

MALAYSIA'S PRIVATISATION OF INFRASTRUCTURE FACILITIES: A CALL FOR FINE-TUNING

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After more than a decade since the contemporary privatisation arrangement was introduced to the world, Malaysia still leads among the developing countries in this field. While some analysts laud Malaysia's privatisation approach, others are less impressed. This paper focuses on the already implemented build-operate-transfer (BOT) schemes with which the share of the public sector in developing physical infrastructure is reduced. The installed North-South Highway project, the Independent Power Generation Schemes and the National Sewerage System - all path-breaking in their own right - are examined. The paper calls for greater transparency when forging future privatisation deals; in particular the selection of concession companies and the formulation of user-charge structures. Policy-makers are well-advised to fine-tune the manner in which future BOT deals are struck. Otherwise a groundswell of public disenchantment may reach to a level whereby the long-term viability of the national privatisation programme is jeopardised.

INTRODUCTION

A major rethinking in economic management policy in the UK and US in the early 1980s triggered an adjustment process which continues to have effect throughout the world (Molz, 1990; Lieberman, 1993). Control over certain parts of the economy which were once the preserve of the public domain has been relinquished to the private sector in many countries. Among the developing countries, Malaysia was a frontrunner in adopting the shift in economic thinking (Jomo, 1995). In fact, even when the global privatisation movement was still in its nascent stage, Malaysia's privatisation programme was already noted for being the most extensive of its kind (Euromoney, 1985). Even though other developing countries have since joined the privatisation foray, Malaysia is still regarded as being among the select few which continues to produce demonstrable results (Kohli, 1995). The World Bank (1995) considers Malaysia's privatisation efforts as a touchstone model for other developing nations to emulate. Pakistan, Croatia, Myanmar and Namibia are among the countries that have studied the Malaysian privatisation model with keen interest.

The privatisation of infrastructure development is a important feature of the Malaysian government's overall privatisation strategy (Hensley and White, 1993). As a vehicle to accomplish this policy, Malaysia is said to yet again lead in the creative use of the build-operate-transfer (BOT) approach. Except for the Light Rail Transit Project which was procured under the build-operate-own (BOO) scheme, the other privatised infrastructure projects were all implemented under the BOT scheme. By 1993, over US\$8.2 billion worth of projects had been privatised in Malaysia using the BOT scheme (Hensley and White, 1993). Table 1 lists some of the infrastructure facilities which have been privatised. Under the BOT format, a private developer is granted the right by the government to plan, finance, construct, operate and maintain a facility over a pre-determined period during which time, the investment is recouped through the collection of toll or other charges. At the end of the period, the facility is handed to the government without charge. (Under the BOO contract, the facility is not required to be surrendered to the government.) The attraction of the BOT approach for the government is that it enables non-debt financing of public construction projects for which the ownership of the facility by the private sector is only temporary.

Table 1: List of infrastructure projects which have been implemented using the BOT scheme.

Projects	Start Date	Sector	Method
North Klang Bypass	1984	Roads	BOT
Jalan Kuching Interchange	1985	Roads	BOT
Kuala Lumpur Interchanges	1987	Roads	BOT
Labuan Water Supply	1988	Water	BOT
North-South Highway	1988	Roads	BOT
Labuan Beaufort Interconnection	1988	Electricity	BOT
Ipoh Water Supply	1989	Water	BOT
Larut Matang Water Supply	1989	Water	BOT
Kuala Lumpur Tower	1991	Building	BOT
Light Rail Transit	1992	Urban transit system	BOO
Shah Alam Highway	1993	Road	BOT
National Sewerage System	1993	Sewerage	BOT
Seremban-Port Dickson Highway	1993	Road	BOT
Second Link to Singapore	1994	Road	BOT

Source: Adapted from Abdul Aziz (1993).

This paper examines Malaysia's privatisation programme, in particular its BOT transactions. While suggesting that the contributory factors to the success of the programme be retained, it calls for greater transparency in the manner in which future BOT deals are forged. Selection of private concession holders should be objective and open. This paper also calls for early public disclosure of the agreed user-charge structure. Inevitably, structuring the funding of any BOT arrangement is never easy and is often far from smooth (Tiong, 1995b). A multifarious number of issues have to be resolved before the balance between the private and public sector roles can be redrawn, not least because the prevailing circumstances of each BOT project differs from others. All things considered, Malaysia has done well in overcoming the financial challenge. Corrective steps, however, need to be taken if the privatisation programme is to continue to perform well. For the purpose of this paper, three sub-sectors - highway, power generation and sewerage - are examined. Despite the Official Secrets Act which severely restricts public debate of BOT projects in Malaysia (Jomo, 1995), sufficient information was obtained from freely available published material to make a case in support of the arguments of this paper.

The paper starts by describing briefly Malaysia's privatisation programme, in particular the stated objectives and contributory success factors. A literature review on the financial structuring of BOT projects is then provided. Three BOT projects which have been implemented in Malaysia are analysed using the framework presented in the preceding section. The rather lengthy clarification of the financial structure of the case studies is necessary as it is crucial towards understanding the premise of this paper. The paper concludes by recommending that the government fine-tunes the privatisation programme so that its momentum can be sustained in years to come.

OVERVIEW OF MALAYSIA'S PRIVATISATION PROGRAMME

Objectives of Malaysia's Privatisation Programme

The Malaysian government defines privatisation as 'the transfer to the private sector of activities and functions which have traditionally rested with the public sector (Economic Planning Unit, 1991:13). One of the objectives of Malaysia's privatisation programme is to relieve the government of administrative and financial burden (Economic Planning Unit, 1985). For a long time, the provision of infrastructure in Malaysia, as in many other countries, was almost entirely the preserve of the public sector (Naidu, 1995). From independence in 1957 until 1985, RM31 billion (US\$12.4 billion) had

been spent on infrastructure facilities. During the pre-privatisation years, the federal government's current account balance always recorded a surplus, but the high level of development expenditure consistently resulted in overall balance deficit (Ismail and Osman-Rani, 1991). During the first half of the 1980s, the deterioration in the balance of payments due to continued decline in export prices of major commodities and the shrinkage of export markets for Malaysia's manufactured goods gave rise to an increasing level of public debt, particularly external borrowing. The rising level of public-sector expenditure had imposed considerable constraints on the public purse. Spurred by the privatisation successes in the UK and US, the transfer of control of certain segments of the economy to the private sector was judged by Malaysian economic planners as the panacea for improving the government's finances (Toh, 1989; Leeds 1989; Ismail and Osman-Rani, 1991). And so the Malaysian government officially embraced the privatisation ideology in 1983 and made it the cornerstone in its broader plan to reform the national economy which was suffering badly from the protracted worldwide recession.

