

Section	Page no.	Topic	Comments / Recommendations	
1.	General	General	For clarity, it would be useful if the Guidelines contained a glossary of the key acronyms (e.g. MAR, ARR, etc.), together with a reference to the sections in which they are primarily defined.	
2.	General	General	For clarity, we suggest that introductory text be provided at the start of each Article and main Section to provide an explanation of the approach to be adopted.	
3.	1.3	7	Definition of Application Year	<p>For clarity, we suggest that this definition (and the definitions of Calculation Year, Historical Period, Forecast Period, etc.) state that it applies only to Article VI. Alternatively, these definitions might be moved to Article VI.</p> <p>The words (calculation, historical, forecast, etc.) are used throughout the Guidelines with their normal meanings and there is some risk of confusion.</p>
4.	1.3	8	Definition of Customer	<p>We recommend that this definition be amended to limit its application to the Regulated Transmission Services which are the subject of these Guidelines.</p> <p>The definition of "Customer" in the Guidelines is different from the definition used (and needed) in the draft OATS, in that the definition here excludes generators unless they are acting as load. A generator would be a customer for excluded services such as connection charges, and might be a customer for any contestable services.</p>
5.	1.3	10	Definition of Force Majeure	We suggest that "change in law" be mentioned more clearly in the definition of Force Majeure Event, perhaps as a subparagraph (c). The definition of "Permitted FM Pass Through Amount" could then be simplified accordingly.
6.	1.3	11-12	Definition of Regulated Entity	<p>We recommend that the definition be amended to recognize that the Regulated Entity might be one or more companies, and not refer to the National Transmission Corporation or Concessionaire.</p> <p>The Guidelines need to accommodate the possibility that both TRANSCO and a Concessionaire are involved in providing the Regulated Transmission Services at the same time.</p> <p>Under the privatization proposal, the Concessionaire will perform all non-operational functions, such as maintenance of the assets, financing and disbursement of capital investments, project management etc., but will not operate the system until granted a franchise by Congress (since operation of a utility requires a franchise). Therefore, the regulation will need to take account of the costs incurred by the Concessionaire in relation to its activities even though TRANSCO remains the operator of the utility, with the corresponding costs. Furthermore, TRANSCO will continue to be the borrower of record for currently on-going investment projects. When determining the regulated revenue, the ERC will need to take account of capex incurred by the Concessionaire and TRANSCO. Finally, since the law prohibits the Concessionaire from owning transmission assets, title to the asset base will always reside with TRANSCO.</p>

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7. 1.3	12	Definition of Regulated Transmission Services	<p>We strongly recommend that the regulation of Ancillary Services be excluded from the Regulated Transmission Services covered by the Guidelines and that Ancillary Services be identified as an excluded service (regulated elsewhere), or that Ancillary Services paid for by the Regulated Entity be a pass-through item in the formula.</p> <p>The revenue from and cost of Ancillary Services will be extremely uncertain and difficult to predict, especially with the move to competition in generation and introduction of the WESM. While it may be possible to determine the price or tariff for these services while NPC is the dominant provider, the quantity of Ancillary Services required is largely unknown and depends on generators' outages, the timing of such outages, and other unpredictable events, or determined by other regulations such as the Grid Code.</p> <p>Once the WESM is operational, the great majority of Ancillary Services costs will be determined through the WESM Rules and will be "regulated" through those Rules. The costs will be outside the control of the Regulated Entity, and will be large relative to the Regulated Entity's RAB and MAR/SMAR. We note also that TRANSCO records Ancillary Services as receivables/payables and not as revenue and cost items. There might be endless debate if forecast Ancillary Services must be included as an opex item in the building blocks because the cost and quantity are so uncertain, especially while the generation sector is being restructured.</p> <p>The EPIRA does not include regulation of ancillary service within wheeling rates in Section 43(f). ERC regulation of ancillary services charges is provided in Section 43(i). While Section 19 of the Act requires ERC approval of "transmission charges", Section 4 (aaa) states only that these "may include" ancillary services. We believe that the designation of Ancillary Services as excluded services is envisaged in the Act.</p> <p>For clarity, the definition should state which activities are covered by the Guidelines, which activities are "excluded services" and regulated elsewhere (such as under the WESM or OATS), and which are "TRANSCO Related Businesses" and not subject to regulation (except as otherwise provided in Section 20 of the Act).</p> <p>It appears that the Guidelines currently set out the method of regulation for the following activities, all of which would be included in the MAR/SMAR:</p> <ul style="list-style-type: none"> • transmission use of system (network service) • sub-transmission use of system (network service) • system operations • ancillary services (we recommend that these be excluded services) <p>Accordingly, we understand that the Guidelines do not prescribe the method of regulation for the following activities:</p> <ul style="list-style-type: none"> • market operations (which are covered by the WESM Rules and are an excluded service) • new connections (which are covered by the OATS and are excluded services) • related businesses, such as maintenance conducted for generators as a contestable service.

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8. 1.3	14	Definition of Trigger Condition	<p>For clarity, the definition should explain whether a 'change in the formula' refers to:</p> <p>a) a change in the algebraic formula</p> <p>b) a change in the numbers used in the formula,</p> <p>c) or a change in the algebraic formula and / or a change in the numbers.</p> <p>We recommend c) to ensure the ERC has maximum flexibility when a Trigger Condition occurs, provided that there is adequate provision for consultation with the Regulated Entity prior to such change.</p>
9. 1.4.1	14	Interpretation	We recommend that the Guidelines state the hierarchy in the event of any conflict between these Guidelines, the WESM Rules, the OATS terms and conditions and other similar relevant laws.
10. 1.4.2	14	Interpretation	For clarity, we suggest that the definition should state whether "rounded to four significant digits" means x.xxx for P/kWh if >P1, 0.xxxx if <P1, xxx,x00,000 for hundreds of Pmillion, x,xxx,000 for Pmillion, or some other rounding.
11. 2.2.– 2.3	16	Early termination of Interim Period	<p>We recommend that the contents of Sections 2.2 and 2.3 be re-grouped as follows in the interest of clarity, with amendments to the substance as stated below:</p> <p>2.2.1 Subject to paragraphs 2.2.2 and 2.2.3, the First Regulatory Period will end 31 December 2005</p> <p>2.2.2 The First Regulatory Period might end prior to 31 December 2005 [state the conditions]</p> <p>2.2.3 The First Regulatory Period might end after 31 December 2005 [state the conditions]</p> <p>For early termination (2.2.2 in the above proposed structure of the section), we recommend that TRANSCO also be allowed to request early termination of the First Regulatory period if it is ready to do so, for example in the event that a Concession is not awarded – the award of a Concession will not occur by 30 June 2003 in any event.</p> <p>The proposed deadline for an early termination request is extremely tight, although we recognize the need for adequate time for the Regulatory Reset process.</p> <p>The Guidelines should mention if the ERC might allow for a regulatory year which is not a calendar year, if so requested. A Concessionaire appointed, say, late in 2003 might request that the First Regulatory Period end in some month during 2006. No penalty should apply in this case.</p>

