



RESOLUTION NO. 17
SERIES OF 2006

**ADDENDUM TO THE POSITION PAPER ON THE REGULATORY
RESET PROCESS FOR THE SECOND REGULATORY PERIOD**

WHEREAS, on December 10, 2004 the Commission adopted Resolution No. 12-02, Series of 2004 entitled "Adopting a Methodology for Setting Distribution Wheeling Rates" thereby promulgating the Distribution Wheeling Rates Guidelines (DWRG);

WHEREAS, Clause 7.1.2 of the DWRG mandates the publication of a Regulatory Reset Issues Paper providing for the issues to be discussed in the current Regulatory Reset Process and specifying the information required to be submitted by each Regulated Entity and the timelines therefor;

WHEREAS, pursuant to the said clause the Commission published a Regulatory Reset Issues Paper on September 30, 2005;

WHEREAS, several public consultations were conducted on October 10, 13, 14 and 26, 2005 as well as November 14, 16 and 18, 2005 for the discussion of concerns of the industry stakeholders where inputs were sought from interested parties;

WHEREAS, based on the inputs received during this process, the Commission established its position with regard to the price reset for the Second (2nd) Regulatory Period and published the same in a Position Paper on December 9, 2005;

WHEREAS, following the publication of the Position Paper, the Regulated Entities sought further clarification on the reset process, particularly the interpretation of certain positions taken;

WHEREAS, to address these inquiries a supplemental document was prepared where the issues raised or sought to be further clarified were included;

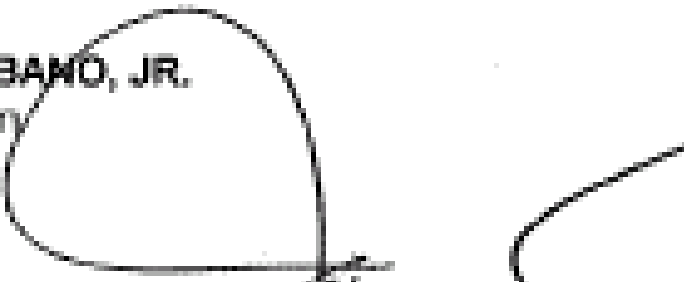
NOW, THEREFORE, be it **RESOLVED**, as the Commission hereby **RESOLVES**, to **APPROVE** and **ADOPT**, as it hereby **APPROVES** and **ADOPTS**, the "**ADDENDUM TO THE POSITION PAPER ON THE REGULATORY RESET PROCESS FOR THE SECOND REGULATORY PERIOD**" hereto attached as Annex "A" and made an integral part of this Resolution.

This Resolution shall take effect immediately after its publication in a newspaper of general circulation. This Resolution is hereby ordered to be posted on the ERC website and filed with the University of the Philippines Law Center Office of the National Administrative Register (ONAR) immediately.

Pasig City, April 11, 2006.


RODOLFO B. ALBANO, JR.
Chairman


OLIVER B. BUTALID
Commissioner


JESUS N. ALCORDO
Commissioner


RAUF A. TAN
Commissioner

(On Leave)
ALEJANDRO Z. BARIN
Commissioner



**Regulatory Reset
for the
Privately Owned Distribution Utilities
subject to
Performance Based Regulation**

for

July 2007 to June 2011

**Addendum to Position Paper
on the Regulatory Reset Process
for the Second Regulatory Period**

April 11, 2006

Republic of the Philippines
Energy Regulatory Commission
Pacific Center, San Miguel Avenue, Pasig City

REGULATORY RESET
for the
PRIVATELY OWNED DISTRIBUTION UTILITIES
SUBJECT TO PERFORMANCE BASED REGULATION
for
July 2007 to June 2011

