoever collects the revenues is officially considered the operator.)

For the DOT component, MFD is given the right to develop the space above the public market, in exchange for building the market structure itself. MFD plans to develop the space above the public market by constructing the commercial complex mentioned above. It then operates the commercial complex for the next 40 years, after which the complex is to be transferred to Mandaluyong. Mandaluyong in turn provides use of the land for free (there is no transfer of land ownership). Mandaluyong does not share in any of the revenues generated from the commercial complex.

A complete listing of the major players is given below:

LGU:	Mandaluyong
Private Company:	Macro Founders and Developers, Inc.
Architect:	C. C. Castro International
Construction Firm:	Ironcon Builders, Inc.

Benefits to the LGU: Mandaluyong expected to receive substantial benefits from the project, even if the municipality is not sharing in any of the commercial complex's revenues. For one, it achieves its overriding goal: to provide a modern public market at minimum cost. (Remember, it would have had to build the public market anyway if the BOT did not push through.) The public market is state-of-the-art, with limited wooden

structures and efficient loading and unloading facilities. The loading facilities are particularly noteworthy: they are situated in the back of the market, thus decongesting Malentong (which the market faces). Two, it is expected to generate incremental revenues through an increase in tax collections. Mandaluyong conservatively estimates an additional annual P10-20 million in business and entertainment taxes, and in licensing and other fees. Third, the land value of the public market is foreseen to appreciate substantially. When the contract was signed two years ago, the land was valued at P10,000 per square meter. It is currently valued at P20,000 per square meter. Finally, there is the less measurable benefit of increased economic activity in the area.

Some problems: Mandaluyong had considerable difficulties attracting investors to the project. Mayor Ben Abalos had to literally chase after several businessmen – most of whom eventually organized themselves as MFD – in order to convince them to bid on the project. This alone took about six months. In addition, the pre-bid qualifications saw ten prospective bidders reduced to one (MFD). A large reason for this was the concurrent start of the Gulf War, which led to uncertainties regarding the price of oil in the Philippines. Many of the interested companies were only willing to take minimal risks, which made their bids less attractive.

General Advantages of the BOT Model: Before we continue, it might be useful to review some of the advantages of BOT-type projects, as presented in previous modules:

- It allows governments to develop needed infrastructure through flexible financing structures without incurring a substantial financial burden.
- Private firms, because they are more focused on efficiency than the public sector, are generally more cost-effective than public sector entities. With this focus on efficiency, the private sector has the objectives of: lowering operating costs, increasing capital investments and utilizing the most up-to-date and efficient technologies. The strength of the BOT model is that it utilizes these private sector objectives to revitalize infrastructure, a sector that is largely managed by the public sector.
- The BOT model has proven effective in numerous forms of capital-intensive infrastructure projects, such as power generation, road transportation, port and airport facilities, correctional facilities, waste water treatment plants, and solid-waste-to-energy plants, just to mention a few.

Project Financing: A number of commercial banks had provided shorter-term loans for the project. A long-term loan was provided by the Asian Financing and Investment Corporation (AFIC), a subsidiary of the Asian Development Bank. Among others, AFIC provides long-term loans to private companies. Macro Founders was able to negotiate with AFIC for a 10-year loan at concessional rates. The project's capital structure is as follows:

MFD Equity = 25%
Advances from Shops, Goodwill = 25%
Debt = 50%

Most of the project risks addressed by the security package appear to be absorbed by MFD. For example, cost overruns and inflation risk are completely shouldered by MFD. Debt service interruption risk is also completely shouldered by MFD, as there are no guarantees of any sort from Mandaluyong on this. Finally, completion risk – the risk that the public market may not be completed on time and according to the specifications promised – are covered by a performance bond and technical specifications outlined in the construction contract. (The performance bond was required from MFD by Mandaluyong).

The complete absorption of cost overruns by MFD might be one reason why Mandaluyong was willing to award the project based solely on the submission of a concept and preliminary cost estimate. In the case of the Marketplace, Mandaluyong appears not to have expressed great concern over the ballooning of project cost from P300 to P450 million (an increase of 50 percent), simply because this is shouldered by MFD. (This has been completely provided by the equity holders of MFD.)

IMPLEMENTATION

A number of institutional and regulatory issues were addressed to implement the project using the BOT scheme, as follows:

A. IN ORDER TO ENSURE THAT INVESTORS COME IN, GOVERNMENT HAD TO CHAMPION THE PROJECT

Mayor Abalos of the City of Mandaluyong was instrumental in ensuring investor interest in the project. Due to the uncertainties posed by the Gulf War at the time, investor interest in the public market was very limited. MFD participated only after being convinced by Mayor Abalos as to the importance and value of the project. Without such intervention from the Mayor, the project would have probably never been undertaken.