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12. 2.3.2	17	Application of X=5% if First Regulatory Period extends through 2006	<p>We recommend that X = 0 throughout the First Regulatory Period, even if such is extended to all or part of 2006.</p> <p>The revenue during the First Regulatory Period will be based on the tariff approved on 20 September 2002, which reflects an asset valuation undertaken in 1996/7 and costs in 2000. The revenue implications of the unvalued RAB and outdated opex figures are penalty enough for failure to comply with the data provision requirements laid down in the Guidelines. Therefore, an additional penalty of X = 5% should not be imposed.</p>
13. 2.5.1	17	Length of Subsequent Regulatory Periods	<p>We recommend that each Subsequent Regulatory Period be at least 5 years in duration.</p> <p>We recommend also that the end of a Regulatory Period not be linked to the expiration or termination of the Concession contract.</p> <p>As performance based regulation becomes firmly established internationally, the tendency is toward longer intervals between price resets as this gives the regulated business maximum incentive to make expenditure efficiency savings (although we note that Section 9.3.1 provides for a 5 year carry forward of efficiency gains regardless of the Regulatory Period). In particular, three years is too short a planning horizon to maximize efficiency savings.</p> <p>The Concession contract envisages that, in the event of termination, an independent valuation of the business (which might be a rebidding) will determine the buy-out price that TRANSCO must pay the Concessionaire. It would be disadvantageous if such an event triggers regulatory uncertainty.</p>
14. 2.5.1	17	Reference to Concession Contract	<p>We recommend that the reference to the Concession Agreement be removed from this clause and from elsewhere in the Guidelines.</p> <p>The Guidelines should apply whether or not a Concession Agreement is awarded. There are significant benefits from performance based regulation compared to the form of RORB regulation previously applied in the Philippines, irrespective of whether TRANSCO and NPC are privatized.</p>
15. 3	18	General	<p>For clarity, this Article III should commence by stating that the First Regulatory Period covers calendar years 2003 to 2005, unless terminated earlier or later as described under Article II.</p>
16. 3.2.1	18	Price Control Formula, MAR_t	<p>For clarity, we suggest that the formula be expressed as follows:</p> $MAR_t = MAR_{t-1} \cdot (1 + Inflation_t - X) - K_t$ <p>We also suggest that the footnote reference 1 be attached to the preceding text rather than to the formula.</p>

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17. 3.2.1	18	Price Control Formula, MAR_t	<p>We recommend that the ERC consider an alternative form of price control for the First Regulatory Period, given the difficulties in determining an appropriate value for MAR_{t-1} for the second year of the First Regulatory Period. This determination will be particularly difficult if Ancillary Services are included in MAR_{t-1}, and this is one reason why we recommend that Ancillary Services be excluded.</p> <p>An appropriate value for MAR_{t-1} for year t commencing 1 January 2004 must be calculated to ensure that the revenue for the First Regulatory Period covers all the Regulated Transmission Services covered by these Guidelines. This is inevitably a complex issue. The value P[20,198] million relates only to transmission (network service or use of system), and does not include the other services covered by the definition of Regulated Transmission Service.</p> <p>The parameters in the price control formula (i.e. the MAR_{t-1} and X) must be determined with reference to the revenue requirements over the whole of the Regulatory Period in order to take account of factors such as demand growth and capital expenditure requirements. Considerable work and time would be required now to produce the appropriate value for the deemed MAR_{t-1} in the context of the formula proposed in the Guidelines.</p> <p>If the value for MAR_{t-1} is based upon the revenue that TRANSCO might expect to collect under the tariff approved on 20 September 2002 and is linked only to increases in CPI, it will not allow for any increase in revenue due to demand growth or increased capital expenditure. While we acknowledge that these factors will be taken into consideration during the Reset Process for the Second Regulatory Period, no such allowances have been made for the First Regulatory Period. Therefore, we recommend that a revenue driver term linked to the rate of growth of demand be incorporated into the price control formula for the First Price Control Period.</p> <p>Alternatively, to avoid the need to determine the starting value for MAR_{t-1}, we request the ERC to consider an alternative approach for the First Regulatory Period. A price cap might be suitable if applied as follows:</p> <p>Year 1: The tariff as approved by the ERC on 20 September 2002 remains in force.</p> <p>Years 2 and 3: Tariffs are permitted to increase in line with CPI according to the following formula:</p> $p_t = p_{t-1} \cdot (1 + Inflation_t - X)$ <p>where</p> <p>p_t is the allowable tariff in the Relevant Year</p> <p>p_{t-1} is the allowable tariff in the Previous Year</p> <p>By adopting this approach for the First Regulatory Period, the need to determine the starting MAR_{t-1} value is deferred until the Second Price Reset, at which time the ERC will have the necessary information available to make this possible. The approach has the added benefits that it ensures no price shocks for customers as well as avoiding the need for a K factor in the formula.</p>

