



10 February 2003

ATTY. MARINA C. BUGAYONG
Director, Regulatory Operation Services
Energy Regulatory Commission
Pacific Center Building
San Miguel Avenue, Pasig City

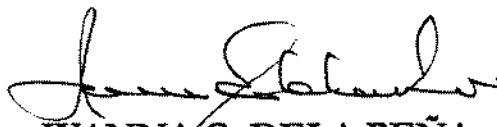


Dear Atty. Bugayong,

We are hereby submitting our comments on the proposed guidelines on the "Alternative Form Rate Setting Methodology for the National Transmission Corporation (TRANSCO) and any future concessionaire thereof". Please see the attached sheets for the details.

If you will need further clarifications, please call us at 632-8525.

Yours truly,


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MERALCO'S COMMENTS ON THE ALTERNATIVE FORM OF RATE-SETTING METHODOLOGY FOR THE NATIONAL TRANSMISSION CORPORATION (TRANSCO) AND ANY FUTURE CONCESSIONAIRE THEREOF

1. Incentive Based Rate Regulation

- ◆ The successful adoption of Incentive Based Rate Regulation relies heavily on skillful forecasting particularly of trend in prices over a regulatory period. This raises some questions on whether incentive-based rate regulation can be effective here in the Philippine setting where the general levels of prices remain volatile. While CPI has remained relatively stable in recent months, inflation rates of around 10% were common in the not so distant past.

2. Price Control Formula

- ◆ In order to ensure the transparency and reasonableness of the transmission rate, the ERC should provide detailed basis for the initial 20 billion maximum allowed revenue (MAR) as provided for in Section 3.2.1? It is of utmost importance that this starting figure will not be too high as to cause a downward trend in the annual MAR which effectively delays any reduction in transmission wheeling rates. Other dependent parameters such as the materiality criteria of a tax change event should also be modified accordingly. [Section 3.2, Section 4.2]

3. Over / Under Recovery Formula

- ◆ Clarification is being sought on why over-recoveries and under-recoveries are treated differently in terms of allowable interest rate, specially the basis of the add-on 4% for over-recoveries. We feel that it may be more appropriate to accord level terms for both over and under recoveries by applying the same add-on charge or even eliminating it. While the Transco will provide its own forecasts for setting the ARR, this will eventually be decided upon by the ERC. It does not seem equitable to penalize the utility for the numbers set by the regulator. The choice of using a 180 day interest reference rate, instead of say a 90 day reference rate was not clear in the draft methodology. [Section 3.4, Section 4.3]

4. General Building Blocks Principles

- ◆ Section 4.4 (a) of the draft guidelines mentions "competition in the provision of such services wherever practicable". As Transco is a regulated activity, the context/meaning of the phrase is not clear and should be clarified. [Section 4.4.1]

5. Timing for Regulatory Periods

- ◆ The parameters for determining the duration of regulatory periods are not clear. Some guidance in Section 2.5.1 in the form of such parameters might be helpful. Since the regulatory period will last for three to five years, there must a mechanism for unplanned projects to be carried out in the middle of regulatory period and how these can be factored in the rates. [Section 2.5.1]

6. Efficiency Factor X

- ◆ The exponential factor of the $(1 - \text{inflation} - x)$ may have been erroneously omitted. In its present form, the X factor will always result to a large negative value. The correct form is believed to be $(1 + \text{inflation} - x)^n / (1 + \text{wacc})^n$. This should be consistent with the procedure of SMAR in Section 4.13.4. [Section 4.13.3]
- ◆ From the formula that determines X during the extension of first regulatory period, there is unique solution for the X factor. How will an initial value of X of 0.05 become part of the equation? [Section 2.3.2]
- ◆ In the section on deferred capital expenditure on projects of major importance, will the X factor be recalculated as if it was being done during the start of the regulatory period? If the timing of the delayed project fell in such a year within a particular regulatory period when actual annual revenues have already been determined, the use of this actual value will significantly alter the prices. [Section 12.8.1]

7. WACC Determination

- ◆ The guidelines appear to mandate a 60-40 Debt-Equity Ratio for the utility, but no explanation is given for the choice of such ratio. Why not base it on a capital structure closer to that of the regulated entity? What will be the basis of the parameters used in estimating both cost of debt and cost of equity? [Section 4.9]

8. Revenue Path Transition

- ◆ At the end of the Second Regulatory Period, it is unclear why over-recoveries are allowed to be carried over to the next regulatory period when under-recoveries are not. Does the term "insufficient revenues" denote an inefficiency on the part of the regulated entity? How does the ERC reckon if it was not due to low sales volume? Will the regulated entity have to absorb such losses? [Section 5.14.1]

9. Operating and Maintenance Expenditure – Net Foreign Exchange

- ◆ Will the item "net foreign exchange" cover all increases or decreases in O&M expenses associated with forex movements? Will the ERC come up with detailed calculation of this? What is the relation of this draft Transco rate methodology with the DÉCOR and DICER? [Section 4.11.1.o]

10. **Service Quality Measure and Targets**

- ◆ The performance measure of service quality is the vital link between the incentive performance based rate and EPIRA objective of modernizing the transmission sector. As such, the ERC should come up with a framework that will capture this objective and which will be included in the MAR or ARR (Annual Revenue Requirement) calculation. This should be done before the finalization of this guideline as this will significantly affect the integrity the equations. Although this will not be implemented in the first regulatory period, the basic calculation will be the same for the remaining regulatory periods. [**Section 4.16, Article VIII**]

11. **Application of Approve FM Pass Through Amount**

- ◆ If the pass-through will only be shown in the customer's billing until the end of a particular regulatory period, what happens if the approved FM pass through occurs close to the end of the particular regulatory period? Will the ERC force the amount to be spread in the remaining months of the period even if it causes a substantial spike in the price of electricity? [**Section 10.5.2a**]

12. **Net Efficiency Gain**

- ◆ The net efficiency gain is not explicitly shown in the ARR Building Block formula. [**Section 9.2**]

13. **Transmission Development Plan**

- ◆ There are no performance metrics for the regulated entity to engage in expansion and improving the transmission system. There should be performance incentives for undertaking projects with low revenue potential. [**IRR Rule 7, Section 10c**]

14. **Transco Related Businesses**

- ◆ How will the net income derived from other related businesses be included in the rate setting methodology? The rate setting methodology should include a mechanism for the regulated entity to engage in related business with the end view of reducing its transmission wheeling charges. [**IRR Rule 7, Section 11**]