

UNRAVELING OF BOT SCHEME: MALAYSIA'S INDAH WATER KONSORTIUM

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ABSTRACT: Malaysia's privatization program, which began in 1983, has been praised by some, while others have been less impressed. This paper describes the return of a privatized infrastructure after seven years to government hands after it had been relinquished to the private sector. Right from the beginning the privatized national sewerage scheme was plagued with controversy—from selection of a concession company, charge structure, and performance to ownership changes. The award of the infrastructure facility was made in the absence of competition. The charge structure accepted by the government was never revealed completely to the public. Inefficiencies and management blunders aggravated public sentiment. The change of ownership three times in as many years gave the impression of industrialists out to make quick money at the expense of public welfare. Despite copious government assistance, Indah Water Konsortium, the concession holder, became infeasible as an independent operating company. This case study provides salutary lessons of what to avoid when structuring a privatization arrangement.

INTRODUCTION

Malaysia was regarded by many as a frontrunner among the developing countries in emulating certain western nations, which in the early 1980s adopted privatization as an economic policy instrument (Molz 1990; Lieberman 1993; Jomo 1995). Malaysia's national privatization program, which began in 1983, was praised by different parties at various times; initially for being the most extensive of its kind (Euromoney 1985), and later for being among the few to produce demonstrable results (Kohli 1995). The economic welfare of Malaysia is said to have improved as a result of privatization (World Bank 1992). The World Bank (World Bank 1995) regards Malaysia's efforts as a model for other developing countries to follow. Yet others have expressed their reservations over Malaysia's reputation (Adam et al. 1992). Critics argue that services and projects that have been privatized in Malaysia have been near-profitable ventures (Goh and Jomo 1995). While the government has made often repeated claims about the tremendous savings in public expenditure, what is less divulged is the loss of public revenue and higher user costs following divestiture. Nine of the initial 11 enterprises that were privatized were monopolies in their respective markets without a regulatory framework for controlling potential monopoly abuse (Leeds 1989). What is also not made public is the generous assistance (e.g., soft loans, exchange rate guarantees, minimum revenue guarantees, etc.) extended to the concession companies, thereby insulating them from much of the risks (Naidu 1995).

This paper describes the unraveling of one of Malaysia's major privatization projects. Seven years after the national sewerage systems were handed over to a private concern, Indah Water Konsortium (IWK), the infrastructure returned to the government following incessant controversies over the selection of the concession company, charge structure, performance, and successive change of ownership. This case study provides salutary lessons of what to avoid in any privatization endeavor.

OPAQUE HANDOVER

In December 1993, a RM6.2 billion (U.S. \$1.6 billion) concession agreement for the development of a national sewerage

system was signed between the Malaysian government and IWK with the understanding that the latter would upgrade and refurbish the existing sewerage systems as well as construct new multipoint sewerage systems during the 28-year concession period. Due to limited public funding and years of neglect, the facilities nationwide were in dire need of substantial investment. The government's own estimate in the late 1980s was that RM10 billion was required to build networks in major cities (Clifford 1993). The Sewerage Act of 1993 was passed in the Malaysian Parliament to permit the legitimate transfer of sewerage treatment responsibilities from the 144 local authorities to the Federal government, and then to the concession company.

The transfer to the private entity took place unknown to the public. A corporate figure, allegedly close to the Prime Minister and his then Deputy Prime Minister, was said to be instrumental in the award of the National Sewerage Project to IWK (Tsuruoka 1993; Jomo 1995). The lack of transparency in the award of privatization projects such as the national sewerage systems stoked allegations of "cronyism" in Malaysia's privatization program (Adam et al. 1992). The government justified selectivity on the grounds that only strong promoters should take over government services or enterprises to ensure success (Crawford 1988). The Prime Minister in one of his speeches said (Mahathir 1988):

The government cannot afford to have too many failures in the privatized companies. We do not want to be forced to take them back. . . . While the government will exercise every care to ensure that government enterprises will not fall into the wrong hands, we hope that responsible institutions in the private sector such as merchant banks, business consultants and intending entrepreneurs will study very carefully the ability of the companies taking over government services or enterprises.