B. FLEXIBILITY IN THE PACKAGING OF THE PROJECT WAS INSTITUTED UNTIL IT BECAME ATTRACTIVE TO ALL PARTIES INVOLVED

The City of Mandaluyong is convinced that the public market would have never been built if the project was opened for bidding solely as a public market. Allowing MFD to decide on the best way to do the project (keeping in mind the constraint that they must meet certain minimum specifications for the public market) was critical to the project's implementation. Bidding out the project as a straightforward public market would have never succeeded under a BOT arrangement, due to the limited revenue stream from the market itself. As mentioned above, the final concept was for a BT/DOT combination, with the expected revenues from the commercial complex compensating for the cost of constructing the public market.

Two additional "sub-lessons" should be noted. First, BOTs are indeed possible at the LGU level, although considerable project repackaging may be needed. Second, Mandaluyong was able to get away with minimal project risk exposure, because of the high commercial potential of the Kalentong area (it is one of the busiest roads in the municipality, and in Metro Manila). Other LGUs may not be as fortunate, and so may

have to be willing to take more risks than Mandaluyong. Such risks should, whenever possible, be spelled out as early as possible (for example, in the tender documents).

C. IN EVALUATING THE PROJECT, INDIRECT COSTS AND BENEFITS WERE INCLUDED

One reason Mandaluyong may have been willing to forego any revenue from the operation of the commercial complex was that they recognized the potential increase in municipal taxes they would obtain from the project. This naturally facilitated negotiations.

NEXT STEPS: LESSONS LEARNED

The lessons learned from implementing the Mandaluyong Project Market can be broken down into three areas according to both government and private sector perspectives:

- Negotiating issues
- Packaging Issues
- Political issues

From the Government perspective:

A. Negotiating Issues

1. **ACCEPT THE LOSS OF CONTROL.** A significant factor in the early stages of a BOT project is that the government is usually troubled by sharing power with the BOT sponsor. The government must recognize that one cost of private investment through BOT schemes is relinquishing a certain amount of control.

2. **DEVELOP ONE COMPETENT TEAM TO HANDLE ALL NEGOTIATIONS.** The appointment of responsibilities to a task force is key to the timely execution of a BOT project. Lack of a single point authority to negotiate and bind the government often results in a paralysis of the negotiations. Governments are usually at a negotiating disadvantage, as they lack the experience with the private sector organizational structure and financing models. In addition, they have limited exposure to the experts in the various fields required to pull off a BOT program, such as financial experts, lawyers, investment bankers, and environmental specialists. Therefore, the government must be able to recruit expert advisors for this stage.

B. Packaging Issues

One of the main reasons for unsuccessful projects is the relative shortage of "packaging skills," such that all parties involved are in agreement at the start regarding the sharing of risks and revenues. Without the basic components of the project acceptable to all parties, no BOT-type project will be able to run smoothly.

1. **STRUCTURE A COMPETITIVE PROJECT.** The project should be structured

competitively to secure the required funding. Profit has to be easily identifiable to the project participants and, moreover, must be partially linked to performance.

2. ESTABLISH A COMPETITIVE SELECTION PROCESS. The selection of a project to be awarded must be accomplished on a competitive basis and evaluated by an independent and incorruptible expert panel, as they are under close political scrutiny. To select projects with even the slightest hint of favoritism would risk legal challenges by the "losers" and inevitably delay negotiations, as well as possibly hinder attracting financing.

In general, any agreement reached between the parties must be a sound and unique business arrangement, one that will withstand the test of close public scrutiny. At the outset, it must be assumed that every aspect of the agreement will be carefully scrutinized by the public as well as by political opponents.

3. BE READY TO PROVIDE CREDIT ENHANCEMENTS. There is a common misconception concerning BOT projects that the private sector should bear all risks (or alternatively, that the government should not provide any credit enhancements). Such an approach greatly threatens the feasibility of any BOT project. The efficient sharing of risks by the government and the private sector (done through credit enhancements) is critical for a BOT project to be successful.

4. THE LOCAL GOVERNMENT AND/OR THE PROJECT PROPONENTS SHOULD NOT BE COMPETITORS. A major concern of the private company implementing the BOT project is the amount of revenue it generates from the project. Revenue would be affected if the implementing agency decides to build projects which compete directly with the BOT project.

