



Annex “A”

**Performance Based Regulation
of
Privately Owned Electricity Distribution Utilities**

**Discussion Paper on Modifications to
the Rules for Setting Distribution
Wheeling Rates (RDWR) for the First
Entry Group : Third Regulatory Period**

October 6, 2009

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

**Performance Based Regulation of
Privately Owned Electricity Distribution Utilities**

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First Entry Group : Third 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). The DWRG has subsequently been revised and re-issued as the Rules for Setting Distribution Wheeling Rates for Privately-Owned Distribution Utilities Entering Performance Based Regulation [Second and Later Entry Points] [ERC Resolution No. 54, Series of 2006, dated December 13, 2006, hereafter referred to as the ~~RDWR~~], with a further subsequent revision on December 8, 2008 for the Third Entry Point and June 22, 2009 for the Fourth Entry Point.

In terms of Section 1.9 of the RDWR, these rules may from time to time be changed by the ERC. Since the next Regulatory Reset is for the First Entry Group on entering the Third Regulatory Period, the ERC has determined that further changes are now required to the RDWR to reflect the next Regulatory Period. The proposed changes are reflected in the attached draft version of the RDWR, titled Rules for Setting Distribution Wheeling Rates for Privately-Owned Distribution Utilities Operating under Performance Based Regulation (First Entry Group : Third Regulatory Period), dated October 6, 2009 and are also described in this Discussion Paper. Submissions from interested parties are sought on the proposed changes of the RDWR, as described in the Discussion Paper. Interested parties are also invited to suggest further changes to the RDWR, for consideration by the ERC. Details of the required format and time of submissions are provided in Section 1.4 of the paper.

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1. INTRODUCTION

1.1 Purpose

In January 2005, the Energy Regulatory Commission (ERC) adopted the Distribution Wheeling Rate Guidelines (DWRG) which had been developed through a public consultation process in 2004. The DWRG, dated December 10, 2004 outline a performance based regulation (PBR) framework using a price cap on the provision of distribution wheeling services by private electricity Distribution Utilities. This DWRG described the setting of rates under PBR, which the ERC has adopted as an alternative form of internationally-accepted rate-setting methodology under Section 43(f) of Republic Act No. 9136, otherwise known as the Electric Power Industry Reform Act of 2001 (EPIRA), and Rule 15, Section 5(a) of its Implementing Rules and Regulations (IRR).

During the Regulatory Reset Process for the first Entry Group, certain revisions were made to the DWRG. Following consultation, a new set of regulatory rules for PBR for Distribution Utilities were therefore issued - the Rules for Setting Distribution Wheeling Rates for Privately-Owned Distribution Utilities Entering Performance Based Regulation [First Entry Point], dated July 26 2006. These rules pertained specifically to the first Entry Group¹. To provide for the Second (and subsequent) Entry Point(s) to PBR, the ERC conducted further consultation and published the Rules for Setting Distribution Wheeling Rates for Privately-Owned Distribution Utilities Entering Performance Based Regulation [Second and Later Entry Points] (RDWR) on December 13, 2006 with a further subsequent revision on December 8, 2008 for the Third Entry Point and June 22, 2009 for the Fourth Entry Point.

In terms of Section 1.9 of the RDWR, the rules may from time-to-time be amended by the ERC. Since the next Regulatory Reset is for the First Entry Group on entering the Third Regulatory Period, the ERC has determined that further changes are now required to the RDWR to reflect the next Regulatory Period. These suggested changes are presented below.

The proposed changes are also reflected in the attached draft version of an updated RDWR, titled Rules for Setting Distribution Wheeling Rates for Privately-Owned Distribution Utilities Operating under Performance Based Regulation (First Entry Group : Third Regulatory Period), dated October 5, 2009.

Interested parties are requested to consider these proposed changes and to make submissions to the ERC in this regard, explaining their views on the proposed changes and highlighting any objection or suggested revision, with supporting justification or evidence. Submissions need not only focus on the changes suggested by the ERC, but may also include suggestions for further changes to the draft RDWR, along with the justification or evidence for suggesting these further changes.

In addition to this Discussion Paper and the Draft RDWR, the ERC has also published the Issues Paper for the Regulatory Reset for the July 2011 to June 2015 Third Regulatory Period for the First Entry Group of Privately Owned Distribution Utilities subject to

¹ Annex B of ERC Resolution No. 12-02 Series of 2004 ~~Adopting a Methodology for Setting Distribution Wheeling Rates~~, dated December 10, 2004, defined five entry points into PBR for privately owned Distribution Utilities. This was later amended to four entry points by the ERC under resolution 24, series of 2007, dated October 24, 2007.