ADDENDUM TO POSITION PAPER
ON THE REGULATORY RESET PROCESS
FOR THE SECOND REGULATORY PERIOD

Pursuant to Section 43(f) of Republic Act No. 9136, otherwise known as the Electric Power Industry Reform Act of 2001, and Rule 15, Section 5(a) of the Implementing Rules and Regulations issued pursuant to that Act, the Energy Regulatory Commission (ERC) promulgated the Guidelines on the Methodology for Setting Distribution Wheeling Rates (ERC Resolution no 12-02, Series of 2004, dated December 20, 2004, hereafter the 'DWRG'). Pursuant to clause 7.1.2 of the DWRG, the ERC published a Regulatory Reset Issues Paper on September 30, 2005 to provide its initial views on the issues to be discussed during the pending Regulatory Reset Process, to specify the information required to be delivered by each Regulated Entity for the purposes of the Regulatory Reset Process and the time by which such information should be delivered.

Public consultation meetings were held and submissions were sought from interested parties on the Issues Paper. Based on the inputs received during this process, the ERC established its position with regard to the price reset for the Second Regulatory Period and published this in a Position Paper, dated December 9, 2005.

Subsequent to this publication, a number of clarifying questions were asked by Regulated Entities about the interpretation of some of the processes and positions described in the Position Paper. This Addendum was prepared to address these questions and to provide further clarity on the Regulatory Reset Process for the Second Regulatory Period.

1. INTRODUCTION

Following the publication of the ERC's Position Paper on the Regulatory Reset Process for the Second Regulatory Period on December 9, 2005, a number of enquiries were made by Regulated Entities to obtain further clarity on the reset process, the interpretation of some of the positions taken and about possible inconsistencies in the Position Paper. The ERC has considered these enquiries and address them in the following sections.

The responses described below are supplemental to the Position Paper and are to be read as part thereof. Where contradictions exist between these responses and positions described in the Position Paper, the information in this addendum should take precedence.

2. HISTORICAL COST INFORMATION

2.1 Operating & maintenance expenditure

Issue raised

As part of their rate applications, section 3.1.5a of the Position Paper notes that Regulated Entities have to provide historical expenditure figures for operating and maintenance expenditure for the five calendar years ending on December 2006. However the Appendix E template only allows for four years of historical data.

Resolution

The Appendix E template will be amended – historical operating and maintenance expenditure figures are required for the calendar years 2002 to 2006, inclusive. (Forecasts have to be included for the remaining period in 2006 after the rate application, to provide the full-year figure.)

In addition, forecast operating and maintenance expenses are also required for the 2007 regulatory year (that is July 1, 2006 to June 30, 2007). There will therefore be a 6-month overlap in the data provided for the 2006 calendar year and the 2007 regulatory year.

Note that the requirement to provide the forecast expenditure information for each of the regulatory years in the Second Regulatory Period remains unchanged.

2.2 Levies, duties and other taxes

Issue raised

As part of their rate applications, in section 3.2a of the Position Paper it is noted that Regulated Entities have to provide historical expenditure figures on levies, duties and taxes other than corporate income tax for the five calendar years ending on December 2006. However the Appendix K template only allows for four years of historical data.

Resolution

The Appendix K template will be amended – historical expenditure figures on levies, duties and other taxes are required for the calendar years 2002 to 2006, inclusive.

(Forecasts have to be included for the remaining period in 2006 after the rate application, to provide the full-year figure.)

In addition, forecast expenditure on levies, duties and other taxes are also required for the 2007 regulatory year (that is July 1, 2006 to June 30, 2007). There will therefore be a 6-month overlap in the data provided for the 2006 calendar year and the 2007 regulatory year.

Note that the requirement to provide the forecast expenditure information for each of the regulatory years in the Second Regulatory Period remains unchanged.

2.3 Capital expenditure

Issue raised

As part of their rate applications, in section 4.2.6 of the Position Paper it is noted that Regulated Entities have to provide historical capital expenditure figures for the five calendar years ending on December 2006. However the Appendix F template only allows for four years of historical data.

Resolution

The Appendix F template will be amended – historical capital expenditure figures are required for the calendar years 2002 to 2006, inclusive. (Forecasts have to be included for the remaining period in 2006 after the rate application, to provide the full-year figure.)