Privatisation was also seen as an instrument to 'crowd-in' a nascent private sector (Economic Planning Unit, 1985; Adam, Cavendish and Mistry, 1992). For socio-economic reasons (see below), state-owned enterprises (SOEs) were set up to operate in most sectors of the Malaysian economy. By the 1980s, some RM10 billion had been directly invested in about 1,000 SOEs, with guarantees totalling a further RM25 billion. Most SOEs simply drained funds from the treasury. Although the malaise of the SOEs had long been noted, it was brought into sharp focus against the deteriorating economic backdrop (Ismail and Osman-Rani, 1991). The Prime Minister lamented, "Even those which are monopolistic are not able to pay their way, much less make a profit" (Mahathir, 1988). As with many other countries, Malaysia increasingly saw SOEs as a bane (World Bank, 1983). The private sector on the other hand was perceived as being capable of bringing about greater efficiency and productivity (Economic Planning Unit, 1985). However, the fact that poor performance has more to do with factors that are non-ownership in nature (e.g. competition) was somehow lost in the exuberance over privatisation (Yarrow, 1986; Nellis and Kikeri, 1989). Relinquishing ownership alone may not necessarily be the remedy for SOEs' woes.

In contrast to the objectives of the Malaysian privatisation programme mentioned above which are implicit in privatisation programmes elsewhere (Pelkmans and Wagner, 1990), there is one additional objective which is uniquely Malaysian, and that is the drive to attain the objectives of the New Economic Policy (NEP), in particular, the income distribution targets

(Economic Planning Unit, 1985). The NEP was formulated following the 1969 race riots between the resentful *Bumiputera* Malays and the Chinese who dominated the economy. It was designed to improve inter-ethnic relations through the eradication of poverty, regardless of race. This led to, among others, the proliferation of SOEs as a means of expediting the process of income distribution. To allay the fears of the *Bumiputeras*, the government had to give the assurance that the pushing back of the state's frontier would be harmonised with the NEP ideals. Adjustments to western privatisation ideals are crucial for the success of privatisation programmes in developing countries (Adam, Cavendish and Mistry, 1992). This stands to reason since the 'original' privatisation ideology is premised on the economic endowments and social, cultural and administrative characteristics of Western Europe. Developing countries do not possess well-evolved, reasonably competitive domestic markets for goods and services. Neither do they have sound regulatory structures. Indeed it is the experience of the International Financing Corporation, a branch of the World Bank Group and is the largest multilateral source of equity and loan financing for private sector projects in developing countries, that privatisation will always be based on political considerations including redistribution of wealth and the resulting winners and losers (Donaldson, 1995).

Success Factors

Several factors have contributed towards the success of Malaysia's privatisation schemes. These should be sustained in years to come. It is commonly accepted that the personal commitment of the Prime Minister himself has maintained the momentum of the privatisation programme and helped quell resistance from various sources including senior civil servants, leaders of state governments concerned with the centralisation of economic power in the hands of a Kuala Lumpur business elite, technocrats; and trade union leaders (Hensley and White, 1993; Rozario, 1993).

Experiences around the world demonstrate that a strong specialised agency with the capability and motivation to privatise effectively is a requisite for successful privatisation endeavours (Schwartz, 1991; Shirley, 1994). These agencies, free from many bureaucratic and regulatory encumbrances, are able to concentrate solely on designing and implementing privatisation packages. Malaysia came to accept the wisdom of having such an independent privatisation vehicle. The Malaysian 'mainstream' privatisation programme was initially the responsibility of the Economic Planning Unit (which is located within the Office of the Prime Minister) while the divestment from the

smaller SOEs in the manufacturing sector was under the ambit of the Ministry of Finance Public Enterprise Monitoring Unit (UPSAK) which was formed in 1987 (Adam, Cavendish and Mistry, 1992). Gradually, the activities of these two agencies relating to privatisation were combined. The centralised privatisation system enables the government to proactively announce its intentions, identify companies, and propose the method and timetable for sale. In the late 1980s, the government published lists of privatisation candidates to serve as a 'shopping list' to domestic and foreign private sector. The most comprehensive action plan so far has been the *Privatisation Masterplan* which details out the timing, mechanism and adjustment processes for privatising viable projects between 1990-2000 (Lee, 1990; Economic Planning Unit, 1991). Such 'master plan' approach is recommended by the World Bank as appropriate in realigning the balance between public and private sector (Nellis and Kikeri, 1989).

A domestic financial market weak in dealing with privatisation transactions can put a tremendous constraint on the economic reform (Yotopoulos, 1989; Schwartz, 1991). Another factor which aided the successful implementation of privatisation in Malaysia was the existence of a fairly large domestic capital market able to absorb public asset sales (Adam, Cavendish and Mistry, 1992; Taylor, 1997). Equally significant was the capability of the financial sector in raising large amounts of capital both domestically and internationally. Market capitalisation of privatised projects in Malaysia since 1980 has consistently represented over 50 per cent of gross national product. Moreover, the volume of trade (as measured by market turnover as a percentage of market capitalisation) is fairly high. Its dynamism is reflected in the institution of a Second Board on the Kuala Lumpur Stock Exchange in 1989 which allows traders to use a real-time, computer-based over-the-counter system, and the introduction of new instruments and techniques such as corporate bonds, commodity futures, mortgage bonds, equity and government paper. With the Asian currency crisis still looming over Malaysia, the positive characteristics mentioned above no longer hold true, at least for the time being.

Finally, the private sector has been able to provide a sufficient degree of competition while the supply of management and industrial labour has been good. With a burgeoning pool of *Bumiputera* entrepreneurs and managers, the privatisation programme played its part in fulfilling the aspirations of the NEP (Mahathir, 1988). Where private capital is not adequate, the SOEs which have been retained to champion the interests of *Bumiputeras* such as PERNAS and Tabung Haji, serve as surrogate investors on their behalf (Leeds, 1989). As

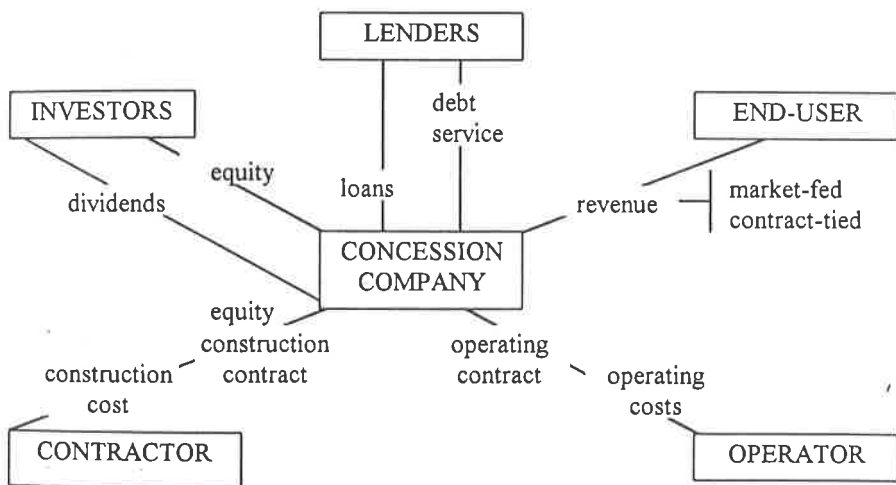
noted earlier, for political reasons the government had to ensure that the privatisation programme aligns as much as possible with the NEP aspirations.

