



**REVIEW OF OPERATING AND MAINTENANCE  
EXPENDITURE (OPEX) FORECAST:  
SECOND REGULATORY PERIOD**

**La Union Electric Company, Inc. (LUECO)**

**ADDENDUM**

**Prepared by**

**REGULATORY OPERATIONS SERVICE  
ENERGY REGULATORY COMMISSION**

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### APPENDIX A: SUMMARY OF COMMENTS

## 1. INTRODUCTION

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The Energy Regulatory Commission (ERC) has promulgated a performance-based form of regulation (PBR) for regulated privately owned electricity distribution utilities in the Philippines. Under the PBR framework, a regulated entity will be subject to a price cap for the delivery of distribution wheeling services. The reset process for the setting of the price cap for the six regulated entities entering the PBR at the third entry point is currently underway. This process will result in the setting of a maximum price path that will determine the maximum average price a regulated entity can charge for each year of the Second Regulatory Period (which commences on July 1, 2010 and ends on June 30, 2014).

The mechanism for the calculation of the price cap and the procedure and timelines for the introduction of this cap, are described in the Rules for Setting the Distribution Wheeling Rate (RDWR), which was released by the ERC on December 8, 2008<sup>1</sup>. The ERC has also formulated its position on the reset process – as set out in a Position Paper dated December 8, 2008<sup>2</sup>.

An important requirement of the reset process going forward is the review of the expenditure forecasts submitted by the DUs as part of their revenue applications filed with the ERC. These expenditure forecasts are critical to the determination of the revenue to which DUs are entitled and on which the price caps will be determined.

Section 4.13.4 of the RDWR requires that the expenditure forecasts provided by a DU be reviewed by a Regulatory Reset Expert/s in isolation or in cooperation with ERC staff as part of the PBR regulatory reset process. Geoff Brown and Associates (GBA) has been engaged by the ERC to provide guidance to the ERC staff to review the operating and maintenance expenditure (OPEX) forecasts and review the capital expenditure (CAPEX) forecasts, as well, of the six DUs entering PBR at the third entry point.

LUECO submitted its PBR revenue application to ERC on June 15, 2009<sup>3</sup> (Revenue Application). The Commission issued its report on its review of the OPEX forecasts included in LUECO's Revenue Application on October 19, 2009<sup>4</sup> (Review of Operating and Maintenance Expenditure (OPEX) Forecast: Second Regulatory Period). ERC issued a draft determination on the Revenue Application on November 9, 2009<sup>5</sup> (Draft Determination). Following the release of the Draft Determination, ERC held a public consultation in San Fernando City, La Union on January 27, 2010. At the public consultation LUECO raised a number of issues in respect of the Draft Determination and was required by the ERC to subsequently provide additional information to support its position. GBA and ERC staff were present at the public consultation and have now reviewed the additional information supplied by LUECO insofar as this information relates to OPEX forecasts. In this Addendum to the Review of the Operating and Maintenance Expenditure Forecasts: Second Regulatory Period, ROS documents its review of the issues raised and, where appropriate, modifies the recommendations in the Review of the Operating and Maintenance Expenditure (OPEX) Forecast: Second Regulatory Period on LUECO's reasonable OPEX requirements for the second regulatory period.

The issues that were discussed at the public consultation are summarized in Appendix A. Only those issues that could have a material impact on the OPEX approved in the Draft Determination are discussed in detail in the body of this Addendum.

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<sup>1</sup> *Rules for Setting Distribution Wheeling Rates (RDWR) for Privately Owned Distribution Utilities Entering Performance Based Regulation (Third Point)*, Energy Regulatory Commission, December 8, 2008.

<sup>2</sup> *Regulatory Reset for the July 2010 to June 2014 Regulatory Period for the Third Entry Group of Privately Owned Distribution Utilities subject to Performance Based Regulation, Position Paper*, Energy Regulatory Commission, December 8, 2008. Note that the start and finish dates of the regulatory period to which the Position Paper applies were subsequently changed to July 1, 2010 and June 30, 2014 respectively, by ERC resolution No. 24, Series of 2007, dated October 24 2007.

