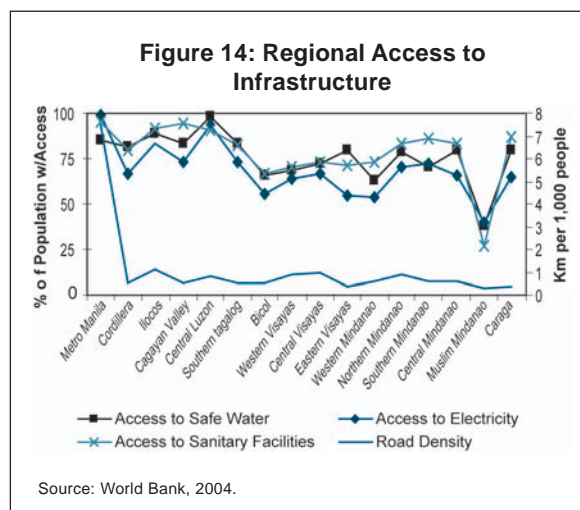


III. SELECTED SECTORS

A. Physical Infrastructure

The Philippines suffers from one of the poorest infrastructure sectors in Southeast Asia, severely dampening its regional competitiveness. With limited public resource upgrades, the government has actively solicited private sector input since 1993 with the adoption of the BOT framework. More than \$28 billion in investment has followed, helping expand total power capacity,⁴⁷ road network quality,⁴⁸ and transport linkages.

Regional disparities are significant, with the highest levels of electrification, access to water, and paved road ratios in Luzon and the National Capital Region in particular, in contrast to the poorest rates in Mindanao, particularly Muslim Mindanao, which consistently ranks below the national average (see Figure 14). Given the proven links between economic growth and infrastructure quality, it is not surprising that Muslim Mindanao also has the lowest contribution to GDP in the country and the highest incidence of poverty.⁴⁹ Much more investment is required if the Philippines is to sustain economic growth and reduce poverty. Indeed it is estimated that an additional \$35–45 billion is needed over the next 10 years to raise the quality of the Philippines’ physical infrastructure to regionally competitive standards.



Attracting this new investment will require fundamental changes to the framework for private participation in infrastructure (PPI) and regulations for industry. Disputes concerning private contracts in the power, water, and airport sectors have highlighted the weakness of the legal and regulatory framework, the limited recourses available to resolve disputes, and the high level of political intervention in the commercial sector. Creating an investment environment that maximizes scarce resources and in which public and private players assume an acceptable level of risk will require specific improvements in the following areas:

- coherent sector investment planning and implementation by government agencies;
- the credibility, competence, and independence of industry regulators;
- clarifying rules and regulations for the solicitation and evaluation of PPI proposals;

⁴⁷ Independent power producers have augmented total capacity by 5,533 megawatts and private distributors have added another 518 megawatts of capacity.

⁴⁸ More than 630 kilometers of new roads have been built outside of Manila.

⁴⁹ See table in section IA above, the government has identified infrastructure investment in Mindanao as a development priority.

- tariff regimes based on cost recovery;
- efficient mechanisms for dispute resolution.

As will be demonstrated in the following sections, these key enabling requirements are common to most infrastructure subsectors (power, transport, water, and telecommunications). Sustainable improvements in infrastructure quality will largely depend on the ability of the Philippine government to meet these requirements.

1. Power

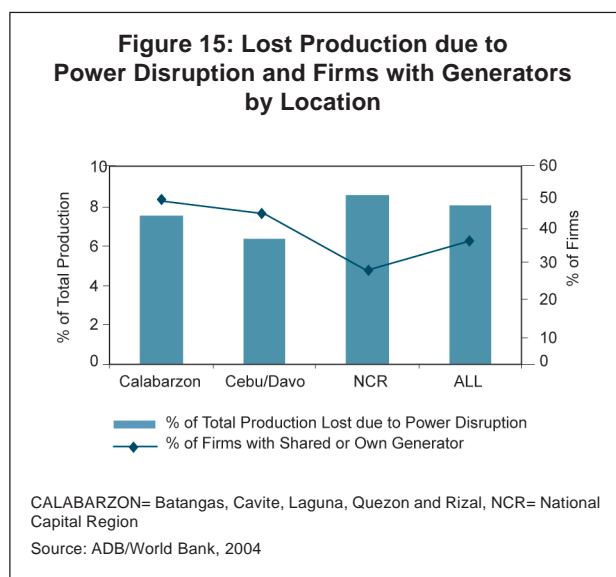
At approximately 80%, the Philippines has a high rate of electrification by regional standards,⁵⁰ but the quality of the electrical supply (measured by number of interruptions) is low⁵¹ and transmission/distribution losses remain among the highest in the region at about 14%. Industrial users already pay the highest prices in the region, and many maintain their own backup sources of power to mitigate the risks of outages (ADB/WB 2004) (see Table 7 and Figure 15). Installed generating capacity is currently at 15 gigawatts with 79% in Luzon, 10% in Visayas, and 11% in Mindanao. According to the Department of Energy's latest power development program (2005–2014), about 9,225 megawatts in new capacity⁵² will have to be added in the next 10 years to meet the growing demand for electricity and thereby avoid power shortages by 2005 in Mindanao and 2008 in Luzon and the Visayas.

The power sector has struggled to recover from the economic crisis that hit in 1997. The reduction in economic growth and the devaluation of the peso reduced the demand for electricity and increased the price of generation to the highest levels in the region, as many contracts have take-or-pay provisions and high levels of foreign-denominated debt service drive up the cost per kilowatt hour.

The private sector currently participates in both generating and distributing electricity. It is estimated that approximately 70% of installed capacity is

City	\$ per kWh 2003
Manila	0.090
Bangkok	0.060
Kuala Lumpur	0.060
Jakarta	0.018
Shanghai	0.035
Singapore	0.050
Hanoi	0.070
Phnom Penh	0.025
Vientiane	0.040

Source: Suiwah Leung, et al., 2003.



generated by IPPs. Distribution is split between Meralco (60% of the total and concentrated in Manila) and 139 smaller utilities, most of which are cooperatives (40% of total distribution). The state still plays a dominant role in the industry through the NPC which generates 30% of the power while the National Transmission Corporation manages all of the transmission (see Box 4).

NPC has signed over 40 power purchase agreements with IPPs to date. These contracts had take-or-pay provisions⁵³ and required NPC to carry fuel price and foreign exchange risk. While the

⁵⁰ Higher than Indonesia and Thailand but behind the People's Republic of China, Republic of Korea, and Malaysia.

⁵¹ 3.1 on a scale of 7, behind all regional competitors.

⁵² Out of 9,225 megawatts, only 575 have been committed, so a total indicative capacity addition of 8,650 megawatts is therefore necessary to address the looming power shortages.

⁵³ The standard contract required NPC to pay for the expected electricity output if the plant operated at around 80% of plant capacity, provided the plant was available for generation, irrespective of whether or not the electricity was actually required.

Box 4: The National Power Corporation

The National Power Corporation (NPC) has, since 1971, been the state-owned national utility responsible for the generation and transmission of electricity. Its primary role has been to sell electricity generated from its own plants and purchased from its contracted, independent power producers (IPP) to distribution utilities that supply end users. At the end of 2002, NPC also sold electricity to approximately 140 large electricity users directly connected to the grid. As of 31 December 2002, NPC owned and operated almost 4,300 megawatts of grid-connected generation. Its transmission system comprised over 20,700 circuit kilometers of line at voltages up to 500 kilovolts and a total of 23,600 megavolt-ampere of substation transformer capacity. In 2002 it employed over 8,000 staff and had a total gross generation of 37,600 gigawatt hours.

In addition NPC, through its Small Power Utilities Group (SPUG), has been responsible for generating electricity to customers connected to networks isolated from the three main grids. To provide this service, it owns and operates 98 power plants with a total installed capacity of about 200 megawatts. Further, it has power purchase contracts with off-grid IPPs with a further capacity of 32 megawatts. SPUG's power is sold to electricity cooperatives that are responsible for distribution and retail sale. SPUG sales totaled 489 gigawatt hours in 2002.

program was very successful in addressing the power shortage, it has been a significant cause of the deterioration of NPC's financial position, largely because of a lower than forecast electricity demand and a substantial deterioration of the peso against foreign currencies. At the end of 2002, NPC had in place power purchase agreements for over 8,100 megawatts of IPP capacity.⁵⁴

Recognizing the need to improve efficiencies in the sector, to reduce debt levels, and to attract further private sector investment, the government restructured the sector in 2001 with the passage of an electric power industry reform act (EPIRA). It provides for the unbundling, privatization, and

commercialization of the sector through (i) the creation of the Power Sector Assets and Liabilities Management Corporation to assume NPC liabilities and manage the orderly privatization of NPC's generation and transmission assets (except those used for off-grid missionary electrification); (ii) the creation of a wholesale electricity spot market to allow competition; (iii) abolition of the Energy Regulatory Board and creation of an independent Energy Regulatory Commission (ERC) with the power to set tariffs in the noncompetitive transmission and distribution subsectors and with wide powers to regulate the behavior of participants in all sectors of the industry; and (iv) the development of competition in the retail supply of electricity, starting with large electricity users and eventually extending to the supply of electricity at the household level.

Implementation of the EPIRA is running significantly behind schedule, due in part to the limited capacity of ERC to drive the reforms but most importantly due to a lack of investor interest. Investor risk assessments of the sector are very high due largely to (i) regulated generating rates that are well below the potential cost of new generation,⁵⁵ (ii) the uncertain political climate, (iii) the weak financial condition of the utilities, including Meralco⁵⁶ that raises doubts about their ability to distribute power in the future, (iv) the lack of credibility of ERC which has been subject to political interference⁵⁷ and has no financial autonomy, (v) renegotiation of legacy IPP contracts, and (vi) the absence of Congressional approval for the franchise bill specifying the terms of operation of transmission assets.