THE BOT FORMAT

The introduction of BOT projects especially in developing countries stems from three concerns. First, the government needs to alleviate pressure on domestic public finances. Second, saving surplus can be reduced in developed economies, and this can be channelled for recycling abroad because of domestic needs. Third, developed countries are less willing to provide official support for their export credit programmes because of increasingly high costs (World Institute for Development Economics Research, 1992). By adopting the BOT approach, developing countries are able to obtain infrastructure facilities not by tapping public funds but by securing resources from home and/or abroad in the form of private equity investment and equity-related flows.

The nature and structure of BOT schemes vary from one project to another due to sheer complexity (Hensley and White, 1993). A simplified schema indicating the possible parties involved in, or affected by, a BOT agreement is shown in Figure 1.

Figure 1: Example of a BOT structure



Source: Hingley (1994) p. 15.

The concession company promotes the project and has ultimate liability to the government under the concession agreement under which the government awards the right to construct the BOT project to the private organisation (Hingley, 1994). This is the primary contract covering all aspects of the particular BOT arrangement, describing in detail the rights and obligations of the government and the concession company. All other contracts on the project emanate from this concession agreement.

BOT schemes are highly leveraged. Debt financing, invariably non-recourse financing, is raised by the concession company from commercial sources (Hingley, 1994; Price, 1995). The equity investors have no obligation other than the equity they put up and if there is a cost over-run, they will not have to come up with additional funds to cover the cost. Security for equity investors and lenders is restricted to the revenues to be received by the concession company. The project risks are distinctly separated from country risks: lenders advance money against the cash flow of the project rather than the government's sovereign guarantee, although this can be effected, to some degree, through bonding and security, and risk distribution.

A construction contract is concluded between both the investors and lenders, and the contractor (Hingley, 1994). The investors and lenders would prefer the contractor to give a fixed price for completion by a fixed date without exclusions. The concession company forms a separate entity to operate the facility. Should the concession company not wish to, or not capable of, operating the facility, a specialised experienced operating company is engaged and bound by an operating contract. The final key contract is the off-take contract which secures the future cash flow.

More detailed explanation is given below regarding three key financial aspects of BOT schemes: equity, debt and risk allocation. These three components will be referred to when analysing the three chosen BOT projects in Malaysia.

Equity

In a BOT tender, equity is often expected of the project promoters by both the governments and lenders alike. This represents the injection of risk capital by the promoter and other equity investors into the concession company. The equity achieves three purposes (Price, 1995). First, it acts as an incentive for the contractor to complete the project on time and within budget. Second, it demonstrates the sponsoring consortium's faith in the economic viability of the project, thus encouraging lenders to provide additional finance. Third, it acts

as a cushion in the event of the project proving to be less economic than expected. Equity can come from various sources (Hingley, 1994): (i) public share issues, as used on the Eurotunnel; (ii) participants in the project such as plant manufacturers; (iii) local institutions such as pension funds and insurance funds; (iv) companies, individuals and local governments; and (v) foreign institutions such as international lending agencies.

The providers of equity may either have a direct interest in the project operation (such as contractors, operators, or the host government); or be purely equity investors, such as public shareholders and institutional investors (Tiong, 1995a). The promoter and equity investors will be rewarded with dividends from profits if the project is successful, but will receive no return at all if the project results in losses. The servicing of debt has priority over dividend payments. In the event of the company becoming insolvent, equity investors rank last in order of repayment and may lose their equity investment. As the cost of equity is higher than debt, high equity requires higher returns (and revenues) to give the same rate of return on equity. In turn, this means that a high return on the project is necessary, thus putting upward pressure on charges to consumers of the good or service.

Debt

Sources of funds for BOT projects are usually (Hingley, 1994):

- (i) commercial markets providing a loan either through a single bank or by way of a syndication;
- (ii) export credit agencies providing subsidised finance for exports;
- (iii) multilateral aid made available by the various international development agencies which include the World Bank and the Asian Development Bank (ADB); and
- (iv) bilateral aid; provided by one country to another.

As mentioned earlier, non-recourse financing is common for BOT contracts. Loans are usually rigid in that specified amounts of interest and principal have to be paid on specified dates (Tiong, 1995a). Loans may therefore not provide the necessary grace periods and maturities needed to accommodate the cash flow needs of BOT projects, which are invariably long term in nature. Moreover, low leveraging at the commencement of the project would permit additional loan finance to be arranged with greater use in the event of cost overrun.

The above arguments would seem to favour high injection of equity. Yet, because equity is more costly than debt, the concessionaire would seek to minimise its equity investment. Banks too would prefer to promote lending because project finance represents a potentially profitable lending opportunity offering higher margins than those of similar-sized corporate loans (Crawford, 1988). Notwithstanding the impositions from governments and lenders, the promoters themselves are confronted with the dilemma of striking the right debt-to-equity balance.

Allocation of Risks

BOT contracts are fraught with all sorts of risks - reservoir, market price, completion and operating. Allocation of these risks underpins the structuring of the finance for BOT contracts (Price, 1995). Reservoir risks revolve around the uncertainty regarding the local supply of labour, materials and plant. Importation of construction resources can result in escalation of the project's costs. Predicting the correct market price for the product or service (such as toll charges) is one of the major risks linked to most BOT projects. If the charges are set too high the project may not generate sufficient volume to make a profit while the reverse may create a huge volume but insufficient returns to remove the debt and give a decent return on equity. BOT projects in particular have to be completed on time and within budget in order to generate income early. Predicting the running and maintenance costs is not easy as each project is unique and BOT projects have substantial life spans.

The concession company will often try to transfer as much of these risks as possible to various private parties such as the contractors, operators, lenders and customers through separate contracts while maximising its revenue (Abdullah Sepein, 1988; Lee, 1991). For example, to ensure that the project is constructed on time and to the required standards, it would obtain guarantees from the contractors. It might also ask the operator of the completed facility to provide an operating guarantee for the quality of services provided.