In the end however, the selection method adopted failed to avert what it dreaded most—the reabsorption of one of its divested infrastructure facilities.

It was not just the selection process that became disputatious. The financing of the project also became controversial. The financing structure of IWK is shown in Fig. 1. A RM475 million soft loan was provided by the government at 6% annual interest, to be accrued and compounded for a period of between 1 and 15 years, to cover start-up costs (Kuan 1996). Payment was supposed to be made from the 16th year until the 23rd year. Ordinarily the injection of risk capital by the sponsoring consortium is a reflection of its faith in the economic viability of the project, and under normal circumstances

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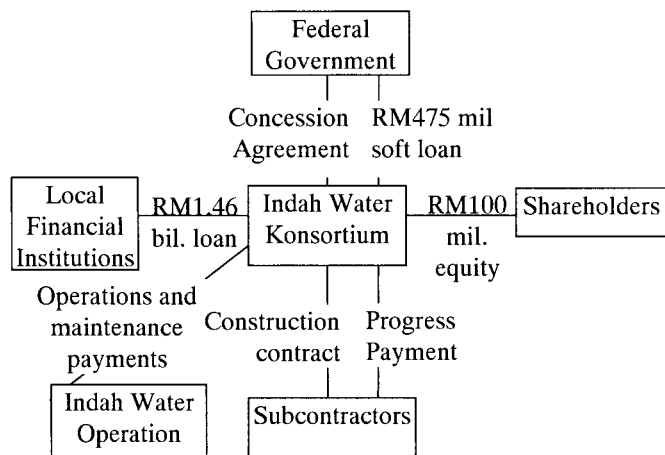


FIG. 1. Financial Structure of Privatized Sewerage Systems Scheme [Source: (Kuan 1996) page 108.]

is scrutinized by the government and lenders alike (Price 1995). Typically, governments expect an equity contribution from the concessionaire of at least 25–30% of the total financing needed (WIDER 1992). In Malaysia's privatized national sewerage project, the debt-equity ratio was nearly 20:1, prompting accusation that the equity holders of the concession company were eyeing potentially handsome payoffs while risking little (Clifford 1993).

CHARGES TO CONSUMER

Ever since the opposition political party exposed certain irregularities in the way the government dealt with the privatization of an earlier project, public debate in connection with privatization has since been largely stifled with the amendment of the Official Secrets Act of 1986 (Lim 1987; Jomo 1995). The secrecy surrounding the privatization of the national sewerage systems left the consumers of this essential service unaware of the charges they were about to be saddled with. Prior to privatization, such charges were nonexistent or minimal.

The agreement IWK entered into with the government permitted it to collect charges from existing facilities acquired at very low cost (Ho 1995). The government also assured IWK that it would intervene in the event of any difficulty faced from nonpaying consumers. Furthermore, the agreement allowed for tariff adjustments to be considered 5 years after the project became operational, thereafter an annual increase of 5% with provision for tariff revision every 3 years. The government guaranteed a minimum internal rate of return (IRR) of between 14 and 18% (Kuan 1996). Should the IRR fall outside of this range, an upward or downward revision of the tariffs would be made. Under a proper privatization scheme, the promoter and equity investors are rewarded with dividends from profits if the project is successful, but will receive no return at all if the project results in losses (Tiong 1995). The servicing of debt has priority over dividend payments. In the event of the company becoming insolvent, equity investors rank last in order of repayment and may lose their equity investment. Minimum revenue guarantee was just one of several "safety nets" extended to IWK. Observers labeled the privatization variant as practiced in Malaysia whereby extensive guarantees and assistance are extended to concession companies as "rent-seeking" (Glade 1989) or "subsidized" (Nellis and Kikeri 1989). To be fair, a purist approach rejecting any government involvement in risk sharing is unlikely to be sustainable, particularly in developing countries (WIDER 1992). All things considered though, the Malaysian government has definitely been over-generous in underwriting privatization projects (Abdul-Aziz 1998).

