

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



IN THE MATTER OF THE JOINT
APPLICATION FOR APPROVAL OF THE
TRANSITION SUPPLY CONTRACT
BETWEEN THE NATIONAL POWER
CORPORATION AND MANILA ELECTRIC
COMPANY WITH PRAYER FOR
PROVISIONAL AUTHORITY

ERC CASE NO. 2006-079 RC

NATIONAL POWER CORPORATION
(NPC) AND MANILA ELECTRIC
COMPANY (MERALCO),

Applicants.

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DOCKETED
Date: MAR 15 2010
By: [Signature]

ORDER

The Commission takes note of the "Motion for Clarification" and "Supplemental (To the Motion for Clarification dated January 25, 2010)" filed by the Manila Electric Company (MERALCO) on January 25, 2010 and February 3, 2010, respectively.

In the said motion for clarification, MERALCO averred, among others, that:

1. On January 10, 2010, it received a copy of the Commission's Order dated December 14, 2009 modifying the Commission's Decision dated June 30, 2008. The dispositive portion of which states as follows:
 - a. Sections 6.3 and Section 6.5 of the Transition Supply Contract between MERALCO and NPC are reinstated.
 - b. In the implementation of Section 6.3 of the TSC, the recoverable cost, from MERALCO's end-users shall be the TOU rate plus 20% premium or the equivalent settlement price/amount in the WESM or cost of replacement power, whichever is the lowest, among the three (3) rates; and
 - c. MERALCO shall submit reports on instances when the implementation of: a) Sections 6.3 have been made, which implementation shall include the particular settlement price in the WESM or cost of replacement power on the interval hour affected; and b) Section 6.5 which shall include the reasons for

the inability of NPC to supply its contractual obligations under the TSC.

2. In reinstating Section 6.3 of the TSC, however, the Commission provided for a condition when it avails of such option under the TSC. According to the Order of the Commission, the implementation of Section 6.3 should be subject to the condition that the cost of the excess supply equivalent to the National Power Corporation-Time of Use (TOU) rate plus the 20% premium must be lower than the hourly equivalent settlement price in the WESM or cost of replacement power. Therefore, its recoverable cost from its end-users for such additional TSC volume shall be limited only to the NPC-TOU rate plus 20% premium or the equivalent settlement price in the WESM or cost of replacement power, whichever is the lowest among the three (3) rates. Under such condition, it will be made to shoulder the excess or difference should the resulting price in the WESM is lower than the NPC-TOU rate plus the 20% premium charge by NPC when it avails of the option under Section 6.3 of the TSC.
3. In view thereof, it would like to clarify from the Commission as to the equivalent settlement price in the WESM as benchmark in determining whether the availment of additional TSC volume under Section 6.3 satisfies the "least cost" condition.
4. It will be recalled that the rationale behind the inclusion of Section 6.3 in the TSC is to address the risk of WESM spot market prices volatility. With all due respect, by considering the settlement price in the WESM during the time the additional TSC volume was availed of as criteria in determining whether the exercise of Section 6.3 is in accord with the least cost principle and which would dictate its recoverability of the cost would clearly defeat the rationality behind it. This is because it is being subjected indirectly to the effect of volatility of the WESM prices.
5. It is a fact that the prices of electricity in the WESM are dictated by the law of supply and demand to which it has no control. More importantly, there is no 100% assurance that it can accurately forecast the actual WESM price by the time it exercises the option to take additional TSC volume under Section 6.3 of the TSC. Obviously, there are factors that affect the outcome of the settlement prices in the WESM to which it also has no control or way of knowing or forecasting.
6. Also and with all due respect, benchmarking the availment of the additional TSC volume on the actual real-time WESM prices might not be proper as this will result to an ironic situation. This is because there may be instances that its energy volume affects the movement of prices in the WESM. For example, the WESM prices may historically be trending higher during the previous days than NPC-TOU rate plus 20% premium which would prompt it to avail of the provision of Section 6.3 of the TSC as it is cheaper. However, the additional volume will be nominated day-ahead as bilateral quantity, thus, reducing the remaining demand requirement from

the spot market. Since the WESM prices are dictated by the law of supply and demand, the reduction in demand will likely result in the reduction in the WESM prices on a real-time basis, and which prices may be lower than the NPC-TOU rate plus 20% premium.