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18. 3.4.1	20	Definition of ATR_{t-1}	<p>We recommend that the estimate of ATR (which is, in any case, on an accruals basis?) cover the relevant calendar year to avoid a mis-match in the data.</p> <p>While we appreciate that the ERC may wish to use actual data and avoid projections to the extent possible, the Regulated Entity and the ERC should have a good feel, by early October each year, for the revenues and demand in the final quarter of the year.</p> <p>If our recommendation here is not adopted, the argument for symmetry in the treatment of under / over recovery of revenue in every year (including the last year of any regulatory period) is further reinforced. See Comment 25 for details.</p>
19. 3.4.1	20	Expression i_t in formula for K_t	For consistency with other Sections of the Guidelines, the units in the formula for i_t at the foot of the page should be the same as those used for I_t and X (i.e. 0.04 rather than 4%, with the Reference Rate defined accordingly).
20. 3.4.1	20	Definition of AMR_{t-1}	For clarity, the Guidelines should state that the revenue AMR relates only to that collected by the Regulated Entity under clauses 3.13.15 and 3.13.16 of the WESM Rules. Further, given that such revenue derives from an “excluded service”, we question whether AMR should be singled out for special treatment when there might be other revenues from other excluded services. We recommend that the formulae and controls under these Guidelines apply only to “included services” as will be clearly defined in the definition of Regulated Transmission Services.
21. 3.4.1	20	Customer Revenue ACR and ATR.	<p>For clarity, the Guidelines should state whether ATR is based on invoiced amount due and owing or on actual revenue collections. The use of the word “actual” in the formulae is confusing since the Guidelines appear to consider revenues on an “accruals” (or accounting basis).</p> <p>We recommend that the Guidelines also state how bad debt will be treated. We recommend that bad debt be included in the list of operating expense items in 4.11.1, and that the Regulated Entity be given a specific target to reduce the level of bad debt over time.</p>
22. 3.4.1 (also 4.3.1)	20 (also 24)	Interest rate on over-recovered revenue	<p>We recommend that the Guidelines clarify that the stated penalty interest on over recovery applies only during the First and Second Regulatory Periods, and that the ERC will review the appropriate rate for Subsequent Regulatory Periods.</p> <p>We recommend also that the penalty rate on over-recovery be 2%. A penalty interest rate of 4% for the First and Second Regulatory Periods is too high, given the difficulties in predicting demand and sales growth in an emerging economy – especially if there is a new Concessionaire. This would be particularly true if the Guidelines (as currently drafted) encourage over-recovery in the last year of each Regulatory Period by not allowing application of the correction factor for under-recovery in that year.</p>

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23. 3.5	21	Grid Performance Information	For clarity, this statement might be better placed at the start of Article III or Article VIII.
24. 4 (All)	22	MAR and ARR	For clarity, the Guidelines should explain the relationship between ARR and MAR, how MAR_{t-1} will be set, and how rates will be derived from MAR_t , MAR_{t+1} , etc. This might be achieved through the provision of a Glossary as suggested in Comment 1
25. 4.2.1	22	Definition of K_t	<p>We recommend that the Guidelines take a balanced approach to over and under recovery, without exceptions for the last year in each Regulatory Period. Any revenue under-recovered in the last year of any Regulatory Period should be recovered in the subsequent year.</p> <p>The Guidelines provide no justification for an asymmetrical approach, and the rationale is not at all clear. An asymmetrical approach is not generally adopted in other countries with incentive-based regulation.</p> <p>The approach proposed in the Guidelines would encourage the Regulated Entity to ensure that it over-recovers in the last year of the First Period. The need for correction of under-recovery becomes even more necessary if the Guidelines continue to use different bases for the comparison of MAR and ATR – see comment 18.</p> <p>In order to avoid price shocks arising through large under or over recovery of revenue, the Guidelines might give the ERC the option to request that the correction factor for any particular year be spread over a number of years.</p>
26. 4.2.1	22	Definition of X	For clarity, the Guidelines should state that the X factor can be either a negative or positive value.
27. 4.3.1	23	Definition of AMR_{t-1}	See comment 20.
28. 4.4.1	24	Recovery of costs	We recommend that the wording be changed to state that the ARR will be set to ensure that the Regulated Entity recovers all reasonable costs including a reasonable return, possibly citing the corresponding words in Section 43(f) of the Act. (The opening paragraph to Section 4.4.1 mentions the <i>reasonable recovery</i> of costs, rather than the recovery of reasonable costs.)
29. 4.4.1 (a)	24	General Building Block Principles	We suggest that “competition” should not be the first objective in this list, given that transmission is generally a natural monopoly and the Guidelines focus on regulation of rates, rather than on the broader objectives of regulation and restructuring. The first objective should be (b) or (c). Nonetheless, we recognize that the introduction of competition wherever possible should be a key objective of the regulatory regime.

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30. 4.4.3	25	Building Blocks – Corporate Income Tax	<p>We recommend that the Guidelines be amended to provide that the benefit of tax holidays and/or tax exemptions for specific projects accrue to the Regulated Entity.</p> <p>Generally, while we agree with the general approach taken in the Guidelines (namely the use of actual tax rather than the corporate tax rate) such tax concessions are granted by the Government to promote investment and, therefore, are intended to benefit the investor.</p>
31. 4.4.1 (j)	25	General Building Block Principles	<p>We recommend that this sentence be amended to omit references to the Concession contract and to refer instead to the end-date for these Guidelines or, preferably, to the end of each Regulatory Period. (See comment 13.)</p> <p>For clarity, the Guidelines should provide further clarification on what is meant by the phrase “above average expenditure on upgrades ...”.</p>
32. 4.4.5	25	Determination of ARR_t	<p>We recommend that this paragraph be amended to state that the ERC must ensure that its decisions on ARR_t do not <i>under or over</i> compensate for the risks of the electricity transmission business.</p> <p>The Guidelines should balance the interests of customers with the interests of the Regulated Entity since an utility which is not financially viable on a sustainable basis cannot provide quality service to customers.</p>
33. 4.5.7	26	Formula for ARR_t	<p>For clarity, we suggest that certain subscripts be amended.</p> <p>Subscript c:</p> <ul style="list-style-type: none"> in $Tax_{c,t}$ refers to corporate (might be replaced with p or π for profit), in $WACC_c$ refers to classical (subscript might be omitted), and in RAB_{ci} refers to closing (para 4.7.2) <p>“i” or subscript i (in various sections):</p> <ul style="list-style-type: none"> i (not subscript) refers to interest, and i (as subscript) refers to any year in a yearly series or any asset category in calculation of RAB and might be replaced with j
34. 4.5.7	26	Definition of RAB	For clarity, the Guidelines should provide further clarification on what is included within the Regulatory Asset Base.
35. 4.5.7	26	Definition of RAB, footnote #4	We recommend that footnote #4 be expanded to clarify exactly what is expected for the RAB and Depreciation parameters, given that the mix of “nominal” and “real” figures in the equation might confuse some readers.

