

PERFORMANCE-BASED REGULATION - GROUP A ENTRANTS
GUIDELINES FOR RY 2010 RATE RESET

Rate-setting for the first entrant group (Group A) into performance-based regulation (PBR) was done in terms of the Rules for Setting Distribution Wheeling Rates (RDWR) as published on July 6, 2006. Subsequently, following further consultation, several changes were made to the RDWR, which culminated in the latest version as published by the ERC on January 28, 2009. Although the Group A entrants into PBR are already on their final stages to the second regulatory period, these changes have a substantial impact on the manner in which their 2010 and 2011 annual price resets will be treated.

To assist the Group A utilities in this regard, the following guidelines were prepared to guide their 2010 rate reset application.

1. RE-OPENING METHODOLOGY

The changes made to the RDWR are so substantial that it requires a re-opening event for the price-control arrangements for the Group A entrants second regulatory period. This relates in particular to Clause 4.14.4 (removal of the corporate income tax building block) and Clause 12.6 (weighted average cost of capital, or WACC) The utilities shall recalculate the smoothing factor (X-factor) that applies for the second regulatory period. The following methodology will be applied for the re-opening calculation.

- a) The recent changes made to the RDWR will be incorporated into the ERC's financial price-cap model, starting from regulatory year 2008. This implies that the price-control arrangements will be recalculated from the start of the second regulatory period, as if the changes had been in place from the start of the period.
- b) Recent further modifications in some of the parameters used for the second entry group into PBR (Group B), will also be reflected in the re-opening calculations, to retain consistency between entry groups. This includes the working capital allowance, construction work in progress factor, new weightings in the CWI index and the revised WACC.
- c) The revised price-control arrangements will be applied going forward (from RY2010 on), but no retrospective changes to earlier price-setting decisions will be implemented (that may require refunds to consumers or additional payments by consumers based on historical consumption and rates).
- d) The originally forecast economic indices for the second regulatory period will remain as approved for the final determination on the price control arrangements for Group A. (There are sufficient correction factors built into the rules to remove the need to retrospectively change these.)
- e) Based on the revised modeling, the utilities will calculate a new X-factor and opening maximum annual price (MAP₂₀₀₈). Using these figures and the original consumption and sales data submitted in the utilities' application for calculating the MAP₂₀₀₉, a revised MAP₂₀₀₉ will be determined. (Earlier under- or over-recovery will be recalculated based on the new calculated MAP₂₀₀₈ and MAP₂₀₀₉.) The revised X-factor, MAP₂₀₀₈ and MAP₂₀₀₉ will be calculated by each utility to form part of its RY2010 rate reset application for approval of the ERC.

- f) The revised figures will be used by the utility as input for its calculation of the MAP₂₀₁₀ and subsequent translation of this MAP₂₀₁₀ into distribution tariffs. It will also be used for the calculation of any under- or over-recovery factors.
- g) No changes are to be made to the performance incentive scheme approved for each utility. The previously calculated performance incentive factor (S-factor) for RY2009 will remain as for the original rate-application for that year. It will, however, be taken into account that the incentive factor is no longer to be constrained under the side constraints that applies to the setting of distribution rates (this will apply for the recalculated MAP₂₀₀₉ as well).

2. CHANGES IN PARAMETERS

The changes in the RDWR that impacts materially on the calculation of the new X-factor and price settings for the Group A utilities are summarized below. A full description of the rule changes and its corresponding reasons are provided in the ERC report titled "*Modifications to the Rules for Setting Distribution Wheeling Rates (RDWR)*", dated December 8, 2008 and is therefore not repeated below.

2.1 Rule changes impacting on the Group A price-setting

- a) The corporate income tax building block will be set to zero for the second regulatory period.
- b) The weighting in the CWI factor (used in the annual rate setting) of the local CPI, US CPI and PhP/US\$ exchange rate was changed from 60/40 to 80/20 ratio between CPI and FOREX.
- c) Changes were made to the weighted average cost of capital, to better reflect the riskiness of investment faced by the utilities. The new WACC figure is 16.27% per annum (which also reflects changes in the economic parameters underpinning the WACC between the time at which the Group A WACC was determined and that for Group B).
- d) The side constraints may be relaxed at the discretion of the Commission.
- e) The impact of the S-factor (incentive bonus/penalty reflecting service quality performance) is to be excluded from the side constraints.

