General Comments

1. ***(MERALCO)*** Ensuring an acceptable MAP_{2005} is important in a decision to enter PBR as this will serve as baseline for future rates. MERALCO's current rates are abnormally low due to recent regulatory decisions. The mechanism by which current rates are to be normalized should be explicitly written in the DWRG guidelines. We recognize that the one of DWRG's guiding principles (Section 4.4.5) states that "…the ERC will adequately compensate the relevant Regulated Entity for all identified and justifiable risks inherent in an electric distribution business in the Philippines".

2. ***(MERALCO)*** It is our understanding that the captive supply function will be a separate regulation issue. May we know what type of regulation ERC intends to employ for this function? Also, if ERC has plan of implementing captive supply regulation simultaneous with DWRG?

ARTICLE 1: DEFINITION OF TERMS

Comments on Definition of Terms

(CEPALCO)

- **Ancillary Services**
  The definition of this should be: "Ancillary Services as defined in the Philippine Distribution Code". The principle is to use only one definition for the special terms applied to the Electric Power Industry in the Philippines; the changes in the reference definition will then be applicable to the regulatory rules and guidelines that incorporate the definition. Only those terms that intended to be different from the definition in the Distribution Code should be separately defined in the Guidelines. The term "Distribution System" below also should be defined as "Distribution System as defined in the Philippine Distribution Code".

- **Customer Segment**
  We suggest that "Customer Segment" be replaced by "Customer Class" in accordance with customary use in the Philippines for "Customers of that Regulated Distribution System who are charged the same tariff by the Regulated Entity". A Customer Segment would be a smaller group within a Customer Class.

- **System Operator**
  Change to "System Operator as defined in the Philippine Distribution Code". The Distribution Code is a reference document for the Guidelines that should have priority over the WESM Rules.

Article 2: Timing for Regulatory Periods

1. ***(MERALCO)*** Section 2.2, 2.3, 2.4 – We propose that the regulatory period follow a calendar year which most of the private utilities have been using. To maintain ERC's direction of having a 6-month gap between rate changes between TRANSCO and DUs, we suggest moving the TRANSCO regulatory year to start in a mid-year instead.

Article 3: First Regulatory Period

1. ***(MERALCO)*** Section 3.3.3 – We suggest that the USER be based on the average Peso-Dollar rates for a whole quarter. Using the average Peso-Dollar rate just for the quarter's last 5 business days leaves no indication of the foreign exchange movements in the early part.

2. ***(MERALCO)*** Section 3.4.2, 4.3.2 – The average reference rate I need not be divided by 100 since it is already in percent form (i.e., $1 + (i_{2007} + 4\%) / 100$).

3. ***(MERALCO)*** Section 3.4.2.c, 4.3.2.d – It appears that the formula will result to a very low K. The equation can be corrected by substituting the expression: $\{DA_{2007} – [1.05 x…\}$ by either $AWAT_{2007} – [1.05 x…\}$ or $\{DA – [0.05 x…\}$.

ARTICLE 4: SECOND REGULATORY PERIOD

Computation of WACC

1. ***(CEPALCO)*** Section 4.9.7, Page 54, prescribed a formula to compute for the Equity Beta, $Beta_e$, as follows:

   $$\mathbf{Beta_e = Beta_a \times [1 + (D/E)]}$$

   Assuming that the Asset Beta, ($\mathbf{Beta_a}$) is fixed as in the case of ERC's proposal for Transco as contained in the regulatory reset Issues Paper, the above formula will result to a lower value when equity goes higher than debt. This may be logical since the low leverage, i.e, lower debt than equity, may have made the equity less risky hence lower Equity Beta.

   However, the reduction in the Equity Beta due to change in financial leverage results to lower WACC. In the book entitled "Principles of Corporate Finance" by Brealey and Myers, it is said that "*when the firm changes its financial leverage, the risk and expected returns of the individual securities change but the asset Beta and the company cost of capital do not change"*. (Richard A. Brealey & Stewart C. Myers, "Principles of Corporate Finance, 5th Edition, Page 217)

   Exhibit 1 shows that a 50:50 debt-to-equity ratio as adopted for TRANSCO (under Case 1) results a higher WACC at 13% than the computed WACC of 12.95% applicable for DUs using the proposed standard Debt-to-Equity ratio of 45:55 (under Case 2).

   We therefore request for clarification on the appropriateness of the above-mentioned relationship between Equity Beta and the resulting WACC, which results in granting a lower WACC for DU **(12.95%)** than for TRANSCO **(13%)** assuming all factors used in the calculation of WACC for TRANSCO remains constant except for the capital structure.

2. ***(CEPALCO)*** WACC is computed at standard debt funding of 45% **[Section 4.9.3, Page 52]**. It is suggested that WACC shall be computed based on the actual debt funding or the standard, whichever is lower, using the Equity Beta **($Beta_e$)** as computed using the standard Debt-to-Equity Ratio.

   The suggestion aims to allow DUs with low debt funding or those having a conservative capital structure to earn the just and reasonable return on the actual equity funding, which happens to be more expensive. As shown in the Reset Issues Paper for TRANSCO **(Section 6.17.1, page 36),** at 13% calculated WACC for TRANSCO, the Cost of Equity is 3.8% percentage points higher than Cost of Debt **or 14.9%** compared to **11.1%** Cost of Debt.

   A sample computation is shown in Case 4, Exhibit 1.

3. ***(MERALCO)*** Section 4.9.2, 5.8.4 – We suggest that WACC to be used in the filing be DU-specific to reflect the actual finance structure of the Utility.