In addition, forecast capital expenditure figures are also required for the 2007 regulatory year (that is July 1, 2006 to June 30, 2007). There will therefore be a 6-month overlap in the data provided for the 2006 calendar year and the 2007 regulatory year.

Note that the requirement to provide the forecast expenditure information for each of the regulatory years in the Second Regulatory Period remains unchanged.

3. EXPENSE CATEGORIES

Issue raised

In section 3.1.2(b) of the Position Paper, some of the maintenance expenditure categories have been omitted from the description.

Resolution

The correct categories for maintenance expenditure are as given in the template in Appendix K to the Position Paper. Paragraph 3.1.2(b) of the Position Paper should therefore be amended to read as follows :

- b) Distribution expenses – maintenance
- Maintenance supervision & engineering
 - Structures
 - Substations
 - Overhead line – demand
 - Overhead line – customer

- Streetlighting (non-roadway)
- Streetlighting (roadway)
- Line transformers
- Information technology
- Metering
- Miscellaneous

4. PERFORMANCE INCENTIVE SCHEME

4.1 Implementation process

Issue raised

- a) The Position Paper states in section 9.1 that details of a final incentive scheme framework would be provided to Regulated Entities. An enquiry was made whether this framework would apply for the Second Regulatory Period or only from the 3rd regulatory period onward.
- b) In addition, an inconsistency was noted with regard to the date for the provision of this final framework to the Regulated Entities between sections 2.2 of the Position Paper, where it was stated as March 15, 2006 and section 9.1(a) where it was stated as February 28, 2006.
- c) In section 9.7 of the Position Paper it was noted that performance information has to be provided from March 31, 2006 onwards. This appears too close to the March 15, 2006 date for providing the final framework to Regulated Entities.

Resolution

The framework of the final incentive scheme is to be provided to the Regulated Entities on March 15, 2006. This framework will apply from the 3rd regulatory period onward (but may be amended during the reset period for the 3rd regulatory period).

Regulated Entities are to use the framework as guidance only when designing their own performance incentive schemes for the Second Regulatory Period (the Interim Incentive Schemes). It is intended that indices included in the Interim Incentive Schemes should take into account the framework of the final scheme, so that performance measurements made during the Second Regulatory Period can be used as historical data for the 3rd regulatory period.

Given that the Regulated Entities have to develop their own incentive schemes, using the framework of the final incentive scheme as guidance, submission of monthly performance data by March 31, 2006 is not feasible. This monthly performance information is now required for each month from the month ending on July 31, 2006 forward – initially for the indices suggested by the Regulated Entities for their own incentive schemes.

Since the ERC intends to adopt the final incentive scheme framework provided to the Regulated Entities on March 15, 2006 for the 3rd regulatory period, it is important that the Regulated Entities develop the capacity to measure the performance indices included in the final framework at an early date, to allow historical trends to be established. As soon as

any of the indices in the final framework can be measured effectively, this information is to be provided to the ERC as part of the monthly performance data for the Regulated Distribution System.

4.2 Approval dates

Issue raised

In section 2.2 of the Position Paper, it is noted that the ERC will communicate the approved incentive schemes for the Second Regulatory Period (Interim Incentive Schemes) to the Regulated Entities by June 30, 2006. This is to allow them to submit the final performance incentive scheme as part of the rate applications on August 31, 2006. However, no interim submissions were requested from the Regulated Entities in the Position Paper.

Resolution

To allow meaningful debate between the ERC and the Regulated Entities on their proposed Interim Incentive Schemes for the Second Regulatory Period, it is proposed that the following timeline be adopted :

