

regulatory

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Sent: Tuesday, 11 February 2003 12:07 AM
To: regulatory@erc.gov.ph
Cc: CKI Eric Kwan; HEI Rupert Mak; HEI Charles Tsai; HEI SH Cheung; HEI Keith TK Pak
Subject: Philippines Transco Privatizatio: Comments on the Draft ERC Guidelines

Dear Sirs,

On behalf of Cheung Kong Infrastructure Holdings Limited and Hongkong Electric International Limited, we are pleased to submit our comments made on the Draft ERC Guidelines (please refer to attachment of this email). We would also express our keen interest in attending the public consultation on the Draft Guidelines as scheduled on 19, 20 and 21 February.

Kind regards,

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**CKI/HEI's Comments on Guidelines on the
Methodology for Setting Transmission Wheeling Rate
for 2003 to 2027**



	Issues	Comments
	Comments referring to relevant Sections of the Draft	
1.	<p>Section 2.5. Subsequent Regulatory Periods</p> <p>Each Subsequent Regulatory Period must be three, four or five calendar years in duration</p> <p>The length of each Subsequent Regulatory Period must be determined by the ERC during the Regulatory Reset Process</p>	<p>What are the principles or rules for the determination of the duration of the Subsequent Regulatory Year (3, 4 or 5)? There is no provision for this under Article VII (not VI).</p> <p>CKI/HEI considers a longer duration of the Subsequent Regulatory Period like the Second Regulatory Period, i.e. 5 years, will enhance financeability of the sale and certainty in future refinancing of the business.</p>
2.	<p>Sections 3.2.1 & 4.2.1 Price Control Formula for First and Second Regulatory Periods</p> <p>The correction factor K_t</p> <p>$K_t = ATR_{t-1} - MAR_{t-1} \times (1 + I_t/100)$ Where $ATR_{t-1} = ACR_{t-1} + AMR_{t-1}$.</p>	<p>What is the base of ACR (actual revenue derived from customers for the provision of Transmission Services)? How is it calculated?</p> <p>What is the base of AMR (actual net revenue by Regulated Entity in pursuance to the WESM Rules in its capacity as Network Service Provider or System Operator)?</p> <p>If $ATR > MAR$, an interest of Manila Reference Rate plus 4% is applied for the rebate of excess revenue received. While if $ATR < MAR$, the interest is only the Reference Rate for compensation for under recovery. A similar additional 4% should be applied for case of under recovery to compensate for investor's time value of money.</p>
3.	<p>Section 4.4.1 General Building Block Principles</p> <p>ARR_t is adjusted in order to encourage :- H) fairness in the charges made for Regulated Transmission Services including through the progressive removal of cross-subsidies.</p>	<p>What are the cross-subsidies that are to be extended to the Regulated Transmission Services. After its removal, how does it impact the revenue requirement of the Transco and eventually, how to ensure that the economic benefit of the Regulated Transmission Provider will be fairly compensated.</p>
4.	<p>Section 4.6 Asset Valuation</p> <p>At the first reset process, the asset (RAB) will be revaluated.</p>	<p>If the result of initial-revaluation furnished by Regulated Entity is not accepted by the ERC, or the accepted asset valuation is different from the RAB used by Bidder to evaluate asset value at bidding, there is risk on the asset valuation mismatch, causing a loss to the concessionaire at the first Reset Process (2 years after the Effective Date).</p> <p>The asset valuation should be pre-agreed and accepted at the time of bidding and then forms the initial base of the revaluation at time of reset, taking account for the subsequent Capex and depreciation.</p>
5.	<p>Section 4.9.1 WACC Determination</p> <p>The Equity is assumed to be 40%, and Debt is to be 60%.</p>	<p>Given that a gearing of 60% is assumed by Australian Regulated Business, a more prudent gearing might have to be assumed in capital structure for similar business in Philippines (for example 40% gearing).</p>



