

Article	Section Title	Comments	Response by ERC Staff / Consultant
1.3	Definition of the term "Customer"	The definition proposed by ERC seems to limit the customer of TransCo to load customers. It is now a practice that transmission companies charge connection charges to generators to provide investment location signals. The definition of ERC seem to rule out connection charges, and refrain TransCo from a billing structure which would not appear consistent with the principles established in the EPIRA. We suggest that the Commission considers TransCo's proposed definition on Transmission Customer: <u>Any party purchasing and/or receiving any services from the Transmission Provider or System Operator (including, for the avoidance of doubt, customers taking service without an existing contract).</u>	Connection assets may become contestable in the future. Connection assets are not shared assets but dedicated to one customer. Charges for these assets should go to the customer using them.
1.3	Definition of "Regulated transmission services"	Since ancillary services are provided by generators who are free to compete, how can the price of ancillary services be regulated? ERC-approved Ancillary service rate may be viewed as too low and it might happen that no generator would offer their ancillary services at that price? Will the system be left with no reserves, no capacity for frequency regulation, and without capacity for load following ancillary services? Presently, ancillary service is not considered as revenue of TransCo but merely a pass-through item. TransCo merely serves as a collector of the service provider. It is suggested that Ancillary Services should be regulated using another form of regime. It has been observed that there is no mention of the Connection Charges which TransCo includes in its Terms & Conditions.	Only Transco owned equipment which provides ancilliary services shall be included under the guidelines (eg: static VAR compensators, capacity banks). Transco should clarify whether or not it owns equipment which provides ancilliary services, and whether or not this equipment is in the current regulated asset base.
1.3	Definition of "Force Majeure (FM) Event and Permitted Force Majeure Pass Through Amount	This does not explicitly provide for 'change in law' as a Force Majeure Event, though the definition of Permitted FM Pass Through Amount provides for increased cost incurred... Should the 'change in ERC guidelines' be considered as part of (b) or 'change in law'	Comment noted.
1.3	Definition of Trigger Condition	The word 'formula' used in the definition should mean the complete formula for the Maximum Revenue cap, to include the letters designation, numbers, constants and functions.	No response.
1.3	Definition of Application Year	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. The words (calculation, historical, forecast, etc.) are used throughout the Guidelines with their normal meanings and there is some risk of confusion.	Document shall be reviewed by legal team before ERC final approval.

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1.3	Definition of Customer	We recommend that this definition be amended to limit its application to the Regulated Transmission Services which are the subject of these Guidelines. 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.	Comments noted.
1.3	Definition of Force Majeure	We suggest that "change in law" be mentioned more clearly in the definition of Force Majeure Event, perhaps as a sub-paragraph (c) . The definition of "Permitted FM Pass Through Amount" could then be simplified accordingly.	Comments noted.
1.3	Definition of Regulated Entity	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. 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.	The guidelines regulate the revenue and rates for the provision of regulated transmission services. How these regulated revenues are divided between the Transco and the Concessionaire is a matter for these parties under contract.
		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.	Comment noted, see row 9.
1.3	Definition of Regulated Transmission Services	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.	Comment noted, see row 3.
		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.	Comment noted, see row 3.

