

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

IN RE: APPLICATION FOR APPROVAL
OF REVISION OF RATE SCHEDULES
AND APPRAISAL OF PROPERTIES
WITH PRAYER FOR PROVISIONAL
AUTHORITY

ERC CASE NO. 2001-646

IN THE MATTER OF THE
APPLICATION FOR APPROVAL OF
THE REVISED RATE SCHEDULES IN
COMPLIANCE WITH SECTION 36 OF
REPUBLIC ACT NO. 9136 AND ERC
ORDER DATED OCTOBER 30, 2001,
AND FOR APPROVAL OF APPRAISAL
OF PROPERTIES, WITH PRAYER
FOR PROVISIONAL AUTHORITY

ERC CASE NO. 2001-900

MANILA ELECTRIC COMPANY, INC.
(MERALCO)

Applicant.

X ----- X

ORDER

Before this Commission for resolution are the following: a) the "Motion for Reconsideration" filed by applicant Manila Electric Company (MERALCO) on April 9, 2003; b) the "Urgent Motion for Immediate Reconsideration" filed by oppositor Genaro C. Lualhati on April 10, 2003; c) the "Motion for Reconsideration" filed by oppositor Jose T. Baldonado on April 14, 2003; d) the "Comment and Opposition to Motion for Reconsideration" filed by Mr. Lualhati on

April 23, 2003; e) the “Manifestation” filed by intervenor Napocor Industrial Consumers Association, Inc. (NICAI) on April 24, 2003; f) the “Motion for Reconsideration and Comment on MERALCO’s Motion for Reconsideration” filed by oppositor National Association of Electricity Consumers for Reforms, Inc. (NASECORE) on April 28, 2003; and g.) the “Motion for Reconsideration” filed by oppositor BAYAN ET AL. on April 28, 2003.

In its motion, MERALCO prays that it be allowed to recover the income tax as a reasonable cost or in the alternative, to apply a rate of return based on its weighted cost of capital; that purchased power cost be allowed as part of two (2) months working capital; that the other disallowances be reversed; that the system loss cap of 9.5% be increased by 1.11% corresponding to subtransmission losses and company use allowance from 0.25% to 0.40%; that the CERA I be recalculated to preserve the revenue-neutrality of the entire CERA; that the Generation Charge be set at the March 2003, which is the latest available; and that its suggestions made on the design of the unbundled charges be given due consideration.

Specifically, MERALCO seeks reconsideration of the following conclusions and rulings in the Decision:

1. Disallowance of Income Tax
2. Disallowance of Purchased Power Cost
3. Other Disallowances:

- a. 5% Allowance for Overvaluations
 - b. Construction Work in Progress (CWIP)
 - c. Proportionate Value of Land
 - d. Disallowance in Land and Land Rights
 - e. Cost Associated with the Ogden Quezon Power, Inc. (now Quezon Power [Philippines] Limited Co. [QPPL]) Transmission Lines
 - f. Meter Inventory
4. System Loss and Company Use
 5. Allowed Rate of Return
 - a. The rates approved in the Decision do not result in a 12% RORB
 - b. The RORB granted is confiscatory
 - c. The RORB granted is discriminatory
 - d. The “*proposed rate of return*” based on Cost of Capital is the appropriate measure of the rate of return needed by the utility to service its debt as well as attract capital for the sustainability of its business undertaking as a public utility
 - e. The Weighted Average Cost of Capital (WACC) is supported by competent and verifiable data and validated by reputable third parties
 6. Rate Design
 - a. Generation Charge
 - b. Transmission Charge
 - c. Currency Exchange Rate Adjustment (CERA)
 - d. Distribution Charge
 - e. Line Loss Charge
 - f. Lifeline Subsidy
 - g. Power Factor Adjustment
 7. Prudent and Reasonable Cost

Mr. Lualhati, on the other hand, prays that the Decision be reconsidered because it ordered the MERALCO customers to continue paying for power they did not use and did not pass thru their meters; it approved MERALCO’s

incredulous claim that its utility plant increased by PhP40 Billion to PhP68.2 Billion in 1998 with fictitious and unauthorized facilities since MERALCO admitted that from 1994, it had never applied for approval of a new CAPEX program; it approved and even designed on its own initiative a new Distribution Schedule of Rates that actually exceed MERALCO's Authorized Revenue Requirement and rates that are actually about 85% higher than MERALCO's actual Distribution Rates in 1999 prior to unbundling of MERALCO in 2000; it approved the grossly inflated UFR unbundling rates that were unlawfully adjusted upwards by trending with the inapplicable Consumer Price Index (CPI); and it did not reject MERALCO's new CAPEX for 2000-2004 valued at PhP53.5 Billion for 417 new expansion/improvement projects which are completely and definitely unnecessary given the fact that MERALCO's Demand Growth is only about 3% a year.

Specifically, the grounds raised by Mr. Lualhati are as follows:

1. The Generation Rate Adjustment Mechanism (GRAM) is unjust, confiscatory and unconstitutional;
2. The approved utility plant at sound value as of December 31, 1998 is excessively inflated with fictitious, unnecessary and unauthorized claimed facilities;
3. The adjusted Revenue Requirement is inflated by trending with inapplicable CPI;
4. The rebased CERA perpetuates an unlawful collection of irrelevant costs to rate base or investment entitled to return;
5. The inclusion of additional PhP5,758,572,351 in the Generation Rate to be recovered at the rate of PhP0.0875/kWh is an unjust additional collection for

- undelivered, unmetered, ungenerated and unused power, concealed under a misleading label of "Deferred Recoverable Costs";
6. The estimated unbundled Generation and Transmission Cost is unrealistic and unsubstantiated by existing records;
 7. The revised approved sample rates for residential using 200 kWh is without basis and exceed the RORB;
 8. The Decision's silence and implied approval of MERALCO's PhP53 Billion application for CAPEX for 2000-2004 is without basis and runs counter to MERALCO's Demand Growth.