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36. 4.6.2	27	Basis for an Independent Expert	We recommend that the Guidelines clarify the basis upon which the ERC may or must require the Regulated Entity to retain an independent expert to undertake the Revaluation. In this Section, the Guidelines should also make it clear that, provided the criteria are followed, the ERC will accept the valuation prepared by the independent expert.
37. 4.6.3	27	Revaluation Methodology	<p>We recommend that the Guidelines specify current cost methodology or simple replacement cost for the Initial Revaluation. The application of optimised replacement cost should be deferred to the Third Regulatory Period.</p> <p>A new valuation methodology might produce a materially different valuation for the existing RAB, thus creating significant uncertainty as to the RAB and MAR for the Second Regulatory Period.</p> <p>We also recommend that the Guidelines state the date by which the ERC will publish the criteria for the revaluation, in the context of the overall timelines.</p> <p>The asset revaluation must commence well in advance of the start of the Second Regulatory Period (and is a condition for requesting early termination of the First Regulatory Period), but the revaluation depends on publication of the detailed methodology and criteria by the ERC.</p>
38. 4.6.6(b)	29	Network Planning Horizon	<p>We recommend that the network planning horizon be extended beyond 10 years, given the length of the planning, design and investment periods.</p> <p>Many stakeholders (and other interested parties) have recommended that the TDP provide a 20-year “vision” because the 10-year plan envisaged by the Act is not sufficient. The current draft TDP already moves in this direction.</p>
39. 4.6.8 (c)	30	Determination of Spares	We recommend that the Guidelines state the date by which the ERC will issue Guidelines on the appropriate quantity of spares, given that such Guidelines would be an input to the Initial Revaluation.
40. 4.6.10	31	CWIP	<p>We recommend that the Regulated Entity be clearly entitled to earn a return on capital expenditure made in accordance with an approved capital expenditure plan, even though the project has not yet been brought into service.</p> <p>We recommend further clarification of the treatment of CWIP. Section 4.10.6 suggests that capital expenditure is added into the RAB only when the assets come into service, but this section 4.6.10 suggests there may be some consideration of CWIP.</p> <p>We recommend that the treatment of CWIP, additions to RAB, and penalties for failing to commence investments (Section 12.8.1) be reviewed to ensure consistency as the treatment in the draft Guidelines is not entirely clear.</p>

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41. 4.7	32	Formula for RAB _t	<p>We recommend that the formula for RAB_t be modified to read as follows:</p> $RAB_t = \frac{RAB_{o,t} + RAB_{c,t}}{2}$ <p>It is more usual internationally for the return to be calculated on the average of the opening and closing RAB over the Relevant Year, and not on the opening value as proposed in the draft Guidelines.</p> <p>If significant assets are brought into service during the Regulatory Year, we believe that the formula to apply WACC on opening RAB (Section 4.5.7) does not provide an adequate return on the investment in such projects.</p>
42. 4.8.1	33	Formula for Regulatory Depreciation	For clarity, the Guidelines should state which formula and result should apply in the event that data are available for both options and the results do not agree. This section provides for one of two methods and formulae depending on the availability of data.
43. 4.9.1 or 4.9.3	34 or 35	Formula for WACC	We recommend that the Guidelines clarify that the values for D and E (and V) will be the market values, not book values.

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44. 4.9.4 and 4.9.10	35 and 38	Risk-free Rate	<p><u>We recommend</u> the use of a US\$ risk free rate and corresponding WACC for the First and Second Regulatory Periods. All references to the Philippine risk free rate should be amended accordingly.</p> <p><u>We recommend</u> that the risk-free rate be estimated based on the longest-dated instrument available, such as a 30-year U.S. Treasury bond as suggested in Section 4.9.5 of the draft ERC guidelines, and that a Philippine country risk premium based on the Philippines default spread and a currency premium based on inflation differentials be added.</p> <p>We recommend that, beyond the Second Regulatory Period, the ERC consider using a rating analysis based on a realistic target credit rating for the Regulated Entity as well as an analysis of comparator companies for determining the capital structure and cost of debt. The ratings and comparator company analysis should also enable determination of the appropriate asset and equity betas for the Regulated Entity.</p> <p>While we understand that the ERC might prefer to use a Philippine risk-free rate and a PhP WACC, we note that – in theory – the choice of risk-free rate should make no difference to the resulting WACC number. However, inappropriate results could arise if the parameters in the formula are distorted for any reason. The benchmark Philippine risk-free rate alluded to in the Guidelines is the only reference instrument and is only a 10-year special-purpose bond which might not provide a realistic benchmark for r_f. This instrument will have only five or six years remaining at the time of the first Reset.</p> <p>The use of a 30-year U.S. Treasury plus premia should address concerns about higher funding costs that normally accompany longer maturities (especially during periods when the US\$ bond yield curve is upward sloping and steep). This also enables the Concessionaire to properly match the life of his investment with the tenor of his borrowings. Borrowing via a 10-year instrument, on the other hand, exposes the Concessionaire to refinancing risk at the end of the tenth year, which is not factored into a WACC calculation that uses a 10-year note as benchmark.</p> <p>In the event that there is insufficient liquidity in the market for the reference instrument(s), or if the local market lacks depth to accommodate the scale of borrowing required for the transmission business, the Regulated Entity might need to borrow off-shore and enter into currency swap arrangements which would add significantly to the “risk free” borrowing cost. Should the investor leave himself exposed to the currency risk, an inflation/currency risk premium equivalent to the inflation differential between the U.S. and the Philippines needs to be added to the borrowing cost. In either case, the required WACC would be very high.</p> <p>We note also that World Bank (or similar) partial credit guarantees might not be available to a private company such as the Concessionaire. In this regard, we propose that the cost of debt be estimated based on the all-in yield of a long-term plain vanilla bond issued by the Concessionaire's project company. We expect this to be higher than NPC's current cost of borrowing in light of the fact that the Concessionaire will not benefit from any guarantee from the Republic, unlike the existing NPC bonds.</p>