THREE CASE STUDIES OF BOT PROJECTS IN MALAYSIA

The North South Highway

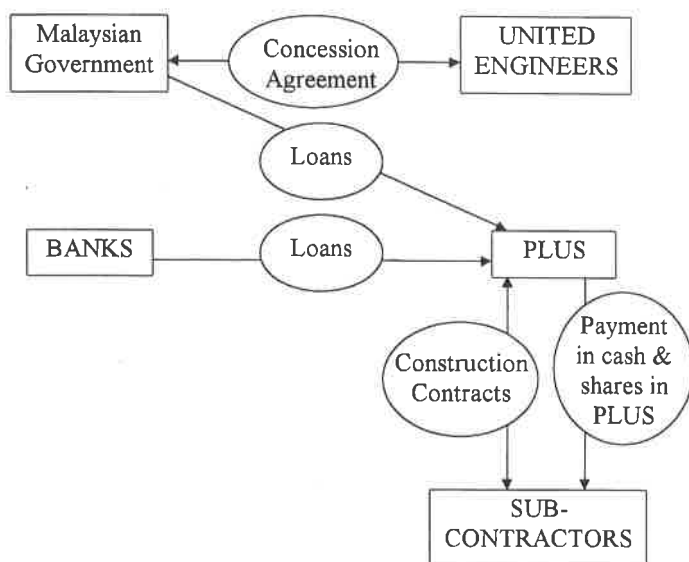
The Concession and Project Structure

Thus far approximately 17 privatised road projects (some of which have yet to be completed) have been approved by the Malaysian government, the

centrepiece being the North-South Highway. In 1988, the concession for the North-South Highway was awarded to a consortium led by the local company United Engineers of Malaysia (UEM) (Naidu, 1995). The construction of the North-South Highway which runs along the entire length of the Western side of the Malaysian peninsula is the largest BOT project ever undertaken in the Southern Hemisphere (Hensley and White, 1993). The 869 km expressway running along the western length of Peninsular Malaysia was completed ahead of schedule in the early 1994. At the time of construction, it was second in size only to the Eurotunnel among the private-sector infrastructure projects being undertaken around the world (Montagnon, 1989). Built at a cost of about RM6 billion, it is estimated that UEM will be able to collect RM34 billion in tolls over a 25-year period (Jomo, 1993), a sum which was scaled down from UEM's original demand for RM54 billion over 30 years, after it became public knowledge.

UEM created a subsidiary company, Project Lebuhraya Utara-Selatan (PLUS) to act as the concession holder and borrower for the project (Jomo, 1993; Tiong, 1992) (see Figure 2).

Figure 2: Project Structure of the North-South Highway Project



Source: Adapted from Tiong (1992), pp. 44

A 30-year concession period was granted, with anticipated net dividend earnings of over US\$400 million. UEM should also make over US\$150 million pre-tax profits from the project during its construction period. One particular attraction of BOT road projects is that income can be generated during the construction phase, unlike bridge and tunnel projects. PLUS was fortunate to have been awarded 309 km of completed highways for toll collection without having to purchase it. The total construction cost of the highway was initially estimated at RM3.32 billion. The rate of return on the investment was calculated to be at least 12%.

Funding Arrangement

The government provided a support loan of RM1.65 billion (about 35% of the total project cost originally projected) for a period of 10 years as start-up finance - RM750 million to be used for construction and RM900 million during maintenance (Lim, 1987). The loan is payable over 25 years, including a 15-year grace period, at a fixed interest rate of 8% per annum (Tiong, 1992). Loans were also obtained from a consortium of 45 local banks (RM2.535 billion) and foreign banks (US\$350 million) (Lim, 1987). Concessional loans amounting to US\$850 million were also obtained from the French and Taiwanese governments as well as a consortium of Japanese banks. Twice in the course of construction, PLUS had to seek additional finance due to cost overruns; the first in 1989 when RM2.54 billion was obtained from local financial institutions, and the second in 1993 when a term loan of about RM1.88 billion was obtained.

Equity, which represented 10 percent of the original expected cost of construction, came from the shareholders - Hatibudi (50%), United Engineers (27.65%) and others such as the Armed Forces Retirement Fund (which individually hold less than 2% stake). To ease its cash flow, PLUS paid its local and foreign subcontractors 87% of the contract value in cash and 13% in equity shares in the project company which the company planned to list on the local stock exchange (Tiong, 1992). It was stipulated that the shares could only be sold at the end of the construction period. This effectively passed much of the equity risk to the subcontractors. It was estimated that PLUS would receive RM500 million in equity from the construction companies involved in the project (Lim, 1987). When looked at in its entirety, the concessionaire had not provided much of its own cash capital for funding the project.

Risk Allocation

The North-South Highway offers a good example of the "underwriting support" offered by the government of Malaysia to encourage investment in its privatised projects. This took the form of loans and guarantees. In addition to the RM1.65 billion loan for start-up finance and the clean transfer of completed highways mentioned earlier, the government assisted in other ways. The government would provide additional finance should traffic volume fall below a certain level during the first 17 years of operation (Lim, 1987). Given pioneer status, PLUS is exempted from income tax for five years. It is also exempted from withholding tax on interest from off-shore loans and income tax on profits until it completely settles all loans supported or guaranteed by the government.

The government originally intended to provide PLUS with the guarantee that it would make up the shortfall if the exchange rate dropped by more than 15% against the rates at the time of drawdown of funds (Lim, 1987; Tiong, 1992). It was also prepared to guarantee that if the floating interest rates on loans increased by more than 20%, the sponsors would be reimbursed the difference in repayment costs. On top of that, the government offered some guarantees against delays and appreciating costs. However, when these became public knowledge, the promises - technically referred to as 'external risk standby credit facility' - worth about RM1,150 million, were withdrawn (Jomo, 1993).

YTL Independent Power Stations

Malaysia is recognised as a pioneer in the developing world in opening its power sector to private participation (Cooke, 1995a). The participation of the private sector in power generation stemmed from the need to improve the nation's power resources in the shortest time possible. Several consortiums (e.g. Genting Sanyen, Port Dickson Power, Powertek, Segari Energy Ventures and YTL Power Generation) were awarded the Independent Power Producer (IPP) licence by the Malaysian government. Together, their installed power stations generate about 35 percent of the nation's electricity requirement. As the BOT arrangements for the respective IPPs differ, only YTL Power Generation is discussed here.