With the delays in implementing the EPIRA, the government is facing a financial crisis in the sector with ballooning deficits and liabilities at NPC, increasingly weak utilities, and tariff rates that do not allow full cost recovery. NPC's losses have been increasing and accumulating (see Figure 16). In 2003, NPC suffered a net loss of P113 billion (\$2.0 billion), and even its operating loss amounted to P21 billion (\$375 million). Out of the net loss, P77 billion was attributable to a major change in foreign exchange loss accounting (the entire loss on loans and lease obligations to IPPs must be recognized in the same

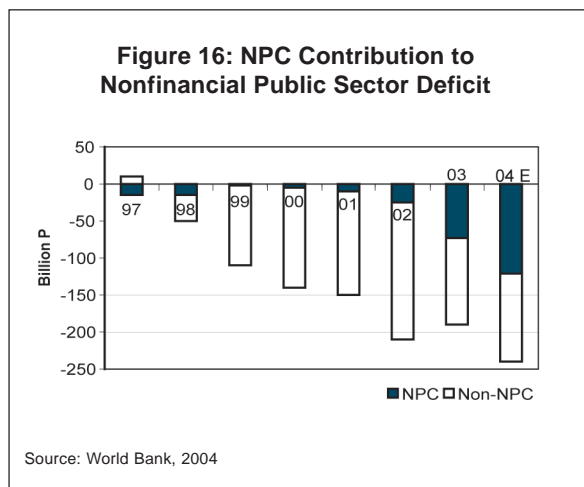
⁵⁴ Including NPC owned plants under long-term operating contracts and IPP plants still to be commissioned.

⁵⁵ President Arroyo ordered the further lowering of consumer power rates in 2002.

⁵⁶ The Supreme Court decision to impose tariff reimbursements on Meralco has resulted in a downgrading of its Standard & Poor's credit rating from BB+ to CC.

⁵⁷ The head of ERC is a presidential appointee.

year rather than amortized over the remaining loan or lease contract life). NPC's liabilities totaled almost P1.3 trillion (over \$22 billion) as of 31 December 2003, with P757 billion (\$13.5 billion), resulting from IPP obligations and P475 billion (\$8.5 billion) from foreign loans and bond issues. Additional loans obtained in 2004 of about \$1.5 billion have raised NPC's indebtedness by P84 billion.



Given the rapidly deteriorating financial condition of NPC and the looming power crisis, it is imperative that action be taken immediately. Now that a new government is in place, it must make every effort to stabilize the market and to present a credible plan for restoring investment opportunities. A broad-based reform plan addressing the policy, institutional, regulatory and operational constraints to private sector investment is needed including a serious effort to address the tariff issue. Full and successful implementation of the EPIRA will require raising the tariff before longer-term efficiencies can force it back down. The impact of tariff liberalization on commercial/industrial users will likely be positive as it will eliminate the surcharge that they pay today to offset losses of utilities in the retail market.⁵⁸

In sum, implementation of the EPIRA should remove the government from service provision so that it can focus on planning and regulation including the definition of targeted subsidies where

required for rural electrification. Specific measures to support EPIRA implementation should include the following:

- strengthening the capacity and independence of ERC to effectively serve as a market-based regulator;
- supporting the establishment of the wholesale electricity spot market that will allow generating and supply rates to be determined by the market;⁵⁹
- ensuring the economic viability of the sector with the establishment of a revised generating tariff schedule based on cost recovery and its integration into the sales contracts of existing NPC generating assets;
- modernizing transmission assets to ensure their ability to handle the increased generating capacity needed beyond 2006;
- strengthening the financial and management capacity of the distributors.

While implementation of the first three of these reforms essentially requires regulatory and legislative input, the remaining two require financial resources that should ideally be mobilized by private investors. Under the terms of the EPIRA, the government should not be making further investments in the sector, and transmission assets are to be privatized. While the most appropriate form of privatization is by concession, the right to operate the NPC franchise has yet to be granted by Congress.⁶⁰ If such approval is not forthcoming, the burden of adding additional capacity to the transmission network will fall on the government, further aggravating its already weak fiscal position.

To address the financial weaknesses of the distributors, both operational and financial measures should be taken. Consolidations in the sector would help strengthen underlying financial weaknesses, but consideration should also be given to modifying the terms under which cooperatives operate in the market. Revisions to the tariff regime will be an important mechanism for improving their financial viability. In all cases, however, the institutional

⁵⁸ As per ERC decision of May 2003, utilities must charge industrial users 60% of residential charges, even though actual costs are lower.

⁵⁹ In its initial phase, generating rates will be determined by the market, then once 70% of the NPC generating assets are sold, open access to distribution assets will be allowed introducing full competition in retail supply rates.

⁶⁰ Moreover, there is a restriction on foreign ownership of utilities or utility concessions that is further deterring potential investors.

capacity of the target utilities and cooperatives must be strengthened before financial assistance is provided.

2. Transport

Transport infrastructure—composed of roads, highways, rail networks, airports, and ports—plays a vital role in supporting economic growth. Private sector enterprises in the Philippines consistently cite poor transport infrastructure (especially roads) as a key impediment to their competitiveness and growth (ADB/World Bank 2004 and AmCham in the Philippines/Gallup Poll 2003). Looking forward, investment requirements in road, rail, port, and airport infrastructure are significant with an estimated \$200 million per year needed to develop, operate, and maintain the road network alone (World Bank 2003).

While the private sector provides virtually all transport services (bus, air, sea) in the Philippines, the public sector develops, regulates and operates the infrastructure. The deregulation of the sector launched in the 1990s is partially complete with the government still exercising many commercial functions. Private participation in the development and operation of infrastructure to date has been focused on toll roads and light rail, with the notable exception of the BOT contract for the NAIA terminal 3. The scope for increased private participation in transport infrastructure remains large and includes the following:

- BOTs for toll roads and light rail;
- management or concession contracts for airports and ports;
- maintenance services for roads, ports, and airports;
- airport and port terminal services.

As is the case with all physical infrastructure subsectors in the Philippines, expanding private sector participation through provision of transport infrastructure will require an improvement in the enabling legal and regulatory environment, including a strengthening of the development and implementation procedures for PPI. In the particular case of transport infrastructure, with its multimodal dimensions, reforming the institutional framework

for the sector is also critically important. The 16 agencies involved in the operations and management of the transport network cannot effectively coordinate their activities and are often subject to conflict. This makes intermodal planning impossible, so that even the best efforts to identify investment priorities based on the economic and geographic development targets of the country often fail. Indeed several proposals (ADB 1996 and 1999) have been made over the years to strengthen intermodal planning, yet lack of data, resources, and institutional resistance have obstructed their implementation.

Without the authority to direct expenditures according to identified priorities, planning agencies cannot be effective. Infrastructure projects have repeatedly been cancelled, postponed, or replaced through the legislative process for reasons of political expediency. The existence of country development funds⁶¹ allows further interference in defining infrastructure priorities. While ostensibly designed to encourage funding of local priorities, they effectively distort those priorities by allowing a high degree of discretionary power by the legislators.⁶² A sector-wide institutional review and strengthening of the planning, budgeting, and expenditure processes would be an important step in (i) proactively communicating priorities to private investors, (ii) facilitating the review of investment proposals and their alignment with regional and national infrastructure plans, and (iii) maximizing scarce investment dollars.

In addition to these sector-wide institutional needs, each transport subsector has specific issues and constraints relating to private sector participation. Brief overviews of each subsector and suggested reforms to facilitate private sector participation follow.

a. Roads and Highways

Empirical evidence has shown the important role played by road links in promoting economic growth and reducing poverty. A good road network integrated with other modes of transport reduces the costs of doing business and makes Philippine companies more competitive. While the road density

⁶¹ Also known as the Priority Development Assistance Fund; estimated at P5.17 billion per year from 2000 to 2003.

⁶² As an example in 2003, 22.46% of the Department of Public Works and Housing's budget was made up of CDF.

of the Philippines is the highest in Southeast Asia, its overall quality is one of the poorest (see Table 8). Paved roads represent only 53% of national secondary roads, 21% of provincial roads, 34% of municipal roads, and less than 7% of barangay roads. About 33% of local roads are not surfaced and are highly vulnerable to bad weather conditions.

**Table 8: Road Densities and Paved Road Ratios
Philippines and Other ASEAN Developing Countries**

Country	Road Density (km./sq. km.)	Paved Road Ratio
Philippines	0.67	0.21
Indonesia	0.19	0.47
Malaysia	0.20	0.74
Thailand	0.42	0.82
Vietnam	0.46	0.35

Source: Department of Public Works and Highways.

Significant investment targets national arterial roads and farm-to-market roads,⁶³ but the secondary network, including national secondary roads and provincial roads, is the most neglected segment of the network. The medium-term infrastructure program (1999–2004) targets needed road investments of approximately P38 billion per annum, with P11 billion allocated to maintenance alone. Given budget constraints, the government has only been able to allocate an average of P22 billion per year from 1997 to 2003. In addition, these allocations have been disproportionately focused on developed regions and biased against regions where agricultural production is concentrated. For example, northern and southern Mindanao have the highest grain outputs in the country but have the lowest paved road ratios. These regions also have high incidences poverty.

Deficiencies in design and construction, inadequate maintenance, and damage from overloaded vehicles are key reasons for the current state of the network. Despite the passage of a motor vehicle user charge act in 2000 and the establishment of a special road maintenance fund in the same year,

⁶³ Farm-to-market roads are often improved under integrated rural development programs.

funds from these sources have been insufficient to prevent the deterioration of the network.⁶⁴

Although management and maintenance of local roads has devolved to LGUs since 1991, investment in local roads is mostly funded by national government agencies—Department of Public Works and Housing (DPWH), Department of Agriculture, Department of Agrarian Reform, Department of Environment and Natural Resources, and the National Irrigation Authority—as part of broader national government projects aimed at improving agriculture, environment, irrigation, or other sectors. Due to this project-by-project approach with fragmented administrative responsibilities, the selection of road sections for improvement is largely decided in an ad hoc manner without due consideration for the integration of the local road network. Many roads have been arbitrarily classified on the basis of administrative, funding, or political decisions, and the road classification system established in 1955 has become inadequate.⁶⁵

Annual needs for maintenance and rehabilitation of local roads are estimated at P14.4 billion, but available resources are only P4.5 billion. A reliable funding mechanism for maintenance and rehabilitation of local roads based on cost recovery from road users must be designed. In addition, efficient incentives, including financial incentives, must be put in place to strengthen the commitment of LGU decision makers to maintain their roads. Lastly, responsibilities need to be clarified for the maintenance of the 122,000 kilometers (km) of barangay roads that is often carried out by provinces and municipalities in the absence of adequate barangay resources.