Performance Based Regulation, dated October 6, 2009 (the Issues Paper). Submissions are also invited on this Issues Paper.

The ERC will, after consideration of the submissions received on the three consultation documents and conducting public consultations in this regard, issue its final decision on the rule changes. This will also result in the issuing of a final revision of the RDWR which will in form the basis for the regulation of the First Entry Group for the Third Regulatory Period as well as the Position Paper that will set out the manner in which the ERC will approach the determination of the price-control arrangements for the First Entry Group for the Third Regulatory Period.

1.2 Use of terms and definitions in the Discussion Paper

Throughout this discussion paper, where capitalized terms are used, this indicates that the term has been defined in clause 1.3 of the RDWR or clause 1.2 of the ERC's Distribution Services and Open Access Rules (DSOAR).

1.3 Submissions on the Discussion Paper

Submissions are invited on this Discussion Paper, the accompanying draft RDWR and the Issues Paper.

Any person with an interest in this matter and wanting to participate in the public consultation must become a party of record by formally making such request in writing to the ERC, providing a clear statement of the person's interest and their address for all correspondence, within twenty (20) days from the date of publication of this discussion paper.

For the public consultation, all parties of record shall file any comments, questions, suggested modifications to data sources, and any other issues pertaining to this Discussion Paper, or the draft RDWR or the Issues Paper in writing, to be received at the ERC offices at the 16th floor, Pacific Center, San Miguel Avenue, Ortigas Centre, Pasig City, not later than November 6, 2009. Any written submissions to the ERC in this case shall include six (6) paper copies and two (2) soft (electronic) copies provided on two (2) compact disks. The ERC shall publish such submissions on its web site by November 10, 2009. Any party filing written comments shall on the same day as the filing is made at the ERC serve as parties of record in the case.

Parties who do not wish to partake in the public consultation, are also welcome to make submissions. Such submissions shall be submitted in the same format as that described above and at the same date.

The ERC hereby sets this matter for public consultation on November 16, 2009 from 2:00 P.M. to 5:00 P.M. at the ERC Hearing Room at the 15th Floor Pacific Center Building, San Miguel Avenue, Ortigas Center, Pasig City.

Although this consultation is open to public viewing, only parties of record who have filed written comments will be allowed to participate in the discussions. Should there be time before the end of the public consultation; the Commission shall allow verbal comments from other persons who have an interest in the proceedings. Parties of record are not required to have a lawyer present but are strongly encouraged to have technical experts present with knowledge of accounting, finance, engineering, energy-economics or pricing issues.

1.4 Process going forward

Following its consideration of the submissions on the Discussion Paper, the draft RDWR and the Issues Paper, and the presentations at the public consultation session, the ERC will make its final decision on the proposed changes to the RDWR and the Issues Paper. This will be published not later than December 14, 2009.

In addition, an updated version of the RDWR will be published on the same date, taking into account the rule changes approved by the ERC.

2. GENERAL CHANGES TO THE RDWR

In this section a number of general changes to the RDWR are discussed. Given the general nature of these changes, specific cross-references to sections of the RDWR is not possible. However, in the attached consultation version of the RDWR, all the proposed changes have been made and highlighted. These changes are mainly editorial in nature.

2.1 Proposed general changes

Change 1

Topic	Date and Regulatory Period references
Issue	The latest version of the RDWR is for the Third Regulatory Period for the First Entry Groups and all date and Regulatory Year or Period references have to be amended.
Proposed change	Issue a version of the RDWR for the First Entry Group for the Third Regulatory Period, in which only the dates pertaining to this particular group are presented.
Reason for change	To provide correct date, year and period references for the First Entry Group in their Third Regulatory Period.

Change 2

Topic	References to %initial Re-valuation+ and %initial Re-valuation Date+ and %initial Re-valuation Report+
Issue	In the various versions of the RDWR for the Second Regulatory Period, reference was made to the Initial Re-valuation of the Regulatory Asset Base, since this was the first time that an ODRC valuation was carried out for Regulated Distribution Systems. For the Third Regulatory Period, this is no longer the case.
Proposed change	Revise all references to %initial Re-valuation+to %Re-valuation+
Reason for change	This is to reflect the fact that this is the second ODRC valuation that will be carried out on each Regulated Distribution System.