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		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 endless debate if forecast Ancillary Services must be included as an opex item in the building block because the cost and quantity are so uncertain, especially while the generation sector is being restructured.	Comment noted, see row 3.
		The EPIRA does not include regulation of Ancillary service within wheeling rates in Sec.43(f). ERC regulation of ancillary services charges is provided in Sec.43(i). While Sec.19 of the Act requires ERC approval of "transmission charges", Sec. 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.	PSALM to elaborate on what section of the Act contemplates treatment of ancillary services specifically as "excluded services". Also what section of the Act governs the rates for excluded services until a market mechanism is effectively in place.
		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).	Comment noted, see row 14.
		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: (a)transmission use of system (network service), (b) sub-transmission use of system (network service), (c) system operations, (d) ancillary services (we recommend that these be excluded services).	PSALM to elaborate on what services it believes should be covered by the guidelines, and where / how rates of remaining services should be regulated.
		Accordingly, we understand that the Guidelines do not prescribe the method of regulation for the following activities: (a) market operations (which are covered by the WESM Rules and are an excluded service), (b) new connections (which are covered by the OATS and are excluded services), (c) related businesses, such as maintenance conducted for generators as a contestable service.	Comment noted, see row 16.
1.3	Definition of Trigger Condition	For clarity, the definition should explain whether a 'change in the formula' refers to: (a) a change in algebraic formula, (b) a change in numbers used in the formula, (c) or a change in the algebraic formula and / or a change in the numbers. 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.	Comment noted.
1.4.1	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.	Normal legislative hierarchy suggests WESM Rules takes precedent over guidelines and the OATS. The ERC shall strive for consistency between the guidelines and OATS which are eventually approved.
1.4.2	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 pf Pmillion, x,xxx,000 for Pmillion, or some other rounding.	Comment noted.

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2.2	Conclusion of First Regulatory Period	This gives no room for TransCo to petition for new rates using the new methodology until December 2005. It should be noted that recently approved TransCo tariff does not "mirror" the revenue of the transmission business during the first regulatory period, simply because the approved rates were based on undervalued or reduced values of assets, unreasonable disallowance of expenses, reduced working capital and other issues that we believe are still contestable. We also believe that this is not reflective of the true cost of transmission. It has to be considered that, to date, the transmission facilities of NPC have not been transferred to TransCo. The assets have not been completely identified and properly valued. Per guidelines, TransCo is not yet given the right to petition ERC for the early termination of the First Regulatory Period, and cannot petition ERC for new tariffs adjustments. In the event a Concession is not awarded during the first regulatory period, TransCo should be allowed to petition for new tariff adjustment using the new methodology.	Comment 1: A filed motion for reconsideration lead to the ERC's unbundled rates decision of September 20, 2002. A chance to file an appeal to the courts existed but was not taken up. This opportunity has now passed. Comment 2: Request for allowance for Transco to access an early regulatory reset under the new rate setting regime is noted. Comment 3: Regulated Entity's rates shall be adjusted for 2004 using mechanism in Articles III (ie: CPI) and VI of the guideline.
2.2.1	Conclusion of First Regulatory Period	The June 2003 is too short a time, we don't foresee an awarding of the concession on or before this date, more so in the absence of the Franchise Bill. Even if the Franchise Bill is approved between before June 2003, it would still be limiting to award the Concession before June 2003. And in the event the nature of the concession is limited to Maintenance and Expansion, wherein the operation of the grid is left with the TransCo, TransCo should be allowed to request for the early termination or extension of the first regulatory period.	Request for allowance for Transco to access the provisions for an early termination or extension of the first regulatory period is noted.
2.2, 2.3	Early termination of Interim Period	We recommend that the contents of Sec.2.2 and 2.3 be re-grouped as follows in the interest of clarity, with amendments to the substance as: 2.2.1 Subject to paragraphs 2.2.2 and 2.2.3, the First Regulatory Period will end 31 December 2005 2.2.2 The First Regulatory Period might end prior to 31 December 2005 [state the conditions] 2.2.3 The First Regulatory Period might end after 31 December 2005 [state the conditions]	Comment noted.
		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.	Comment noted, see rows 21 & 22.
		The proposed deadline for an early termination request is extremely tight, although we recognize the need for adequate time for the Regulatory Reset process.	Comment noted.
		The Guideline 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.	Comment noted.