Atty. Baldonado, in his motion, prays that the Decision be reconsidered in favor of the oppositors. He avers that:

1. The Decision does not comply with the policy declared by Republic Act No. 9136 because it bundled the Purchased Power Adjustment (PPA) with other charges and hence, hides instead of make transparent said cost;
2. The parties were denied due process because it considered evidence made known to the parties only by way of the Decision itself such that they were not given an opportunity to comment, clarify or contradict the same before they were made the basis of the Decision;
3. The rulings on the offers and objections to evidence, particularly the documentary evidence, were given only via the Decision itself;
4. The costs made bases of the approved rates are not in accord with the provisions of the law because they are not least cost, prudent, just or reasonable;
5. There is a need to reconsider the determination of a system loss cap of 9.5% because there is nothing in the application which asked for the determination of the system loss cap so that the other parties were taken by surprise;

6. There is a need to reconsider the use of the Appraisal Report submitted by MERALCO in ERB Case No. 2000-57 which is "as of December 31, 1998" and the appraisal itself because the same lacks sufficient legal and/or factual basis.

NASECORE moves for the reconsideration of the Decision on the following grounds:

1. That the Honorable Commission gravely erred when it allowed MERALCO to unbundle its rates when the proposed rules on unbundling of functions and business activities are still pending for approval;
2. That the approved PhP0.22 per kilowatt-hour increase in rates is not accurate as the real approved rate is higher; and
3. That the Honorable Commission should withdraw its earlier decision and require MERALCO to file a new application for unbundling of its rates since the decision of the Supreme Court has a bearing in the unbundling of rates of MERALCO.

Finally, oppositors BAYAN et al. moves for the reconsideration of the Decision on the following grounds:

1. The Honorable Commission gravely erred in incorporating in the Generation Cost Unmetered and Undelivered Power;
2. The Honorable Commission gravely erred in simply adopting MERALCO's Net Utility Plant in Service at sound value as of December 31, 2000 amounting to PhP61,649,407,957, and in admitting the amounts of MERALCO's operating and maintenance expenses using the trending method;
3. The amounts of Distribution Charge approved by the Honorable Commission were arbitrarily made; and

4. The Honorable Commission gravely erred in failing to deduct from the basic rate the PhP0.167 per kWh that MERALCO overcharged its customers pursuant to the final decision of the Supreme Court.

In its manifestation, NICAI comments on the motion for reconsideration of MERALCO and prays that said comments/arguments be considered in the resolution of MERALCO's motion. NICAI's pertinent comments were considered by the Commission in resolving the aforementioned motions for reconsideration as shown in the discussion below.

DISCUSSION

I. Rate Unbundling in General

NASECORE argued that the unbundling of rates should be revenue-neutral. The Commission had always taken the position that unbundling of rates per se does not result to an adjustment in rates. However, Section 36 of Republic Act No. 9136 requires that the rates shall reflect the respective cost of providing each service. Furthermore, Section 6 (c), Rule 15 of the Implementing Rules and Regulations (IRR) of R.A. 9136 specifically requires historical test year cost for the year 2000 for the rate unbundling, which in itself is not a revenue-neutral exercise.

NASECORE's contention that the promulgation of the Business Separation and Unbundling Plan (BSUP) or the Rules on Structural and Functional Unbundling of Business Activities of Utilities is a condition precedent to rate unbundling is without merit. The unbundling of electric utilities' rates as well as business activities are both required under R.A. 9136. However, there is nothing either in the said law or in its IRR, which requires that, the unbundling of business activities should come first before the unbundling of rates. In addition, while Section 36 of R.A. 9136 requires the utilities to submit, for the Commission's approval, their unbundled rates within six (6) months from its effectivity, no such requirement exists insofar as the unbundling of business activities is concerned.

Finally, NASECORE moved that the Commission withdraw the challenged Decision and require MERALCO to file a new application for the unbundling of its rates in view of the decision of the Supreme Court which has a bearing on the unbundling. While the Supreme Court's Decision may indeed have a bearing on the rates to be charged by MERALCO, the same, however, does not necessarily imply that the issue cannot be settled separately and independently. It is in the same light that the Commission finds no merit in oppositors BAYAN et. al's. contention that the Commission gravely erred in failing to deduct from the basic rate the PhP0.167 per kWh that MERALCO overcharged its customers pursuant to the same Supreme Court Decision. To reiterate, the said case is independent and separate from MERALCO's unbundling application. Moreover, at the time of

the rendition of the challenged Decision (March 20, 2003), said Supreme Court decision has not yet attained finality in view of the pendency of MERALCO's motion for reconsideration.

On the other hand, Atty. Baldonado contended that the challenged Decision did not comply with the policy declared by R.A. 9136 because it bundled the Purchased Power Adjustment (PPA) with other charges. The contention is without merit. The new unbundled rates segregate the individual cost associated with providing electric service to consumers in accordance with the sectors or functions identified in Section 5 of R.A. 9136, i.e., generation, transmission, distribution and supply. The current PPA is allocated between the generation and transmission rates. The generation component shall be periodically updated through the Generation Rate Adjustment Mechanism (GRAM).

II. Income Tax

MERALCO argued that: a) the ERC has recognized in its position paper submitted to the Supreme Court in G.R. Nos. 141314 and 141369 that income taxes are not operating expenses but are reasonable costs and that ERC has the right to determine whether such income tax is a reasonable cost; and b) that the ERC has made a determination that income tax is recoverable as part of rates is clearly demonstrated by the Uniform Filing Requirements (UFR) it prescribed as guidelines for the rate unbundling mandated by R.A. 9136.

