

Republic of the Philippines
ENERGY REGULATORY COMMISSION
San Miguel Avenue, Pasig City



**IN THE MATTER OF THE PETITION
FOR ISSUANCE OF MARKET FEE
SETTING RULES FOR THE
PHILIPPINE WHOLESALE
ELECTRICITY SPOT MARKET
(WESM)**

ERC CASE NO. 2010-001 RM

**PHILIPPINE ELECTRICITY MARKET
CORPORATION (PEMC),**

Petitioner.

x-----x

D O C K E T E D
Date: JUL 29 2010
By: _____

D E C I S I O N

Before the Commission for resolution is the Petition for the Issuance of Market Fee Setting Rules (MFSR) for the Philippine Electricity Market Corporation (PEMC) filed on February 3, 2010 by PEMC

In the said petition, PEMC alleged, among others, that:

1. Upon approval of the proposed MFSR, the same will be used as a guide for its future applications for approval of revenue requirements;
2. Setting up of control period which is between two (2) to five (5) regulatory years, to be approved by the Commission;
3. Building blocks for the Annual Revenue Requirement (ARR) estimate, which are calculations of the ARR for each regulatory year where operating costs, tax, depreciation and cost of capital are used;
4. Smoothing of the ARR over the revenue control period to arrive at a smooth revenue profile which sets the Maximum Allowed Revenue (MAR). The MAR will be embodied in the calculations of the Market Fees for each regulatory year and will be the basis of the conversion to a Market Fee rate;

5. Verification to confirm the level of over or under-recoveries of the MARs of the previous years, the purpose of which is to incorporate any adjustment needed ; and
6. Reopening of the Revenue Control Determination. This process represents the procedures in which approved revenue may be applied for reconsideration due to a revenue shortfall or excess as a result of unforeseen expenditure, requirements, changes in regulatory mandate, or a significant change in the market structure or design.

Having found the said petition to be sufficient in form and in substance with the required fees having been paid, an Order dated February 17, 2010 was issued setting the case for Public Hearing/Consultation on March 26, 2010.

In the said Order, PEMC was directed to publish the attached Notice of Posting issued by the Commission and the complete text of the proposed MFSR at its own expense, once (1x) in a newspaper of general circulation in the Philippines within five (5) days from receipt thereof.

On March 2, 2010, PEMC submitted its "Compliance" with the directive of the Commission.

During the scheduled public consultation on March 26, 2010, only PEMC and Manila Electric Company (MERALCO) appeared. No other intervenor/oppositor appeared nor was there any other intervention/opposition registered.

In the said hearing, PEMC presented its proofs of compliance with the Commission's publication of notice requirements which were duly marked as exhibits. Thereafter, PEMC made an expository presentation of its petition.



The expository presentation having been terminated, the Commission propounded clarificatory questions.

MERALCO presented its comments, clarifications and suggestions on the instant petition. Due to a number of clarifications sought by MERALCO, the Commission directed PEMC to submit its response thereto. PEMC was further directed to submit its position paper on the applicability of the Weighted Average Cost of Capital (WACC) to a non-stock non-profit corporation, within fifteen (15) working days or until April 20, 2010.



On April 20, 2010, PEMC filed a "Request for Additional Time" praying that it be given an additional period of five (5) days within which to file the required documents.

On April 26, 2010, in compliance therewith, PEMC submitted the following:

- (a) Response to MERALCO's "Comments" on the draft MFSRs; and
- (b) Response to the Commission's query on whether or not WACC applies to a non-stock non-profit corporation, i.e. PEMC.

DISCUSSION

From the Market Fee application for CYs 2009 to 2011 which was filed on September 11, 2008 and docketed in ERC Case No. 2008-050 RC, PEMC introduced a new methodology in establishing said Market Fees. The Commission ruled to subject said methodology to further study and public consultation.



Thus, in its Decision dated March 16, 2009, the Commission deferred the implementation of a new methodology and directed PEMC to submit a set of Market Fees Rules for WESM for review and approval. The Rules to be developed shall contain detailed procedures in setting up an output-based Market Fee mechanism implementable for the succeeding years' budgeting.