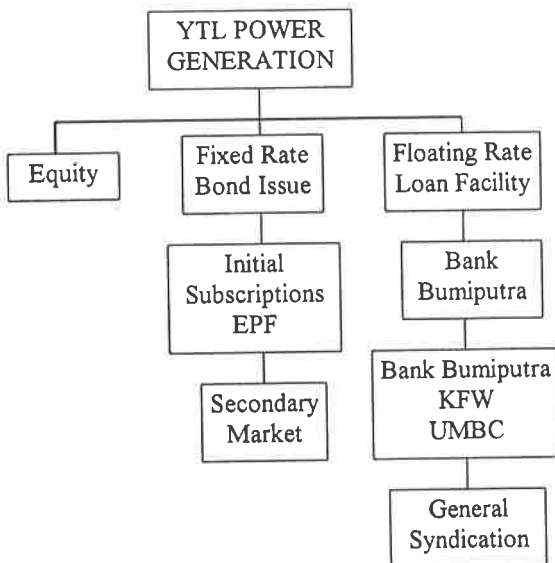
The first recipient of the independent power producer (IPP) licence was YTL Power Generation, a subsidiary of the major contractor Yeoh Tiong Lay (YTL). Following the issuance of the licence, YTL Power Generation

completed the construction of its two generating power plants - one in Paka, Terengganu (808 MW) and the other in Pasir Gudang, Johor (404 MW) - in 22 months, 7 months ahead of schedule. The concession period is 21 years. The two power stations are said to be the most advanced and sophisticated in the country. The two sources generate 15 percent of the total electricity consumption in the peninsula.

Financial Arrangement

YTL Corporation first tried to seek foreign bankers to assist in the financing of the power projects (*The Star*, 1995b). There was speculation that without a foreign equity partner, YTL would face problems raising such a huge amount (i.e. RM2.66 billion) of debt financing for the project. In the end, Bank Bumiputra headed a group of local institutions to arrange the finance, which comprises two facilities; (i) a RM1.5 billion 15-year fixed rate ringgit bond issue, which was subscribed by the Employees Provident Fund (EPF) at 10% interest; and (ii) a 15-year ringgit floating-rate commercial loan. The financing for the project was raised in six months (Cooke, 1993).

Figure 3: Funding Structure for YTL Power



Source: Burnham (1993)

The loan was underwritten by Bank Bumiputra, United Malaysian Banking Corporation and Kreditanstalt für Wiederaufbau (KfW) of Germany. Bank Bumiputra was planning to sell down its floating-rate loan to other Malaysian banks. KfW was also funded by local banks.

The structure of equity holding of the concession company is as such: YTL Corporation 50%, Tenaga Nasional 20%, the EPF 10%, while the remaining 20% is held by Mayban Ventures, John Laing Investment (Singapore) Pte Ltd and a *bumiputera* company, Bara Aktif Sdn Bhd.

According to Burnham (1993) of J. Henry Schroeder Wagg, YTL's financial advisers, the YTL Power project secured several notable achievements such as the sourcing of the huge financing entirely from local funds (which is very unusual outside of the US and UK). KfW's involvement is also unusual for an export credit bank. YTL's was the second independent power generation plant in the world to make use of a bond issue, and financing for the project was Malaysia's largest debt financing arrangement.

Operation

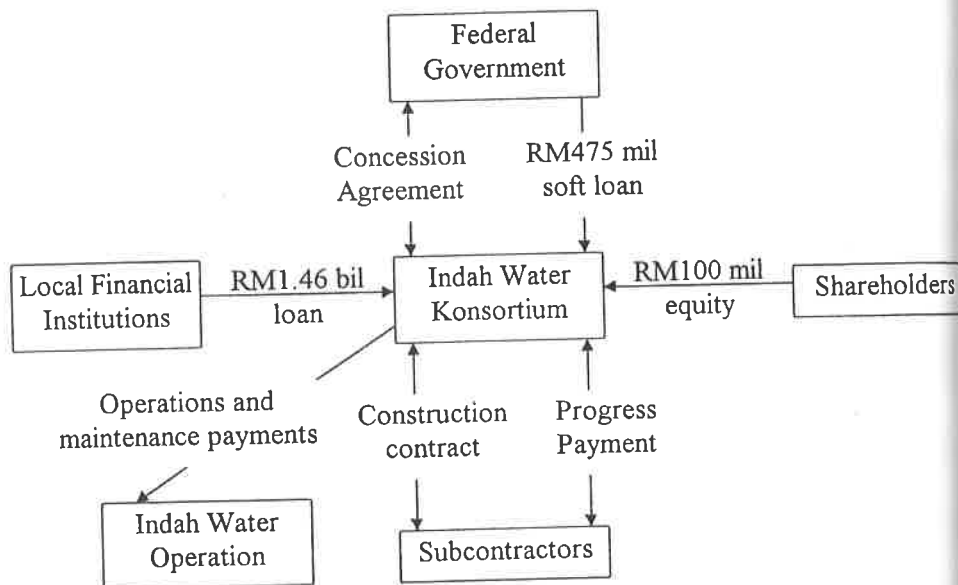
YTL Corporation is said to have struck a favourable deal with Tenaga Nasional, the national power utility company. Under a 21-year power purchase agreement between the two parties, Tenaga Nasional is required to purchase 7,450 Gigawatt hour of electricity from YTL Power at a guaranteed 15.5 cents per kilowatt-hour - a very favourable deal, given that there are strong indications the country is heading towards surplus power. The completion of the power plants several months ahead of schedule brought early revenue and savings in terms of cost of interest. YTL Power expects to earn RM800 million in revenue for the first two years of operation of the two plants, and RM1 billion annually thereafter.

The two power stations are being operated and maintained by a joint venture company between YTL Corporation (49%) and Siemens AG of Germany (51%). Siemens is one of the world's largest gas turbine manufacturers and has tremendous experience in designing, constructing and installing of power plants. Into the 7th year of the concession period, the stakes would be reversed. For undisclosed reasons, Siemens did not take any equity in the project although it was the turnkey contractor for the two power stations. Under the arrangement, Siemens guaranteed the provision of operating and maintenance services.

National Sewerage System

In December 1993, a RM6.2 billion concession agreement for the development of a national sewerage system was signed between the government and Indah Water Konsortium (IWK) (Naidu, 1995). The project involves the upgrading and refurbishment of the existing sewerage systems as well as the construction of new multi-point sewerage systems. The sewerage systems throughout the country was in dire need of substantial investment as limited public funding over the years had left it in a serious state of neglect. Indeed, in the late 1980s, the government estimated that RM10 billion was required to build networks in the major cities (Clifford, 1993) but for the 1991-95 period, only RM551 million was actually budgeted. With this agreement, IWK took over the sewerage services of 144 local authorities.

Figure 4: Financial Structure of the Privatised National Sewerage System Project



Source: Kuan (1996), pp. 108

The concession period is 28 years. Prior to the award of the contract, the Sewerage Services Act of 1993 was passed by the Malaysian Parliament to enable the responsibilities pertaining to sewerage treatment to be transferred from local authorities to the Federal government. Since the beginning, IWK has been plagued by vexing controversies - from the award which was done on the quiet; to the charge rates; the discharge of effluents in drains, rivers and bushes; wrong billing and rapid change of ownership. Private and corporate consumers, state governments, even ruling and opposition political parties have criticised IWK at one time or another.