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45. 4.9.12	39	Amendment of WACC formula	<p>We strongly recommend that this section be amended to allow the Regulated Entity to request a change in the WACC formula during a Regulatory Period if the Regulated Entity can demonstrate that there has been a material adverse change in circumstances.</p> <p>While the Guidelines provide for the ERC to obtain the agreement of the Regulated Entity for any change to the WACC formula during the Second Regulatory Period, the Guidelines imply that any such change would be initiated by the ERC. Potential investors and lenders would derive substantial comfort if the Guidelines stated that Regulated Entity had the right to request a change, given the recent history (Asia financial crisis, Enron, and MWSS / Maynilad).</p> <p>Although we appreciate that the WACC formula includes parameters for country and currency risk, it is set only during the Regulatory Reset Process once every five years and these parameters reflect the long term perspective – they do not provide for dramatic short term fluctuations (as witnessed in the Philippines from July 1997 to 2001). In an emerging economy, significant changes could occur during a regulatory period, with serious implications for the cash flow of the regulated entity. As demonstrated in 1997-99, the changes are not necessarily reflected in CPI.</p>
46. 4.10.2(b)	39	Prioritization of projects	For clarity, we suggest that the Guidelines explain that priorities must be assigned to projects within the capital expenditure program
47. 4.10.2(f)	40	Division of forecast capital expenditure	For clarity, we request further explanation about the nature of expenditure covered within the category “overheads”. We believe that allocated overheads would be part of fixed operations and maintenance expenses rather than capital expenditure.
48. 4.10.4, 4.10.9 & 4.11.4	40 & 42	Independent Expert	<p>We recommend that the ERC clarify in the Guidelines the circumstances under which the Regulated Entity may or must retain an independent expert.</p> <p>These Sections 4.10.4 and 4.11.4 state that “The ERC <i>must</i> require the Regulated Entity to retain an independent expert ..”. However, other Sections (for example Section 4.6.2) state that “the ERC <i>may</i> require the Regulated Entity to retain an independent expert ..”. Section 7.1.4 states that the ERC <i>must</i> require .. but makes reference to section 4.6.12 in which “any report” suggests that there might not be an independent expert. Section 4.10.9 also mentions “any reports”.</p>

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49. 4.10.1 & 4.10.6	39 & 40	Capital Expenditure Forecast	<p>We recommend that the Guidelines require the Regulated Entity to provide information on the expected annual disbursements under the proposed annual capital expenditure program.</p> <p>Section 4.10.1 requires the Regulated Entity to submit its “forecasts of its proposed annual capital expenditure program for each Regulatory Year”. This suggests a conventional investment plan which would show expected annual disbursements. A statement of such expected annual disbursements would provide the basis for determining CWIP.</p> <p>However, Section 4.10.6 states that the forecasts for any Regulatory Year must include only the forecast cost for those new assets which will commence supporting the provision of Regulated Transmission Services in that year. This deviates from the recommendations in the EA Technology report, and provides no basis on which to estimate CWIP.</p> <p>Further, the treatment required under Section 4.10.6 is not consistent with ERC monitoring actual disbursements (Section 12.8.1, on which we comment later below).</p>
50. 4.10.6	40	Capital Expenditure Forecasts	<p>We recommend that the Guidelines state whose responsibility it is to decide on the forecast inflation to be used for producing capital expenditure forecasts in nominal terms.</p> <p>Such forecast should reflect inflation in the country from which the item is being purchased.</p>
51. 4.10.8	41	ERC identifying projects of major importance	<p>We strongly recommend that the ERC not be obliged to identify projects of major importance.</p> <p>Under incentive based regulation, the focus should be on output measures such as meeting network performance targets rather than on input measures such as expenditure on individual projects. (This is related to Section 12.8.1, on which we comment later below.)</p> <p>We recommend also that the Guidelines not mention specific projects, as the main purpose of the Guidelines is to set the Transmission Wheeling Rates. In particular, it is PSALM's view that the technical and financial case for the Leyte-Mindanao interconnection is not yet proven. Mentioning this project in the Guidelines suggests that its importance has already been decided by the ERC.</p> <p>In the event that the Guidelines continue to require the ERC to identify projects of major importance, the Guidelines should state the criteria which the ERC will apply.</p>
52. 4.12	43	Calculation of Corporate Income Tax	<p>For clarity, we recommend that this Section be amended to explain the treatment of tax loss carry-forward. Paragraphs 4.12.2(a) and 4.12.2(b) are difficult to follow. Introductory text to explain the approach might be sufficient.</p> <p>It does not appear to be possible to calculate MAR from ARR since, other than in the first year of a regulatory period, income tax will depend on MAR, but the income tax is required to calculate ARR from which MAR is derived.</p>