For LGUs from poor rural areas that have insufficient resources to cover even the maintenance requirements of their networks, access to affordable funding sources for road development is problematic. Under the present financing scheme, LGUs have to borrow at high interest rates⁶⁶ to access funds, and only better-off LGUs in developed regions have

⁶⁴ Despite the intention to use these funds for preventative maintenance, most have been diverted instead to routine maintenance and repairs.

⁶⁵ TA 1412-PHI: *Road Classification Study*, for \$760,000, approved on 8 November 1990, recommended the establishment of a functional road classification system. However, the issue of funding requirements for rehabilitation and maintenance of roads to be reclassified from national to local roads, unresolved since the study was completed in 1994, has remained an obstacle to the implementation of the new classification.

⁶⁶ The present lending rate of the Municipal Development Fund Office is 14%.

sufficient debt-servicing capacity to improve their roads. To enable low-income LGUs in poor rural areas to improve their roads, a financing framework needs to be formulated that will set priorities for national government support for local roads, the role of official development assistance resources in rural road development must be defined, and more attractive financial terms for LGUs must be provided.

The scarce funds that exist for maintenance are not used efficiently. While DPWH has largely shifted from maintenance by administration to maintenance by contract for national roads,⁶⁷ it still employs an estimated 6,000 regional maintenance workers. Some provincial and municipal LGUs also operate maintenance equipment pools and employ maintenance workforces, but many contract such services to the private sector and resist pressure to use DPWH pools. A mechanism needs to be developed to liberalize maintenance and to introduce more incentives for efficiency in public pools. A shift toward maintenance by contract could be a useful mechanism for evolving public sector maintenance groups into cooperatives or private companies that could bid for maintenance contracts against private sector competitors.

A final key constraint to improving the road network is the complicated process of land acquisition and development. The absence of reliable cadastral surveys and land registries in the Philippines complicates the identification of land titles. Once the rightful owner has been identified, a legal framework exists for exercising eminent domain (RA 8974), but DPWH has resisted adopting market-based compensation for lands acquired. This is in contrast with other agencies such as the Department of Transport and Communications (DOTC) and even LGUs that have more systematically used market-based values. Disputes about rates of compensation have resulted in protracted project delays as has the difficulty of finding suitable resettlement locations for squatters.

Going forward, improving the road network will require (i) significant institutional reforms to coordinate planning and budgeting among national agencies and in relation to LGUs, (ii) institution-

alization of a process to fund maintenance, (iii) clarification of compensation mechanisms and procedures for exercising eminent domain (including sources of funding), and (iv) more private sector participation and full competition in output-based maintenance and rehabilitation contracts.

b. Toll Roads

Over the past 10 years, five toll road projects have been developed in the Philippines: southern Tagalog arterial road, Manila-Cavite toll expressway, north Luzon expressway, and Skyway phases II and III. While the involvement of the private sector in toll roads is a central tenet of the government's policy, implementation to date has been reactive with the government fielding unsolicited bids rather than setting out a detailed development strategy for the road sector. Without the reference point of a strategic plan, key road links are still lacking, and the government's development objectives are not being met.

Much of the risk in existing BOT contracts is borne by the government either explicitly or through contingent guarantees, yet transferring risk should be one of the central purposes of private sector participation.⁶⁸ Further distorting the framework for effective private sector participation is the presence of the state-owned Philippine National Construction Corporation (PNCC) which holds the exclusive franchise to develop, operate, and extend expressways/toll roads. Private investors wanting to develop a toll road must do so either as a joint venture with PNCC or must use PNCC to operate a BOT. To date only two such collaborations have been completed, the skyway extension of the south Luzon expressway and the rehabilitation of the north Luzon expressway.⁶⁹

The toll regulatory board serves as the sector regulator, with the authority to review tariffs, but it is questionable whether tariffs need to be fixed for toll roads when alternative side roads exist. Allowing market forces to determine the appropriate toll may be a more effective and certainly a more regulatory mechanism. For toll roads to have an effective monopoly, tariff levels can be determined with agreed formulas included in BOT or joint venture contracts.

⁶⁷ The government agreed to adopt maintenance by contract as a national policy under ADB Loans 1046-PHI (SF) and 1047-PHI: *Road and Road Transport Sector Program*, for \$50 million each, approved on 8 November 1990.

⁶⁸ It should be noted that the north Luzon expressway and Skyway contracts present generally market-based risk allocations.

⁶⁹ With ADB participation as a lender.

Investors in the sector have raised concerns over the (i) ability to maintain toll rates that allow acceptable rates of return; (ii) slow and cumbersome land acquisition, right-of-way determination, and resettlement; and (iii) high currency exchange risks. Indeed two additional BOT projects are currently stalled by a combination of land acquisition and financial issues: the Manila-Cavite toll expressway and the southern Tagalog arterial road.

Any approach to restore private sector interest in the sector must therefore include the following:

- strengthened sector planning in the context of other transport modes and the government’s development objectives;
- strengthened project planning addressing land acquisition, resettlement, and right-of-way issues in advance of project implementation;
- clarification of RA 8974 so that landowners can obtain market value for their property and so land acquisition can be facilitated;
- strengthened ability of DOTC and DPWH to evaluate and assess the economic impacts of private sector participation in infrastructure proposals for roads, especially where usage forecasts and target tariff levels can be objectively tested and where realistic risk-sharing scenarios can be developed;
- clarification of the role of the toll regulatory board particularly its role in regulating tariff levels;
- ending the monopoly of PNCC on the toll road franchise so that private consortia can organize construction and operation to maximize efficiencies;
- expanding the range of private sector participation modalities available as in effect only the joint venture and BOT models have been used to date when other modalities exist that could be used under existing regulations and may reduce the risk exposure of both contracting parties. e.g.,
 - operate and maintain—private sector maintains existing roads to defined standard and collects tolls;
 - rehabilitate, operate, transfer—upgrading existing roads to toll roads.

c. Rail

The rail subsector is dominated by the national carrier, Philippine National Railways (PNR) which acts as owner, operator, and regulator of 1,296 km of track, less than 50% of which is operational. Indeed only two routes are currently operating: the 479 km between Manila and Legazpi and 15 km between Manila and Meycauayan. The loss of market share to road transport over the years has led to chronic underutilization of track and rolling stock and to operating losses of approximately P200 million per year. When non-operating expenses (depreciation, financing charges) are factored in, PNR is losing close to P500 million per year for transporting only 300,000 passengers, or P1,666 per passenger.

The poor state of the national rail network has resulted in its increasing irrelevance as a mode of transport. Old equipment, lack of preventive maintenance, and absence of right-of-way management have meant that PNR no longer offers dedicated freight service, and most passengers opt for faster road transport. Its charter-mandated obligation to maintain low fares, however, keeps its commuter fares well below those of its light rail competitors.⁷⁰

While it may still be possible to attract private investors to rehabilitate and operate selected PNR corridors, experience to date has not been promising. What is needed in the case of PNR is substantial restructuring to reduce operating costs and the fiscal drain on the government. This recommendation has been made repeatedly over the past 5–7 years, but the estimated 60,000 squatters that would have to be moved to rehabilitate the PNR track coupled with the high number of layoffs in the case of organizational restructuring (PNR has approximately 2,000 employees) have made implementation of these recommendations politically difficult. Indeed the extent of rehabilitation needed to improve the financial performance of PNR is daunting and the cost/benefit has yet to be firmly established.

In the commuter light rail sector, scope does exist for increased private sector participation. Indeed, one light rail project (MRT3) was completed with private partners,⁷¹ albeit with mixed results for

⁷⁰ P6.6 for PNR compared with P12.4 for mass rail transit and light rail transit.

⁷¹ Under a build-lease-transfer arrangement.

the government. In this case the passenger levels projected by the private initiators of the project proved to be far in excess of actual numbers forcing the government to incur significant losses on operations. The government is now considering adding additional light rail projects in Manila to further decongest the city.

In structuring these new light rail projects, allocating risks will need to be more carefully managed with improved planning and demand forecasting. An objective framework for determining and adjusting tariffs will also be required.

d. Maritime Ports

With so much dependence on sea transportation for the movement of domestic and international cargo, the efficiency and productivity of port operations have important economic impacts. The current structure of the sector, however, does not favor either. Apart from a selected number of independently operated ports,⁷² the PPA directly manages 114 ports and serves as the regulatory authority for all. There has been private participation in various container terminals, but scope remains for greater private sector participation in port management and services, provided that the PPA redefines its mandate and a rational program of port development and subsidization is adopted.

Worldwide experience shows that the commercialization and privatization of port operations can introduce significant efficiencies. Private participation can be limited to selected services within a port, or it can be as comprehensive as a concession to manage all port operations. In defining the right level of private participation, the government will need to determine the most efficient means of financing the network of smaller ports that are not financially self-sustaining but that are nonetheless deemed necessary for social/developmental reasons. These could either be directly subsidized or packaged with other more profitable ports in a management contract. In making these determinations, direct reference to intermodal transport development plans is essential as the viability of ports is closely linked to the quality of their supporting transport links (e.g., road, rail).

⁷² Subic Bay, San Fernando, Port Irene, Mindanao container, and 14 ports operated by the Cebu Port Authority.

Increasing private sector participation will require several reforms: (i) separation of the regulatory and operating roles of the PPA so that it can continue to regulate the sector without direct conflict of interest; (ii) incorporation of all ports and creation of management companies to operate them; (iii) privatization of port services and port management where feasible; and (iv) devolution of tariff setting to port managers who can best determine the rates necessary to cover costs without deterring traffic. The successful experiences of Subic Bay and Cebu in incorporating port management and introducing more private sector participation should serve as useful references.

e. Airports

The Philippines has a total of 90 operational airports run by public authorities in addition to an estimated 87 private airstrips. Civil aviation plays a key role in the country's economic development and is essential to supporting many forms of private enterprise. While the country has sufficient coverage in terms of number and location of airports, most are in disrepair and do not meet minimum international standards for flight operations and for safety. This is particularly true in Mindanao. As with roads and ports, lack of adequate funding for maintenance and of incentives for efficiency has led to the severe deterioration of infrastructure.