Change 3

Topic	Reference to TransCo
Issue	The previous versions of the RDWR reference are made to the National Transmission Corporation or TransCo.
Proposed change	Following recent changes in the TransCo operating structure, the transmission company is now run as the National Grid Corporation of the Philippines, or NGCP. This is now reflected in the RDWR.
Reason for change	To reflect recent operational and name change in the transmission service provider.

Change 4

Topic	Reference to a %Valuation Handbook+
Issue	It is intended to issue a Valuation Handbook for the Third Regulatory Period.
Proposed change	Provide definition for the Valuation Handbook (as described in Clause 4.8.7 of the draft RDWR)
Reason for change	Provide definition for the Valuation Handbook

3. SPECIFIC CHANGES

In this section the specific proposed changes to the RDWR are discussed. These changes follow the headings and sequence of the RDWR.

Change 5

Section	3.1
Topic	Reflection of previous Regulatory Periods
Issue	The new RDWR should reflect the impact of carry-over figures from the previous Regulatory Periods on the Third Regulatory Period.
Proposed change	Recognize the previous Regulatory Periods and the impact that previous price-settings, under- or over-recovery or regulatory interventions may have on the price-setting for the Third Regulatory Period. Also reflect the fact that earlier performance against the performance incentive scheme will be carried forward into the price-setting for the Third Regulatory Period.
Reason for change	To provide context and information on the price-setting for the Third Regulatory Period.

Change 6

Section	4.2
Topic	Price-control formula
Issue	Reflect carry-over of correction factor and performance incentive factor from the Second Regulatory Period.
Proposed change	Correct the formula for the calculation of the RY2012 Maximum Annual Price (MAP).
Reason for change	The Third Regulatory Period follows on from the Second Period and as such price-corrections for the performance incentive scheme and for earlier under- or over-recoveries are carried forward into the Third Period.

Change 7

Section	4.3.1 and 4.3.2
Topic	Over/under recovery formula
Issue	Reflect the fact that no difference exists in the manner in which the recovery factor is calculated between the first and subsequent regulatory years in the Third Regulatory Period. In calculating the under- or over-recovery factor for RY2012 and RY2013, values from Regulatory Years from the Second Regulatory Period are to be taken into account.
Proposed change	Provide the correct references to earlier Regulatory Years in the calculation of the under- or over- recovery correction factor.
Reason for change	To correct the formula for the Third Regulatory Period.

Change 8

Section	4.5.5
Topic	Definition of MAP _{bs} or the initial MAP at the start of the Second Regulatory Period
Issue	This definition is no longer required, since the Third Regulatory Period opening values are a continuation from the Second Regulatory Period.
Proposed change	Remove definition of MAP _{bs}
Reason for change	To correct the formulas for the Third Regulatory Period.

Change 9

Section	4.8.3
Topic	Asset Re-valuation for the Third Regulatory Period : Previously optimized assets
Issue	Previously optimized assets may now require to be re-included in the Regulatory Asset Base.
Proposed change	If during the asset re-valuation for the Third Regulatory Period previously optimized assets are found to no longer require optimization, these should be included in the Regulatory Asset Base for the Third Regulatory Period.
Reason for change	To ensure the optimization principle is consistently applied.

Change 10

Section	4.8.4
Topic	Asset Re-valuation for the Third Regulatory Period : Methodology
Issue	The RDWR allows flexibility on the valuation methodology to adopt for the Third Regulatory Period.
Proposed change	The ERC may apply an ODRC (or other internationally recognized) valuation, or a rolled-forward valuation for the Regulatory Asset Base for the Third Regulatory Period.
Reason for change	Reflect the flexibility provided.

Change 11

Section	4.8.7
Topic	Asset Re-valuation for the Third Regulatory Period : Valuation Handbook
Issue	If the ERC decides to adopt an ODRC valuation methodology, it will issue a Valuation Handbook that will guide the valuation of the Regulatory Asset Base for all Regulated Entities in the Third Regulatory Period.
Proposed change	Describe the proposed Valuation Handbook.
Reason for change	Clarity of understanding.

Change 12

Section	4.8.9
Topic	Asset Re-valuation for the Third Regulatory Period : Optimization
Issue	Optimization will be carried out in terms of the proposed Valuation Handbook
Proposed change	Optimization will be carried out in terms of the proposed Valuation Handbook
Reason for change	Clarity of understanding.

Change 13

Section	4.10.3
Topic	Depreciation of assets and regulatory life
Issue	The regulatory lives of assets will be described in the Valuation Handbook.
Proposed change	Since the ERC will develop a Valuation Handbook which will contain the regulatory asset lives, it will no longer employ a Reset Expert specifically for that purpose.
Reason for change	No longer required.

