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February 10, 2003

Atty. MARINA C. BUGAYONG
Director
Regulatory Operations Service
Energy Regulatory Commission



Dear Ms. Bugayong,

This is in reference to the Commission's Draft Guidelines on the Methodology for Setting Transmission Wheeling Rates for 2003 to 2007, which is subject for consultation on February 19 to 21, 2003.

Please find attached comments for discussion.

Very truly yours,


ALVIN S. ARCO
Asst. Vice President

Article IV- Second Regulatory Period (pg.22)

The proposal calls for forecasting each year in the Regulatory Period and calculating what the revenues should be collected under optimal conditions. This prudence review is tantamount to ERC micro-managing the transmission owner, and will give additional workload to ERC.

Asset Valuation (pg.27)

This is like preserving the traditional method of asset valuation used in the Philippines.

Construction Work In Progress (pg. 31)

Construction work in progress should be included in rate base. In addition, plant investment should be handled through a separate allowance be established for new construction. Those new construction investments would then go into ratebase each year, thus increasing allowed revenues independently of the PBR. In the next year, that new construction portion of the revenue requirement would be escalated as part of the formula. This point is crucial since congestion investments and reliability improvement investments are not likely to be covered by growth in load and/ or growth in customers. These investments must be independent of the PBR. It is strongly advised that this point not be compromised in negotiations with the regulator. If investment is not handled in this fashion, the transmission owner will have little incentive to make the necessary capital investments to relieve congestion points on the transmission system, thus frustrating the development of wholesale electric commodity competition. Moreover, reliability improvements that will improve service to customers may likely end up being deferred or not pursued at all, unless incorporated into rates endogenous of the PBR.

Comments on the proposed Guidelines on the Methodology for Setting Transmission and Wheeling Rates for 2003-2027

Article III-First Regulatory Period (pg.18)

The Price Control formula, as proposed by ERC is a standard formula for Revenue Cap Regulation. However, various components of the formula need further clarification to clearly define its intention

MAR= Maximum Allowed Revenue

The starting maximum revenue (MAR) should incorporate all transmission costs including a fair return to the investors. It is critical for the initial revenue to recover costs of transmission particularly at this time when additional transmission investment is necessary for the country's economic expansion specifically on the development of its energy infrastructure.

Change in CPI (pg.19)

The choice of CPI as an escalator, Why not explore the possibility of a different escalator than just CPI since it has mostly food components?

Over/Under Recovery Formula(pg20)

This is a "revenue stability" formula where transmission owner cannot keep "excess revenues" over those allowed by the formula, and will be able to recover any revenue deficiency.

Article V. Subsequent regulatory periods (pg.49)

Efficiency carry over (pg.53-54)

Item (a) are likely to be difficult to measure. No PBR has such provisions now and it is unlikely that such heavy handed regulation will be successful. Competitive firms often benefit from events "beyond their control. Often suffer from events beyond their control as well. The same is likely true for the transmission owner. ERC should remember that the goal of PBR is to determine if prices are reasonable and are in line with benchmark prices derived from exogenous sources.

Others

Performance Base regulation (PBR) is all about prices, not costs, not ratebase, not regulatory micromanagement, not mounds of unnecessary data. PBR is intended to break the cost-price link and further attempt to simulate a competitive environment. It is all about "light handed regulation" even to the point of self regulation.

We reserve the right to make additional comments based on the discussion during the consultations.

ERC should stick with the PBR formula and benchmark transmission service PRICES against other ASEAN nations to see if the transmission owner is at least commensurate with other utilities. If prices are significantly higher than other ASEAN nations, then the transmission owner should be required to justify why is this so. The key to PBR is PRICES, not costs. No one cares about costs if prices are reasonable.

It is worth mentioning that it also costs money to collect these data, which is most likely to be paid by the transmission customer. It is possible that customer could not care less about all this data. The customer is primarily concerned with the price for transmission service and whether or not the customer is getting a fair deal. If the customer sees that transmission prices in the Philippines are comparable to those in other ASEAN nations, this should be sufficient. It is not economically efficient to collect a bunch of data that will likely just sit in some ERC file cabinet.

Calculation of Corporate Income Tax

Calculation of taxes is fine as long as the transmission owner is allowed to recover actual taxes paid through rates each year.

Service Quality Measures and Targets (pg. 47)

PBR is all about Performance. It is intended to set free the drive and enthusiasm- energy and efficiency-quality and service through capitalistic, hard money incentives to reward those utilities that do well and punish those who do poorly. Performance incentives must be part of PBR. The focus of ERC must be on performance and appropriate performance measures. Rewards for relieving congestion points, service to new areas, and additional available transmission paths are also areas that ERC may wish to reward through incentive payments.

WACC Determination (pg 34)

It appears that the level of debt is too high relative to most utilities. Why not use the 50:50 ratio as the common practice. The high debt ratio increases the risk to debt holders of default. This is because of the fixed nature of the interest and debt and interest coverage requirements, if for any reason, earnings are down or cash is insufficient to cover this interest expense, the utility could be in default. If more equity is introduced, the fixed requirement for interest is reduced since dividends on equity can be delayed or foregone altogether without default consequences. Generally, the higher the debt ratio the higher the risk and thus the cost of debt (interest) increases.

The cost of equity (pg 35)

Beta (the risk measure of the Capital Asset Pricing Model or CAPM), has a limited application in regulatory cost of equity calculations since it is indicative of only capital market risk and a particular stocks reaction to changes in overall market changes. All other risk factors are ignored. It should be used only as a check on other, more practical methods, such as discounted cash flow or the risk premium. Furthermore, the data to measure the beta of the Philippine utilities may or may not exist in sufficient quantity and quality to accurately calculate beta. Besides, the stocks of the various utilities may not be traded in sufficient quantity to make a beta calculation statistically valid. It is suggested that the use of the CAPM in determining not be used at this time.

Capital Expenditure Forecast (p39)

Refer to comments under construction work in progress

Operating and Maintenance Expenditure (pg 41)

This requires voluminous data, what does ERC intend to do with all this data? To benchmark these items against utilities overseas makes no sense. The characteristics of transmission service in other countries are not the same as that of the Philippines. The