



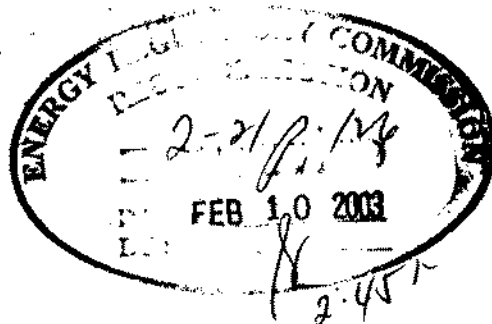
PHILIPPINE ELECTRIC PLANT OWNERS ASSOCIATION

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February 10, 2003

Atty. Marina C. Bugayong
Regulatory Operations Service
Energy Regulatory Commission
San Miguel Avenue, Ortigas Center,
Pasig City



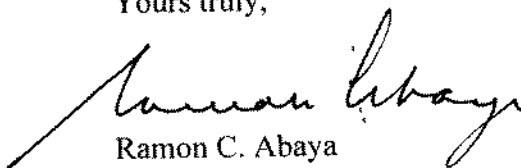
Dear Atty. Bugayong:

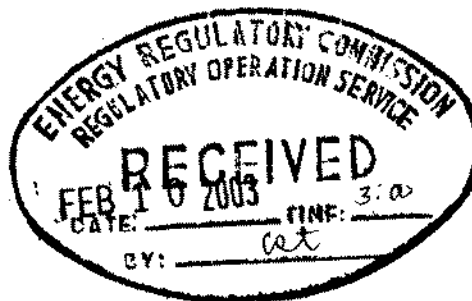
In compliance with ERC Case No. 2003-34, "In the Matter of the Adoption of an Alternative For of Rate Setting Methodology for the National Transmission Corporation (TRANSCO) and any Future Concessionaire Thereof", we respectfully submit to your office our initial comments and questions on the proposed methodology.

We look forward to attending the public consultations.

Thank you.

Yours truly,


Ramon C. Abaya
Fist Vice-President



**GUIDELINES on the METHODOLOGY FOR SETTING
TRANSMISSION WHEELING RATES for 2003 to 2027**

General Comments

There is a move on the part of the Energy Regulatory Commission (ERC) to shift from the current practice of Return-On-Rate-Base (RORB) to a Performance-Based-Ratemaking (PBR) for the setting of the Transmission Wheeling Rates charged by the National Transmission Company (TRANSCO). The issue of which method is more appropriate is debatable and hence the need for an explanation from the ERC, or its consultants, on the purpose of abandoning RORB in favor of PBR. If the ERC believes that the RORB has some inherent flaws, then these flaws must be pointed out. How the proposed method can correct these flaws must also be explained.

The need for a detailed justification from the ERC, or its consultants, is to convince all the stakeholders that the proposed shift is anchored on the right reasons, and not on what may be a misconception on the current method being used. There were some criticisms against RORB, focusing on revaluation, rate of return, income taxes; these issues are still to be addressed by PBR, as recommended by the consultants.

In addition, the proposed methodology calls for the use of Revenue Caps instead of Price Caps. The use of a Revenue Cap may be disadvantageous to the regulated entity in the sense that an increase in demand/consumption – a factor not within the control of the regulated entity – will ultimately translate into more revenues for the regulated entity. This would mean that under a Revenue Cap prices would have to dip very sharply so that the maximum revenue will not be breached. Demand is a major cost driver, using Revenue Caps may result to a deficiency in revenues for the regulated entity. On the other hand, with a Price Cap, as demand grows, revenues increase while the price remains the same, giving the regulated entity a better opportunity to cover costs and earn a reasonable return.

We suggest that the ERC, or its consultants, present to the various stakeholders the pros and cons of using Revenue Caps vis-à-vis Price Caps and what the ERC, or its consultants, feel is best for a regulated entity operating in the Philippines.

The use of PBR (whether through a Revenue Cap/Price Cap/hybrid) is supposed to result into self- or light- handed regulation. However, the proposed guidelines show otherwise. The methodology presented requires the use of forecasted figures; figures that are even more controversial or contestable than past yet audited figures.

(In the context of Philippine rate-making, past figures – though audited – have been a sticky and controversial point during rate application hearings. It is safe to assume that a

shift to forecasted figures for capex, opex, taxes, etc., will make rate-making applications even more controversial – to say the least)

Also, the use of forecasting will result to an even heavier or closer style of regulation never before experienced by the industry and even runs counter to the public announcements of the policy makers.

Specific Comments

1. Sections 3.2.1 and 4.2.1 – Price Control Formula

The Maximum Allowable Revenue (MAR) to be fixed by the ERC for the First Regulatory Period **should allow a just and reasonable RORB.**

The “starting point” of the PBR is very critical. The starting revenues to be earned by the regulated entity must be sufficient to cover its costs and at the same time earn a reasonable return for the first year of the PBR period. If at the start revenues are too low, then this may distort the necessary investments needed by regulated entity to operate viably. On the other hand, if revenues are set too high it may result to excess earnings.