Change 14

Section	4.11.15 and 4.11.16
Topic	Regulatory weighted average cost of capital (WACC)
Issue	Correction for changes in the WACC over the Third Regulatory Period
Proposed change	An equivalent WACC for the full Regulatory Period will be calculated during the Regulatory Reset. Difference between this and the actual WACC applied to an entry group will be corrected for.
Reason for change	To ensure consistency in the return on capital for Regulated Entities of various entry points.

Change 15

Section	4.12.8
Topic	Historical capital expenditure records
Issue	Historical capital expenditure records are required as part of the assessment of the allowed capital expenditure for the Third Regulatory Period.
Proposed change	Require the historical capital expenditure for the four Regulatory Years ending on June 30, 2010 to be submitted, as well as the budgeted expenditure for RY2011.
Reason for change	At the time of the Revenue Application, RY2011 will only just have commenced and expenditure figure therefore has to be budgetary. For historical figures, Regulatory Year expenditure is required to allow consistency in analysis.

Change 16

Section	4.13.1
Topic	Historical operating and maintenance expenditure records
Issue	Historical operating and maintenance expenditure records are required as part of the assessment of the allowed operating and maintenance expenditure for the Third Regulatory Period.
Proposed change	Require the historical operating and maintenance expenditure for the four Regulatory Years ending on June 30, 2010 to be submitted, as well as the budgeted expenditure for RY2011.
Reason for change	At the time of the Revenue Application, RY2011 will only just have commenced and expenditure figure therefore has to be budgetary. For historical figures, Regulatory Year expenditure is required to allow consistency in analysis.

Change 17

Section	4.13.2
Topic	Historical taxes, levies and duties (other than corporate income tax) expenditure records
Issue	Historical taxes, levies and duties (other than corporate income tax) expenditure records are required as part of the assessment of the allowed taxes, levies and duties (other than corporate income tax) expenditure for the Third Regulatory Period.
Proposed change	Require the historical taxes, levies and duties (other than corporate income tax) expenditure for the four Regulatory Years ending on June 30, 2010 to be submitted, as well as the budgeted expenditure for RY2011.
Reason for change	At the time of the Revenue Application, RY2011 will only just have commenced and expenditure figure therefore has to be budgetary. For historical figures, Regulatory Year expenditure is required to allow consistency in analysis.

Change 18

Section	4.14.3
Topic	Calculation of $SMAP_{t-1}$
Issue	Reflect the manner in which the Third Regulatory Period follows on the Second Regulatory Period.
Proposed change	$SMAP_{t-1}$ will be based on the MAP for the last Regulatory Year of the Second Regulatory Period.
Reason for change	Reflect the manner in which the Third Regulatory Period follows on the Second Regulatory Period.

Change 19

Section	4.15.1, 4.15.5 and 4.15.6
Topic	Smoothing
Issue	Correction for earlier excess under-recoveries or regulatory interventions.
Proposed change	As part of the calculation of the smoothed price path for the Third Regulatory Period, earlier excess under-recoveries and/or regulatory interventions are to be addressed. This will be done through adding the outstanding amounts to the allowed revenue

	requirement for the Third Regulatory Period (without interest).
Reason for change	To ensure that historical amounts outstanding to Regulated Entities from the Second Regulatory Period are fully recovered during the Third Regulatory Period.

Change 20

Section	4.18.4
Topic	Performance incentive scheme targets
Issue	Performance targets may be based on historical performance or may reflect a measure or improvement
Proposed change	The ERC may conduct benchmarking against other Regulated Entities (or internationally) to guide it in setting improved performance targets for under-performing Regulated Entities.
Reason for change	To address poor performance of Regulated Distribution Systems.

Change 21

Section	4.22
Topic	Financial ratio analysis
Issue	This analysis is superfluous
Proposed change	Remove this section
Reason for change	This analysis is superfluous

Change 22

Section	4.22.3
Topic	Historical energy consumption and maximum demand figures
Issue	Historical energy consumption and maximum demand records are required for the Regulatory Reset Period for the Third Regulatory Period.
Proposed change	Require the historical energy consumption and maximum demand for the four Regulatory Years ending on June 30, 2010 to be submitted, as well as the budgeted energy consumption and maximum demand for RY2011.
Reason for change	At the time of the Revenue Application, RY2011 will only just have commenced and the energy consumption and maximum demand figures therefore have to be budgetary. For historical figures, Regulatory Year energy consumption and maximum demand is required to allow consistency in analysis.