The sector is under the general policy and planning oversight of DOTC. ATO, an office of DOTC, is the most active government body in the sector and is responsible for (i) ensuring air safety, (ii) providing air traffic control services, (iii) determining airport fees and tariffs, and (iv) managing 86 of the 90 public airports.⁷³ The Civil Aeronautics Board (CAB) is responsible for the economic regulation of the sector and determines routes and frequencies allocated to airlines.

The current structure is less than optimal as it obstructs potential incentives for efficiency, builds in conflicts of interest for participants, and deters private sector participation. None of the existing public airports has been fully incorporated, so they

⁷³ The remaining four major airports are managed by GOCCs: Manila International Airport Authority for the Ninoy Aquino International Airport, Metro Cebu International Airport Authority for the Cebu International Airport, Subic Bay International Airport Authority for the Subic Bay International Airport, and Clark International Airport Authority for the Clark International Airport.

continue to operate on simple operation and maintenance budgets and to remit all revenues to the Treasury. This structure effectively removes incentives to cut costs and to increase operating margins. Even the four airport authorities that have been created to operate on more commercial principles do not have this necessary financial autonomy and accountability. Second, ATO sets fees for all airports, including those that it manages, thereby creating an inherent conflict of interest that would need to be resolved in any attempt to attract private airport management. Lastly, there is little coherence in the charges and fees levied by various airports, and in general they are substantially below the actual costs of the services provided.

Attracting private sector participation will therefore require a general restructuring of the institutional and regulatory framework to favor a more commercial orientation. There is scope for private participation in the management of airport concessions as a whole or in the provision of selected services to a public airport authority. The government embraced this commercial vision for the sector in its 1997 commercial aviation master plan⁷⁴ which calls for (i) incorporating ATO, (ii) creating an independent regulator to assume the regulatory responsibilities of ATO and CAB, (iii) implementing cost recovery principles in determining airport charges, (iv) introducing commercially oriented airport management, (v) deregulating domestic and international air services, (vi) promoting private sector participation in air transport infrastructure and services, and (vii) developing human resources in an incorporated ATO.

In sum, the government intends to focus on providing air safety aids and equipment and will leave development and operation of airport facilities to the private sector. To date, however, little progress has been made in implementing the action plan, as there has been institutional and political resistance. The reallocation of regulatory responsibilities requires new legislation, and this has not been forthcoming. Incorporating existing airports to introduce more financial accountability and to give managers the authority to contract out concession space to private entrepreneurs has still not begun in earnest.

As in most countries, many of the smaller regional airports are not likely to be financially self-sustainable⁷⁵ so will continue to require some form of budget support. This should not prohibit them from adopting a more commercial orientation and management structure, however, as increased financial and performance accountability should create incentives for efficiency. Private management contracts could be considered for these airports either as concessions (packaged with more profitable airports) or stand-alone management contracts for a fee. The recent experience in Indonesia in developing such contracts should prove instructive.

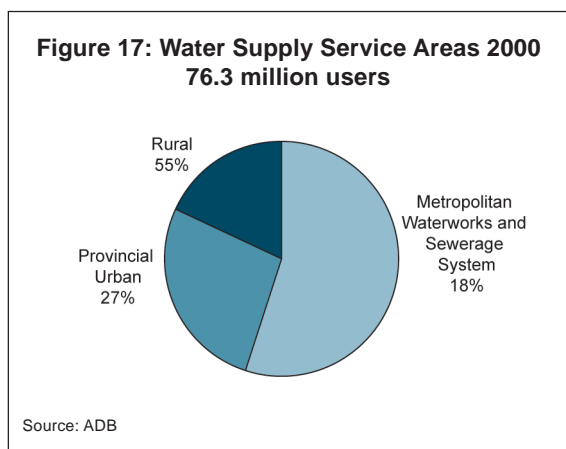
In general, commercializing airport infrastructure management should introduce cost savings and should allow greater financial transparency so that the government can determine the costs/benefits of those airports that it sustains with direct subsidies. As with all of the transport subsectors, such subsidy and investment decisions should be made in the context of integrated transport plans as airports need road (and sometimes port/rail) links to fully serve their local constituencies.

3. Water

Water supply in the Philippines is managed by a diversified range of national and local institutions with some private sector participation. Service provision is allocated geographically as follows: (i) the Metro Manila area is serviced by the Metropolitan Waterworks and Sewerage System now with two private concessionaires, Manila Water Co., and Maynilad Water Services, Inc.; (ii) provincial urban areas are serviced by water districts (WDs), LGUs, and private utilities; and (iii) provincial rural areas are serviced by rural waterworks and sanitation associations, barangay waterworks and sanitation associations, a few WDs, and LGUs (see Figure 17). While an estimated 80–83% of the population has access to drinking water, the quality of this water remains problematic with more than 500,000 morbidity and 4,200 mortality cases per year due to contaminated drinking water and waterborne diseases.

⁷⁴ Prepared with the assistance of ADB TA 2559-PHI.

⁷⁵ Only 29 of the 90 public airports have regular traffic.



Financing is provided by a combination of government subsidies, local government contributions, user charges, and foreign grants and loan assistance. While the government has identified improved water supply as an important development goal, its funding is barely sufficient to cover operations and management leaving little to nothing for capital investment. Private sector investment has also been limited to date with the notable exception of the Manila and Subic water concessions and a large number of small-scale independent providers.⁷⁶ WDs are essentially local GOCCs.

Expansion and modernization of the water system is impeded by the weak financial condition of most LGUs and WDs responsible for water supply⁷⁷ and by the absence of coordinated investment planning among municipal, regional, and national authorities. While subsidy schemes exist to help LGUs and WDs address the gap between revenues and costs, these have traditionally been input-based and as such have provided few incentives for service providers to increase efficiency.

Coordinated investment planning is complicated by the many agencies involved in the sector and by the absence of mechanisms to integrate investment proposals (see Table 9).

The poor economics of the water sector have meant that most service providers cannot access commercial funding and therefore rely on

⁷⁶ SSIPs are estimated to serve 15% of the urban population and 10% of the rural population; services range from simple pushcart distribution to the construction and operation of piped water systems.

⁷⁷ Due to high levels of nonrevenue water (estimated at 53% for Manila Water Company, Inc. [Manila East], 69% for MWSI [Manila West], 70% for LGUs, and 31% for WDs) and user tariff charges that do not cover the cost of service.

Table 9: Water Sector Institutional Responsibilities

Agency	Responsibilities
NEDA	<ul style="list-style-type: none"> - defines institutional roles and responsibilities of sector agencies - sets broad national coverage targets - defines broad subsidy policies - defines incentives for increased efficiencies - defines mechanisms for private sector involvement
LWUA / DILG	<ul style="list-style-type: none"> - set and are expected to enforce specific quality and performance standards for WD and LGU-managed systems, respectively - performance monitoring - capacity building of service providers
NWRB	<ul style="list-style-type: none"> - tariff regulation for WDs and small, privately-run systems
MWSS	<ul style="list-style-type: none"> - regulation and supervision of private concessions for Manila
LGUs	<ul style="list-style-type: none"> - regulation and supervision of private concessions - limited policy, planning and regulation over jurisdictions

Source: World Bank, Meeting Infrastructure Challenge Study, 2004

concessionary financing provided by the Local Water Utilities Administration⁷⁸ which itself receives funds from the national government and from external assistance.⁷⁹ Going forward, the economics of the sector must be improved through a combination of greater efficiency in service provision (including reductions in nonrevenue water), the evolution of subsidy schemes from input to output based, a review of tariffs and tariff setting to ensure better cost recovery and to adequately reflect the user's ability to pay, and the development of a tighter, more simplified regulatory framework.

Private participation in the sector, apart from the Manila concession, has been limited to date.⁸⁰ A few systems are managed by private operators, but LGUs have not managed to sign any contracts with private operators despite attempts. Ultimately, potential contracting parties have not been able to agree to a

⁷⁸ In 2002, the Local Water Utilities Administration reported 23.6% of its current receivables as nonperforming, up from 11% in 2001, and nonperforming loans were reported at 4.8% of total long-term loans.

⁷⁹ Financing facilities have been set up by Development Bank of the Philippines, Land Bank of the Philippines, and Department of Finance's Municipal Development Fund Office.

⁸⁰ Some BOT projects have been attempted but were aborted in Cebu, Baguio, and Bulacan.

satisfactory allocation of risks associated with (i) the unknown operating conditions of the systems, (ii) high nonrevenue water levels, and (iii) uncertainty regarding tariff levels. Other notable issues have centered on the lack of clarity of the proposed contracts in addressing taxation, performance bonds, and impacts of change orders during construction (see Box 5).

Box 5: Metropolitan Waterworks and Sewerage System's Manila Water Concession—Lessons in Risk Management

In 1997, the Manila water system was privatized, creating two concessions covering the east and west sections and 12 million users. The concessions, each with a 25-year term and requiring a combined investment commitment of \$7 billion, were awarded to the Manila Water Company Inc. (MWCI) and Maynilad Water Services Inc. (MWSI). While both concessionaires initially struggled to achieve revenue and service targets, between 1997 and 2002 they managed to add 200,000 new connections and increase the population served by 1.7 million. High levels of nonrevenue water proved very difficult to contain, however, and while MWCI eventually became profitable, MWSI declared bankruptcy in 2001 and has since required a government bailout.

While several factors contributed to this divergent performance, one of the most important was the structure of the MWSI concession which was based on the assumption of 90% of past foreign debt service obligations of MWSS as a concession fee. With the devaluation of the peso following the award of the concession, MWSI's payment obligations rose by more than 70% leading to its unilateral cancellation of the agreement and declaration of bankruptcy. Despite attempts to cover foreign exchange risks in the contract, provisions were inadequate to address the magnitude of the devaluation, and the parties were unable to agree to a restructured contract.

The ongoing attempt to structure a concession for the San Fernando City water system in La Union Province, which so far has attracted several bidders, will provide valuable lessons. This concession agreement is based on explicit, output-based subsidy payments to the operator to provide connections to low-income households and on defined investment commitments by the operator.

Both the government and the private sector have learned valuable lessons from the Manila water concessions. They are being applied in San Fernando and will need to be applied going forward. They are: (i) the financial and technical capability of the proposed operator must be objectively assessed, (ii) credible feasibility studies must be conducted to assess the current state of the operating systems, (iii) contracts must assign risks to the parties best able to manage them, and (iv) bidding must be completely transparent. These factors, though seemingly self-evident, have proved challenging in previous bidding attempts, particularly at the LGU level.