The aforesaid arguments of MERALCO have been rendered moot by reason of the April 9, 2003 Resolution of the Supreme Court in G.R. Nos. 141314 and 141369 declaring with finality, among other things, that income tax should be excluded as part of operating expenses for rate making purposes. In a separate Resolution dated April 30, 2003, the Supreme Court denied MERALCO's urgent motion for consideration of the November 15, 2002 Decision and April 9, 2003 Resolution and further declared that no further pleadings shall be entertained in said cases.

The UFR model was not meant to prescribe the items or expenses that may be recovered by a public utility from its customers but was so devised mainly to establish a uniform system or format to standardize or facilitate the process of unbundling the rates. The UFR enumerated the data and information that the Commission needs in order to determine the rates that may be charged by the utilities but it did not, in any way, set forth the manner by which said data would be evaluated.

III. Purchased Power Cost

MERALCO claimed that the Commission departed from the RORB formula when it totally disallowed the cost of purchased power component of the working capital allowance and stated that the RORB formula should be as follows:

RORB=Operating Income [i.e. Revenues less Operating Expenses]
Rate Base (i.e. value of property entitled to return + two (2)
months working capital)

The purpose of the cash working capital is to provide a utility with cash requirements on operating expenses where they are needed. Thus, the cash working capital allowance that should be included in the rate base should approximate the actual cash requirements based on the estimated net lag in the cash flow.

MERALCO's cost of purchased power is an operating expense that could have been entitled to a corresponding cash working capital. However, a "Lead Lag Study" conducted by the Commission disclosed that MERALCO is able to collect from its customers the cash requirements on its cost of purchased power even before the payment for purchased power becomes due.

There was no denial of due process when the Commission disallowed the cash working capital for cost of purchased power. The records would show that as early as July 2002, MERALCO has submitted various data and documents pertaining to time lag in customer collection. This fact alone negates MERALCO's contention that it was denied due process. Let it be emphasized that "due process was designed to afford an opportunity to be heard, not that an actual hearing should always and indispensably be held" (Pamantasan ng Lungsod ng Maynila v. Civil Service Commission, 241 SCRA 506). It is a

requirement of due process that the parties to a litigation be informed of how it was decided, with an explanation of the factual findings and legal justifications that led to the conclusions of the court (People v. Bellaflor, 233 SCRA 196).

MERALCO likewise contended that the individualized working capital allowance for purchased power serves as a disincentive for efficiency. Said contention was based on the premise that a utility's collection efficiency deserves an accompanying incentive. MERALCO and the other utilities, for that matter, should bear in mind that it is their duty to implement a collection efficiency program, regardless of whether a cash working capital is provided for the cost of purchased power. This will ensure that the customers who pay on time will not bear the costs of the customers who do not pay on time. If additional finance costs are incurred because of late payment of bills, these costs should be recovered in the form of penalties for late payment.

IV. Other Disallowances

A. 5% Disallowance on Overvaluation

NICAI and Mr. Lualhati both argued that the application of the 5% disallowance for overvaluation is favorable to MERALCO. The Commission believes otherwise, considering that the 5% deduction was not designed to favor any particular utility but was intended to provide an allowance for probable overvaluation considering that the appraisal methodology is, to reiterate, based on mere estimates that could either be higher or lower. The 5% was maintained

taking into account the practice in the past, which used the same percentage in the absence of an extensive study that will justify the increase or decrease of said percentage.

The deduction of 5% either from the entire appraisal value or from the appraisal increase will decrease MERALCO's rate base and, subsequently, its revenue requirements resulting in a lower rate.

The previous practice of adjusting the appraisal increment by 5% stems from the growing concern over the accuracy of the appraisal methodology used to establish the value of a utility's assets included in the Rate Base.

The ultimate goal of the Commission now is to develop a higher level of accuracy in the appraisal process with the end in view of making the appraisals as close as they can be to the fair current values. The Commission does not deny that said practice might have been, to some extent, helpful in protecting consumers from possible overvaluation. However, a blanket application of said practice can result in adjustments being made in cases where the appraisal estimates actually understate the value of the utility's assets.

Thus, taking into consideration the responsibility of the Commission to balance the interests of the utility and its customers, the issue regarding the fair value of a utility's assets must be made on an individual case basis, at least until

such time that specific guidelines would have already been formulated on appraisal methodologies. These guidelines should determine the acceptable level of accuracy, which can be applied to appraisal.

The Commission is aware that appraisals, being mere estimates, may result to either an overvaluation or an undervaluation of the actual value of the utility's assets. In both cases, the Commission would want to be safeguarded since overvaluation is prejudicial to the consumers while undervaluation is detrimental to the electric utility.

The appraisal considered in the case of MERALCO was performed in September 1999 earlier than the 2000 test year. Accordingly, any presumed overvaluation might have already been well compensated, if not mitigated, by the lag in time when the same was considered. As such, the Commission decided not to apply the 5% allowance for overvaluation in this particular case. Let it however, be emphasized at this point that any appraisal made by independent appraisers shall be treated on a case to case basis and the Commission shall undertake measures to ensure that independent appraisers aim for the highest level of accuracy attainable.

B. Construction Work in Progress (CWIP)

MERALCO claimed that the disallowance on CWIP should only be PhP2,196,561,263 considering that an additional CWIP of PhP1,694,563,448 was completed and placed in service during the period July 1, 2002 to February 28, 2003. However, upon verification by the Commission only PhP1,210,415,211 was substantiated and confirmed to be in service. The remaining amount of PhP484,148,239 was disallowed since these are assets related to projects previously disallowed. Accordingly, the Commission deems it proper to include in MERALCO's rate base the CWIP found in service as of February 2003 pursuant to the principle that for purposes of rate determination, a utility is entitled to a return on the present value of its assets in service. Therefore, only PhP1,210,415,211 was allowed instead of PhP1,694,563,448.