Change 23

Section	Article V
Topic	Subsequent Regulatory Periods
Issue	A new RDWR will be required for each Regulatory Period
Proposed change	Instead of having a generic RDWR to cover all subsequent Regulatory Periods, it is intended to issue a new version for each Regulatory Period.

Reason for change	A generic version of the RDWR is difficult to understand (given the numerous date references). Issuing new documents at each reset allows for continual fine-tuning of the RDWR.
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Change 24

Section	8.2 and Appendix B
Topic	Performance Incentive Scheme
Issue	For the Third Regulatory Period the interim performance incentive scheme will no longer apply
Proposed change	For the Third Regulatory Period the interim performance incentive scheme will no longer apply, and Regulated Entities must adopt the ERC ϕ scheme.
Reason for change	Consistency across all Regulated Entities.

Change 25

Section	9.2.3
Topic	Net Operating and Maintenance Efficiency Adjustment
Issue	Calculation of the efficiency adjustment at the start of a Regulatory Period
Proposed change	The Net Operating and Maintenance Efficiency Adjustment for the first Regulatory Year should reflect improvements against budgeted expenditure for that year only.
Reason for change	The Net Efficiency Adjustment is based on the performance of two adjacent Regulatory Years - to ensure that a one-of saving is not viewed as an efficiency improvement. However, at the start of a Regulatory Period the approved Operating and Maintenance Expenditure figures are likely to already reflect the efficiencies gained during the previous Regulatory Period. The calculation of the efficiency factor can therefore not be adjusted again for the actual opex performance of the previous Regulatory Year.

Change 26

Section	9.2.5
Topic	Net Efficiency Adjustment
Issue	At the time of the Regulatory Reset, the efficiency gains for the last Regulatory Year will be unknown.
Proposed change	Regulated Entities are to provide an estimate of the efficiency gain for RY2011. During the annual price reset for RY2013, the ERC will assess actual expenditure for RY2011 against this estimate and conduct the necessary correction if the difference is material.
Reason for change	To ensure that an efficiency gain/loss in the last year of the Second Regulatory Period is adequately taken into account.

Change 27

Section	12.2.2
Topic	Re-opening for deferred capital expenditure
Issue	Recalculation of the smoothing factor as a result of deferred capital expenditure is

	complex and would require an extra round of public consultation.
Proposed change	The ERC may in future calculate the excess return earned on deferred capital expenditure and take this into account as an over-recovery carried into the following Regulatory Period. It will then be deducted from the allowed revenue requirement for the first Regulatory Year of the next Regulatory Period.
Reason for change	Recalculation of the smoothing factor as a result of deferred capital expenditure is complex and would require an extra round of public consultation. Carrying over-recovery into the next regulatory period is more effective and simpler to accommodate.

Change 28

Section	12.2.4
Topic	Re-opening for deferred capital expenditure
Issue	Projects deferred beyond the end of a Regulatory Period
Proposed change	Projects deferred to the next Regulatory Period will be excluded from a Regulated Entity's construction program, and the return earned on the funding allocated will be recovered. Should the Regulated Entity still wish to proceed with the project, it will have to re-apply for it during the Regulatory Reset for the following Regulatory Period.
Reason for change	To prevent over-recovery on projects not constructed, or double-allowance of the same capital expenditure.

Change 29

Section	14.4.2
Topic	Split of contribution for Regulatory Reset Expert costs
Issue	Calculation of the correct proportional contribution by Regulated Entities
Proposed change	The proportional allocation of payments for the Regulatory Reset Expert Fees will be based on the average consumption by Regulated Entities over the three calendar years 2006 to 2008.
Reason for change	To provide an updated, smoothed calculation of energy sales by all Regulated Entities and a fair basis for the allocation of costs.

Change 31

Section	Appendix A, D and F
Topic	Additional Regulated Entity
Issue	Additional Regulated Entity included in the Fourth Entry Group.
Proposed change	Add Clark Electric Distribution Company to the Fourth Entry Group. This is also to be reflected in the contribution of each Regulated Entity to the Regulatory Reset Expert costs.
Reason for change	Clark Electric Distribution Company will now also fall under performance-based regulation.

Change 32

Section	(Current) appendix D
Topic	Optimization principles
Issue	This is now to be covered in the Valuation Handbook
Proposed change	Remove this appendix
Reason for change	Optimization will now be covered in the Valuation Handbook.

Pasig City, Philippines, October 5, 2009.

ZENAIDA G. CRUZ-DUCUT

Chairperson

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Commissioner

ALEJANDRO Z. BARIN

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