4. Telecommunications

The Philippines has a well functioning ICT infrastructure with one of the highest telephone densities in Asia.⁸¹ The liberalization of the sector in 1993⁸² brought a substantial increase in investment⁸³ and led to a sharp increase in service providers (see Table 10). Service quality also markedly improved, cutting the time required to get a fixed telephone line from 5–6 years to only 1–3 days. Mobile telephone use also expanded rapidly with the number of cellular mobile providers increasing from 2 in 1992 to 5 in 2000. Parallel increases in Internet service providers and Internet terminals (e.g., the proliferation of privately-run Internet cafes) have also led to an increase in Internet penetration and number of hosts.

Among telecommunications service providers, 10 were vertically integrated, multi-service firms offering all four or some of the services mentioned above. However, recent mergers and acquisitions have decreased the number to 7. Philippine Long Distance Telephone Company (PLDT) still remains the dominant operator in the most lucrative areas in the country including Metro Manila. In 2001, PLDT's total number of subscribers represented 62.6% of the total for the industry. New operators are gaining market share in selected regions, however. For example, Digitel is fast becoming a major

⁸¹ Four main lines and 22 subscribers per 100 people in 2003.

⁸² Executive Order 212 required mandatory interconnection of other firms with the Philippine Long Distance Telephone Company's fixed land lines.

⁸³ Investment in the sector grew at an average annual rate of 28% between 1993 and 1999.

Table 10: Number of Service Providers by Type of Telecommunications Service, 1992-2000

Telecommunications Service	1992	1993	1994	1995	1996	1997	1998	1999	2000
Local Exchange Carrier Service	45	49	60	67	74	76	76	76	77
Cellular Mobile Telephone Service	2	5	5	5	5	5	5	5	5
Paging Service	6	6	10	11	14	15	15	15	15
Public Trunk Repeater Service	7	8	8	10	10	10	10	10	10
International Gateway Facility	3	5	9	9	9	11	11	11	11
Satellite Service	3	3	3	3	3	3	3	3	3
International Record Carrier	4	4	5	5	5	5	5	5	5
Domestic record Carrier	6	6	6	6	6	6	6	6	6
Very Small Aperture Terminal	4	4	3	3	3	4	4	4	5
Public Coastal Station	13	13	13	12	12	12	12	12	12
Radiotelephone	4	6	6	5	5	5	5	5	5
Value-Added Service	—	—	—	1	27	47	70	106	156

Source: http://www.ntc.gov.ph/state2000/telecomm_is.htm, Serafica, 2000

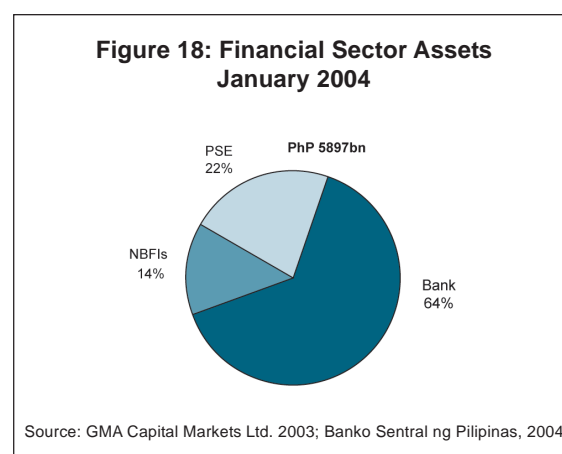
operator in Luzon, serving 11.7 % of the total number of subscribers with fixed telephone lines. Competition in the cellular market⁸⁴ has also become stiffer, with the two largest firms (Smart-PLDT and Globe) holding market shares of 39.8% and 38.4%, respectively.

Despite this market liberalization, certain segments of the market remain difficult to penetrate. PLDT still dominates the provision of backbone, international gateway facilities and leased lines, and despite Executive Order 212 mandating interconnection, both private sector land lines and cellular lines complain of difficulties. With the continuing rise in demand for broadband, it may be useful to consider how to further liberalize the upstream market. A review of selected market policies and regulations is therefore recommended, including the current delineation of the country into service areas that may unduly segment the market and allow some amount of market power and the reduction of consumer choices.

B. Financial Sector

The Philippine financial sector is dominated by banks with an estimated P3,758 billion of assets as of January 2004, compared with only P1,292 billion

of total PSE market capitalization and P847 billion of assets held by nonbank financial institutions (NBFIs) (see Figure 18).⁸⁵ Despite recent reforms designed to strengthen the financial sector, it remains weak and relatively underdeveloped. Although strong capital positions and manageable foreign exchange exposure largely protected the sector from the systemic crises that affected neighboring economies in 1997–1998, the ensuing slowdown in economic activity has led to deteriorating asset quality and a general weakening of the banking sector.



⁸⁴ With about 6.5 million subscribers.

⁸⁵ For the purposes of this discussion, NBFIs are considered separately from PSE, and include insurance companies, finance companies, securities brokers/dealers, fund managers, pension funds, and pawnshops.

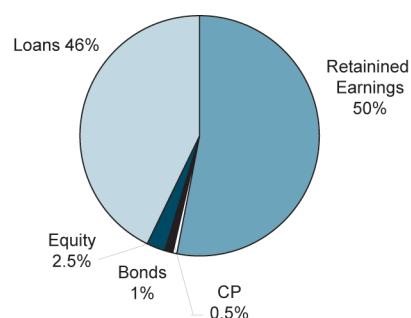
Sector supervision and regulation are fragmented, with the BSP, SEC and the Insurance Commission (IC) serving as the main supervisory bodies tasked with implementing various regulations pertaining to each financial instrument and institution. The central banking act of 1993 and the general banking law of 2000 provide the legal framework for regulating banks and financial institutions that have quasi-banking functions. BSP and SEC share in supervising and regulating nonbank financial institutions with BSP overseeing those that have quasi-banking functions and/or whose charters specify that BSP is the supervisory agency;⁸⁶ SEC supervises and regulates the rest.⁸⁷ IC is tasked to supervise and regulate the private insurance industry, and NFBI are governed by their respective charters.

About 50% of Philippine companies finance their working capital needs with internal sources of funds.⁸⁸ Those companies that seek external financing contract short- and medium- term funds from the banking sector (see Figure 19).⁸⁹ Long-term investment capital is not available from the banking sector or from the capital markets as the small and non-liquid profile of the equities market makes it unattractive to new issues, and the domestic corporate bond and asset-backed securities markets are virtually nonexistent.⁹⁰ The commercial paper market provides an alternative source of short-term (i.e., 1 year or less) and medium-term (i.e., ranging from 1 to 5 years) funds to the private sector⁹¹ but also remains very small with less than P1 billion of commercial paper issued in 2000.

There are several reasons for the underdevelopment of the financial sector, chief among them (i) the concentrated nature of the

banking sector and propensity of banks to channel funding to their preferred (and often related) customers, (ii) high interest rates, (iii) weak corporate governance practices,⁹² (iv) the ineffective insolvency regime, and (v) weak implementation of the regulatory framework. These factors are explored in more detail below and echoed in the earlier discussion on impediments to private sector development.

**Figure 19: Sources of Business Finance
Average 1995-1999**



Source: ADB/World Bank Investment Climate Survey 2004

1. Banking

The Philippine banking sector is composed of commercial banks,⁹³ thrift banks, and rural banks. Commercial banks dominate the sector with an estimated 90% of total assets as of January 2004. A high degree of concentration exists with the seven largest commercial banks (out of a total of 43) holding an estimated 60% of total assets. Two of these seven large commercial banks are government-owned, the Land Bank of the Philippines and the Development Bank of the Philippines, while the remaining five are private.⁹⁴ The top four private banks have a 40% market share and are each owned by a separate, larger commercial conglomerate.⁹⁵

⁸⁶ Microfinance-oriented thrift, rural, and cooperative banks are under the general banking law and are supervised and regulated by BSP; credit unions are supervised by the Cooperative Development Authority, and nongovernment organizations are supervised by SEC.

⁸⁷ The securities regulation code provides the legal framework for SEC's jurisdiction over the equity market as well as the nongovernment debt securities market.

⁸⁸ According to the January 2004 investment climate survey by ADB (with 700 firms participating from the manufacturing sector), over 50% of working capital needs are financed internally compared with only 20% from the banking sector and trade finance.

⁸⁹ Excluding the financial intermediation sector (22.7%), the biggest borrower from the banking system was the manufacturing sector which accounted for 19.2% of total loans outstanding, followed by the real estate sector (13.6%) and the wholesale and retail trade sector (13.1%). The rest, such as agriculture, construction, etc., had shares of 5% or less.

⁹⁰ The withholding tax of 20% imposed on corporate bonds of more than 1-year term serves as a further disincentive.

⁹¹ Note that the long-term commercial paper issued in the Philippines has the same features as bonds.

⁹² This includes disclosure practices, accounting standards, and minority shareholder protection.

⁹³ Including expanded commercial (universal) banks.

⁹⁴ The government has a 46% stake in Philippine National Bank.

⁹⁵ Metropolitan Bank and Trust Company (part of George Ty group), Bank of the Philippine Islands (part of Ayala group), Equitable-PCI Banking Corporation (part of George Go group), and Philippine National Bank (part of Lucio Tan group).

Owning banks is a characteristic feature of Philippine corporations and reduces their need to seek external financing from the capital markets (ADB 2003). Indeed, the reliance of corporations on intra-group finance allows owners to maintain tight control and to avoid the disclosure requirements of listed companies.

While there are no published estimates of the value of intra-group lending in the banking sector, the general banking act of 2000 has adopted new guidelines for reporting and monitoring related party lending. Sector analysts report that the effectiveness of BSP in enforcing these new prudential regulations remains limited, although recent agreements among BSP, SEC, and IC to allow on-site examination, the sharing of information, and the reorganization of the BSP's supervisory functions according to the conglomerate structure should strengthen the ability of these institutions to monitor connected lending.