Upon gaining control, IWK set a domestic tariff of between RM2.00 and RM10.00, and commercial rates of between RM0.90 and RM1.20 per cubic meter for the first 5 years of operation (Ho 1995). Industrial premises were set as a minimum tariff of RM9.00 per month. Public resentment immediately arose over charges from a private company that had yet to make any real investment. Usually consumers are willing to bear inevitable burdens from privatization schemes if they can expect tangible benefits (Schwartz 1995). That important link, however, was missing in IWK's case. Under pressure, IWK offered discounts to commercial and industrial users amounting to RM300 million over a period of 3 years. Public outrage was so intense as manifested by widespread nonpayment that the government was forced to step in by way of relieving consumers from making any payments for sewerage charges before January 1, 1997, much to the dismay of IWK, which claimed to have lost 33 months of revenue amounting to RM180 million. The government also took the decision that residential consumers would be charged between RM2.00 and RM8.00, while commercial customers between RM10.00 and RM15.00 from that date henceforth. When this move failed to appease the public, the government reviewed IWK's charges for the second time. As of July 1, 1998, the commercial sector charges were reduced by 30%. To recompense IWK, a soft loan of RM500 million was provided with a possibility of extending the concession period by a further 10 years. The two charge revisions typify the Malaysian government's expedient recourse of defusing public discontentment over privatized projects by injecting public funds in exchange for a lower cost to users.

To aggravate matters, as of December 1, 1997, developers were required to pay 1.65% of the property value to the Sewerage Capital Contribution (SCC) fund, supposedly for regional sewerage systems to be built by IWK. Compliance was a condition for the approval of all development projects. Developers were expected to pass the extra costs on to house purchasers for the facilities to be built some time in the future. Alternatively, the developers may choose to construct the permanent plants themselves for exemption from the contribution; temporary facilities are subjected to half the contribution. Two years later, the controversial ruling was rescinded.

PERFORMANCE

Internal inefficiencies and bad management compounded IWK's malaise, which the press was eager to publicize along with its other failings. Public relations turned nightmarish despite vast expenses on "information and education" campaigns—the one in 1998 had a RM6 million budget. Blunders include charging neighboring homes dissimilar rates, billing low-cost housing owners four times the correct amount, and charging consumers desludging work that was never carried out. IWK was also accused of allowing mosquitoes to breed in septic tanks due to infrequent desludging, foul emission to emit from sewage overflow or poorly functioning oxidation ponds, and shoddy road repairs after sewage pipe-laying. Under the privatization deal, the government agreed to obtain a license for IWK to contravene the provisions of the Environment Quality Act of 1974 for the first 3 years of operation. When the period expired, IWK faced the wrath of the Department of Environment. On several occasions, Indah Water Operations (IWO), the subsidiary of IWK was fined for discharging effluents in drains, rivers, and bushes. Finally, in 1999, IWK admitted that only 20% of the sewage treatment plants met the standards set by the Environmental Quality Act and Environmental Quality Regulation. The performance of IWK and IWO was so bad that one state government contemplated creating a monitoring committee on behalf of the users. The Ministry for Housing and Local Government began ad-

vising dissatisfied users to contact its Sewerage Services Department established under the Sewerage Services Act of 1993 to, among others, monitor the proper development and maintenance of the privatized infrastructure.

In hindsight, expecting IWK to carry out its obligation properly was a tall order. The situation with the nation's sewerage systems was bad even before privatization. Only 1.0% of septic tanks throughout the country had been desludged, even then only when requested. Some 60% of sewage treatment plants did not function or were completely out of order. The systems built by developers were often substandard due to poor construction and maintenance. Portions of the 4,700 km of underground sewer pipes were leaking. Nonpayments of consumers severely hampered IWK's investment program. As of January 1998, unsettled debt by approximately 70% of the users amounted to RM103 million. A year later prior to government take-over, uncollected debt rose to RM145 million.