2.2 Further changes made in price-setting parameters for the Group B final determination

In addition to the rule changes, a number of further changes were made in parameters used for the price setting of the Group B entrants into PBR. By themselves, these changes are not sufficient to give cause to a re-opening event, but since a re-opening is already indicated due to the rule changes, they will also be reflected in the recalculated price control arrangements for Group A. In particular, the following changes will be made to ensure consistency between the entry groups:

- a) The working capital factor was adapted following further lead/lag studies of the later entrants. This is set at 4.9% of the approved operating expenditure building block.
- b) The construction work in progress (CWIP) factor was adapted. This is now set at 4.6% for substation and related projects, and at 3.3% for other infrastructure projects. This has an impact on the value of the opening asset base as well as the approved capital expenditure for the second regulatory period.

3. RE-ESTIMATION OF ENERGY CONSUMPTION AND EXPENDITURE

The revised RDWR (clause 12.3) makes provision for a re-opening event if actual energy consumption varies by more than 15% from that forecast for the final determination. If such a situation has arisen in RY2009, then this should be reflected by a utility, which will be required to submit new consumption forecasts for the remainder of the regulatory period.

However, the ERC is concerned that the current international economic slowdown may impact substantially on utilities in the form of reduced consumption figures, but that this may only substantially manifest itself during RY2010 and 2011. Since a re-opening event will apply already for RY2010, the Group A utilities are therefore requested to consider the expected impact of the global slowdown on their consumption figures. If this is anticipated to have a material impact on a utility's consumption, it is to provide an updated energy forecast for the second regulatory period, including actual consumption figures for RY2009.

At the same time however, the ERC expects that a prudent, efficient utility will adjust its expenditure in line with the economic slowdown. It further expects that utilities should carry some of the burden of the economic slowdown, and should not be able to merely pass this on to their consumers. If a slowdown in consumption is therefore forecast, the ERC expects that this will also be reflected in a utility's forecast expenditure levels (capex, opex and taxes, levies and duties). Utilities are therefore required to revise their expenditure forecasts in view of the current economic slowdown and the anticipated reduction in energy consumption. These revised figures will be considered by the ERC along with the proposed revised consumption forecasts.

4. RELAXING SIDE CONSTRAINTS

In terms of the new RDWR, the ERC may at its discretion relax the side constraints for an annual price reset. In doing so, it will consider an appropriate balance between the best interest of consumers and avoiding excessive further under-recovery by utilities (which will result in future higher distribution rates).

Following advice from utilities, the ERC also accepts that utilities may be best placed to understand how the relaxation of side constraints could impact on sections to their consumer base, and that it may be appropriate to selectively relax side constraints (while still avoiding intergroup cross-subsidies). The ERC will therefore welcome suggestions by utilities on how limited relaxation of side constraints may be imposed for the RY2010 rate reset. These suggestions will be considered by the ERC in its decision on 2010 distribution rates.

5. REVISED TIMELINE FOR SUBMISSIONS

The timeline for submission of the RY2010 rate applications for Group A has been amended from that published in the RDWR. It will now be as follows:

- a) Utilities to file application for approval of the following in consideration of this guidelines:
(1) Revised X-factor; (2) SMAP for the Second Regulatory Period; and (3) RY2010 MAP Translation - March 20, 2009
- b) Public hearings Decorp - April 21 & 22, 2009
- c) Public hearings Cepalco - April 23 & 24, 2009
- d) Public hearings Meralco - April 27 & 28, 2009
- e) Submission of follow-up information - May 11, 2009
- f) Commission approval of new rate structure - May 25, 2009

- g) Utilities to publish rates in local newspaper - May 29, 2009
- h) Rates implemented - July 1, 2009