Again, to take the leap towards PBR, it cannot be over emphasized enough that at the very beginning, the regulated entity **MUST** be allowed to earn a just and reasonable return otherwise the industry will be shifting to PBR on the wrong foot negating any benefits PBR aims to give to the various stakeholders.

2. Sections 12.1.1b, 12.1.2b – Conditions for Revenue Cap Re-Opening Section 12.2 – Triggers Allowing Regulated Entity to Apply for Re-Opening

Both sections state that MAR if the first and second regulatory period shall apply until the ERC has determined a formula following an application made by the Regulated Entity under Section 12.2.

Section 12.2 mentions that the triggers allowing a change in the MAR formula is limited to the change in CPI (should be >0.10) and in the 3-month average non-coincident peak (NCP) between two regulatory years of greater than 1.00. The allowable change in the NCP as computed under Section 12.7.1 is too high and unrealistic. This means an increase in the NCP of 100%!

Article XII also fails to include a discussion of how a change in NCP, which means an increase in demand that will trigger an increase in capex, shall be factored into the change in MAR formula. Does this mean that under the proposed method, changes in the MAR formula that can be accommodated under Article XII are recalculation of the I and X variables only? If so, then is it presumed that the X factor - as computed by the formula prescribed under Section

4.13 - takes into consideration the increases in capex and opex due to system expansion and load growth. Is this correct? If not, then a factor must be added into the formula to provide incremental investments.

The preceding comment looks at the urgent need for TRANSCO to upgrade its facilities to reduce the incidence of "blackouts" and to relieve the constraints in the lines so as not to undermine the competition among generation companies. If the X factor is assumed at zero for the first period and if there are no separate factors to address the need for expansion and upgrade, then any new investments will come into the second regulatory period. This will only exacerbate the congestion and reliability problems of TRANSCO and will impair competition among generation companies.

Should a separate allowance for new construction be allowed in the formula? This is crucial since investments to relieve congestion and reliability improvement are not likely to be covered by the growth in load and/or the growth in number of customers and/or the inflation adjustment. Not giving the TRANSCO or its buyer/concessionaire the impetus to improve and/or expand the system will have dire consequences to the industry and to the economy.

On the use of trigger mechanisms, there are no allowances in the first and second regulatory period for peso devaluation and/or hyper-inflation. Based on the methodology being presented, the first regulatory period can go on for three years while the second regulatory period for five years. The likelihood of any of the two scenarios, or a combination of both, is very high given current Philippine economic and social situations.

3. Section 4.13 – Revenue Smoothing

As stated in the MAR formula, the Efficiency Factor (X) should be the Industry Efficiency or Productivity performance. However, it cannot be understood as to how an Industry Efficiency Performance standard can be correctly arrived at by the formula presented. With the exception of inflation, the variables used are company specific, i.e., WACC, previous year MAR, etc.

The proposed methodology for calculating X does not result in an industry-wide productivity index against which utilities are benchmarked. The efficiency factor is the most critical component of PBR as it refers to the productivity the regulated entity being benchmarked to its sector/industry. In the proposed methodology, the X factor is arrived at endogenously. If X is endogenously arrived at, then the inefficient regulated entity will not have the additional stimulus needed to improve while an efficient one will not be properly rewarded eventually losing its desire to improve.

An X factor based on an industry wide measure must be used. This issue is crucial in the sense that the X factor must not be high enough to present a

challenge to the regulated entity, but at the same time not placed too high that it becomes unachievable. For the first regulatory period, the X factor is pegged at 0.0, this may give some time for the proponents to seek a better way of arriving at a more appropriate X factor.

Again, the X factor cannot be endogenously arrived at. A regulated entity cannot be asked to compare itself with itself!

4. Article X – Force Majeure Event Regulated Pass Through
Article XI – Tax Event Regulated Pass Through

How is a “pass through” factored into the MAR during the regulatory year? If the “pass through” is included in the Annual Revenue Requirement (ARR) then an adjustment in the MAR is necessary or there will be an over recovery on the part of the regulated entity.

5. Section 9.3 – Mechanism for Carrying Over Net Efficiency Gains

The proposed methodology allows the regulated entity to retain any Net Efficiency Gains (NEG), i.e., capex and/or opex gains, for a 5-year period after the NEG was realized.

Our comment is similar to that of the “pass through”. While the NEG is added into the ARR, which becomes the basis for setting the maximum transmission charge, it is not clear if the MAR will be adjusted to factor in the NEG. If not, then the addition to the ARR is meaningless as this will only translate to a recovery beyond the MAR when actual revenues are compared against the cap.