Financial Agreement

The financial structure of the privatised project is shown in Figure 4. A RM475 million soft loan was provided by the government. The debt-equity ratio is nearly 20:1. Thus, Indah's shareholders are eyeing potentially handsome payoffs while risking little (Clifford, 1993). The equity holders of the concession company changed on several occasions from the day the privatisation proposal was put forward to the government (Kuan, 1996). Following that, the composition of equity took the form of NorthWest Water, 12.5%, Armed Forces Retirement Fund, 10%; Police Force Investment Co-operative, 10%, Aims Worldwide, 7.5%; Berjaya, 10%; and Prime Utilities, 50% (Ho, 1995). Prime Utilities which has the greatest stake in IWK has changed ownership three times, stoking further public anxiety that private industrialists are out to make quick profit at the expense of public interest. Drawing lessons from it, the government decided to include in future privatisation agreements the prohibition of change in shareholders for the first three years unless approved by the government.

Risk Allocation

The Malaysian government provided a soft loan of RM475 million to the consortium at 6% annual interest, to be accrued and compounded for a period of between 1 and 15 years, to cover start-up costs (Kuan, 1996). Payment is to be made from the 16th year until the 23rd year. The government guarantees a minimum internal rate of return (IRR) of between 14 and 18%. Tariff adjustment will be considered 5 years after the project becomes operational and every 3 years thereafter. Should the IRR fall outside the 14-18% range, an upward or downward revision of the tariffs will be made. The government also agreed to obtain a licence on behalf of IWK to allow it to contravene the provisions of the Environment Quality Act 1974 for the first 3 years of operation. In addition, the concessionaire was allowed to collect charges from

existing facilities which it acquired at very low cost (Ho, 1995). The government gave the assurance that it would intervene if IWK faced any difficulty in the collection of charges from non-paying consumers. The government justifies the copious assistance on the basis that it would cost more for the nation-wide sewerage system to be provided from the national purse.

THE EQUITY, DEBT AND RISK ALLOCATION FEATURES OF MALAYSIA'S BOT PROJECTS

Equity

It is typical for BOT contracts for host governments to expect an equity contribution from the concessionaire of at least 25-30% of the total financing needed (World Institute for Development Economics Research, 1992). The equity stakes for the three Malaysian projects discussed above range from 5 to 10 percent (see table 2). The table also indicate a wider divergence in equity investment when other BOT projects in Malaysia are also considered. The pattern in Malaysia supports Tiong's contention (1995a) that the precise share of the equity component cannot be derived from any formula. As the examples in Malaysia show, the figure varies between projects even within a particular country. Furthermore, there is no discernible correlation between length of experience in privatisation and level of equity injection.

Table 2: Equity Investment in Bot Projects

BOT Projects	Start Date	Equity (%)
Labuan Water Supply	1988	33
North-South Highway	1988	10
YTL Power Station	1992	7
Kuala Lumpur Light Rail Transit	1992	30
Johor Bahru Water Supply	1992	23
National Sewerage Project	1993	5

Source: Tiong (1995a) pp. 286

A number of factors influence the amount of equity that is injected into the BOT project, including request by the government, level of competition and uncertainty of project (Tiong, 1995a).

Developing countries tend to limit the participation of foreign companies as equity holders (Tiong, 1995a). While the Malaysian government has various rulings on the participation of foreign investors in all economic sectors, a special exemption is granted to those who are involved in BOT contracts (Adam, Cavendish and Mistry, 1992). Even so, the government makes certain that contracts are given to consortiums which include local companies, ideally as lead members.

The latest development in Malaysia, and one which will provide a boost to concession holders of BOT contracts by easing the difficulties they face in sourcing funds is that the Securities Commission has consented to the flotation of privatised projects on the Kuala Lumpur Stock Exchange without having to fulfill the regular listing requirements (Malaysia, 1996). Under the new guidelines, Infrastructure Project Companies (IPCs) are not required to meet the track record requirements provided they contribute to overall economic growth, have concessionary licence from the relevant authorities, that the projects cost not less than RM500 million and generate 'suitable rate of return' to their shareholders and have a minimum remaining concession period of 18 years at the time of submission. The first infrastructure project company (IPC) to go public in Malaysia is Powertek, an independent power producer. The listing of YTP Power Generation makes it the third IPC to trade on the local stock exchange. In this respect, Malaysia (and other South-East Asian countries such as Singapore and Thailand for that matter) is emulating the developed countries in floating privatised infrastructure projects in their local stock markets.

Debt

Malaysian borrowers have been accustomed to syndicated lending. The government's push to get the private sector to invest in infrastructure development created a high demand for large-scale commercial credit, especially the more risky limited recourse funding (Price, 1995). Only well-established lenders have the experience to deal with limited recourse projects on such a scale. Yet, wherever possible, the Malaysian government encouraged on-shore participation in most of the privatisation loan syndications, partly to stimulate a more sophisticated domestic financial market (Montagnon, 1989). The local banking sector responded by creating a substantial and well-

developed capital market, enabling funds to be raised domestically for BOT projects.

The other motive of the government for encouraging local borrowings is to ensure that exchange risk exposure is kept to the minimum (Montagnon, 1989). As a result, concession companies including PLUS, YTL Power Generation and IWK have little or no foreign borrowings. The current currency crisis has affirmed the wisdom of this decision. Of course, some companies needed to find the additional fund overseas. Doing so previously was relatively easy (compared to other countries at similar levels of development as Malaysia) due to the country's then low rate of inflation and relatively stable currency (Kassim, 1994). Of course, the current currency crisis has drastically altered the scenario by deeply undermining the local capital market and making servicing foreign borrowings prohibitive. Foreign investors are no longer attracted to the region. For the time being, initiating fresh privatisation projects is not viable.

Risk Allocation

Most of the BOT arrangements in Malaysia have been near-certain profitable ventures (Goh and Jomo, 1995). The Malaysian government has repeatedly mentioned the billions of Malaysian ringgit which has been saved as a result of privatisation. It was claimed that up to the end of 1996, the government has saved RM6.2 billion as a result of privatisation (*Utusan Malaysia*, 1997). What is not indicated is the tremendous loss of revenue by relinquishing these profitable projects to the private sector, highways and power stations included. The reduction in public expenditure has not led to any appreciable reduction in taxation for the ordinary tax-payer. Conversely consumers are burdened by higher costs arising from the transfer.

What is also not brought to the attention of the public is the generous assistance extended to the concession companies. Naidu (1995) points out that promoters of privatised infrastructure projects have been insulated from much of the risks as a result of assured profitability in the form of soft loans, exchange rate guarantees and minimum revenue guarantees. Adam, Cavendish and Mistry (1992) contend that the 'safety net' guarantees offered by the government to protect private-sector operators against future revenue shortfalls effectively undermines the whole purpose of BOT. In some instances, public monopolies of the infrastructure sector have merely been converted to private monopolies. Strictly speaking, BOT arrangements can only be

considered as privatisation if there is a transfer of commercial risk from the government to the private sector. Glade (1989) coined such variant of privatisation as 'rent-seeking' in the sense that profits are privatised while costs socialised, whereas Nellis and Kikeri (1989) from the World Bank views it as subsidised privatisation.