Subsequently, on February 3, 2010, PEMC filed a "Petition for the Approval of the Proposed Market Fee Setting Rules (MFSRs)". The proposed Rules were formulated by a technical working group headed by PEMC's officers with the assistance of expert consultants from LECG, Limited.

MERALCO's comments, queries and recommendations largely dealt on concepts relative to the MFSRs, more especially on the building block model including the cost components thereof whereby PEMC attempted to address MERALCO's concerns.

In addition, MERALCO raised the possible integration of a reward/penalty mechanism in the MFSRs. PEMC, in its reply, did not see this as appropriate, given the following reasons:

1. Extra income as a result of rewards will not be distributed to owners there being no shareholders. Not allowed to have retained earnings, on the other hand, penalties may result in a deficit;
2. Performance-based regulation encourages efficiency and the motive is profit; it is not applicable to a non-stock non-profit entity; and
3. Market Fees are set on recovery of costs of the Market Operator, governance and development; reduction will result in non-delivery/inadequate services.



3. Market Fees are set on recovery of costs of the Market Operator, governance and development; reduction will result in non-delivery/inadequate services.

Further, the concerns raised by the Commission in all of the hearings largely delved on the ownership of PEMC vis-à-vis payment of market fees by consumers and the applicability of the WACC to a non-stock, non-profit entity which does not have investors or shareholders.

On the other hand, in its submitted Position Paper, PEMC laid down the foundation for the appropriateness of the MFSRs as a methodology for it to base the determination of its Market Fees by discussing the nature of a non-stock corporation as compared to a stock corporation.

It averred that the capital of a non-stock corporation is not divided into shares like a stock corporation. It contended that although a non-stock corporation does not have shareholders that have expectations of earning dividends, it does not follow that it does not have contributors to capital that will be exposed to the risk of the business of the corporation.

It argued that a non-stock corporation may obtain profits in the course of its operation. It anchors its argument on the qualifying clause under *Section 87 of the Corporation Code* where it is provided that *“any profit which a non-stock corporation may obtain as an incident to its operations shall, whenever necessary or proper, be used for the furtherance of the purposes for which the corporation was organized.”*



Adopting the foregoing, PEMC claims that the income derived from the collection of Market Fees, pursuant to the mandate of Republic Act No. 9136, otherwise known as the "Electric Power Industry Reform Act of 2001", shall be utilized to pay for its expenditures. PEMC submits that it is authorized to retain any excess, provided, that the same shall be used to further its objectives under its Articles of Incorporation.

Touching on the issue of ownership, it cites that PEMC as a corporation is a separate and distinct juridical entity from its members, hence, it owns all the assets it has acquired as well as incurred obligations in the process, during its corporate existence.

As to its owners, PEMC admits that these are its members, .i.e. all generating companies, distribution utilities, suppliers, bulk consumers and other similar entities authorized by the Commission.

PEMC, further, differentiates itself with other non-stock, non-profit corporations in that its creation did not depend on the voluntary participation of its members, but on the mandate of the EPIRA to establish the WESM. It contended that, unlike a non-stock corporation that relies on member capital contributions, the cost of administering and operating the WESM is to be recovered through a charge imposed on market members.

As the profit of PEMC may only be utilized for the purpose of furthering its objectives, it argued that no WESM member shall directly benefit from its excess earnings, but rather indirect gain shall be obtained through better services to its members through expansion projects.



On the question of whether or not consumers are paying for the Market Fees, PEMC argued that it is possible that generators have merely factored in such cost in its price offers, thus, Market Fees do not automatically constitute a charge upon the consumers.

Given PEMC's submission, it manifested that:

1. It would not be unusual to apply a WACC formula to set a capital charge to be used in applying the building block model for PEMC;
2. A primary purpose for including a capital charge in the building block model would be to make subsidies given to consumers by providers of equity capital more transparent;
3. As PEMC is almost completely financed by debt, some consideration should be given to whether the rate of interest charged accurately reflects the risk and opportunity cost of the debt providers, as they are in substance, like equity providers in an all-equity financed entity. It may be that the debt providers are subsidizing PEMC's consumers; and
4. Because PEMC's capital base is currently small, disclosing a return on capital may not meet the cost-benefit test at this point in time.