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53. 4.12.3	43	Interest payments on outstanding debt	PSALM proposes that the Concessionaire will be given an obligation to make certain annual payments to TRANSCO as part of the consideration for the Concession. These payments will, in effect, be a liability on the Concessionaire's books similar to debt. Although there will be no explicit interest component, the ERC might wish to consider how these payments will be reflected in the determination of TIncome.
54. 4.13.1	45	Revenue Smoothing	<p>We recommend that the ERC retain the right to introduce a small step change in revenue / price (or "P_o adjustment") at the start of any Regulatory Period so that it has maximum flexibility in setting the smoothed revenue requirement.</p> <p>P_o adjustments are typically part of the regulator's "tool-kit" under incentive based regulation. Without such an adjustment, the first X factor (at the start of the Second Regulatory Period) might be a large negative number. Tariffs would be "too low" in the initial years of the Regulatory Period but "too high" at the end, resulting in a "see-saw" tariff for customers and possible cash flow problems for the Regulated Entity (as experienced by the MWSS concessionaires).</p> <p>Figure 1 at the end of this document shows an estimate of the revenue profile for the Second Regulatory Period, based on the best data currently available. Without a step change at the start of the regulatory cycle, a large negative X factor is needed to preserve the present value over the period.</p>
55. 4.13.2	46	Formula for PV _{t-1}	<p>For clarity, we recommend that the formula be expressed as follows (in the event that the ERC chooses to continue with the smoothing approach described in the draft Guidelines, without any step change in prices at the start of the Second Regulatory Period):</p> $MAR_{t-1} + \sum_{i=0}^4 \frac{ARR_{t+i}}{(1+WACC)^{i+1}}$ <p>The long form of the equation could be spelt out as a footnote.</p>
56. 4.13.3	46	Formula for PV _{t-1}	<p>We suggest that this formula be reviewed. We believe that the exponents for (1+WACC) should be between the two closing parentheses for each yearly expression and that, technically, the inflation parameter should relate to the appropriate year (i.e. t+1, t+2 etc.). The Guidelines should clarify how forecast inflation will be determined.</p> <p>If it is intended that the same inflation rate be used in each year (i.e. Inflation_t = Inflation_{t+1}=Inflation_{t+2}, etc.), the Guidelines should state this and the equation could then be expressed as follows:</p> $MAR_{t-1} \cdot \sum_{i=0}^5 \left(\frac{1+Inflation_t - X}{(1+WACC)} \right)^i$

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57. 4.13.4	47	Revenue Smoothing	<p>We suggest that the equations for determining the smoothed revenue (SMAR) in each of the Relevant Years be reviewed. We believe that the inflation term should correspond to the Relevant Year – for example:</p> $SMAR_{t+1} = SMAR_t \cdot (1 + Inflation_{t+1} - X)$
58. 4.14.1	47	Revenue Path Transition	We recommend that any revenue under-recovered in the last year of any Regulatory Period be recovered in the first year of the next Regulatory Period, for the reasons given in our comment above on Section 4.2.1.
59. 4.18.2	48	Financial Ratios Analysis	There is scope for varying interpretations of the terms used for the financial ratios (such as the treatment of preferred stock in the debt/equity ratio, debt or net debt, etc.). We recommend that the Guidelines require that the interpretations used by reputable rating agencies be used. The Guidelines should also provide for the use of different ratios in the future if the reputable rating agencies adopt different approaches or ratios. Paragraph 4.18.2(e) might be expanded to this effect.
60. 5.1	49	General Price Control Principles	For clarity, it would be helpful to have a statement at the start of Article VII to the effect that there will be a Regulatory Reset Process in accordance with Article VII before each Subsequent Regulatory Period such that there will be a period of consultation to consider the ERC's proposals.
61. 5.2.1	49	Price Control in Subsequent Regulatory Periods	We suggest that the Guidelines give the ERC flexibility to add other alternative components to the formula for Subsequent Regulatory Periods, provided that such components reflect internationally accepted rate making methodologies prevailing at the time. Examples might be the treatment of ancillary services (depending on how these will be treated in the Guidelines) or transmission losses.
62. 5.3.1	49 and 50	Over / Under Recovery Formula	<p>We recommend that the ERC also have due regard for the impact on the Regulated Entity before modifying or removing the AMR_{t-1} factor.</p> <p>Operation of the WESM Rules is beyond the control of the Regulated Entity. The formula might be operating to the detriment of the Regulated Entity as well as of Customers, or its modification/removal might have an adverse impact.</p>
63. 5.3.3	50	Over/Under Recovery Formula	We recommend that this Section should also provide for correction if the Regulated Entity under recovers, for the reasons given in our comment above on Section 4.2.1. This section provides only for a refund to customers if the cap is exceeded. We strongly recommend balance in the application of the correction factor.

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64. 5.6.1	50	Asset Valuation	<p><u>We strongly recommend</u> that the Guidelines not restrict the ERC to using a particular valuation method for the Third Regulatory Period.</p> <p>We recommend that the choice of valuation methodology to apply after the Second Regulatory Period should be considered in the regulatory reset process, and that the ERC should be bound only to adopt an internationally-accepted methodology (using wording similar to the provision on WACC in Section 5.9.1).</p> <p>The Guidelines state that optimised deprival value will be used. Optimised Deprival Valuation is complex, and subject to debate as to the appropriate method for optimising the assets. The approach is currently attracting widespread criticism for its impact on investment decisions that could be particularly relevant for a developing network such as that in the Philippines. We would be happy to provide the ERC with copies of published papers which appraise this methodology.</p>
65. 5.6.2(a)	51	Asset Valuation	There may be an error in the stated formula, since it appears that “asset value” will be multiplied by “asset value”.
66. 5.8.1	51	Regulatory Depreciation	We recommend that this clause be amended to read ‘... so that the Regulated Entity does not <i>under or over</i> recover the value of its regulatory asset base’, for the reasons given in our comment above on Section 4.2.1.
67. 5.14.1	53	Revenue Path Transition / Correction Factor	<p>We recommend that any excess revenues be returned to customers and any deficit in revenue be recovered from customers, for the reasons given in our comment above on Section 4.2.1. Any excess / deficit revenue should be returned to / recovered from customers in the following year regardless of whether it is the last year of a Regulatory Period</p> <p>Section 5.14.1 refers to the over/under recovery correction factor but applies it only to excess revenues for refund to customers. Section 5.14.2 explicitly states that the correction factor will not be applied to remedy any under-recovery in the last year of the Second Regulatory Period. The rationale for this approach (which is not generally followed internationally), is not clear and the Guidelines do not explain why this approach has been adopted.</p>
68. 5.17.1(a)	54	Efficiency Carryover	We suggest that the wording of this paragraph be amended to clarify the treatment of any “windfall gains” and any “windfall losses”.
69. 5.17.1(c)	54	Efficiency Carryover	We recommend that this section be expanded to include other possible options for the treatment of efficiency gains. For example, it should might include improvements in the network which benefit Customers by reducing the need for (or cost of) spinning reserve.