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6.	<p>Sections 4.9.4 & 4.9.9 WACC Determination</p> <p>$R_o = R_f + \text{Beta} \times (R_m - R_f)$ Where $R_m - R_f = \text{MRP}$ (market risk premium), which indicated to be 6%, taking consideration of UK and Aus market.</p>	<p>Given that a 6% premium is given for regulated asset in Australia, 6% market premium is too low for a market in Philippines.</p> <p>An market risk premium should be equitably offered to provide a higher return to meet investor's risk compensation.</p>
7.	<p>Section 4.13. Revenue Smoothing</p> <p>$PV_{t-1} = \frac{MAR_{t-1}}{(1+WACC_c)} + \frac{ARR_t}{(1+WACC_c)^2} + \dots = \frac{MAR_{t-1}}{(1+WACC_c)} + \frac{ARR_t}{(1+WACC_c)^2} + \dots$</p>	<p>If $ARR_t > MAR_{t-1} \times (1+\text{Inflation})$, then does it mean that the Efficiency Factor (X) will be negative.</p>
8.	<p>Section 5.2.1 Price Control Formula</p> <p>ERC may amend the formula by the addition of any of the following :- c) a factor that reflects changes in Peso purchase power parity or changes in the Peso exchange rate against a basket of other currencies (in which case the building block analysis, the value of WACC will need to be altered to avoid double counting or over compensation for the risk).</p>	<p>What will be the mechanism if the purchase power of Peso or Exchange Rate is considered as part of the price control formula.</p> <p>In the price control mechanism or the building block mechanism, there is no adjustment factor to cater for the fluctuation of Fx or the purchase power of Peso, this will impose a great concern to the investor. investor would be exposed Fx risk due to Peso fluctuation, as investor might have to finance for the investment using foreign currencies given the thin financing market of Peso.</p>
9.	<p>Section 5.5 Primary Building Blocks</p> <p>ERC may adopt a different Building Block analysis to that set out in Section 4.5 for any Subsequent Regulatory Period (including by altering the relevant Building Blocks).</p>	<p>The potential introduction of different "Building Block" analysis for any "Subsequent Regulatory Period" may introduce uncertainty to future cash flow of the Regulatory Entity.</p> <p>CKI/HEI feels more comfortable with the continuation of a well defined and firm "General Building Block Principles", "Primary Building Blocks" and its relevant formulae like being specified for the First and Second Regulatory Periods.</p>
10.	<p>Section 5.14 Revenue Path Transition</p> <p>Based on the Section 4.3, the over/under recovery correction factor for the last Regulatory Year of the Second Regulatory Period, the excess revenues derived in the last Regulatory Year of the Second Regulatory Period are returned to Customers through lower tariffs in the first Regulatory Year of the Third Regulatory Period.</p>	<p>Section 4.3 is to deal with the balance of revenue of the last Regulatory year. It is not clear regarding the procedure as to how the excess revenues derived in the last Regulatory Year is returned to the customer.</p>
11.	<p>Section 5.18.1 Financial Ratios Analysis</p> <p>ERC may require the Regulated Entity to provide the ERC with a forecast financial ratios analysis for each Regulatory Year of that Subsequent Regulatory Period, using financial ratios of a kind and calculated in a manner specified by the ERC.</p>	<p>What are the details of the financial ratios of a kind and manner of calculation to be specified by ERC for the process?</p> <p>Will there any limitation posted on these financial ratios?</p> <p>CKI/HEI considers excessive stringent limitation may restrict financeability of the business.</p>



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Comments in Particular	
12.	<p>Comment on the overall rate setting regime:</p> <p>Obviously, there is a large degree of similarity between the Guidelines proposed by the Philippines and the regime adopted by Australia and the UK. However, as we are aware, the Philippine transmission network faces many challenges that its peers in the UK and Australia do not encounter. These include</p> <ul style="list-style-type: none">(1) the need for large capital expenditures to upgrade and extend the network;(2) the lack of an adequately deep local currency capital markets; and(3) the highly extensive use of cross-subsidies in the system. <p>From a practical perspective, concerns may include</p> <ul style="list-style-type: none">(a) the fact that the ERC has no experience in operating this type of regulatory regime;(b) whether quality information can be made available on a timely basis to enable the formulae in the Guidelines to be applied accurately; and(c) projects to extend the network could potentially be subject to delays due to difficulties in obtaining the necessary rights of way. <p>We provide more specific comments below.</p>
13.	<p>Timing / duration of the First Regulatory Period:</p> <p>Based on experience of power projects in the Philippines, the timetable given for the expiry of the First Regulatory Period is ambitious. In particular, there are likely to be instances where the First Regulatory Period needs to be extended due to factors beyond the Regulated Entity's control. We would therefore question the appropriateness of assigning a number of 0.05 to the X-factor if the First Regulatory Period is extended (Section 2.3.2).</p>
14.	<p>Adequacy of capped revenues in the First Regulatory Period:</p> <p>Given that the PhP 20,198 million cap forms a starting point for the determination of short term revenues, as well as the implementation of tariff smoothing in the Subsequent Regulatory Periods, CKI/HEI would likely require more clarity on</p> <ul style="list-style-type: none">(1) how the figure was determined / whether there is any historical / financial basis to the number; and(2) whether the imposed cap is adequate to support the Transco business at least as a short term matter.
15.	<p>Significant uncertainties in the long term regime:</p> <p>The Third Regulatory Period (and subsequent periods thereof) lacks certainty on virtually all major components associated with determining the price caps, including price control (with relation to inflation and currency adjustments), the application of the Building Blocks approach, methodology for determination of depreciation, and calculation methodology for WACC etc. ERC would appear to have far too much discretion under the proposed Guidelines.</p> <p>Please also refer to our Comment 9 as stated above.</p>