<sup>3</sup> ERC Case No 2009-044RC.

<sup>4</sup> *Review of Operating and Maintenance Expenditure (OPEX) Forecast: Second Regulatory Period, La Union Electric Company, Inc. (LUECO)*, ERC, October 19, 2009.

<sup>5</sup> *Regulatory Reset for La Union Electric Company, Inc. (LUECO) July 2010 to June 2014 (Second Regulatory Period) Draft Determination*, Energy Regulatory Commission, November 9, 2009.

## 2. EXECUTIVE SUMMARY

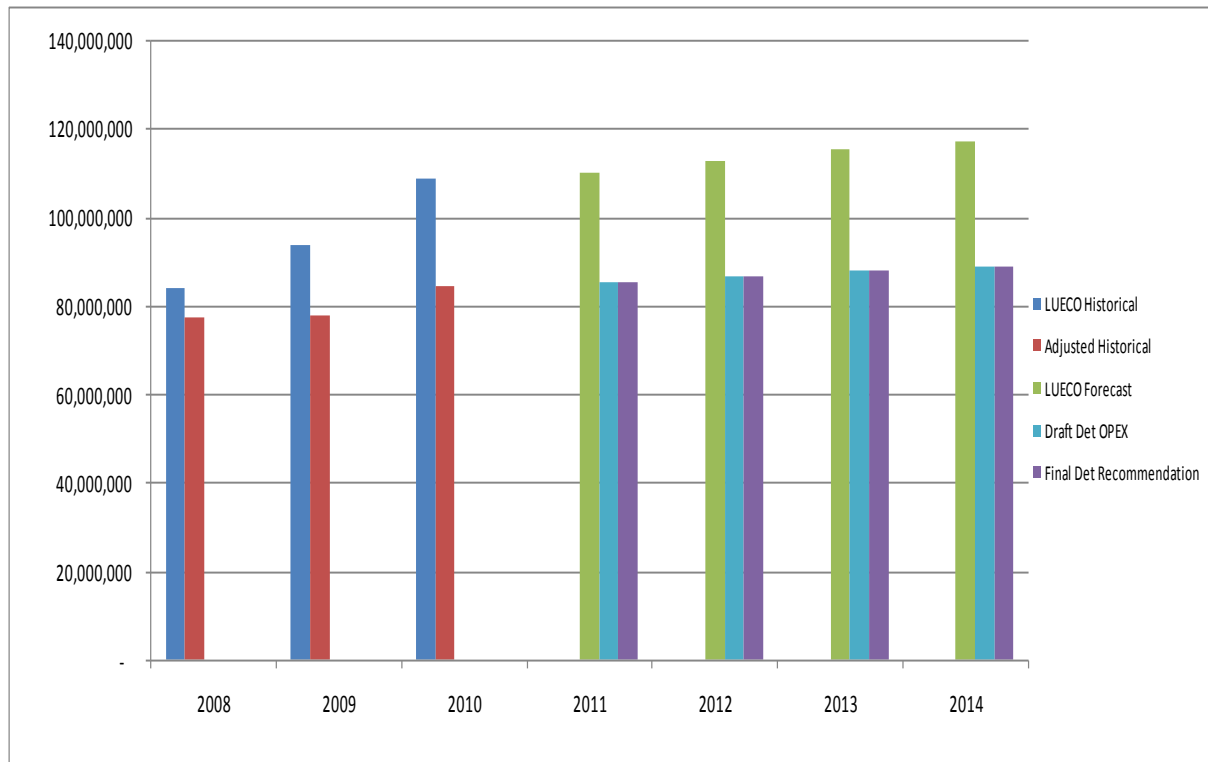
ROS recommends adjustments to the OPEX forecast allowed in the Draft Determination considering GBA's recommended adjustments on the CAPEX forecasts and updated CPI data as of February 2010 as published by the EIU