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70. 6.2.1(a)	55	Annual Rate Setting Timetable	The cross-references in sub-paragraphs (vi) and (vii) do not seem to be correct
71. 6.2.1(g)	57	Late Filing Provision	<p>We recommend that the Section be amended to clarify that, if the Regulated Entity misses the deadline, the ERC will set rates until such time that the Regulated Entity files its submission and the new rates are approved.</p> <p>The Guidelines do not contain any provision for late filing by the Regulated Entity. As drafted, it appears that the ERC would set the rates for the entire year.</p> <p>We recommend also that the Guidelines state what protection is afforded to the Regulated Entity if the ERC fails to meet the deadlines. While this event might be unlikely, the Regulated Entity should not be locked into unreasonably low tariffs if there is inaction on the part of the ERC.</p>
72. 6.3.3	58	Demand projection	We recommend that the Guidelines require the Regulated Entity to submit a forecast of peak demand, and provide guidance on whether coincident or non-coincident peak demand is to be used (and, if coincident, how determined).
73. 6.4.1	59	Side Constraints	<p>For clarity, we recommend that the formula be expressed as follows:</p> $\frac{FCR_{k,t}}{ACR_{k,t-1}} \leq \frac{(1 + I_t + SC_t) \cdot FQ_{k,t}}{AQ_{k,t-1}}$ <p>The use of subscripts in the equation as written in the Guidelines does not follow convention – it would be better to use the subscript k,t rather than t,k.</p>
74. 6.4.1	59	Side Constraints	<p>We recommend that the value for the Side Constraint for the First Regulatory Period be increased to 10% over the rate of inflation. Alternatively, the value might be set at 5% over the rate of inflation if it is applied on top of any increase required under the cross-subsidy removal scheme already imposed by the ERC, or if the constraint is measured as P/kW rather than P/kWh.</p> <p>We recommend that the Guidelines affirm that the main determinant in setting rates should be the value for MAR.</p> <p>During the First Regulatory period, it may not be possible to limit the change in PhP/kWh for any customer segment to no more than 1% over the rate of inflation given the uncertainty about the effects of the current transmission charge structure, the existing plan for removal of cross-subsidies within three years, and the possibility that actual revenue (ACR) per kWh might be affected by changes in load factor as most transmission rates are set on a kW basis. The higher cap has only a small impact on End-user rates because the transmission charge is a relatively small component.</p>

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75. 7.1.2	61	Regulatory Reset Process Timelines	We recommend that the final sentence of this Section be modified as follows to provide for technological change over the lifetime of the regime: ‘...web site(...), or through such other medium as is generally accepted and in use at the time, ‘
76. 7.1.4 (a)	61	Independent Expert	We suggest that the Guidelines clarify the circumstances under which the Regulated Entity will be required to retain an independent expert for the purpose of undertaking the asset revaluation. This paragraph states that the ERC “must require” but refers to paragraph 4.6 which uses “may require” (4.6.2).
77. 7.17	62	Reset Process Timeline	We recommend that the Guidelines state whether or not the reports from the Independent Experts would be made public. If the intention is to publish such reports, the Regulated Entity should be permitted to request that certain commercially sensitive information be withheld from the public domain.
78. 7.1.9	62	Reset Process Timeline	We recommend that a minimum of 2 months be allowed for submissions. The period of 1 month as provided in the draft guidelines is insufficient. There must be sufficient time after the publication of the draft determination of the price control to allow interested parties to make submissions.
79. 8.1.1	63	Establishment of Transmission Reliability Standards	We recommend that the timetable for the ERC’s publication of draft performance targets be included in the Guidelines. The regulated entity is required to propose a capital expenditure forecast for the second regulatory period in good time for the reset process. In order to ensure that the capital program is designed to deliver the required performance, the ERC must have already published draft performance targets.
80. 8.1.3	63	Establishment of Transmission Reliability Standards	We recommend that the Guidelines not stipulate the need for ‘due notice and hearing’ for setting the performance standards, to minimize the risk of delays in the timetable. Public hearings should be restricted to the Price Resets and certain Force Majeure events (as defined under Article X).
81. 8.2.3. (c)	64	Performance Incentive Scheme	We recommend that the maximum limit of rewards and penalties be 3% of ARR_t (paragraphs (c)(i) and (c)(ii)(B)), and 10% under paragraph (c)(ii)(A). It is unlikely that a reward of 10% of ARR_t would ever be awarded to the Regulated Entity (due to the fact that customers will be unwilling to pay higher prices in order for the Regulated Entity to receive a bonus). The narrower bands are recommended in order to maintain symmetry between the penalty and the plausible level of reward.

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82. 9.2.4	67	Definition of Net Efficiency Gain	<p>We recommend that the materiality band of $\pm 1.5\%$ be increased to $\pm 3\%$</p> <p>We recommend also that the ERC's discretion in adjusting the forecasts for the purpose of calculating the net efficiency gains be exercised only after consultation with or submissions from the Regulated Entity.</p> <p>Demand could fluctuate by more than 1.5% from forecast due to economic factors or weather, without any impact on capital or operating expenditures.</p> <p>There is no direct link between demand and capital or operating expenditures in a period of one or two years. For capital expenditures, equipment sizes will have been specified, equipment ordered and a portion installed.</p>
83. 9.3.1	68	Carrying Over Net Efficiency Gains	<p>We suggest that this section be amended for greater clarity in the treatment and carry forward of Net Efficiency Gains.</p>
84. 10.2.4	70	Claim for a Force Majeure Event	<p>We recommend that the threshold above which FM Events are subject to public hearing be increased to PhP0.05/kWh. This is still a relatively small impact on End-user rates, reduces the need for public hearings, and better represents the level of costs that might be faced after a very severe FM event. The threshold of PhP0.02/kWh is only a small percentage of the transmission rate and equates to only approximately US\$15 million.</p> <p>If this recommendation is not accepted, we recommend that the threshold be allowed to increase over time as PhP0.02/kWh might be a negligible amount by 2027.</p>
85. 12.2.1(a)	79	CPI Trigger	<p>We recommend that any CPI trigger be set at a 5% increase in CPI between two quarters. While we recognise the need to limit changes to the MAR formula, a 10% increase in CPI between two quarters is a very high hurdle.</p> <p>Alternatively, it might be sufficient to permit the option of changing the numbers in the formula or allowing the Regulated Entity the option of adjusting tariffs mid-year in the event of substantial changes in CPI. It may not be necessary to have a CPI Trigger for a change in the algebraic formula for calculating MAR. CPI feeds automatically into the calculation of the allowed revenue, albeit lagged.</p>
86. 12.2.1(b)	79	Peak Demand Trigger	<p>We recommend a trigger of $\pm 20\%$ of demand.</p> <p>A doubling or halving of demand over a period of one year is a very high hurdle, to the extent that the trigger serves no practical purpose. A 10% or 20% drop in demand would already have a material adverse impact on the Regulated Entity's net revenues unless the regulation continues entirely as a revenue cap. A 20% increase in demand over one year would necessitate a rapid increase in capital expenditure and/or might result in a failure to achieve performance standards.</p>