Determination of Working Capital

1. ***(CEPALCO)*** On the determination of working capital **(Section 4.5.7 page 39).** We suggest that similar methodologies, which could be used to set the working capital proposed in the TWRG draft Issue paper, shall be adopted in order not to limit the setting of working capital based on lead-lag analysis of relevant payables and receivables. These methodologies are:

    a. Benchmarking against other electricity distribution utilities in other jurisdictions;
    b. Benchmarking against other Philippine companies in the utility sector, either in the electric, telecommunications or water sectors;
    c. Undertaking an industry average lead-lag analysis of relevant payables and receivables (excluding ECs) over a 12-month period;
    d. Set at a theoretical level of an efficient company, say 30 days of sales revenue;
    e. Other methodologies which may be relevant

Income Tax Adjustment

1. ***(CEPALCO)*** The Income Tax Adjustment (ITA) as computed under **Section 4.12.4, page 66** takes care of the actual Corporate Income Tax (IT) paid for 2005 and 2006 only. Such amount is included in the ARR for 2008.

   It is suggested that an ITA for 2007 equal to actual IT paid for 2007 shall also be included. Although the Regulatory Reset Process shall start in not less than 21 months prior to the start of the next regulatory period (hence, actual IT for 2007 is still not available), the final determination of the price control arrangement is done in not later than 3 months from the start of the second regulatory period or July 2008. By then, actual IT for 2007 shall already be available. This is to allow recovery in the second regulatory period of the full IT paid by DUs for the first regulatory period rather than stretching recovery of IT for 2007 in the third regulatory period.

2. ***(CEPALCO)*** Section 5.3, page 26 of the TWRG Reset Issues paper states that ITA is undertaken to ensure that any difference between the actual IT paid and the recovery of IT, including the impact of the time value of money, is adjusted in the revenues allowed to be recovered by TRANSCO in the following regulatory period.

   Section 5.4.2 of the TWRG Reset Issues Paper also provides that there is a need to separately account for actual IT payments.

   By adopting the above sections in the DWRG, ITA for the first regulatory period is easily determined. It is equal to actual IT paid to BIR for the years 2005 – 2007 because the MAP and the AWAT has zero provision for IT recovery.

   For the second regulatory year, estimated IT for the years 2008 – 2011 is included in the projected ARR that goes into the MAP as well as in the actual tariff/charges.

   Hence, to calculate for ITA starting in the second regulatory period, actual IT recovery thru rates as included in the actual charges/AWAT and the MAP has to be accounted for separately. However, the guidelines do not provide a procedure on how the IT recovery is separately quantified and accounted for. Hence, it is suggested that a formula in arriving at the actual IT recovery thru rates shall also be provided in the guideline.

Asset Revaluation

1. ***(CEPALCO)*** 4.6.2 The asset re-valuation referred to in Section 4.6.1 must be undertaken by either:

    (a) an independent appraisal company engaged by the Regulated Entity that operates the relevant Regulated Distribution System, in which case the ERC **must also retain a Regulatory Reset Expert** or Regulatory Reset Experts pursuant to Article XIV for the purposes of reviewing that re-valuation; or

    COMMENT:
    Retention by ERC of a Regulatory Reset Expert should not be made mandatory; the ERC should have the option of accepting the output of the independent appraisal company without getting the opinion of a Regulatory Reset Expert.

2. ***(CEPALCO)*** In Sec. 4.6.5(a), include categories for: distribution transformers, capacitors, line switches and sectionalizers, grounding cables, overhead ground cables, and guying cables. Replace “sub-sea cables” with “submarine cables”. Include a category in this section or elsewhere for streetlights and their accessories.

3. ***(CEPALCO)*** In Sec. 4.6.6, the first sentence in the last paragraph, which reads, “Other optimization principles may be used as approved by the ERC following advice from a Regulatory Reset Expert or Regulatory Reset Experts referred to in Section 4.6.2” should be revised by deleting all words after “ERC”. The ERC should not be made dependent on the advice of an external Regulatory Reset Expert.

4. ***(MERALCO)*** Section 4.6.5 – We suggest that the asset categories use the ones employed by the Uniform Unbundling Requirements (UFR) since the utilities already have this in place.

Article 12: Re-Opening & Adjustment events

- ***(CEPALCO)*** MAP's are automatically adjusted each year by the Price Control Formula under Sections 3.2 and 4.2 for the first and second regulatory periods, respectively. Consequently, DUs also files for annual verification and adjustments of tariff rates to make actual rates at par with MAP for each year.

We suggest that the guideline explicitly states that the annual adjustments of tariff rates provided under **Article VI** and the re-opening and adjustment under **Article XII** are not subject to the public hearing requirements under Rule 3 Section 4e of the IRR of RA 9136.

Article 14: Experts & Consultants

- ***(CEPALCO)*** 14.1.1 Where these Guidelines confer on the ERC the right **or obligation** to retain a Regulatory Reset Expert in relation to a matter pursuant to this Article XIV, that Regulatory Reset Expert must be an expert who:

COMMENT:
Suggest to delete **"or obligation".** Retention by ERC of an external Regulation Reset Expert should be only an option, not an obligation. Any provision anywhere in the Guidelines that requires the ERC to retain an external Regulatory Reset Expert should be deleted.

Appendix B: Performance Indices

- ***(CEPALCO)*** In Appendix B, Part I, page 134. Suggest that the **"number of frequency limit violations"** should be excluded from indices to be used to measure the performance of a Regulated Distribution System. This is not controllable by distribution utilities in the Philippines, except possibly by MERALCO.