### Recommended Operating and Maintenance Expenditure Forecasts (PhP million, real 2009)

	RY 2010	RY 2011	RY 2012	RY 2013	RY 2014	Total <sup>1</sup>
Draft Determination	84.48	85.4	86.64	87.9	88.79	433.21
Adjustment to <i>Distribution Operating and Maintenance</i>	0.00	0.03	0.09	0.13	0.12	0.37
Adjustment to <i>Administration and General</i>	0.01	0.01	0.02	0.03	0.03	0.09
Adjustment to Regulated Retail Services	0.00	0.01	0.01	0.01	0.02	0.02
<b>Total Adjustments</b>	<b>0.02</b>	<b>0.04</b>	<b>0.11</b>	<b>0.16</b>	<b>0.15</b>	<b>0.48</b>
<b>Revised Recommendation</b>	<b>84.50</b>	<b>85.44</b>	<b>86.75</b>	<b>88.06</b>	<b>88.94</b>	<b>433.69</b>

The recommended adjustments to Distribution Operating and Maintenance and Administrative and General cover additional expenditure on the additional capacity of the Bauang substation transformer and the cost timing adjustment of the Central Bank line upgrade that were not provided for in the OPEX allowed in the Draft Determination.

The impact of these recommended adjustments to the OPEX allowed in the Draft Determination is shown in the figure below.



ROS recommends no further adjustments to the taxes, levies and duties allowed in the Draft Determination.

### **3. OPERATING AND MAINTENANCE EXPENDITURE**

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#### **3.1 OPEX REVIEW METHODOLOGY AND ASSUMPTIONS (APPENDIX A - ITEMS 1 & 2)**

##### **3.1.1 Background**

In its Revenue Application LUECO indicated its forecasting methodology to justify its OPEX forecast. In the OPEX Review Report, ROS indicated that it used the OPEX forecasting model in order to assess the reasonableness of the LUECO forecast.

LUECO seeks clarification on the basis of the substantial decrease in some OPEX line items which are relevant to LUECO's operation.

##### **3.1.2 Analysis**

The OPEX forecasting model escalates the actual OPEX in the base year (after adjustment for abnormal base year expenditures and review for efficiency) to reflect the impact of anticipated changes in significant cost drivers over the forecast period. The base year OPEX submitted by LUECO is PhP77.35 million (real 2009). Adjustment on LUECO's bad debts expense was made to the modeled base year cost, considering that the OPEX costs over the historical years 2006-2008 has abruptly increased in CY2008 due to its bad debts expense.

The adjustments made for each line item, as provided in the OPEX Review Report, are accounted for by the cost drivers used reflecting the impact of efficiency initiatives by providing reasonable expenditures. This will further be shown in the OPEX model which will be provided as part of the Final Determination.

As described in the OPEX Review Report, the OPEX model forecasts specific cost categories by escalating the base year values by the correlated cost drivers. The Distribution Operating and Maintenance expenditures are correlated to the growth in regulated assets, Regulated Retail costs are closely aligned to the growth in customer numbers, the water and electricity cost is aligned with the number of staff. The total OPEX is also affected by the prices in materials and labour costs.

The resulting adjustments from LUECO's OPEX forecasts would account for the difference in the OPEX forecasts generated by the model. In consideration of the GBA recommended adjustments on the CAPEX forecasts, ROS identified corresponding adjustments to the OPEX forecasts specifically on Distribution Operating and Maintenance and Administrative and General expenditures, as follows:

**Comparison of Draft Determination and ROS' Forecast Operating and Maintenance Expenditure (PhP million, real 2009)**

<b>Operating and Maintenance Expenditure Category</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>Total<sup>1</sup></b>
<b>Distribution and Connection Services Operation and Maintenance</b>						
Draft Determination	20.42	20.82	21.37	21.93	22.16	106.70
Adjusted OPEX Model	20.42	20.85	21.46	22.06	22.29	107.07
Difference	0.00	0.03	0.09	0.13	0.13	0.37
<b>Administrative and General</b>						
Draft Determination	32.68	32.74	32.84	32.93	32.97	164.15
Adjusted OPEX Model	32.69	32.76	32.86	32.95	32.99	164.24
Difference	0.01	0.02	0.02	0.02	0.02	0.09
<b>Regulated Retail Services</b>						
Draft Determination	31.39	31.83	32.43	33.04	33.66	162.36
Adjusted OPEX Model	31.39	31.84	32.44	33.05	33.66	162.38
Difference	0.00	0.01	0.01	0.01	0.00	0.02
<b>Total Operating and Maintenance Expenditure</b>						
Draft Determination	84.48	85.40	86.64	87.90	88.79	433.21
Adjusted OPEX Model	84.50	85.44	86.75	88.06	88.94	433.69
Difference	0.02	0.04	0.11	0.16	0.15	0.48
<b>Recommended Adjustment</b>	<b>0.02</b>	<b>0.04</b>	<b>0.11</b>	<b>0.16</b>	<b>0.15</b>	<b>0.48</b>

<sup>1</sup> It includes RY2010 plus the Second Regulatory Period which comprises a four-year regulatory period

## **4. TAXES, LEVIES AND DUTIES**

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### **4.1 REAL PROPERTY TAXES (APPENDIX A - ITEM 3)**

In the OPEX Review Report, ROS recommended that these be adjusted down to CY2009 value under Forecast Taxes, Levies and Duties, as taxes for which LUECO's liability has not been confirmed should not be included.

In its comments on the Draft Determination, LUECO noted that the real property taxes paid in CY2009 has not been considered in its forecast for the second regulatory period. ROS verified that this formed part of the forecast taxes, levies and duties allowed in the Draft Determination.

### **4.2 VEHICLE REGISTRATION FEES (APPENDIX A – ITEM 4)**

In Section 4.3.4 of the OPEX Review Report, it is stated that LUECO did not provide an explanation for the increase from CY2009 to the second regulatory period. In this regard, the Commission find it reasonable that the component of vehicle registration fees remain constant in real terms in CY2009 value.

LUECO stated that it had submitted capital expenditures related to these costs, which had not been taken into account in determining the OPEX forecasts.

ROS finds that LUECO has been allowed a provision on its CAPEX forecasts for additional transport equipment needed for the maintenance and repair of the 69 kV sub-transmission line to be purchased from NGCP, which justifies the probability for an additional vehicle registration fees for the second regulatory period.

It has been the Commission's policy that uncertain tax liabilities should not form part of the forecast. In the event of the future imposition of additional taxes or should LUECO become liable for taxes that are not included in the annual revenue requirement, Article XI of the RDWR allows for unexpected tax liabilities imposed during the Second Regulatory Period by means of a "Tax Event Pass Through". Considering that such transport equipment is non-existent, there is uncertainty to pay additional vehicle registration fees, thus, ROS recommends no changes to the taxes, levies and duties forecasts.

### **4.3 REGULATORY RESET EXPERT FEES (APPENDIX A – ITEM 5)**

In Section 4.3.2 of the OPEX Review Report, ROS determined that LUECO should only be allowed to recover the regulatory expert fees for CY2009 and RY2010 starting RY2011, as advised by ERC. Though the reset costs components for CY2009 and RY2010 have been disallowed, the Commission allows LUECO to recover such reset project costs for the period 2006-2010 in the first regulatory year, which entails an increase in RY2011.

As regards to the additional costs incidental to the reset costs such as bank charges and documentary stamp tax, it is clear under Appendix B of the Position Paper that these costs should form part of the office supplies and expenses line item. ROS verified that such costs have been considered to form part of its OPEX forecasts for the second regulatory period.