C. Political Issues

1. DEVELOP AN ENVIRONMENT OF LOW POLITICAL RISK. There needs to be a perception of low political risk in order to attract sound international institutional investors. Those projects which have been the most successful have been carried out in countries with relative political stability. This provides the investors with security to know that the project should be able to be completed without changes in the government's makeup, laws, and regulations.

2. ESTABLISH A SUPPORTIVE POLICY FRAMEWORK. A legislative, legal and regulatory policy framework on issues ranging from foreign investment to the regulation of public utilities to actual BOT programs should be in place before individual projects are implemented on an ad hoc basis. If this is not the case, there is a high probability that the total effort will lead to poor results. The establishment of such legislation is a prerequisite to the performance of a BOT program. The earlier in the process that the legislation is established, the higher the potential to attract investors to the project.

The Philippines is fortunate because it already has much of this framework in place. In addition, such a policy framework will succeed if two criteria are met.

First, projects targeted for implementation as BOTs must serve a pressing public need. Second, the government must recognize that its resources are limited, and thus that it will have to access private capital to finance these projects.

3. **FORM A CONSENSUS BETWEEN GOVERNMENT ENTITIES.** The consensus process within government is difficult and time-consuming. Since the issues span technical, fiscal, and economic questions, this framework must be based on a consensus among the relevant Cabinet members, and the concerns of vested interests, labor unions, consumers, other government officials and politicians.

From the private sector perspective:

A. Negotiating Issues

1. **UNDERSTAND PUBLIC SECTOR NEGOTIATING PRACTICES.** The private sector must acknowledge that the government does not operate as a private entity. It is difficult for the government to appoint one person to negotiate freely and agree to virtually any reasonable conditions.

B. Packaging Issues

1. **UNDERSTAND THAT THE BOT- PROJECT IS A BUSINESS.** The project consortia need to approach BOT projects on the basis that they are setting up a business, not simply offering technical, construction and consulting services, with some project financing thrown in for good measure.

2. **INCLUDE EXIT PROVISIONS FOR INVESTORS.** Exit provisions allow providers of equity an option for leaving the project. Among others, they are useful for incompatible or non-performing partners. Likewise, entry provisions should be provided for new participants.

C. Political Issues

1. **UNDERSTAND THE GOVERNMENT'S OBJECTIVES AND CONSTRAINTS.** The private sector must understand the host government's objectives and constraints. The government is probably structuring the project as a BOT because it does not have enough funds, but can provide adequate credit enhancements.

From both perspectives

A. Negotiating Issues

1. **RECOGNIZE THE NEED FOR FLEXIBILITY.** When negotiating a BOT scheme, flexibility is required by both the public and private sector participants. The Mandaluyong Marketplace got off the ground only because Mandaluyong had no reservations about allowing the private sector to repackaging the public market to make it financially attractive.

2. RECOGNIZE THAT THE PROJECT MUST BE FINANCEABLE ON A LIMITED RECOURSE BASIS. Put differently, limited-recourse financiers should be convinced that the project will be completed relatively within budget and on time. This means, among others, that the project is able to collect substantial user fees and often has the potential for non-user revenues.

B. Packaging Issues

1. LIMIT THE LENGTH OF NEGOTIATIONS. Being able to coordinate the required resources in order to head off this problem is thus essential. Note, however, that regardless of the dollar value of the projects, each security package requires roughly the same amount of time and effort to negotiate.

2. THE PARTIES INVOLVED SHOULD HAVE SUBSTANTIAL BOT EXPERIENCE, WHEN POSSIBLE. All parties must be able to provide unquestionable financial and technical expertise to design, build and operate the project. BOT projects are usually managed by private sector managers with little or no relevant experience. This is often a problem, since there is a very limited knowledge base in the private sector on practical approaches to the creation of these complex public/private agreements. In addition, projects are frequently staffed by "seconded" staff, who are temporarily assigned to the project.

Likewise, the public sector is generally slow in developing a project and seeing it through the implementation stage, primarily because of the number of agencies and vested interests involved. In addition, the public sector has limited experience in the preparation and execution of large infrastructure projects under the time and cost constraints typically observed by the private sector.

3. MAINTAIN CONSTANT AND CLEAR COMMUNICATIONS BETWEEN ALL PARTIES. The technical, economic and commercial elements of a BOT project are closely integrated and coordinated. Clear communication between the project participants at all stages of the project is necessary when working out financing arrangements, especially when relying on syndicated financing.

Project creditors waver in intensity of interest in the project throughout the project's development and implementation stages, creating ordeals while the project company struggles to develop the financial structure of the project. This is a result of the long life of a BOT project and can therefore be mitigated through good communication links between the private and public sector entities involved with the concerned creditors.