6. Section 6.4.1 – Side Constraints on Proposed Maximum Transmission Wheeling Rates

What is the basis of fixing the Side Constraint for the First Regulatory Period at 0.01? What is the basis for its subsequent adjustment in the subsequent Regulatory Period? Why is it that only the needs of the users are being considered? What about the regulated entity?

7. Section 4.5.7 – Primary Building Blocks

What is the basis for fixing Working Capital at 30 days? Shouldn't this be based on the actual industry collection performance or actual cash turnover? Philippine jurisprudence has fixed working capital at 60-days; why the sudden shift to 30 days?

There are no discussions on the items to be included in the allowance for working capital.

8. Section 4.9 – WACC Determination

The proposed methodology uses a Weighted Average Cost of Capital (WACC) computation that includes ERC's best estimates of the following: a) risk free interest rate, b) the debt margin requested by debt providers, c) the equity Beta, and d) the long-term average return to investors in the equity market of the Philippines of the Market Risk Premium (MRP).

Does the ERC have the needed information, skills, and expertise to come up with the best reliable estimate for the above listed factors? Will they be unilaterally determined by the ERC or through consultations with the regulated entity? If the regulated entity is not publicly traded, how then would the ERC estimate the regulated entity's cost of equity?

It should be noted that the Philippine capital market is very small, not liquid, and is still very much underdeveloped. Because of this, sharp changes in the cost of debt, cost of equity, and Peso devaluation must be allowed as legitimate triggers (Section 12.2) for adjusting the calculation of the MAR.

Also, why must the debt-equity ratio of the regulated entity be pegged at 60:40? What is basis for such a ratio? The ERC has to show to the stakeholders that this capital structure is ideal under the proposed methodology.

Lastly, Section 4.5.7 states that the WACC will be held constant for the entire five years of the Second Regulatory Period. Is there historical evidence that the WACC for the transmission business in the Philippines will not change significantly from year to year?

9. Section 3.4.1 and 4.3.1 – Over / Under Recovery Formula

Why should there be a penalty of 4% for over recoveries? The ARR and the maximum transmission rates for the year are determined by the ERC, based on the proposed rate setting guidelines (Section 6.2.1), or are determined by the ERC if the regulated entity fails to submit its proposed rates within the timelines set (Section 6.2). Therefore, if the ARR and the transmission rates are determined/set by the ERC, then why is regulated entity penalized if the same ARR and rates result to an over recovery?

If the over recovery is driven by an increase in demand, is the regulated entity also penalized? The growth in demand is not within the control of the regulated entity so why is it penalized?

10. Section 4.6.5 and 4.6.6 – Asset Revaluation

The proposed methodology includes the provision for revaluation of assets based on replacement cost, but with some optimization principles. One of these

principles is to declare: "assets which are assessed to have over capacity or excess redundancy will have their value split between the value of that capacity or redundancy which is necessary to meet customer requirements ... and the value of that capacity or redundancy which is in excess of this requirement." The regulated entity is also likewise required to justify to the ERC, under the procedure for capex forecasting, any additional investments and state its potential impact on the reliability and performance of the grid.

It must be noted that the regulated entity has/will put in additional investments for compliance with the performance standards set up by the ERC. If these investments are to be approved by the ERC, what assurance can the regulated entity get that the same assets/investments will not be classified as excess capacity or over redundancy? This is equally important when there are significant drops in the level of demand AFTER the investments have been put in place.

In Section 4.6.5, is the averaging of economic life to be done for each group (a, b, c, d, and e) or for each sub-group within the group? We suggest that the averaging be done for each sub-group. Averaging by group disregards the fact that meters and protective equipment in group (b), communication equipment in group (c), control equipment in group (d), and computers and office equipment in group (e) have economic lives that are significantly shorter than the other components of the respective groups. In addition, utility experience in the Philippines shows that wooden poles, which constitute a significant portion of the subtransmission assets of the TRANSCO, have economic lives much shorter than the other components of group (a).

11. Section 8.2.3 – Performance Incentive Scheme

If caps are imposed on awarding performance incentives to avoid rate shock, then the award should be fully awarded over an estimated period to mitigate its impact on the rates.

12. Section 4.5.6 and 4.5.7 – Primary Building Blocks

Both sections define Corporate Income Tax as to be included in the ARR for the regulatory year as the estimate tax payable in the regulatory year as will be determined in Section 4.12.1. However, under Section 4.12.1, income tax is computed based on the tax due for the net taxable income for the previous year.

It seems that income tax paid the previous year is being deferred to the succeeding year. If so, then there is a deferral in the recovery of income tax payments since the income taxes included in the ARR are based on the previous year taxes. In view of this, there are carrying charges that the regulated entity must be allowed to recover.

**13. Additional Comments and Suggestions to follow during the Public
Consultations**