CHANGE OF OWNERSHIP

Prime Utilities, which had the greatest stake in IWK changed ownership three times in as many years, fueling further public anxiety that private industrialists made quick profit at the expense of public interest.

The controlling stake of IWK, originally held by Datuk Ghazi Ramli, was acquired by Datuk Wan Adli Wan Ibrahim through Transwater Corporation in October 1996. Less than a year later, the interest was disposed to Datuk Ishak Ismail. With each change of ownership, the transaction price rose, thus bringing a profit windfall to the previous owner with no appreciable changes to IWK's performance. The experience with IWK spurred the alarmed government to prohibit in subsequent privatization agreements the change in shareholders for the first three years of operation unless officially approved.

Finally, after 7 years of endless controversies and difficulties, the government announced in February 2000 the purchase of IWK from Prime Utilities for a sum of almost RM200 million. By then IWK had amassed a debt estimated at RM700 million. Prior to this, the government had acquired some control in the management of IWK through the subscription of special shares in early 1999. RM925 million in support loans was included in the transaction. Under the full ownership of the government, IWK still exists as an operating entity, albeit under the control of the Finance Ministry. A reputable international consultant, Price Waterhouse, was engaged to study how best to manage the sewerage infrastructure of the country.

As a private entity, IWK was commercially unviable, even with massive cash injections and loans from the government to keep it afloat. IWK officials might have argued that the tariff charges originally devised were capable of sustaining the capital and running costs of the company. However, even if the charge collection had gone as scheduled, it has since been revealed that IWK would still have run into financial difficulties. A 1993 estimate that RM6.058 billion worth of capital expenditure was required to fulfill the concession agreement, was revised in 1998 to RM17.237 billion, in light of the number of sewage treatment plants being 7,000 (instead of the originally expected 1,800), many of which were in neglectful state. The operating expenditure originally projected for the 28-year concession period, escalated to RM30 billion. The government had hoped that by the end of the concession period, 48 large local authorities would come to possess 84.3% connected sewerage services and 15.7% septic tanks, while the remaining 96 small local authorities 29.5% and 70.5% of the same. As events turned out, this was not to be.

CONCLUSION

Even though Malaysia's sewerage systems are now in public hands, the government is adamant that the reverse divestment

does not signify a failure. The rationale for surrendering them to the private sector was expected to lower cost to modernize the entire infrastructure. Not only was this objective unfulfilled, but a vast amount of public money was instead spent to prop up IWK during its seven years of existence as a private entity. What is clear was that certain industrialists together with their top management team reaped undisclosed amounts of quick returns from their foray in the privatized sewerage project. Furthermore, nonmonetary costs were incurred that ultimately tarnished the public's perception of the nation's privatization program, the most obvious being the unpopularity of IWK from consumers, opposition parties, news media, and state governments, to even politicians within the ruling coalition parties. Some members of parliament had voiced their opinion that there should not be a recurrence of privatized schemes returning into government hands.

The episode provides important lessons for all. In any privatization effort, there must be transparency in the selection of the concession company while the sensitivities of the consumers must not be dismissed lightly. The users, in particular, and the public in general, should be made aware of who the concession holders might be before the award is made. There should also be full disclosure of the charge structure. The divested infrastructure should be surrendered to parties capable of fulfilling their obligations efficiently and not out to make quick profits through outright sale of controlling stakes, for example. Re-involvement of the public sector once privatization has taken place, particularly through the injecting of new funds, should be refrained as much as possible. In short, the scheme must be carefully structured to render it commercially and operationally viable for all concerned. As pointed out by Nixon (1995) there is little to be gained and much to be lost by the state giving up its ownership claims too quickly.

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