In truth, even after an appropriate ownership structure has been devised, private-sector investors are unlikely to bear all the risks (World Institute for Development Economics Research, 1992). A purist approach rejecting any government involvement in risk sharing is unlikely to be sustainable, particularly in developing countries. Thus, governments recast the privatisation disposition by getting re-involved in the investments as risk partners or as the exclusive bearers of certain categories of risk. The delicate task of apportioning risks to the private and public sectors is essential but difficult to get right. Privatisation strategies, it seems, can assume many forms with few prescriptions.

All things considered, the Malaysian government have definitely been over-generous in underwriting BOT projects. Ideally, now that the already installed privatisation projects have demonstrated their operational credibility, all if not a substantial proportion of the BOT risks should be transferred to the private sector. Given that the privatisation programme was initiated more than a decade ago, the learning and experimentation stage must be well over by now. In the beginning, packaging test case BOT schemes to make them highly desirable was the priority. With a string of successful BOT contracts already in place, there exists a sufficiently large body of experience for would-be promoters of BOT projects, investors and lenders to assimilate and make their own judgements. 'Sweeteners' to overcome scepticism and doubt can be retracted without unduly dampening the private response to Malaysia's prospective privatisation initiatives.

AREAS OF MALAYSIA'S PRIVATISATION PROGRAMME WHICH REQUIRES RE-EXAMINATION

The Lack of Transparency in the Selection of Concession Companies

One of the many criticisms levelled at the Malaysian government is that the privatisation procedures lack transparency in the award of BOT contracts. The first private company to identify projects for privatisation under the 'first-

come, first-served' rules places a virtually exclusive premium on the company that submits the privatisation proposal first (Naidu, 1995). Even privatised projects initiated by the government have been awarded via closed tendering instead of the more acceptable open tendering system. Critics point to many beneficiaries of the privatisation programme being chosen on the basis of political and personal connections (Tsuruoka, 1994; Jomo, 1995), leading some like Adam, Cavendish and Mistry (1992) to allege that 'cronyism' is allowed to reign - a term which came into currency in public discussions recently (see below). Even in its realisation of the NEP objectives through privatisation, the government is accused of favouring only a small elite group of politically well-connected *Bumiputeras* (Jomo, 1993; Tsuruoka, 1994). Just like the North-South Highway Project which was given to a contractor with poor financial track record and limited experience, the award of the privatised national sewerage project to Indah Water Konsortium (IWK) also stirred controversy. The lingering issues over the performance, charge structure, and successive change of ownership of IWK bear testimony to its inexperience in the field. Worse, the transfer to the private entity took place unknown to the public. The head of the Berjaya Group, Vincent Tan allegedly has been closely linked to the Prime Minister and his Deputy Prime Minister, which is said to be instrumental in the award of the National Sewerage Project to IWK (Tsuruoka, 1993; Jomo, 1995). Given the amount of safeguards that is provided by the government to concession companies against all kinds of adversities (see above), the lack of transparency in their selection is all the more unacceptable. The degree of openness of the selection procedure for the privatisation of power generation in Malaysia could not be properly ascertained. In any case, given that multiple parties were awarded separate BOT contracts in this field, less controversy arose.

A counter-argument may be presented to defend the government's actions. The government has the responsibility to carry through the aspirations of the privatisation programme which is a major plank of its management of the national economy. For that reason, the concession companies must have won full confidence and assurance of the policy-makers as to their abilities. As hinted by the Prime Minister (Mahathir, 1988):

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

will study very carefully the ability of the companies taking over government services or enterprises.

This point was emphasised by the merchant bank, Morgan Grenfell of London, "Of equal importance to the demonstration of strong political will on the part of the government is the involvement of a strong promoter" (Crawford, 1988). Foreign financial sources too would want to see domestic equity partners that are strong enough and motivated enough to be effective interlocutors with the government in any areas from regulation to risk sharing where the relationship will be crucial to the success of the investment (World Institute for Development Economics Research, 1992). All things considered, the controversies surrounding the selection of certain companies as concession holders remains.

While doubtful integrity of the privatisation process may not in itself stir a political backlash in a country where open public dissent is rare, as a controversy it may be stoked by the growing acrimony of end-users over the increased utilisation cost of infrastructure facilities which have been privatised (see below).

The Lack of Transparency of the Charge Structure

The impact of privatising infrastructure facilities on end-users has never been debated openly; ever since the opposition party attempted to gain political mileage out of the North-South Highway project by alleging that the government sold the documentation and plans for the project three months ahead of the tender announcement (Lim, 1987). To gag local dissenters, the government amended the Official Secrets Act in 1986 so that the definition of official secrets also include, among other things, government tender documents (even after completion of the tender exercise) and any other documents or materials which ministers and public officials may deem secret or confidential (Jomo, 1995). The consequence is that, as illustrated below, Malaysian consumers have little inkling of what lay ahead.

Under the original concession agreement, PLUS was entitled to increase the toll incrementally to cover financing costs and escalating maintenance and service charges; the first upward change of 33% was supposed to have taken place in 1996, followed by 6% in 1997 and 1998. Because the public was very much in the dark regarding this toll structure, strong protest arose when it was made known that PLUS was seeking the government's consent for the first

upward revision. Due to public outcry, the government was forced to re-negotiate with PLUS. Several months later, it was agreed that the toll rise of 20% take place in 1996, 20% in 1997 and 7% in 1998. The government also agreed to pay PLUS RM100 million (US\$40 million) in compensation for the company's loss of revenue from the delay in implementing the toll increase. When it came for PLUS to increase the toll in 1998, there was renewed outcry from many quarters including the Federation of Malaysian Consumers Association (FOMCA) who felt that it was inappropriate at a time when the Asian financial crisis was gripping the country. Due to overwhelming resistance, even from within the component coalition parties of the ruling government, the toll rate increase was deferred for a year.