- a) Details of the draft of their respective Interim Incentive Schemes should be provided for discussion purposes to the ERC by each Regulated Entity not later than May 12, 2006. This will allow the ERC to form an early view of potential difficulties and shortcomings and to work out an approach with the Regulated Entities on how to address these.
- b) The updated version of the Regulated Entities' Interim Incentive Schemes should be provided to the ERC not later than June 9, 2006. While this version would not yet have to include the final performance level targets or penalty levels, it has to describe all the indices that would be measured and the manner in which the performance incentives would be derived from that.
- c) The ERC will assess the updated versions of the Interim Incentive Schemes proposed by the Regulated Entities and, if considered appropriate, will accept them for implementation during the Second Regulatory Period. This will be communicated to the Regulated Entities on June 30, 2006 as part of the overall information to be provided on that date. If an Interim Incentive Scheme is found to be inadequate, the Regulated Entity will be requested to revise or expand it. If no satisfactory resolution is achieved in a reasonable time, the ERC will design and implement such an Interim Incentive Scheme at its own discretion and will also communicate the details of this on June 30, 2006.
- d) As part of their August 31, 2006 rate applications, the Regulated Entities will determine the appropriate performance levels for each of the approved performance indices making up the Interim Incentive Scheme (including further threshold levels, as appropriate), as well as the penalty levels that should apply to the Guaranteed Service Level (GSL) scheme. This information will be assessed by the ERC as part of its assessment of the rate applications and will be incorporated, amended as appropriate, in the draft and final determinations of the price-caps for the Second Regulatory Period.

4.3 Implementation dates

Issue raised

An enquiry was made about the date at which the Interim Incentive Scheme would commence.

Resolution

The Interim Incentive Scheme will be effective from the start of the Second Regulatory Period.

However, since actual measurements against the performance indices used for the price-linked incentive scheme will only commence from July 2006, sufficient performance data for implementing the price-linked incentive scheme (S-factor) will only be available for the second regulatory year onwards. The first real S-factor will therefore only be calculated and applied for the second regulatory year, commencing on July 1, 2008, based on actual performance levels over the 2007 calendar year. For regulatory year 2008, the S-factor will be zero.

The GSL scheme will take effect from the start of the Second Regulatory Period, based on the service and penalty levels approved by the ERC as part of the final determination of the price-caps.

The information disclosure data has to be measured and submitted from the start of the Second Regulatory Period.

4.4 Price-linked incentive scheme

Issue raised

Confirmation was requested that the S-factor for any regulatory year would be based on the actual performance measurements taken over the previous calendar year.

Resolution

This interpretation is correct.

For example, the S-factor in regulatory year 2010, that is July 1, 2009 to June 30, 2010, will be based on performance measurements taken over the 2008 calendar year. This is to allow sufficient time to calculate the S-factor in time for price setting at July 1, 2009.

To allow the collection of calendar year performance data, the template for performance information in Appendix J of the Position Paper has been changed in the final performance incentive framework issued to Regulated Entities on March 15, 2006.

4.5 Guaranteed service level scheme

a) Issue raised

An enquiry was made about the definition of urban, sub-urban and rural customers as suggested in the preliminary Guaranteed Service Level (GSL) definitions in sections 9.4.1 (a) and (b) of the Position Paper.

a) Resolution

In preparing the final framework for the performance incentive scheme, the ERC concluded that insufficient data exists at present to allow a meaningful distinction to be drawn between urban, sub-urban and rural customers. In addition, it was not satisfied that effective definitions existed that could be practically applied to differentiate between these customer groups.

The ERC has therefore removed any reference to different customer categories in its final definitions for the GSL indices and will apply these indices consistently across the whole customer base. This was indicated in the final framework submitted to Regulated Entities on March 15, 2006.

b) Issue raised

An enquiry was made about the time at which the GSL penalties would be paid to consumers.

b) Resolution

The GSL penalty levels will be determined for each regulatory year in accordance with the allowed annual revenue for that year and the historical performance against the measured indices. (The procedure to determine penalty levels is described in section 9.4.2 of the Position Paper.) Additional revenue for the GSL scheme will be allowed in the allowed annual revenue for the regulatory year and will hence be reflected in the prices from the start of that regulatory year. The GSL penalties should therefore also be payable from the start of the regulatory year, after allowing a reasonable time for the identification of a penalty event and the response to it.

c) Issue raised

An enquiry was made about the carrying forward of efficiency adjustments related to the GSL scheme to future regulatory periods.

c) Resolution

The intention of including the GSL scheme in the efficiency carry-over was to provide an incentive for improved service performance that will be sustained towards the end of the regulatory period. However, on reconsideration it has been decided that this efficiency carry-over is not necessary for the GSL scheme.