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16.	<p>Currency risk:</p> <p>The Guidelines envision that all rates will be denominated in PhP. This extends to the calculation of WACC, which raises a number of issues (see below). The only protection available against adverse currency movements is in the Third and subsequent Regulatory Period in which the ERC may make changes to the rate setting formulae to reflect "changes in Peso purchase power parity or changes in the Peso exchange rate against a basket of other currencies". As you may be aware, the Philippines provide PhP/US\$ exchange rate protection to power producers under its PPAs, and operate (at least in theory) a Currency Exchange Rate Adjustment ("CERA") mechanism for its electricity and water utilities. Under CERA, the utilities can, on a monthly basis, pass on foreign exchange losses to the end users.</p> <p>Please also refer to Comment 8 above.</p>
17.	<p>Availability of long-term PhP funding:</p> <p>The calculation of WACC (and return on capital) assumes that Transco will be funded 60% by Peso-denominated debt. Given the volatility and lack of liquidity in the Peso capital markets, Transco is unlikely to be able attain the suggested level of Peso debt. For your reference, there are only a very limited number of debt issuances in the Peso market beyond 5-7 years. In terms of benchmark yield, Globe Telecom's 10 year Peso bond, for example, is trading at 14.5% per annum yield-to-maturity. Issue amount is typically PhP 1-2 billion. Against this background, a substantial amount of US\$ and possibly other non-Peso denominated debt is likely to be required, giving rise to significant currency risks.</p>
18.	<p>The WACC calculation outlined in the Draft Guidelines may be appropriate for Philippine domestic investors, but does not adequately account for the country risk premium demanded by foreign investors</p> <p>The costs of debt and equity suggested in the Draft Guidelines do not fully account for the risk premium demanded by foreign investors. Cost of debt assumptions are similarly unclear</p>
19.	<p>Assumed debt/equity ratio in WACC calculation:</p> <p>Given the credit rating of the Philippines and the much publicised regulatory issues facing Meralco, we would question the use of a 60/40 debt/equity ratio in the WACC calculation. A more appropriate assumption may be 40% debt.</p> <p>Please also refer to our Comment 5 as stated above.</p>
20.	<p>Determination of beta for the purpose of WACC calculation:</p> <p>The beta used in the WACC calculation ought to be a reflection of the operational, regulatory, and financial risk of the Transco business. We therefore question the use of data from the U.K., Australia, and Singapore, which all have utilities operating in a well-developed, more transparent regulatory regime. For reference, the local market beta of Meralco, which like Transco has its revenues regulated by the Philippine Government, has a local market beta of 1.05.</p>
21.	<p>Asset Valuation:</p> <p>As noted above, the timetable for the start of the Second Regulatory Period is ambitious. Depending on the quality of information available, it may not be possible to complete the asset valuation in accordance with Section 4.6.</p>
22.	<p>Regulatory Depreciation:</p> <p>Many of the assumptions needed to calculate RegL₁ could potentially be subject to dispute between ERC and the Regulated Entity. As we are aware, in Australia, many of the assets typically found in a transmission network have agreed pre-determined regulatory lives.</p>