### **4.4 RECOMMENDATION**

ROS considers the taxes, levies and duties allowed in the Draft Determination are sufficient to enable LUECO to pay its tax liabilities on time and that no further adjustment is necessary.

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**APPENDIX A  
SUMMARY OF COMMENTS**

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Item	Page/ Section Number	Discussion of Comment/s and/or Questions for Clarification	Suggestions / Proposed Change(s)	Comment
1.	page 10, Sec 3.3 Review of Operating and Maintenance Forecast	LUECO submitted on August 28, 2009 and September 7, 2009 the details of OPEX line items, contradictory to Sec 3.3. of the Review of OPEX Forecast, ERC states that '... LUECO did not provide an operating expenditure which could facilitate the review of the underlying assumptions and inputs incorporated into its forecast OPEX...'	LUECO suggests that a review of submitted OPEX line items on August 28, 2009 and September 7, 2009.	This is discussed briefly in Section 3 of this report and the details can be found in the OPEX Model.
2.	page 74 and 75, Appendix B of Draft Determination	<p>A comparison between LUECO's and ERC's OPEX line items forecast has been made. Substantial decrease in some line items which are relevant to LUECO's operation.</p> <p><b>Under Regulated Distribution Services:</b>  Operation– Operation Supervision and Engineering, Load Dispatching, Rents ;  Maintenance – Substation, Overhead Lines, Line Transformers, Information and Technology (distribution network);  Admin and General – Admin and General Salaries, Outside Services Employed, Officer's Allowances and Benefits.  The net decrease for RY 2010, RY 1011, RY2012, RY2013 and RY2014 is about Php12,049,992; Php12,519,886; Php14,038,223; Php15,662,675; and Php 17,227,491 respectively</p> <p><b>Under Regulated Retail Services:</b>  Consumer records, billing and collection  The net decrease for RY2010, RY 2011, RY 2012, RY 2013 and RY 2014 is about Php1,890,333, Php1,891,743 Php1,859,935, Php1,776,337 and Php1,484,414 respectively.</p>	LUECO would like to know what particular expenses are affected to enable us to understand the rationale of the substantial adjustments.	ROS recommends adjustments in OPEX forecast resulting from the changes in asset growth which GBA recommends CAPEX adjustments.
3.	page 25, Sec 4.3.3 Review of Operating and Maintenance Expenditure Forecast	The Real Property Tax was based on the assessment made by the city or provincial assessors on the real properties.	LUECO will provide documentation on real property taxes.	ROS verified that this formed part of its forecast taxes, levies and duties allowed in the draft determination.

4.	page 25, Sec 4.3.4 Review of Operating and Maintenance Expenditure Forecast	The increase vehicle registration fee from CY2009 to the second regulatory period was based on the CAPEX Forecast.	LUECO suggests a review of submitted CAPEX forecast on June 19, 2009, August 28, 2009 and September 7, 2009.	ROS confirmed that there are no proposed vehicles in its CAPEX forecast and recommends no change to the approved taxes, levies and duties.
5.	page 24, Sec 4. 3.2 Review of Operating and Maintenance Expenditure Forecast	<p>LUECO followed the ERC advised to share on the Regulatory Reset Expert fees. LUECO reflected the share of the expert fees on the Other Taxes Template (US\$ Expenditure). While the other costs (such as documentary stamps &amp; bank charges) pertaining to the remittance of the said fees is reflected in the Other Taxes Template (Local Expenditure).</p> <p>As stated in Section 1.4 of Position Paper for Third entry groups, there will be no First Regulatory Period and therefore they will enter PBR directly in the Second Regulatory Period. In this regard, LUECO followed such rule by including the Regulatory Reset Expert Fees cost in CY 2009 and RY 2010 to recover the amount incurred.</p>	LUECO suggests a review of submitted Other Taxes Templates on June 19, 2009 and September 7, 2009 (LUECO-link templates, schedules and application).	ROS recommends no change since LUECO failed to provide proof of its justification.