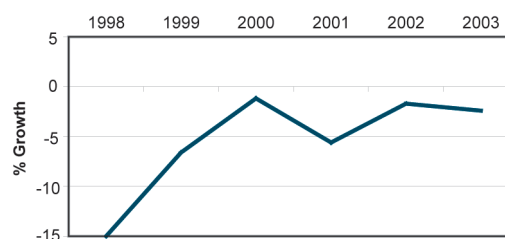
The six largest banks in the sector own trust, investment, securities, insurance, foreign currency deposit and thrift subsidiaries as well as business and real estate development projects. This structure facilitates risk arbitrage within the conglomerate⁹⁶ and increases the difficulty of supervision without close coordination among regulatory bodies. The need for improved corporate governance practices in the banking sector has been recognized by BSP which has adopted measures including the requirement of all banks, quasi-banks, and trusts to have at least two independent directors.⁹⁷

Further pressing corporate governance reforms are needed in the accounting and auditing practices of both financial institutions and corporate entities. While the Philippines has the most certified public accountants per capita in Asia and statutory accounting guidelines are sound, there is little capacity to enforce these guidelines or disclosure requirements. The Board of Accountancy⁹⁸ has never suspended or revoked accountancy charters, despite numerous cases of malpractice. Furthermore, companies often prepare different financial statements for different end-users, although the recent SEC ruling setting the international

accounting standards as the standard by 2005 should help eliminate this practice. In the financial sector in particular, BSP should actively pursue its program of accrediting external auditors and imposing penalties on bank auditors who do not alert BSP to events that materially affect the financial condition of banks.

Real credit growth of the banking system has been contracting since 1998 as the general economic downturn reduced the demand for loans and the deteriorating quality of the loan portfolio led banks to practice credit rationing despite relatively high levels of liquidity (see Figure 20). The steady stream of risk-free government securities has given banks an alternative source of investment to offset the decline in corporate lending and has helped the government maintain a low interest rate regime despite ballooning budget deficits (ADB 2003).

Figure 20: Annual Real Credit Growth Rate 1998-2003



Source: Asia Recovery Information Center, ADB

Interest rate spreads have historically been high relative to other Asian countries due to a combination of limited competition, higher intermediation costs generated by high reserve and directed lending requirements,⁹⁹ and the high interest rates set by monetary authorities on which bank lending rates were based. The availability of low-cost funds on international markets allowed banks to rely less on domestic deposits thereby keeping deposit rates low. Both lending and deposit rates have been falling since 1997, as the general decline in funding demand and

⁹⁶ An example of this is the failure of Urban Bank in 2000 that was primarily a result of the financial distress experienced by one of its subsidiaries, an investment house.

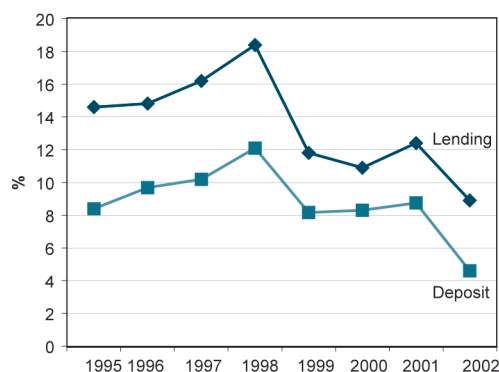
⁹⁷ As specified in the amendments to the Manual of Regulations for Banks and NBFIs (Circular 296).

⁹⁸ Body responsible for the supervision of accountants.

⁹⁹ The government requires all banks to set aside credit allocations to SMEs and agrarian reform beneficiaries.

the worldwide interest rate slump have affected the domestic market (see Figure 21). It should be noted that the average lending rates for SMEs and microenterprises are higher than this average with SMEs recently reporting average rates of 11–13% per annum while microenterprises typically pay 3% per month. In the absence of usury laws, some finance companies have been known to charge interest rates of over 50%.

Figure 21: Average Lending and Deposit Rates 1995-2002



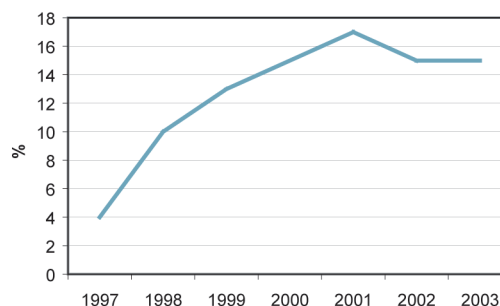
Source: The Institute of International Finance, Inc.

The NPL ratios of the banking sector remain one of the highest among the Asian crisis economies and were estimated at 15% of outstanding bank loans at end 2003, or 53% of capital (see Figure 22). If ROPOA are factored in, total net NPAs are estimated at 14% of total banking assets, or 64% of capital and 12% of GDP. Although reserves for NPAs ostensibly cover one third of those in the system, foreign market analysts believe that they are unlikely to be sufficient to absorb the losses resulting from the resolutions.¹⁰⁰

The highest concentration of NPAs lies in the commercial banking sector, where 42 banks hold 88% of them. The remaining 12% are held by thrift and rural banks. The passage of the SPV law (RA 9182) in December 2002 has done little to entice banks to resolve their NPAs. Issues of valuation and appraisal

¹⁰⁰ According to recent analysis by ADB and the World Bank Development Policy Update of October 2003, the comparatively high capital adequacy ratio of Philippine commercial banks (16%) is misleading due to the use of substandard accounting practices to record NPLs.

Figure 22: Ratio of NPL to Total Loans



Source: Bangko Sentral ng Pilipinas

persist, and banks are generally unwilling to recognize the current market values of their NPAs.¹⁰¹

The steady decline in the profitability of banks¹⁰² is putting more pressure on them to restructure, although controlling shareholders have demonstrated continued resistance. A notable exception is the recent agreement reached by the National Housing Mortgage Finance Corporation (NHMFC) to sell an estimated P13.4 billion¹⁰³ of its NPLs to Deutsche Bank Real Estate for a reported P5.123 billion, or 38.08% of outstanding principal balance. Deutsche Bank and NHMFC agreed on a 51/49% equity split in an SPV to be set up to resolve the loan portfolio, with Deutsche Bank as controlling shareholder. Deutsche Bank's bid assumes third-party financing of 50% of the purchase price.¹⁰⁴ This transaction represents the first major effort to resolve a large NPL portfolio in the Philippines.

Going forward, strengthening the banking sector will require resolving the NPA overhang and implementing the provisions of the general banking law, particularly those concerning disclosure of related-party lending, risk-based capital adequacy,¹⁰⁵ and corporate governance and accounting practices.

¹⁰¹ There is a disincentive to dispose of ROPOAs as they can be retained and counted toward capital; disposing of them would force banks to recognize the losses immediately.

¹⁰² Return on assets and return on equity have dropped from 2.2% and 15.9% in 1996 to 0.6% and 4.3% in 2001, respectively.

¹⁰³ Book value of outstanding principal balance.

¹⁰⁴ ADB provided a letter of support and a term sheet for a financing package that would be available to the winning bidder in the auction. These two documents were made available to all registered bidders to allow them to structure their bids. ADB and Deutsche Bank are currently in negotiations for a debt-financing package. ADB Board approval has not been obtained as yet.

¹⁰⁵ BSP Circular No. 389 (25 June 2003) sets the guidelines for the granting of loans and other credit accommodations, and BSP Circular No. 360 (3 December 2002) provides guidelines for incorporating market risk in the risk-based capital adequacy framework for universal banks and commercial banks.

Positive steps have already been taken by BSP in adopting a financial sector reform program aimed at strengthening the prudential and regulatory framework and encouraging market-based consolidation in the banking sector. With the adoption of most of the core principles for effective banking supervision of the Bank for International Settlements, BSP has tightened prudential norms regarding industry sector limits, credit concentration, real estate exposure, income recognition, and restrictions on speculative trading and foreign currency activity.

To ensure the effective implementation of these tightened regulations, the authority and capacity of BSP to prosecute violations must be enhanced.¹⁰⁶ This will require some form of protection of BSP examiners from prosecution¹⁰⁷ and more discipline from BSP in implementing regulations uniformly, i.e., avoiding regulatory forbearance and the use of liquidity support to prop up failing institutions. Weak banking institutions with limited prospects for market-based recovery should be allowed to fail.¹⁰⁸

2. Nonbank Financial Institutions

The nonbank financial sector (NBFS) remains small, representing only 14% of the total assets of the financial sector. It is composed of financing companies (with and without quasi-banking functions), mutual funds, pre-need funds, insurance companies, pension funds, security brokers, and pawnshops. The largest share of assets among NBFIs is with the two pension funds that represent 52% of the total.¹⁰⁹

The Government Service Insurance System and the Social Security System are funded pension schemes. Market analysts express serious doubts about the long-term solvency of both funds.¹¹⁰ While

they should play important roles as institutional investors and providers of long-term finance to the housing sector, their relatively small size and the prevailing government policies regarding their investments have limited their presence in the market. Both funds allocate a significant portion of their portfolios to low-cost mortgage funding and loans to members¹¹¹ which further limits their profitability. Investments in the equity market typically represent 30–40% of their portfolios and government bonds another 10–20%. Further growth and rehabilitation of the pension funds will require a review of subsidized lending requirements as well as improved perception on the part of individual savers that the funds will pay out in the future. Prevailing sentiments today indicate a lack of confidence in the viability of the pension schemes and a consequent propensity to withdraw savings as early as possible.

Beyond pension funds, the pre-need industry also contains numerous memorial and education plans, one of the largest of which is the college assurance plan (CAP). This plan, which recently posted an estimated P17 billion shortfall in its trust fund,¹¹² is under intense scrutiny as a test for the solvency of the sector as a whole. As with other pre-need plans, CAP has largely escaped the tight regulation afforded to the insurance sector by IC, falling instead under the supervision of a department of SEC. While the tightened regulations issued by SEC in 2001 have largely served to strengthen the disclosure and prudential management practices of the industry, the absence of close regulatory oversight in previous years coupled with poor management¹¹³ has led to the weak financial condition of several plans, most notably CAP. Given the size of this plan, it is feared that its failure could precipitate a general run on pre-need plans; efforts are being undertaken by the industry to improve its financial outlook.

There are over 150 licensed insurance companies in the Philippines although three companies dominate the sector with 72% of the assets. Filipinos

¹⁰⁶ As an example, BSP did not have sufficient authority in the rehabilitation of Philippine National Bank to force its majority shareholder to inject additional capital or sell/dilute his position; it therefore resorted to liquidity support.