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87. 12.2.1	79	Re-Opening Trigger for Currency Exchange Rate	<p>We strongly recommend that significant changes in the currency exchange rate be added as a Trigger, with a threshold of a 10% change in the Peso/US Dollar exchange rate relative to the forecasts used in setting MAR, sustained over a period of one year. Ideally, a precise formula should be included with the Trigger so that its effects can already be predicted with certainty. (It might be possible to require that a significant adjustment to transmission charges be phased but, in this case, the period should not exceed two years and, preferably, should be shorter.)</p> <p>We recognize that some protection is provided through the annual CPI adjustment, the WACC and the asset revaluation, and we appreciate the need to avoid any risk of over-compensating the Regulated Entity. However, the Guidelines do not provide adequate protection against a severe devaluation such as occurred in 1997-98.</p> <p>Movements in the exchange rate are not fully reflected (and sometimes not at all) in the CPI. From mid-1997 to 2002, CPI rose by only about 31% while the exchange rate (Pesos per Dollar) doubled from PhP26 to PhP52.</p> <p>The bulk of the costs of the regulated transmission business are driven by the exchange rate. If the regulatory regime does not provide adequate protection, there is a risk that the Regulated Entity will be unable to raise finance for its investment plan or only on onerous terms. This would have an adverse impact on customers. In a severe devaluation, as occurred in 1997/98, there is a risk of negative cash flows in every year, even on a pre-finance basis, and the IRR is halved despite the increase in RAB at the Reset in 2003. Using actual financial projections for the transmission business going forward, devaluation of only 12% in the first year of the Second Regulatory Period would result in negative cash flow, post tax and post finance, in three out of the following five years.</p> <p>The WACC formula does incorporate measures of country and currency risk but these do not cover significant short- or medium-term changes in the exchange rate. It would be necessary to add as much as 9% on top of the calculated WACC to provide for Peso:Dollar currency swaps.</p> <p>Asset revaluation can be expected to restore the real dollar value of the RAB but does not compensate the Regulated Entity for losses incurred in the previous Regulatory Period.</p> <p>The Asia financial crisis and its impact on the debt service burden of Maynilad are very fresh in the minds of potential investors and lenders. It is imperative that the Guidelines provide explicit forex protection against severe devaluation of the Peso.</p> <p>Explicit protection in the form of a realistic trigger is the least cost option for customers and for the Philippines. Customers would bear the cost only if the trigger threshold is reached (and would benefit if the Peso appreciates within a Regulatory Period). Without such a trigger, transmission charges would have to reflect the <i>cost of the risk</i> that the Peso would depreciate significantly.</p> <p>As a final point, it has been suggested that any residual currency risk could be borne by the Government, through proceeds in the privatization of TRANSCO. We strongly believe that this is not economically efficient. The <i>risk</i> of Peso depreciation over 25 years would be locked in (if the privatization were even possible on these terms), at huge cost to the Government but a windfall gain to the investor if the currency does not depreciate as much as expected.</p>

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88. 12.6.1	80	Formula for Quarterly Change in CPI	For clarity, the formula should be expressed as follows (with corresponding adjustments in the preceding text): $\Delta CPI = \left(\frac{CPI_{\vartheta}}{CPI_{\vartheta-1}} \right) - 1$
89. 12.7.1	81	Formula for Three Month Average of Non-Coincident Peak Demand	For clarity, the formula should be expressed as follows (with corresponding adjustments in the preceding text): $\Delta NCPD = \left(\frac{NCPD_t}{NCPD_{t-1}} \right) - 1$
12.8.1	82	Deferred Capital Expenditure on Projects of Major Importance	<p>We recommend that this section be deleted.</p> <p>In order to reduce uncertainty, it is essential to avoid intervention during a Regulatory Period. Under incentive-based regulation, the key focus of the Regulator should be on output-based measures, such as network performance, rather than on the day to day running of the business and on individual projects. Adjustments for any capital underspend should occur in the Reset, at which time issues such as depreciation and return on unspent capital expenditure can also be addressed. Attempting to address such issues through a change in the X factor during a Regulatory Period increases the burden on the Regulated Entity and on the Regulator in terms of data provision and monitoring. Therefore, we recommend that the ERC not make any adjustment to the X factor due to deferred capital expenditure (or indeed on any other matter) during a Regulatory Period.</p> <p>If the Regulated Entity cannot prove that capital underspend is attributable to management efficiency, the benefit should be transferred to Customers at the start of the next control period in the form of an immediate P₀ adjustment.</p> <p>If our above recommendations on this subject are not accepted, the Guidelines should, as a minimum, set out the criteria by which the ERC will determine that a project is “of Major Importance” and clarify that “so forecast to be undertaken” in this context relates to Section 4.10.6, meaning the date on which the investment project was forecast to be brought into service and added to the RAB. We recommend also, in this case, that the Guidelines not penalize the Regulated Entity if capital has been spent but the project cannot be brought into service for reasons beyond its control.</p>
90. 14	85	General	We question whether it is necessary for the Regulated Entity to maintain a list of Experts. Would it be sufficient to require the Regulated Entity to place an ‘open’ call for Expressions of Interest as and when required?
91. 14.1.2	85	List of Experts	We recommend that the length of time allowed to establish the list of experts be increased to 60 or 90 Business Days. Independent Experts are not required until the asset valuation for the Second Regulatory Period.

Figure 1 – Supplemental Information to Comment 54

Comparison of ARR and MAR for Second Regulatory Period