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23.	Treatment of capital expenditure: The "tariff smoothing", CPI-X approach proposed in Section 4.13 is better suited to a stable, mature market, and less well in a market such as the Philippines where large amounts of capital expenditure may be required for network expansion / upgrade. With respect to the timing of including construction work in progress ("CWIP") into the Regulated Asset Base ("RAB"), there appears to be a lack of clarity as reflected in Section 4.10.6 (which suggests only capital expenditure coming into service in the forecast year will be included in the RAB) and Section 4.6.10 (where CWIP appears to be counted on an as-incurred basis.) In any event, the means for the inclusion and determination of the final figure for CWIP appears to be purely subject to the discretion of the ERC.
24.	Extent to which investor can retain efficiency gains: While it appears from Section 9.3.1 that efficiency gains can be kept for a period of 5 years ("the Net Efficiency Gain for a Regulatory Year will be retained by the Regulated Entity for a period of 5 years after the year in which the Net Efficiency Gain was realised"), Section 9.2.3 (b) appears to imply that efficiency gains are to be calculated on a year-on-year basis (i.e. any out performance in a given year sets a new benchmark which must be bettered in the subsequent year for realization of further efficiency gains).
25.	ERC must develop service level guidelines and incentive scheme prior to start of Second Regulatory Period Draft Guidelines set out the establishment process of the service and reliability standards, including the parameters to be utilized. However, there is no mention of actual levels or absolute indices to be met by the operator.
26.	Side constraints on wheeling rates: Section 6.4 suggests that tariffs may be adjusted at the ERC's discretion "having regard to the needs of end-users and the need to remove cross-subsidies over time". Apart from the fact that this gives ERC wide ranging powers to change the tariff, we would question whether the formula in Section 6.4.1 can be applied in practice. For example, the Regulated Entity could be required to undertake projects to extend the network to rural areas mainly to serve a particular Customer Segment. These projects may involve large capital expenditures without an immediate commensurate increase in the consumption of electricity by that Customer Segment.
27.	Inclusion of revenues through role as Network Service Provider / System Operator: Sections 3.4.1 (for the purpose of determining over / under recovery) includes these services-related revenues in the formula, while Section 4.4.1 (g) explicitly excludes costs associated with responsibilities as Market Operator from the transmission wheeling rates.
28.	Availability of insurance coverage: Given certain political risks associated with the Philippines, the ability of Transco to obtain adequate insurance coverage at commercially reasonable rates is subject to due diligence. In any event, CKI/HEI would have better protection if the insurance charges were formally adopted as part of the O&M expenses to be reimbursed in the price-setting formula (in addition to the "property insurance" line item stated in Section 4.11.1 (q)).
29.	Tax Change Event Pass Through Definition of "relevant taxes" and materiality requirement mean that Tax Change Events pass through mechanism is likely to have no substantive operation



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30.	<p>Definition of Force Majeure is limited and process to claim for pass-through is difficult</p> <p>Definition under the Draft Guidelines is very brief and intended to be exhaustive. By comparison, the ACCC in Australia has not adopted a force majeure pass through but has accepted three other categories, namely</p> <ol style="list-style-type: none">(1) Services Standards Event – allowing or requiring the Transco to pass through increases or decreases in costs resulting from regulatory changes after the date of a determination;(2) Terrorism Event; and(3) Insurance Event – covering losses resulting from material increases in premiums after the date of determination, as well as any uninsured losses resulting after an insurance event.
31.	<p>There are not many trigger events allowing ERC to revoke revenue cap decisions</p> <p>In Australia, in addition to similar provisions relating to false or misleading information, the ACCC may revoke a revenue cap if:</p> <ol style="list-style-type: none">(1) there is a material error in setting the cap and if the ACCC has obtained consent of affected parties to revoke the cap; or(2) there is a substantial ownership change which may lead to a material change in the revenue requirement of the Transco; or(3) there is a material change in Government policy which leads to a material change in the revenue requirement.
32.	<p>Draft Guidelines provide detailed information on certain key areas, while leaving some ambiguous issues outstanding</p> <p>Demand risk There is scope for ERC to transition to a price cap methodology in Subsequent Regulatory Periods. This poses additional volume risk for the operator if adopted, and the Draft Guidelines are vague on the additional adjustments allowed and the timing of the transition. This poses a delayed regulatory risk. Adjustments to methodology based on Peso movements and inflationary environments also pose a risk. Lack of clarity on the triggers for such adjustments is cause for concern.</p> <p>Cross-subsidies Burden of ensuring cross-subsidies are removed after three years of imposition of universal charge. The universal charge was approved but it is yet unclear whether it is effective in eliminating the cross-subsidies</p>