¹⁰⁷ This same protection from prosecution is also sought by SEC.

¹⁰⁸ It should be noted that secrecy laws prevent deposits from being transferred to another institution at the time of failure resolution, so performing loans tend to linger in failing institutions.

¹⁰⁹ The Government Service Insurance System (GSIS) is for government employees, and the Social Security System (SSS) is for private sector employees; each is governed by its respective charter.

¹¹⁰ The latest actuarial valuation indicates that from 1999 to 2001, SSS paid out P7 billion more in benefits than it collected in contributions, forcing it to dip into reserves and leading to a possible depletion of the fund by 2015 without remedial action.

¹¹¹ GSIS is required to invest at least 40% of its resources in housing loans and loans to members; in 2001 the actual allocation was 49.4%.

¹¹² In 2003, an audited financial statement submitted by the company's external auditor to the Philippine SEC stated that CAP's trust funds managed by trustee banks was only P8.49 billion against its liabilities of P25.6 billion.

¹¹³ CAP's trust fund assets are managed by some of the Philippines' biggest and most stable banks, namely the Bank of the Philippine Islands, Metropolitan Bank and Trust Company, Allied Banking Corporation, Bank of Commerce, Equitable-PCI Bank, Philippine Veterans Bank, Union Bank of the Philippines, and East West Banking Corp.

remain modest buyers of insurance with annual per capita expenditure of only P336 in 2001 (ADB 2003). Insurance companies are active in the capital market investing on average 40% of their portfolios in government bonds and another 30% in equities and promissory notes.

The mutual fund industry is the smallest in the Association of Southeast Asian Nations region representing only 0.1% of the size of the industry in the Republic of Korea and 1.8% in Thailand. A history of scandals and poor information dissemination has left investors very wary of the industry. A lack of distribution infrastructure and competition from banks that prefer to market their own common trust funds to investors have left the mutual fund industry with few participants.

Because of their long-term liabilities, contractual savings institutions, mutual funds, and insurance companies can play a key role in developing the domestic capital market. However, investment restrictions and required security deposits imposed on these institutions have created a situation in which a large share of their assets consists of short-term investment instruments and government securities.¹¹⁴ Addressing the key impediments to NBFI development requires a holistic approach taking into consideration the needs of all stakeholders: investors (e.g., information, ease of access), providers (e.g., distribution infrastructure, corporate governance) and regulators (e.g., disclosure, enforcement powers and immunity from harassment). SEC and the Capital Markets Development Council have recently adopted such an approach in issuing their “blueprint” for developing the nonbank financial sector (NBFS). This approach, which anchors NBFS development to national economic objectives and involves the private sector in defining measures to be taken, should be actively encouraged.

3. Debt and Equity Markets

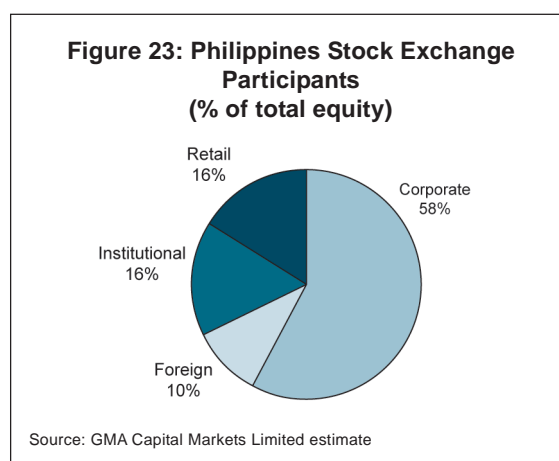
Active capital markets play a key role in channeling finance and diversifying risk allowing a

¹¹⁴ These restrictions include limits on investments in stocks, bonds, and other certificates of indebtedness, real estate investments, investment in a single enterprise, and investments in foreign currency.

broad base of investors to finance economic growth. The Philippine equity market is still very small relative to its economy¹¹⁵ and is by far the thinnest in Asia. The total number of companies listed on the PSE is only 238, and 5 of those are listed on the smaller board reserved for SMEs. Initial public offerings average 4 per year and raised only \$3.3 million in 2003. The top 20 equities represent 80% of trading volume on average. It is further estimated that between 500 and 1,000 additional companies qualify for listing but choose not to, preferring to source funding from the banking sector or from retained earnings.

The slow growth of the market can be attributed to four key factors: (i) lack of interest by many qualified companies who prefer to self-finance their operations, (ii) poor corporate governance practices (e.g., disclosure, minority shareholder protection), (iii) relatively high transaction costs,¹¹⁶ and (iv) restrictions on foreign ownership.¹¹⁷ Given these market limitations, it is not surprising that the participation of retail and foreign investors in PSE is low at only 16% and 10%, respectively (see Figure 23).¹¹⁸

The private debt market is also very small, with few corporate bond issues and little liquidity. The largest corporate issuers, such as Meralco, prefer to



¹¹⁵ Total market capitalization of PSE was 23.6% of GDP in 2002 compared to 36% for Thailand and 46% for the Republic of Korea.

¹¹⁶ Documentary stamp taxes (DST) and stock transaction taxes added 1.25% to each transaction, giving PSE the second highest transaction costs in Asia; DST on secondary trading has recently been eliminated.

¹¹⁷ In practice nearly all listed companies have ownership limitations.

¹¹⁸ The California Public Employees' Retirement System put the Philippines on its blacklist in 2002 due to poor standards of disclosure, regulation, and governance, but this rating was then removed following lobbying efforts on behalf of the Philippine government.

list debt on foreign markets given their higher liquidity and better pricing mechanisms. Trading has historically been conducted on an over-the-counter basis, although the planned establishment of a new fixed income exchange in 2004 will automate this process and allow real time pricing. The mortgage market also remains small as current laws weaken the ability of lenders to foreclose on defaulting loans, and until very recently no legal mechanisms existed for secondary trading through portfolio securitization. The generally unstable macroeconomic environment, poor protection offered to creditors, high tax regime,¹¹⁹ and absence of a long-term benchmark rate¹²⁰ have hampered the development of the market.

The volume of government debt, on the other hand, remains quite large, and at P2.3 trillion is almost double PSE market capitalization.¹²¹ Major buyers of government debt are institutional investors (banks, insurance companies, and pension funds) as retail customers have only limited access. The growing fiscal deficit of the government ensures a steady supply of bonds, and their corresponding interest rates will have to steadily increase to match the risks associated with the increasing level of public debt. This phenomenon may have the effect of crowding out future issues of corporate bonds.

SEC has attempted to increase the supply of equities into the market by encouraging PSE to enforce the free-float rule,¹²² by encouraging the top 5,000 corporations to list, by circulating its draft rules and regulations to govern alternative trading systems, and by redrafting the rules to govern the trading of commodity futures.¹²³ In reality, however, it is SEC's and the Capital Markets Development Council's holistic approach to addressing the impediments to NBFS development (as embodied in the "blueprint") that is more likely to be effective. Confidence in the market must be restored to make

it an effective tool for channeling investment. A notable step in this direction was taken in 2003 with the demutualization of PSE and the initial listing of 20% of its shares.

Further improvements in corporate governance practices will be central to restoring confidence in the capital markets. Efforts by SEC to date have included issuing the Code of Corporate Governance, Memorandum Circular Number 5 on the accreditation of external auditors of public companies, and amendments to accounting and auditing rules to incorporate international standards and to increase the responsibility of management for accurate and complete disclosure. In addition, SEC has promulgated guidelines on the nomination and election of independent directors and has developed a corporate governance self-rating process. Other initiatives are under way with the Institute of Corporate Directors.¹²⁴ On the whole, corporate governance is new to the Philippines and a departure from the tradition of opaque, closely held conglomerates with limited need for external finance. Given the closed nature of many corporate groups, corporate governance reforms will not necessarily be implemented voluntarily and will therefore need careful and competent oversight from a combination of SEC, BSP, IC and encouragement from such private organizations as Institute of Corporate Directors.

4. Housing Finance

Housing finance is currently provided by most private banking institutions, although they tend to focus on the highest tier of the market. Lower income groups receive subsidized mortgage loans from the Government Service Insurance System and Social Security System both of which are obligated to provide these loans at rates that barely cover administrative costs. The experience of NHMFC,¹²⁵ created to channel subsidized housing finance from the pension funds, showed how these programs can

¹¹⁹ Interest income on bonds is subject to a 20% final tax withheld at source; capital gains derived from the sale of bonds are considered as ordinary income and taxed accordingly.

¹²⁰ Of the P2.3 billion in outstanding treasury bonds at the end of 2003, 9% had a 20-year maturity which should begin to lengthen the benchmark yield curve.

¹²¹ Figures as of December 31, 2003.

¹²² The free-float rule requires listed companies to maintain a minimum public float of 10–33% depending on size and market capitalization. This rule was suspended from 1998 until 2004.

¹²³ According to the draft rules, alternative trading system refers to any organization, association, person, or group of persons, or system that constitutes, maintains, or provides an electronic market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a recognized exchange or clearinghouse. Among others, this alternative trading system will provide smaller companies with a more cost-efficient source of corporate financing and offer investors investment products that are not currently offered by traditional investment outlets.

¹²⁴ Examples of the proposals are the following: corporations must institute the "commitment to corporate governance," which involves setting up an operative system of accountability, checks and balances, and performance evaluation and adherence to "transparency" which involves, among others, the regular release of financial and nonfinancial information to regulators and to the general public (ICD 2000).

¹²⁵ Launched under the national shelter program of 1986.

fail as it has proved unable to service and recover the portfolio of 200,000 loans that it built up nationwide leading to the insolvency of the corporation.

It has been demonstrated that lower income groups can pay market rates for housing finance and generally have a low default rate. With the passage of the foreclosure and asset-backed securities laws, the risks of lending to lower income groups should be reduced and modes of risk diversification should be expanded making the market more attractive to lenders and bringing down interest rates.

It is therefore recommended that commercialization of the mortgage market be pursued letting both supply (including pension funds and other contractual savings institutions) and demand (including from commercial banks) meet freely in unsegmented markets. Ensuring affordability for the poor could be achieved through a carefully targeted and transparently budgeted up-front subsidy program.