In its desire to increase electricity capacity in the shortest time possible, the government entered into highly attractive agreements with private entities to the extent that the national power utility company, Tenaga Nasional, is compelled to purchase electricity from IPPs at rates higher than its own production costs. This, exacerbated by the government's refusal for Tenaga Nasional to increase its tariffs, led to the electricity utility company suffering a 17 % pre-tax profits decline for the year ended August 31, 1995. It was only in March 1996 that the tariff revision was approved. The reversal in decision came too late to curb the financial deterioration. For the following financial year, the group suffered a further 29 percent drop in pre-tax profits. In May 1997, i.e. a year after the electricity tariff was revised, the power rate was again increased by 8.3%. It was revealed that this second upward revision will largely cover some of Tenaga Nasional's costs, especially the IPP costs which constitute nearly 40 % of the utility company's operating costs (*Sun*, 1997). There was public disquiet over the increase in power costs, with the Consumer Association of Penang (CAP) and the opposition party, Democratic Action Party (DAP), accusing the IPPs of reaping huge profits at the expense of the public. Perhaps in admission of its haste in privatising power generation, the government announced that it may modify the approval system for IPPs in the future (*Sunday Star*, 1996). The Prime Minister said, "...IPP's must convince us that they want to help the economy. We also do not want to 'kill' Tenaga and give a lot of profit away to IPPs (*The Star*, 1996). Once again, whatever was agreed between the government and IPPs regarding the electricity sales to Tenaga Nasional did not come out in the open until the tariffs were increased. Unfortunately as the intermediate party, Tenaga Nasional absorbed much of the criticisms surrounding the privatisation of power generation.

The national sewerage system project has been controversial from the moment it was awarded to IWK. Public, private and state government resentment over a

private consortium seemingly profiteering from an essential service still simmers. Upon giving control, IWK indicated domestic tariffs of between RM2.00 and RM10.00, and commercial rates of between RM0.90 per cubic metre and RM1.20 per cubic metre for the first five years of operation (Ho, 1995). While for industrial buildings, a minimum tariff of RM9.00 a month would be imposed (Kuan, 1996). Public dissatisfaction immediately arose over collection of revenue from a private company which had yet to make any investment. Under pressure, IWK offered discounts to commercial and industrial users totalling RM300 million over a three-year period (*The Star*, 1995a). Even then it was estimated that over the concession period, IWK stands to earn RM50 billion compared with expected operating and maintenance costs of RM18 billion (Ho, 1995). Unabated public outrage (which manifested in non-payment) compelled the government to intervene. It was decided that consumers did not have to pay sewerage charges before the 1st of January 1997, much to the annoyance of IWK which claimed a loss of potential revenue of RM290 million. Under this charge review exercise by the government, it was decided also that residential consumers be charged between RM2.00 and RM8.00 while commercial customers be charged between RM10.00 and RM15,000 a month subsequent to the date. When this decision failed to quell public discontent, the government reviewed IWK's charges for the second time. It was decided that as of the 1st of July 1998, the charge for commercial sector was reduced by 30%. To recompense IWK, a soft loan amounting to RM500 million was extended. The government is also looking into the possibility of extending IWK's concession period by another 10 years. The post-award complications pertaining to sewerage charges could have been averted had there been public disclosure and debate in the beginning. The legacy of that omission is likely to persist in years to come.

The foregoing discussion indicate that the lack of transparency in the privatisation deals struck between the government and the private sector, in particular the user-charge structure, has much to do with the ensuing delayed public dissatisfaction. It is unlikely that the controversies over user-charges by PLUS, IPPs and IWK has run its full course. Each time the government intervenes to defuse public discontentment, fresh public funds are injected into the concession companies in exchange for lower user charges. These companies enjoy huge economic rents at the expense of the public, a situation which is increasing untenable. In ensuring that infrastructure development is attractive to the private sector, too much may have been given at the expense of the consumers without their prior knowledge. One can only speculate that high charges was the inhibiting factor behind non-public disclosure. If the momentum of privatisation of infrastructure development were not to be lost,

policy-makers have to give serious consideration to the backlash if public appeal was lost.

CONCLUSION

The Asian financial crisis which began in the middle of 1997 has seen foreign investor confidence and funds evaporating on a dramatic scale. One analyst indicated that the infrastructure capital base in Asia for the next two to three years has been wiped out (*The Star*, 1988). Malaysia is still reeling from the unprecedented shock. Before the crisis, planned development expenditure in Malaysia for 1996-2005 was expected to exceed US\$90 billion (Price, 1995). One of the initial reaction of the government to the economic malaise was to put on hold mega-infrastructure projects worth RM65.6 billion (Bakun Dam, Kuala Lumpur Linear City, etc.). Almost a year later, the government decided to resuscitate some of these projects (water supply projects, KLIA-KL highway, Kuantan port, etc.) with the setting up of a RM5 billion Infrastructure Development Fund. The success of this effort of course will hinge on the reception of the domestic and international markets to the IDF's bond issues - no easy task in this current economic climate. Finance aside, the government's stand is that the country's infrastructure development will in the main continue to be the province of the private sector. The Prime Minister has once said, "What we can privatise, we will privatise" (Cooke, 1995b).

This paper highlights two main operational areas which require attention. It is not the contention of this paper that the bold and innovative Malaysian privatisation model which has won favourable response worldwide be rejected in its entirety. Neither does it attempt to belittle the oft-repeated positive benefits that privatisation has brought. What is argued here is that, while retaining the success factors, fine-tuning be made in two main areas - transparency in the bidding procedure and early disclosure to the public of the charge structure. Three large BOT projects in dissimilar infrastructure subsectors were used as case studies in presenting the arguments. Fortuitously, their latent problems manifested at around the same time, making the analysis possible. The intrigues surrounding the three BOT deals inadvertently portray the government as being lop-sided, strengthening the economic power of large corporations at the expense of the masses. The three infrastructure facilities which are highlighted are not isolated cases; they represent a malaise which is endemic in the entire Malaysian privatisation disposition. By virtue of their size, the spectrum of affected end-users is widest. Hence a much clearer sense of the imperative for changes could be put across.

The inherent shortcomings of the Malaysian privatisation mechanism are by no means trivial; experiences in other countries have illustrated that even successful privatisation may fail because of public distrust stemming from alleged corruption or excess profiteering by the privileged few large conglomerates (Naim, 1993). In short, abusive privatisation programmes have short term lives. Malaysian policy-makers should take heed of the warning given by Shirley (1994 p.1320) that "The public will only support privatisation if they have a sense that the process is fair, open and honest." Mollification of public disquiet is imperative if Malaysia's privatisation programme is to be carried into the new millenium. If by being open, the privatisation process may be slowed down by public debate, then so be it. Given the alternative scenario that may develop, what choice is there to make.

As luck would have it, events have to a certain extent played out the anticipated backlash. In the latest development, even component political parties of the government echo the dissatisfaction of the public. In their 1997 annual delegates conference for instance, the Gerakan party members accused privatised companies of reaping huge profits at the expense of the public. At the 52nd UMNO General Assembly held in June 1998, the UMNO Youth blatantly accused the government of practising cronyism and nepotism in awarding mega-projects to a few politically well-connected *Bumiputera*-owned corporations. Soon after, the Gerakan Youth in its annual general meeting called for transparency in the selection of companies for privatisation projects. The delegates at the meeting also called on the government to monitor and supervise concession companies in their discharge of duties to the consumers. These events should send a strong signal to the government that corrective measures are most urgently required.

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