C. Proportionate Value of Land – MERALCO Theatre

The original 50% disallowance corresponding to the MERALCO Theater was based on the floor area of the building. Considering that the questioned disallowance pertains to land, MERALCO is correct in contending that said disallowance should be based on the land occupied by the said theater. Thus, the corresponding appropriate adjustments are made based on the disallowance of 50% of the square meters of land area occupied by the said theater.

D. Land and Land Rights

MERALCO insisted that an amount equivalent to PhP119,071,585 should be included in its rate base corresponding to certain land and land rights which were placed in service. Upon verification through ocular inspection by the Commission, certain land and land rights amounting to PhP117,467,415 were found to have been placed in service. Accordingly, adjustments are made to reflect the inclusion of the same in MERALCO's rate base.

On the other hand, the amount of PhP1,604,170 which was found to be still not used/useful cannot be included in MERALCO's rate base following the established principle that only assets used and useful in business operation should be included in the rate base and be entitled to a return.

E. Ogden Quezon Power, Inc. (now QPPL) Transmission Line Cost

The Commission sees no cogent reason at the moment to disturb its earlier position to allow only the amount of US\$6,097,164 per year as transmission line cost considering that an exhaustive study being conducted on the matter is still on going.

F. Meter Inventory

MERALCO proposed that it be given a three-month (3) allowance for meter inventory for those removed for maintenance and restoration, and two-month (2) allowance for meter inventory for newly installed ones. The

Commission deems it proper to modify its earlier ruling on this item by maintaining the two-month (2) inventory for newly installed meters and another two-month (2) inventory for those removed for maintenance and restoration. Said inventory levels are found to be reasonable considering that it will not take MERALCO more than two-month (2) to order from suppliers new meters that would either replace defective meters or meet new demand. Accordingly, the disallowed amount of PhP343,656,491 is adjusted downward to PhP260,535,536.

The Commission, however clarifies that the treatment of meter inventory shall be determined on a case to case basis.

V. System Loss and Company Use

The system loss cap of 9.5% was expressly provided for by law, namely, Republic Act No. 7832 (the Anti-Pilferage Act). Thus, until such time that a new system loss cap has been fixed pursuant to R.A. 9136, said cap will still be used.

MERALCO claimed that there are circumstances, which are peculiar to its system, which should entitle it to a higher system loss cap. However, these circumstances already existed at the time the system loss cap of 9.5% was established by R.A. 7832. If it were the intention of Congress to exempt MERALCO or other utilities similarly situated from the system loss cap, having in

mind the peculiarity of their respective systems, it could readily have done so. Unfortunately, it did not.

On the other hand, the Commission finds merit in MERALCO's contention that its recoverable company used energy should be set at a higher percentage than 0.25% considering that as early as 2002, the company use level was already at 0.40%. Thus, the Commission sets MERALCO's company use level at 0.33%, which is its average company use level for the years 2000 to 2002 and which reflects a more realistic company use level.

VI. Revenue Requirement

With regard to Mr. Lualhati's contention that MERALCO's revenue requirement is inflated by trending with inapplicable Consumer Price Index (CPI), the same is without basis. The Commission did not apply the trending/indexing methodology previously implemented by the then ERB. MERALCO's declared revenue requirement was practically reduced by the Commission by PhP23 billion as a result of this Order. It is for the same reason that the Commission finds no merit in oppositor BAYAN et al.'s contention that the Commission erred in adopting MERALCO's net utility plant in service and in admitting the amounts of MERALCO's operating and maintenance expenses using the trending method. To reiterate, the Commission did not apply said method in this case.

VII. Allowed Rate of Return

MERALCO alleged that a) the rates approved in the Decision do not result in a 12% RORB; b) the RORB granted is confiscatory; c) the RORB granted is discriminatory; d) the “proposed rate of return” based on Cost of Capital is the appropriate measure of the rate of return needed by a utility to service its debt as well as to attract capital for the sustainability of its business undertaking as a public utility; and e) the Weighted Average Cost of Capital (WACC) is supported by competent and verifiable data and validated by reputable third parties. In supporting said arguments, MERALCO submitted supporting data/documents to clarify its requested rate of return.

It may not be amiss to point out that the oppositors in this case have not offered any single piece of evidence relating to MERALCO’s rate of return during the hearings or even in the motions for reconsideration of the challenged Decision.

As embodied in the challenged Decision, the Commission recognizes that if income tax is not allowed as a recoverable item, then the 12% cap on rate of return established in current jurisprudence may no longer be reasonable. Considering that the issue on income tax has been finally passed upon by the Supreme Court in two (2) separate Resolutions issued on April 9, 2003 and April 30, 2003 in G.R. Nos. 141314 and 141369, and considering further the mandate of the ERC under Section 43 (f) of Republic Act No. 9136 to fix rates that will

“allow the recovery of just and reasonable costs and a reasonable return on rate base (RORB) to enable the entity to operate viably”, the Commission believes that its findings and conclusion pertaining to MERALCO’s rate of return should be reviewed.

An important function of ratemaking is the determination of the overall rate of return that the utility should be granted. This Commission utilizes in this proceeding the following definition of “rate of return”, to wit:

“x x x the amount of money a utility earns, over and above operating expenses, depreciation expense, and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the ‘return’ are interest on long term debt, dividends on preferred stock, and earnings on common equity. In other words, the return is the money earned from operations which is available for distribution among the various classes of contributors of money capital” (Paul J. Garfield and Wallace F. Lovejoy, Public Utility Economics [Eaglewood Cliffs, N.J.: Prentice –Hall, 1965], 116).