C. Social Sectors

1. Education

The Philippine educational system reaches most of its eligible students with enrollment rates of 97% in elementary schools, 73.4% in secondary schools, and 25% in universities. While these numbers compare favorably with other countries in the region, the overall quality of education has been declining in recent years with budget allocations unable to keep pace with the growing population.¹²⁶ Real per capita expenditure on education declined 12% from P493 in 1997 to P433 in 2001 while the population of eligible students grew by more than 2% per year during the same period.

The private sector has historically played a significant role in providing secondary¹²⁷ education with over 40% of total enrollments in the mid-1980s. With the government's introduction of free public

secondary schools in 1987,¹²⁸ private school enrollments declined rapidly to 24% of the total in 2000. With few exceptions, private schools are not able to retain enough students to be financially viable even with the modicum of scholarship assistance available under the Government's Assistance to Students and Teachers in Private Education (GASTPE) program.¹²⁹ Total allocations to GASTPE in 2000–2001 were 2% of total government spending on secondary and higher education.

The crowding out of the private sector is also occurring in the university system with market share of private tertiary institutions dropping from 85% of enrollments in 1987 to 73% in 2000. Contributing to this phenomenon is the proliferation of state universities and colleges (SUCs) throughout the country which increased from 78 in 1987 to 115 in 2003. These SUCs charge on average less than 10% of unit cost, allot minimal budgets for scholarship, and admit mostly the nonpoor.¹³⁰ They are often created at the behest of a congressman within his constituency, and once created must be funded by the Department of Budget and Management.¹³¹ The role of the Commission on Higher Education (CHED), the planning and regulatory authority for the sector, is minimal as only the president can veto the request.

The role of the government in the sector should be to ensure access to quality education services to all who seek them. The current policy environment fails to do this effectively relying too heavily on public provision of services rather than on a considered policy framework that enables both public and private providers to compete equally, thereby allowing market pressures to induce efficiencies. To reduce the overall cost to the government of providing education, several measures must be considered: (i) strengthening the planning process of the Department of Education and CHED so that

¹²⁸ "Free" elementary and secondary education was mandated by the 1987 Constitution.

¹²⁹ The program provides tuition fee supplements for students, subsidies to private high schools purchasing approved textbooks, subsidies paid to private high schools that enroll students in areas where there is either no public high school or where there is insufficient space in public high schools to meet demand, scholarships to underprivileged first-year college and university students, tuition fee supplements to nonfreshmen students in private colleges and universities enrolled in priority courses and programs, educational loans to college students, low-interest loans to private educational institutions, and scholarships for graduate degrees and nondegree workshops or seminars for faculty members in private colleges and universities.

¹³⁰ An estimated 25% of SUC students are below the poverty line, suggesting that the remaining 75% could afford to contribute to tuition fees (Tan 2002).

¹³¹ In 2001, SUCs absorbed 13% of the total government budget for the education sector.

¹²⁶ The Philippine education system is plagued with teacher, textbook, classroom, and armchair shortages as approximately 90% of the Department of Education's budget goes to teachers' salaries.

¹²⁷ Secondary schools cover grades 7–10 with universities covering grades 11–14.

licensing of schools can be done according to need;¹³² (ii) elimination of the discretionary authority of congressmen to create SUCs without CHED approval; (iii) broadening CHED mandate to include supervision/regulation of SUCs; (iv) improved targeting of sector subsidies to the poor so that students who can afford to contribute to tuition fees are obligated to do so;¹³³ and (v) expansion of the GATSPE program to allow more students to select schools based solely on the quality of education rather than cost.

2. Health

With the steady growth of total health expenditures from 0.78% of GNP in 1995 to 1.04% in 2003,¹³⁴ key indicators have also improved with increases in overall life expectancy and a decline in infant mortality rates.¹³⁵ There is a high disparity among provinces and regions. Mindanao, Eastern Visayas, and Ifugao, for example, still have much higher infant mortality rates than the national average; this is directly related to the highly unequal distribution of health services among classes and regions.

The private sector provides a large portion of health services—66% of the hospitals and 42% of the hospital beds—reflecting a high level of investment.¹³⁶ Private providers typically focus on personal care services while the public sector provides both public health care and personal care. Despite the significant presence of private sector health care providers, their presence has done little to reduce the fiscal burden on the government due to poor planning, public-private coordination, and licensing and accreditation practices in the sector (see Box 6).

The Department of Health (DOH) is responsible for licensing health care facilities, as well

as for the operation of 78 hospitals.¹³⁷ Accreditation is done by the National Health Insurance Corporation (PhilHealth). In licensing private facilities for the sector, DOH is not empowered to consider their proposed location and therefore cannot manage the ratio of facilities per capita which results in suboptimal coverage throughout the country.

Box 6: Opportunities for Local Public-Private Partnerships

At the local level, with devolution, the private sector has an opportunity to partner with the public sector in developing interlocal health zones where expensive medical equipment and emergency services can be shared.

With the passage of the National Health Insurance Act of 1995 and the creation of PhilHealth, the government took an initial step in formally integrating private health care providers into the universal health care system. PhilHealth now reimburses both private and public accredited facilities for their health care services. The evolution of the sector should see the government focus its role on planning, licensing, and accreditation leaving health care service provision to the private sector, particularly in the urban areas. This can be achieved by strengthening the planning and budgeting capabilities of DOH¹³⁸ to introduce professional management and accounting practices, and strengthening the accreditation capabilities of PhilHealth. The planned incorporation of two DOH hospitals¹³⁹ and similar reforms launched by LGUs to create financial autonomy in provincial hospitals should be actively pursued as initial reforms to strengthen the performance of the sector.

¹³² A step in this direction is CHED's current program mapping for all higher educational institutions to identify institutions per region offering duplicate, oversubscribed, and undersubscribed programs.

¹³³ Equal subsidization of public and private schools could be facilitated with the use of vouchers to allow students to choose their schools.

¹³⁴ This is below the 5% of GNP standard set by the World Health Organization.

¹³⁵ Life expectancy increased from 64.5 years in 1991 to 67.6 years in 1999; infant mortality fell from 55/100,00 in 1991 to 29 in 1999.

¹³⁶ Of the total expenditures for the sector, 54% are paid by users for services provided by the private sector.

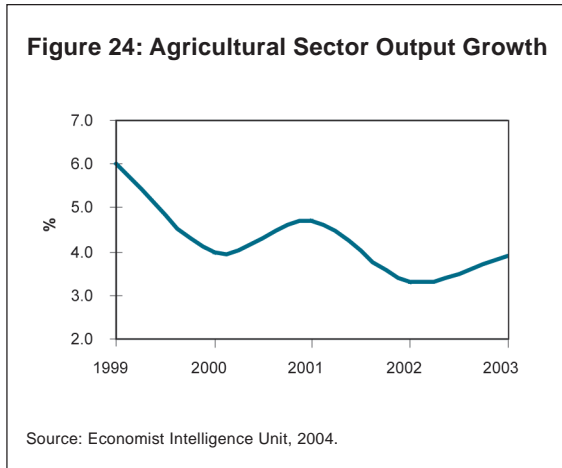
¹³⁷ The devolution of health care services to LGUs in 1991 has meant that public hospitals are now run by LGUs, and only 78 tertiary and highly specialized hospitals remain under DOH management.

¹³⁸ Only 4 of the more than 600 existing public hospitals are incorporated today.

¹³⁹ DOH has four hospitals nominally set up as corporations (heart center, kidney institute, lung center, and children's medical center).

D. Agriculture

The agriculture sector still contributes a sizeable share of employment and income accounting for nearly half of the total labor force and contributing close to 15% of GDP in 2003. Recent agricultural growth slowed, however, from 6% per year in 1999 to 4% in 2003 (see Figure 24). Contributing factors include drops in world commodity prices and public expenditures for irrigation combined with a sharp increase in the cost of constructing new irrigation systems. Agricultural research and development continues to suffer from underfunding¹⁴⁰ that contributes to low productivity growth as few technological changes have been introduced over the past several years.



The Philippines has one of the lowest arable land per capita ratios in Asia. Given the high population growth (2.1% annually), there is increasing pressure on land and natural resource availability. Landownership, moreover, is highly concentrated. Two percent of all landowners control 36% of farmland, while 86% own only 35% of agricultural land consisting of farms of less than 7 hectares. To address this inequality and to help reduce rural poverty, the government launched the comprehensive agrarian reform program (CARP)¹⁴¹ in 1988. CARP is conceptually the most

comprehensive agrarian reform program ever attempted in the Philippines because it covers all public and private agricultural lands regardless of products produced or tenure arrangements of the farmer. CARP has identified 7.8 million hectares of agricultural land for redistribution to 3.9 million rural producers, farmers, and workers. As of 30 June 2003, 6.01 million hectares had been redistributed, most of which was public land. Addressing the redistribution of private land is a much more sensitive matter and has therefore been delayed, with the target completion date of CARP extended to 2008 from its initial target of 1998.

In addition to the difficulties encountered with implementation due to the lack of documentation (cadastral maps of the entire territory, except for high-value real estate, are either nonexistent or obsolete), to poor interagency coordination, to the weak legal framework for the exercise of eminent domain,¹⁴² and to the lack of funds for land acquisition, CARP has fallen short of its stated goals as almost no private land has been redistributed. Resistance from large landowners remains predictably strong and effective. Moreover, land redistributed under CARP is not transferable for 10 years which prohibits beneficiaries from pledging the land as collateral for bank financing. This has significantly reduced the ability of beneficiaries to develop their land.

Fostering continued output and productivity growth in agriculture would require improvements in irrigation facilities, farm-to-market roads, postharvest facilities, credit support, and research and extension. Incentives and support services should be extended to landowners who invest in viable agricultural industries. Farmers' organizations and cooperatives can be strengthened to enhance their institutional capabilities to serve their members through effective utilization of support services extended by the government, by nongovernment organizations, and by the private sector. Lastly, the transferability feature of CARP lands must be addressed so that it does not impede the functioning of the land market and long-term investments in agriculture.

¹⁴⁰ About 0.4% of gross value added of the sector.

¹⁴¹ Based on the 1988 comprehensive law on agrarian reform.

¹⁴² Although RA 8974 addresses the process of eminent domain, it does not clearly provide for just compensation as mandated by the Constitution. This law needs clarification.