7. Furthermore, the use of the hourly equivalent settlement price in the WESM would not be the appropriate comparison as against the NPC-TOU rate plus the 20% premium since its forecast of its hourly demand requirement is made on a day-ahead basis. It is, therefore, not possible for it to adjust or decide on whether to avail of the provision of Section 6.3 or not on an hourly basis just so to make sure that it will be able to recover the cost.
8. Nonetheless, it would like to propose that the prices from the Day-Ahead Projection (DAP) run of the WESM be used instead as criteria for it to determine whether it should exercise or avail of the option provided for under Section 6.3 of the TSC. The DAP is posted by the Market Operator or the Philippine Electricity Market Corporation in its website and are downloadable by the WESM members. The projection, which contains hourly volumes and prices, is for the next day and updated by WESM every four (4) hours. The hourly DAP WESM price forecast for the next day can be used as benchmark instead of the resulting actual price settlement in the WESM comparison with the NPC-TOU rate plus 20% premium. Hence, if the DAP WESM prices exceed the NPC-TOU rate plus the 20% premium, it will exercise the option under Section 6.3 and nominate additional TSC volume. In such case, the NPC-TOU rate plus the 20% premium shall be recoverable from its end-users regardless of the resulting settlement price in the WESM for the period of availment. On the other hand, if the DAP WESM prices do not exceed the NPC-TOU rate plus the 20% premium, it will not exercise the option under Section 6.3 and source instead from the WESM.
9. Thus, in line with the above proposal, the procedure will be after it has downloaded from the WESM website the DAP run WESM Prices (12NN or 4PM), it will determine whether the DAP WESM price is higher than the NPC-TOU rate plus the 20% premium. If it is so, it will schedule and nominate additional TSC under Section 6.3 to NPC (1PM OR 5PM). If not, the needed additional requirement will be sourced from the WESM.
10. In view of the foregoing, it is respectfully submitted that the proposed criteria to set as benchmark rate the DAP run of the WESM, instead of the actual WESM price, in deciding whether to exercise the option under Section 6.3 of the TSC will be more reasonable, fair and feasible under the circumstances.
11. Finally, it would like to clarify that the Order of the Honorable Commission with respect to Sections 6.3, 6.4 and 6.5 would have a prospective application. It is a fact that the TSC between the parties have been provisionally authorized by the Honorable Commission. Hence, parties thereto have already implemented all the provisions thereto including the foregoing provisions. Retroactively applying

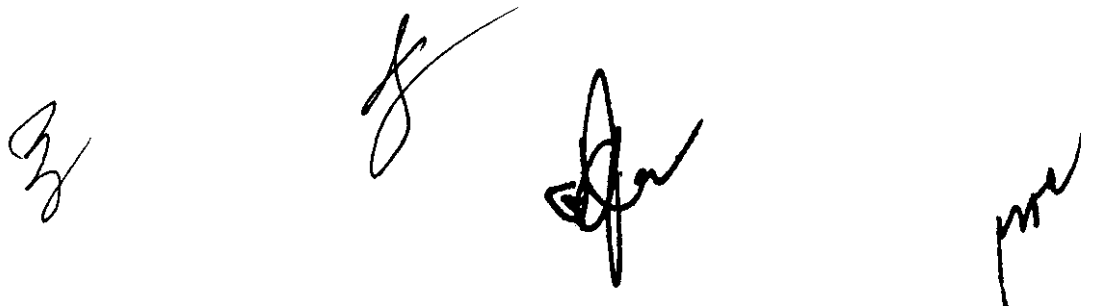


the subject Order would result to complications in the rights and obligations of the parties to the TSC.

12. Thus, it prayed to the Commission that an Order be issued clarifying the conditions imposed on the implementation of Section 6.3 of the TSC, in that the proposed Day-Ahead Projection (DAP) run of the WESM be used as benchmark instead of the actual resulting settlement price in the WESM

Further, on February 3, 2010, MERALCO filed a "Supplemental (To the Motion for Clarification dated January 25, 2010)" which averred, among others, the following:

- a. On January 25, 2010, Applicant MERALCO filed with the Commission a Motion for Clarification of its Order dated December 14, 2009.
- b. In said Motion, it proposed that the prices from the Day-Ahead Projection (DAP) run of the WESM be used as criteria for it to determine whether it should exercise or avail of the option provided under Section 6.3 of the TSC.
- c. In support of the foregoing proposal, it would like to emphasize that when it executed the TSC with co-Applicant NPC, the annual contract energy was agreed upon for the duration of the contract. Under the TSC, it is required to submit at least one month in advance prior to the start of a year for any changes in its monthly contract energy but the total annual contract energy will still remain the same as agreed upon. Any increase in the annual contract energy would also require at least one month in advance its notification. The level of its annual contracted energy is determined based on the forecasted energy demand and, as such, there is no assurance that the same would accurately be equal to the actual demand. Actual demand is something that no one has control of as it depends on several factors beyond anybody's control such as economic and environmental factors. Hence, any gap between the forecast and the actual demand is understandable given such volatile factors affecting the same. One clear example is the financial crisis of 2008. Demand growth in the first half of 2008 was lower compared to the same period of 2009. The table below illustrate clearly show such point:



MERALCO ENERGY SALES: 2009 vs 2008 (in million kwh)				
I. Monthly				
	Month	2008	2009	Growth Rate ('09 over '08)
	Jan	1,981	1,785	-9.88%
	Feb	2,144	2,085	-2.78%
	Mar	2,039	2,198	7.79%
	Apr	2,285	2,252	-1.43%
	May	2,313	2,295	-0.74%
	Jun	2,314	2,385	3.05%
	Jul	2,311	2,395	3.62%
	Aug	2,295	2,421	5.47%
	Sep	2,312	2,397	3.66%
	Oct	2,301	2,301	-0.02%
	Nov	2,298	2,352	2.37%
	Dec	2,214	2,408	8.78%
	Total	26,808	27,275	1.74%
II. Semestrally				
	Month	2008	2009	Growth Rate ('09 over '08)
	Jan - Jun	13,077	13,001	-0.58%
	Jul - Dec	13,731	14,273	3.95%
	Total	26,808	27,275	1.74%

On the other hand, demand growth for January 2010 is quite strong compared to January 2009 as evidenced by the Net System Input figures for the said period, to wit:

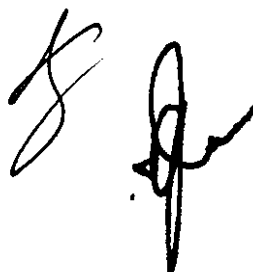
January 2009	2,082,657,978 kWh
January 2010	2,444,538,449 kWh

- d. Thus, given the uncertainty in demand, it is very difficult, if not impossible, for it to accurately predict and assume that its forecasted demand is its exact energy requirement. If it would fully contract its forecasted energy requirement and the demand drops due for example to economic crisis, it will end up with stranded contract cost. On the other hand, under-contracting may result to exposure to volatile spot market prices which is dictated largely by the law of supply and demand. As mentioned in its Motion for Clarification, it has no control of the resulting settlement price in the WESM.
- e. Hence, the TSC provided for certain provisions wherein it is can cope with the foregoing difficulty and, at the same time, source power for its consumers at the least cost possible manner. The TSC provided for both carving out provisions in case the demand drops (due to economic, loss of customer and open access) and provisions for increase in contract energy in case additional volume will be needed to address unexpected increase in demand. Thus, it can adjust the regular TSC annual contracted energy on a month ahead notice and additional TSC volume under Section 6.3 on a day-ahead basis.
- f. At this point, it is worth reiterating, to the point of being repetitious, that Section 6.3 of the TSC is a contingent provision. It does not always avail of the said provision or invoke the same on a whimsical basis. The intention of the parties to the TSC is to give it enough leeway to cope with unexpected and uncontrollable factors that affect its supply and manage the cost it will incur in addressing the same taking into consideration the interest of its end-users. In other words, it will avail of Section 6.3 of the TSC under certain exceptional cases if, in its determination, the cost will be lower than the WESM price such as when there is shortage of supply in the market or the existence of transmission constraint which usually drive the prices to be higher.
- g. Thus, with the limitation on the recoverability of cost imposed on Section 6.3 of the TSC, it will be very difficult for it to avail of the additional TSC with premium since it will not know what the actual WESM price would be at the time it nominates for additional TSC. Under normal conditions, it relies on the day ahead projection in the WESM as its best guess. With such limitation, it will be constrained to always maximize its 10% WESM requirement despite high WESM prices to address such contingencies as shortage of supply or transmission constraints, since in such case it is assured of full recovery. At any rate, it would like to reiterate that it avails of Section 6.3 of the TSC only in exceptional cases such as when there is fuel supply constraint (e.g. coal), transmission constraint (e.g. San Jose S/S outage), or even when a plant providing significant volume of its demand is out.