The Commission’s analysis of the evidence regarding the appropriate rate of return in this case must be guided by the following principles or standards:

- 1.) The allowed return should be sufficient to maintain the utility’s credit standing and enable it to attract necessary capital;
- 2.) The allowed return should be at par with other investments of comparable risk; and
- 3.) A reasonable return may vary over time to reflect changing economic conditions.

The Commission recognizes that there are a number of internationally acceptable methodologies for the determination of a fair rate of return. With this in mind, the Commission carefully analyzed the economic and financial evidence within a regulatory context.

Irrespective of the procedure employed in determining a fair rate of return, this Commission must exercise *informed judgment*. As the Pennsylvania Public Utility Commission has stated:

“The return finding should consider the financial costs being incurred, so that the utility has the opportunity to recover its present cost of capital or to attract needed capital at reasonable costs. A fair rate of return for a public utility, however, is not a matter which is to be determined by the application of a mathematical formula. It requires the exercise of informed judgment, based upon a valuation of the particular facts presented in each proceeding. There is no one precise answer to the question as to what constitutes a proper rate of return. The interest of the company and its investors are to be considered along with those of the customers, all to the end of assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility involved (Pennsylvania PUC v. West Penn Power Co., 73 Pa. P.U.C. 454, at 502-503 [1990], [“West Penn 1990”] (Underscoring supplied).

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In the instant case, MERALCO based its revenue requirements calculation on the following WACC:

COMPONENT	AMOUNT PER FILING	% OF TOTAL	COST	WEIGHTED COST
CUSTOMER DEPOSITS	PhP 7,561,667,000	5.05%	6.80%	0.34%*
DEBT	25,646,632,000	17.12%	10.04%	1.72%*
PREFERRED STOCK	830,189,000	0.55%	10.38%	0.06%*
COMMON EQUITY	115,725,798,695	77.27%	17.92%	13.85%*
TOTAL	<u>PhP149,764,286,695</u>	<u>100.00%</u>		<u>15.97%*</u>

***Post tax costs**

In its motion for reconsideration, MERALCO provided supporting data/documents to justify its request for a rate of return based on the WACC. In light of this information, the Commission further analyzed the issue.

1. Capital Structure

In calculating a utility's weighted average cost of capital to be used in the determination of revenue requirements, the capital structure should reflect the actual sources of capital used to fund rate base. This synchronization of capital structure and rate base is necessary to assure proper recovery of capital costs. A mismatch between the components of the capital structure and the actual sources of funding for the rate base will result either in an over or under recovery of capital costs.

MERALCO used the recorded amounts for the Debt, Customer Deposits, and Preferred Stock components of the capital structure. However, the equity component was calculated based on an estimate of the market value of MERALCO's stock. The resulting equity component equaled PhP115,725,798,695. Said estimate far exceeded the recorded stockholders equity of MERALCO as of December 31, 2000 including the Appraisal Increase in Utility Plant amounting to PhP62,937,049,000. The Commission believes that the recorded amount of equity capital, including the Appraisal Increase in Utility Plant, is the best representation of the equity capital actually used for investment in rate base. The use of the actual recorded capital structure, including Appraisal Increase in Utility Plant, yields a total level of capitalization, which is more consistent with the approved Rate Base. Therefore, the Commission has recalculated MERALCO's capital structure to include only the recorded level of equity capital.

2. Cost of Debt

MERALCO used a 10.04% net of income tax cost of debt in the calculation of its weighted average cost of capital. This was equivalent to a 14.77% pre tax cost of debt. MERALCO's cost of debt was determined by applying the Fisher Effect to the quoted foreign interest rates of the foreign currency loans. The Fisher Effect is used to calculate a Philippine equivalent interest rate for foreign currency loans. The Fisher Effect is based on the theory that the real rate of interest in all countries is the same and that differences in nominal rates of

interest between countries is due to differences in inflation rates prevailing in each country. MERALCO has foreign currency loans from three countries: Japan, Germany, and the United States. The calculation of the Fisher Effect requires the use of an appropriate inflation rate for each of the foreign countries and for the Philippines. MERALCO used the following rates of inflation in its calculation:

Philippines	9.20%
Japan	0.40%
Germany	1.40%
United States	1.40%

An analysis of published data on inflation rates in the countries listed above shows that MERALCO relied on an inflation rate for the single year of 1999. The Commission believes that the use of a single year's inflation rate results in a Philippine effective interest rate may not be indicative of current economic conditions considering the volatility of inflation rates. Therefore, in order to determine a Philippine effective interest rate, the Commission used the average annual inflation rate for the period 1997 to 2002. The resulting average inflation rates are as follows:

Philippines	6.00%
Japan	-0.03%
Germany	1.50%
United States	2.32%

The use of the average rates of inflation calculated by the Commission in the application of the Fisher Effect results in a Philippine effective interest rate of 11.34% as compared to MERALCO's calculation of 14.77%.

MERALCO reduced its calculated Philippine effective interest rate by the effective tax rate in recognition of the inclusion of income taxes in the calculation of the Revenue Requirement proposed in the application. However, in view of the Supreme Court's ruling that income taxes should not be considered as an operating expense, such an adjustment should not be made. While the Commission has some concerns about the methodology used by MERALCO, the resulting cost of debt as adjusted by the Commission is reasonable and in line with market conditions.