The performance levels on which the GSL penalties will be based will in turn be based on long-term historical trends, of up to five years of performance data for each performance index. Short-term above- or below- average performance will therefore not greatly affect the target levels. The ability to gain from reduced penalties, or the losses associated with increased penalties, should therefore provide a stronger incentive than influencing the target levels by weaker performance towards the end of the regulatory period. The effect would therefore be similar to that provided by the efficiency carry-over.

It has therefore been decided that the efficiency adjustments, described in section 8 of the Position Paper, should not apply to the GSL scheme.

d) Issue raised

In section 9.3.4 of the Position Paper it is noted that the DWRG limits the total level of penalties or rewards under the performance incentive scheme to 3% of the allowed annual revenue for a regulatory year. Of this capped total, an amount equal to 0.5% of the allowed annual revenue is allocated to the GSL scheme. However, to keep the GSL scheme revenue-neutral, an additional allowance of 0.5% on top of the annual allowed revenue will be made for each regulatory year.

An enquiry was made to determine whether:

- i) this implies once this 0.5% revenue cap on GSL expenditure has been reached, no further penalties will apply during any particular regulatory year; and
- ii) a poor-performing Regulated Entity will then effectively have a maximum penalty of 2.5% of annual allowed revenue (through the price-linked incentive scheme), while enjoying a potential upside benefit of 3%.

d) Resolution

In terms of the DWRG, the maximum penalty level applicable may be up to 3% of the allowed annual revenue. The implication of this is that a poorly performing Regulated Entity can not only lose the 0.5% additional revenue allowance for the GSL scheme, but also an additional 0.5% of allowed revenue until the penalty cap takes effect, effectively meaning that the downside potential is capped at 3%. Conversely, a well-performing Regulated Entity can stand to gain up to 3% of the allowed annual revenue (2.5% on the price-linked incentive scheme and the 0.5% GSL allowance).

It is theoretically possible that a Regulated Entity could pay out such a high number of penalties that the GSL allowance and the additional 0.5% of allowed annual revenue is spent before the end of a regulatory year. In such instances it would not have to pay out any further penalties – otherwise the 3% penalty cap could be breached. However, since the GSL penalties are based on average historical performance levels, such a situation would mean that the Regulated Entity has to be grossly under-performing– essentially 100% worse than its average historical performance. Such a situation is highly unlikely and, if it should occur, would normally be indicative of fundamental problems in the operation of the Regulated Distribution System which would warrant further investigation and possible intervention by the ERC.

4.6 Information disclosure

Issue raised

An enquiry was made about the definition of forced outages as included in the average forced-outage duration index described in section 9.5 (c) of the Position Paper.

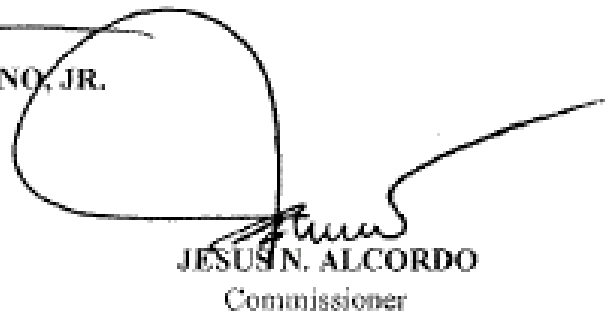
Resolution

In preparing the final framework for the performance incentive scheme, the ERC concluded that insufficient data measurement capacity exists at present to allow the forced-outage duration index to be meaningfully determined. It has therefore decided to remove this index from the information disclosure requirements. This was indicated in the final framework submitted to Regulated Entities on March 15, 2006.

Pasig City, April 11, 2006.


RODOLFO B. ALBANO, JR.
Chairman


OLIVER B. BUTALID
Commissioner


JESUS N. ALCORDO
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