The Commission now determines whether a WACC is an appropriate revenue measure under the mechanism proposed by PEMC. PEMC contended that non-stock entities are allowed to earn profits which will be utilized to defray their expenses. It made a comprehensive presentation of the building block model that is often used to set required revenue in a regulatory context which reflects the general principle that business entities must aim to generate sufficient revenue to meet their operating costs, depreciation and a total return on capital.



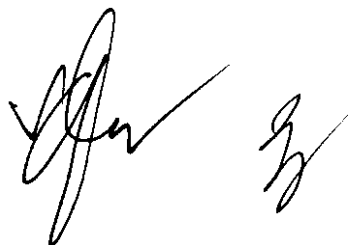
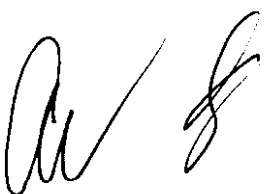
output-based mechanism on which the MFSR is based. Output-based methodology incorporates or includes incentives that are to be gained once target outputs are realized or accomplished.

However, PEMC did not include sufficient argument which the Commission may use as basis in applying the WACC for PEMC. Any existing asset which PEMC owns has been paid for by its members through the Market Fees that it has imposed, hence, it has no equity to speak of.

The discussion essentially points to the end that PEMC needs to retain earnings in order to have the resources/money to improve and/or expand its services.

The Commission notes that the current practice is that an annual budget is approved for PEMC to meet the cost of its operations. If it intends to implement expansion projects or improve its services, it has to submit the same to the Commission for approval so that, if deemed appropriate, the same will be included in its annual budgetary requirement.

Moreover, PEMC is likewise allowed to file for approval a supplemental budget for urgent and important requirements which cannot be accommodated from its approved Market Fees and which cannot be reasonably and timely financed through loans. On the other hand, PEMC may deduct unused portions of the budget or over-recoveries in the succeeding year's approved budget.

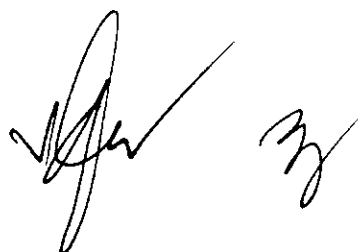
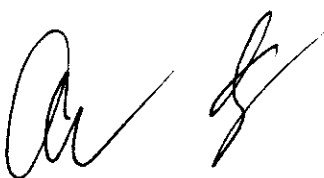


In view of the foregoing, the Commission finds that PEMC failed to provide sufficient arguments to justify the use of the WACC and the adoption of the output-based methodology it has proposed in setting its budgetary requirement and corresponding Market Fees.

Further, the Commission takes judicial notice of the fact that initial steps have been undertaken to implement the EPIRA mandate of setting up an independent Market Operator.

Thus, PEMC is directed to initiate a study to determine an appropriate methodology in setting its budgetary requirement and Market Fee rate which is applicable to its nature as a non-stock, non-profit entity taking into account its intended structure of a separate and independent Market Operator.

WHEREFORE, the foregoing premises considered, the petition for the issuance of Market Fees Setting Rules for the Wholesale Electricity Spot Market (WESM) filed by the Philippine Electricity Market Corporation (PEMC) is hereby **DENIED**.



Consequently, the Commission shall retain methodologies it has previously applied in determining the annual budgetary requirement until a new and appropriate methodology is approved. PEMC is hereby directed to initiate a study to determine an appropriate mechanism which is applicable to its nature as a non-stock non-profit entity.

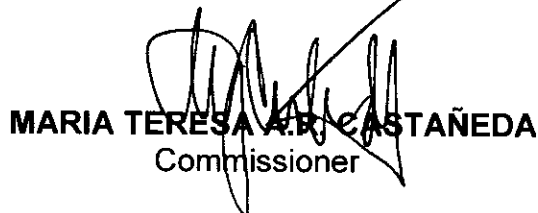
SO ORDERED.

Pasig City, July 19, 2010.


ZENAIDA G. CRUZ-DUCUT
Chairperson


RAUF A. TAN
Commissioner


ALEJANDRO Z. BARIN
Commissioner


MARIA TERESA A.R. CASTAÑEDA
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