3. Cost of Customer Deposits

MERALCO used a 6.80% rate on customer deposits in the calculation of its weighted average cost of capital. This amount was determined by reducing the approved interest rate on customer deposits of 10.00% by the effective income tax rate of 32%. As explained above, in order to be consistent with the removal of income taxes as an operating expense as required by the Supreme Court, the Commission used MERALCO's pre tax cost of 10.00%. The Commission therefore adopts the rate of customer deposits of 10.00%, which conforms to the approved rate for accruing interest on customer deposits under ERB Resolution No. 95-21 as amended.

4. Cost of Preferred Stock

MERALCO used a 10.38% cost of preferred stock in the calculation of its weighted average cost of capital. MERALCO's preferred stock has a stated

annual dividend rate of 10.00%. Dividends on preferred stock are paid quarterly by MERALCO. The 10.00% stated dividend rate when paid quarterly, results in an annual compounded rate of 10.38%. Therefore, the Commission agrees with this calculation, since it represents the effective annual cost of the stated dividend rate for MERALCO's preferred stock.

5. Cost of Equity

The cost of equity is the most difficult element of the WACC to establish. The determination requires the exercise of sound judgment applied in a logical manner and based on reasonable economic data.

MERALCO used a 17.92% cost of equity in the calculation of its weighted average cost of capital employing the Capital Asset Pricing Model (CAPM) to estimate the expected return on equity. The CAPM holds that the cost of equity capital or expected return on a utility's common equity is equivalent to that on a risk free security plus risk premium related to the risk inherent in a particular utility's stock; that is, the model combines risk and return in a single measure (Charles F. Philipps, Jr., *The Regulation of Public Utilities* [Arlington, Virginia: Public Utilities Reports, Inc. 1993], 396).

MERALCO submitted in support of its calculation of the return on equity (Annex "L" of its Motion for Reconsideration) different assumptions on the cost of equity as determined by a number of investment and brokerage firms. Said assumptions, including that of MERALCO's are tabulated below:

COMPARATIVE COST OF EQUITY	
Deutsche Bank	17.03%
Phil Equity	17.10%
MERALCO	17.92%
BNP Paribas	19.37%
ABN AMRO	20.50%

The Commission noted that the values of cost of equity range from a low of 17.03% to a high of 20.50%. The 17.92% proposed by MERALCO is within said range. Moreover, the Commission conducted its own verification of the assumptions used by the different investment and brokerage firms in the derivation of the cost of equity. In order to establish a benchmark on the most appropriate value of cost of equity, the Commission likewise considered the return on capital being granted to utilities similarly situated with MERALCO.

Based on the evidence presented in this case, and taking cognizance of the current economic conditions, the Commission must keep in mind its mandate to balance the interests of the utility and its customers, and mandate of R.A. 9136. In line with the mandate: "[T]he rates must be such as to allow the recovery of just and reasonable cost and a reasonable return on rate base (RORB) to enable

the entity to operate viably”, the Commission must apply its judgment in the determination of the appropriate return on equity from the range of reasonable returns provided by a select group of brokerage firms.

In exercising its judgment, the Commission must consider several factors. The ability of a utility to be financially sound and operationally viable should be of critical importance to both the stockholders and customers of said utility. Only a financially sound and operationally viable utility will be able to provide safe, reliable and efficient service at a reasonable cost. Utilities must be able to secure the additional sources of capital necessary to meet the growing demands for service to its customers at reasonable rates.

In November 2002, international credit rating agency Standard and Poor’s downgraded MERALCO’s rating by two notches, from BB to B+. This downgrade was followed by a further downgrade in May 2003 to B-. Such a downgrade is a clear indication of increased risk associated with investments in MERALCO, which will potentially result in increased capital costs in the future.

Regulators must also consider current economic conditions and temper their decisions in a socially responsible manner. Part of this consideration should include the environmental, regulatory and investment climate. The Commission believes that the information from the brokerage firms, when viewed in its entirety

provides it with reasonable estimates for the cost of equity. With all the aforementioned factors in mind, the Commission finds the 17.92% cost of equity proposed by MERALCO acceptable.

6. Weighted Average Cost of Capital

The Commission has recalculated MERALCO's WACC to reflect the restatement of the equity component to the recorded amount, the adjusted costs of debt and customer deposits, and use of a cost of equity capital of 17.92%.

The calculation of the weighted average cost of capital is as follows:

COMPONENT	AMOUNT PER F/S	% OF TOTAL	COST	WEIGHTED COST	POST TAX COST
CUSTOMER DEPOSITS	PhP 7,561,667,000	7.80%	10.00%	0.78%	0.53%
DEBT	25,646,632,000	26.45%	11.34%	3.00%	2.04%
PREFERRED STOCK	830,189,000	0.86%	10.38%	0.09%	0.06%
COMMON EQUITY	62,937,049,000	64.90%	17.92%	11.63%	7.91%
TOTAL	PhP96,975,537,000	100.00%		15.50%	10.54%

Based on the analysis made on the supporting documents submitted by MERALCO, it was determined that the fair rate of return that should be applied to MERALCO's rate base is 15.50%. This approved rate of return is a pre-tax rate of return. When the effect of income taxes is considered the 15.50% rate of return translates to a post-tax rate of return of 10.54%.

At this juncture, the Commission deems it proper to point out that it reserves its right to revisit the assumptions used in computing the WACC whenever circumstances will so warrant.

In this connection, the Commission intends to depart from the use of the RORB method of computing rates and to adopt, pursuant to Section 43(f) of R.A. 9136, an alternative method that would apply to distribution utilities. This was manifested in the issuance by this Commission of ERC Resolution No. 04 dated May 29, 2003 officially adopting a Performance Based Ratemaking (PBR) methodology in determining the transmission wheeling rates of the National Transmission Corporation (TRANSCO).