- h. As part of its regulatory authority to monitor the events occurring in the electric industry which would have an adverse impact on the rates to be charged to consumers, this Commission may take judicial notice of the imminent scheduled maintenance or outage of Shell Philippines Exploration (SPEX) from February 10, 2010 to March 11, 2010. The SPEX provides fuel to about 2,700 MW capacity or 25.32% of the installed generating capacity of 10,664,228 kW for Luzon Grid based on ERC's 2009 figure. This constitutes about one-third of Luzon's dependable capacity. With such significant volume affected, it is expecting a significant impact on the supply side and might cause the WESM prices to surge higher.
- i. To mitigate the impact of potentially high WESM prices during the SPEX outage, and thereby avoid, as much as possible, exposure to WESM volatility, it would like to avail of the additional TSC with premium under Section 6.3 of the TSC with NPC. However, despite a reasonable forecast, there is no assurance that the WESM prices would, indeed, surge higher than NPC rate plus premium, during the period of SPEX outage. With the limitation set by the Commission in its Order dated December 14, 2009, on the recoverability of cost, it instead of getting more from TSC, would have no or little choice, but to maximize its procurement from WESM up to 10% of its total demand, and get the rest from the TSC. In this scenario, the consumers would not reap the benefit of lower generation cost.
- j. Thus, it prayed to the Commission that an Order be issued clarifying the conditions imposed on the implementation of Section 6.3 of the TSC, in that the proposed Day-Ahead Projection (DAP) run of the WESM be used as benchmark instead of the actual resulting settlement price in the WESM, especially in exceptional cases where there is reason to believe that WESM prices would be much higher than NPC TSC rate plus premium.

DISCUSSION

After due consideration of the issues sought to be clarified by MERALCO, the Commission maintains that the reinstatement of Section 6.3 in the TSC is in cognizance of the representation made by MERALCO that the additional 20% is a mechanism by which it would be able to cope with the changing customer demands and hedge against exposure from the volatile spot market prices, for the protection of end-users.



The Commission likewise recognizes that to precisely predict the prices in the WESM is not an easy task to accomplish. Thus, when MERALCO claimed that it would only exercise the option provided under Section 6.3 of the TSC as soon as it determines that NPC-TOU rate plus the 20% premium is lower than the WESM prices, MERALCO is possessed with reasonable means to estimate its occurrence during, for instance, extreme circumstances, i.e. shortage in supply and existence of extreme transmission constraints. Bearing in mind Section 23 of Republic Act No. 9136, the Commission in setting the condition on recoverability, simply ensures that the supply of electricity to a DU's captive market is procured in the least cost manner.

The prices from the Day Ahead Projection (DAP) in the WESM proposed by MERALCO are not reliable bases or benchmark upon which the decision to implement Section 6.3 shall be anchored and determine the recoverable cost that MERALCO would be allowed to implement on its end-user. DAP prices are not indicative of the eventual hourly settlement price in the WESM. Given the dynamics of supply and physical network condition, participants would still change their offers, thereby influencing the price, up to the gate closure time before the actual trading interval.

The Commission further notes that MERALCO has failed to provide empirical evidence indicating that WESM price is influenced by the volume of energy that it will additionally nominate on its bilateral contract with NPC. In fact, bilateral nominations are not accounted for in the Market Dispatch Optimization Model (MDOM) as WESM is a gross pool market, hence would not influence the actual resulting WESM prices.

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Further, it bears stressing that MERALCO is granted the prerogative to manage the sourcing of its supply given the mixture of its power supply contracts. MERALCO should therefore manage prudently and wisely its power supply contracts to ensure that the supply of electricity to its captive market is procured in the least cost manner pursuant to Section 23 of Republic Act No. 9136.

In regard to the clarification sought by MERALCO anent the effectivity of the said Order with respect to Sections 6.3, 6.4 and 6.5, the Commission clarifies that the same shall be applied prospectively. The TSC, which basically represents that which was provisionally authorized by the Commission in the January 22, 2007 Order, is reasonable and clearly beneficial to the end-users.

WHEREFORE, based on the foregoing, the December 14, 2009 Order is hereby affirmed and shall be implemented prospectively.

SO ORDERED.

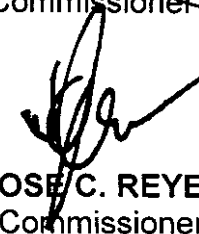
Pasig City, February 8, 2010


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