VIII. Rate Design:

Mr. Lualhati argued that the estimated unbundled generation and transmission costs are unrealistic and unsubstantiated by existing records. However, said oppositor did not offer any evidence to support such argument. The Commission, in fixing MERALCO's generation and transmission costs, used the National Power Corporation's (NPC) approved rates per kWh based on the weighted average cost of power and the cost of power supply from MERALCO's Independent Power Producers (IPPs) during the six-month period covering October 2002 to March 2003.

A. Generation Charge

The Commission has decided to consider the most current data available and has thereby adjusted the generation charge to be adopted. This was done to closely approximate the generation charge with the current cost of purchased power.

In view of the nature of the generation charge as a pass-through to the consumers, the Commission is impelled to enjoin Meralco to exert utmost efforts, with its own independent power producers (IPPs) to pursue ways and means by which to reduce the generation charge, including mutually acceptable renegotiation of its IPP contracts. In so doing, Meralco will also comply with its obligation to mitigate stranded contract costs.

The Commission deems it appropriate to reiterate that the prevailing environment, coupled with Section 33 of the EPIRA, provide Meralco sufficient cause to pursue arrangements with its IPPs on approaches to provide relief to Meralco's consumers. Meralco's right to directly pass on such costs again carries the corresponding obligation to ensure that such costs are reasonable and prudent, and the EPIRA provides the standard for determining the reasonableness and prudence of such costs.

B. Transmission Charges

MERALCO claimed that since the transmission rates it pays are not fixed, it suggested that there should be a recovery mechanism to address the changes in monthly transmission charges due to load factor. Automatic adjustment clauses are adopted for recovery of certain utility costs but only under the following limited and well-recognized circumstances: a) when such costs are extremely volatile, changing rapidly over short periods of time (recurring); b) when such volatile cost changes represent significant portions of total utility operating expenses (substantial); and c) when such costs are beyond the control of the utility.

The Commission sees no need for a recovery mechanism to address changes in MERALCO's transmission rates for several reasons: a) the range from which said rate raises (PhP0.90/kWh to PhP1.03/kWh) cannot be considered extremely volatile; and b) as correctly stated by NICAI, MERALCO should not convert the transmission charges from a Peso per kW to Peso per kWh since by nature, transmission service related costs are mostly fixed. This erroneous conversion was the basis for MERALCO's claim that there will be changes in the Transmission Charges. Its concern regarding under or over recoveries is negated by the fact that the transmission and distribution charges for commercial and industrial consumers are also in Peso per kW. Thus, any significant change in the demand is reflected both in the transmission/sub-

transmission charge that MERALCO pays to TRANSCO and in the transmission and distribution charges that customers pay to MERALCO.

C. Currency Exchange Rate Adjustment

MERALCO disagreed with the Commission when it did not adjust the levels of Currency Exchange Rate Adjustment I (CERA I) in the same manner that it did in CERA II to make the same revenue-neutral. However, the Commission was constrained to maintain the prevailing levels in CERA I because MERALCO failed to submit evidence that would have warranted adjustments thereof, among which is the information on which among its operation expenses are denominated or paid for in foreign currencies. The Commission would have considered making the necessary adjustments if only MERALCO was not remiss in its duty of proving its cause.

Mr. Lualhati's contention that the rebased CERA perpetuates an unlawful collection of irrelevant costs to rate base or investment entitled to return is without merit. The purpose of rebasing the CERA to current levels is simply to update the US Dollar to Peso exchange rate to be more reflective of the true cost levels. The CERA mechanism is devised to address changes in operation and maintenance expenses and foreign debt principal payments due to the volatility of the Peso against the US Dollar.

D. Distribution Charge

BAYAN et al.'s contention that the distribution charge approved by the Commission was arbitrarily made is without merit. The Commission, in fixing the distribution charge as well as other charges, has always embarked on an in-depth study of all costs associated in providing electric service to the consumers. Thus, the approval of said charges cannot be considered arbitrary.

The Commission is concerned about the removal of the subsidies currently being provided to Residential and General Service customers consuming 300 kWh or less each month. The immediate removal of this subsidy will significantly increase the rates of consumers with low consumptions. Thus, to mitigate its impact, the Commission adopted the block rate design which is an intra-class subsidy rather than an inter-class subsidy. It would not be appropriate to resolve the issue through the inter-class cross subsidy rate, as R.A. 9136 requires the removal only of inter-class subsidies. Likewise, the issue cannot be fully addressed through the lifeline subsidy charges considering that the subsidy in the current rates affects consumption levels of up to 300 kWh per month.

The Commission recognizes the concern raised by MERALCO with respect to the level of charges for consumption between zero and 70 kWh per month. Accordingly, the Commission decided to reconsider its previous ruling and to revise the Distribution Rates for the Residential and General Services

Class as follows:

<u>Consumption Level</u>	<u>Distribution Charge (PhP/kWh)</u>
0 to 200	0.5729
201 to 300	0.8765
301 to 400	1.1628
over 400	1.6615

D. System Loss Charge

The Commission inadvertently attached as Annex “A” the schedule of rates with a system loss charge item that does not accurately reflect its view on the matter. Said error is accordingly corrected.

F. Lifeline Subsidy

To mitigate the additional administrative burden and complexities to MERALCO considering its huge consumer base, a new lifeline subsidy scheme is adopted as follows:

CONSUMPTION BLOCK	% DISCOUNT
0-50	50%
51-70	35%
71-100	20%

On the basis of the foregoing scheme, the lifeline subsidy is calculated at PhP0.0761/kWh.

G. POWER FACTOR ADJUSTMENT

MERALCO claimed that the Commission erred in retaining the power factor adjustment percentages (penalty of 0.6% and discount of 0.3%) and in changing the base of the adjustment from a higher to a lower value without considering the purpose of the adjustments. The Commission admits that these discounts are meant to encourage customers to invest in power factor correction equipment that results in a more efficient use of electricity and in better operation of the system. However, the Commission still maintains the existing adjustment percentages, as MERALCO failed to justify the need to change the same. MERALCO never presented any evidence to prove that the existing adjustment percentage is no longer serving its purpose to encourage customers to invest in power factor correction equipment. Further, the change in the base approved by the Commission was a change proposed by MERALCO. Thus, if MERALCO believes that the discounts were too low, a new filing should be made and substantial evidence should be presented to justify the change.

IX. Denial of Due Process

Atty. Baldonado's contention that oppositors were denied due process in this case when the Commission considered evidence made known to the parties only by way of the Decision itself and when it ruled on the offers and objections to evidence only in the same Decision, is without merit. The Commission, in evaluating the merits of the instant applications, confined itself to the data/information provided by MERALCO together with the voluminous annexes

appended thereto. These same data/information were made available to the oppositors who were given ample opportunities to rebut MERALCO's claims during the hearings.

The essence of due process is simply an opportunity to be heard, or as applied to administrative proceedings, an opportunity to explain one's side or an opportunity to seek a reconsideration of the action or ruling complained of (*Var Orient Shipping Company, Inc. v. Achacoso*, 161 SCRA 732). Moreover, administrative tribunals exercising quasi-judicial powers are free from the rigidity of certain procedural requirements observed in the courts. This sound and settled rule is deemed necessary so that disputes before such bodies may be resolved in the most expeditious and inexpensive manner possible (*Adamson & Adamson, Inc. v. Amorez*, 152 SCRA 237).

Finally, the issues raised by Mr. Lualhati pertaining to the GRAM and MERALCO's capital expenditures (CAPEX), as well as those raised by oppositor BAYAN et al. on the PPA will not be addressed in this Order as they involve subject matters separate and distinct from this application. Moreover, the abovementioned issues are the subject of separate cases wherein issues relating to them would be more squarely dealt with by the Commission in due time.

WHEREFORE, the foregoing premises considered, the challenged Decision dated March 20, 2003 is hereby modified as follows:

- 1.) MERALCO's **"Summary Schedule of Unbundled Rates"** as provided in Annex **"A"** of this Order is hereby APPROVED to be effective on the next billing cycle after the date of this Order;
- 2.) MERALCO's **"Schedule of Unbundled Rates Per Customer Class"** as provided in Annex **"B"** of this Order is hereby APPROVED to be effective on the next billing cycle after the date of this Order;
- 3.) MERALCO's adjusted rate base as of December 31, 2000 from PhP74,475,910,302 to PhP76,838,084,457 as shown in Annex **"C"** of this Order is hereby APPROVED; and

Relative thereto, MERALCO is directed to:

- a) Discontinue charging the PPA upon effectivity of the approved unbundled rates; any change in the cost of power purchased shall be reflected as deferred charges or credits that shall be recovered through the Generation Rate Adjustment Mechanism (GRAM) approved by the

- Commission for implementation per its Order dated February 24, 2003;
- b) Bill its respective end-users using a ***billing format*** that contains at least the rate elements provided in Annex “D” of this Order upon effectivity of the approved unbundled rates, including the refund directed by the Supreme Court upon approval of the refund scheme by the ERC;
 - c) Set the CERA at 11.87% applied on the Distribution revenue only upon effectivity of this Order until such time that the Commission issues a notice for the implementation of a new CERA;
 - d) Submit within six (6) months from date of this Order;
 - i.) A new CERA formula that would be consistent with the new unbundled rate structure to be filed within six (6) months from the effectivity of this Order;
 - ii.) Detailed components of the foreign debt service payments due in 2003;
 - iii.) Time when such loans were contracted and approved by ERB, if any, for these loan contracts; and
 - iv.) Loan details of each contract including utilization of proceeds.
 - e) Set up a depreciation fund each year corresponding to the whole amount of depreciation that it has recorded in its

books. The setting up of this fund should be done on a monthly basis corresponding to the monthly depreciation. MERALCO is required to strictly account for the expenditures out of this fund, which should be used strictly for investment in electric plant. All withdrawals from this fund should be reported to the Commission within thirty (30) days from such withdrawal;

- f) Submit within thirty (30) days from receipt of this Order detailed and updated information on its affiliates as it affects its electric power business consistent with the requirements of Schedule "G" of the UFR;
- g) Adequately inform the end-users within its franchise area of the approved unbundled rates not later than thirty (30) days after receipt of this Order;
- h) Submit a detailed schedule on discounts granted to its officers and employees for their electric bills from 2000 to 2002, and the latest approved Collective Bargaining Agreement (CBA);
- i) Submit on or before the fifteenth (15th) day of October 2003 a report on policies and procedures for cost cutting measures to be adopted by it.

- j) Submit on or before the thirtieth (30th) day of June 2003 and quarterly thereafter, a status report on the results of their negotiations with their IPPs in its effort to bring down its generation costs;
- k) Submit the following data/information for verification and confirmation purposes on or before the twentieth (20th) day of the month following the effectivity of the approved unbundled rates and every month thereafter:
 - i) Copy of bills from the generation and transmission companies; and
 - ii) Reports M001 and M002 with all related schedules;
- l) Make a formal application to establish the rate of Reconnection Fees and Other Charges within one (1) year from date of this Order using a format to be prescribed by the Commission; and
- m) Provide reasonable access to the Commission for verification of sample bills for each customer class.

The findings and conclusions reached in our March 20, 2003 Decision shall continue to have force and effect except as herein modified.

SO ORDERED.

Pasig City, May 30, 2003.

MANUEL R. SANCHEZ
Chairman

MARY ANNE B. COLAYCO
Commissioner

OLIVER B. BUTALID
Commissioner

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