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2.3.2	Extension of First Regulatory Period	We recommend that $X=0$ throughout the First Regulatory Period, even if such is extended to all or part of 2006. 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 / 1997 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.	Regulated Entity's rates shall be adjusted for 2004 using mechanism in Articles III (ie: CPI) and VI of the guideline. Comment otherwise noted.
2.3.2	Extension of First Regulatory Period	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?	The effects on the X factor shall be compounded.
2.5.1	Subsequent Regulatory Periods	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)	The choice of the duration of the subsequent regulatory periods shall be one of the three options at the discretion of the ERC at that time (ie: 2010).
2.5.1	Subsequent Regulatory Periods	The parameters for determining the duration of regulatory periods are not clear. Since the regulatory period will last for three to five years, there must be a mechanism for unplanned projects to be carried out in the middle of regulatory period and how these can be factored in the rates.	There is nothing stopping the Regulated Entity from changing the priority of its approved capex program should a planned or unplanned project or higher priority arise. Regulatory oversight shall be required during the subsequent regulatory reset process before the assets are included in the regulatory asset base. Risk of exclusion would appear to be higher for an unplanned project. Otherwise unplanned projects are covered by the scope of the force majeure provisions (see Article X) or the excess demand provisions (see Section 12.2).
2.5.1	Subsequent Regulatory Periods	Three years is too short, we suggest a minimum of four (4) years.	Comment noted.

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2.5.1	Subsequent Regulatory Periods	<p>We recommend that each Subsequent Regulatory Period be at least 5 years in duration. We recommend also that the end of a Regulatory Period not be linked to the expiration or termination of the Concession contract. 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.E36</p> <p>The Concession contract envisages that, in the event of termination, an independent valuation of the business (whichm 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>	Comments noted.
2.5.1	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>	Comment noted.
Article II	Subsequent Regulatory Periods	<p>CK/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>	Comment noted.
3	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>	Comment noted.
3.1	General Price Control Principles	<p>The proposed methodology for setting Transmission Wheeling Rates calls for the use of Revenue Caps instead of Price Caps. Though both price and revenue caps are the most comprehensive mechanisms for PBR. Revenue caps do not, however, correct distortions in price signals under COS. Revenue caps can also seriously hamper the utility's ability to expand sales and compete effectively in contestable market. An increase in demand/consumption - factors not within the control of the utility - will ultimately translate into more revenues. Thus, the use of Revenue Caps may be disadvantageous to the utility.</p>	The guideline specifies a revenue cap for the purposes of regulation of transmission wheeling rates. It makes no comment on and has no provisions relating to distribution wheeling rates.
		<p>On the other hand, with Price caps, as demand/consumption grows, revenues increase while the price remains the same, giving the utility a better opportunity to cover costs and earn a reasonable return. With Price caps, the benefits and risks can be shared between the utility and its customers to ensure mutual welfare and prevent windfall gains. Price caps make it possible for utilities to compete more effectively by using pricing strategies to retain existing loads and expand sales to new contestable markets.</p>	Comment noted, see row 36.

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3.1.1	General Price Control Principles	In the particular case of TRANSCO, the ERC should heed the Consultants' recommendation to examine the base rate or the maximum transmission wheeling rates as set by the ERC Order of September 20, 2002 in ERC Case No. 2001-90, considering that the RORb (set at 12.38%) is beyond the maximum allowable return considered fair and reasonable in this jurisdiction. There was also a cursory examination of the composition and valuation of the assets as well as the operating and maintenance expenses. This will result in relatively high transmission wheeling rates as well as Ancillary Charges which might encourage the bypass of transmission system.	The ERC's order of September 20, 2002 was based on 12% RORB. Comments otherwise noted.
3.1.2	General Price Control Principles	What will be the based year in determining Maximum allowed Revenue? Year 2002?	The base year is 2003.
3.1.2	General Price Control Principles	How would the utility account of other costs over which a regulated company had no control like for example the Currency Exchange Rate Adjustment.	The FOREX adjustment shall continue while the rates set by the ERC's order of September 20, 2002 apply, subject to the base year for exchange rate measurement being the base year for the order. Once the provisions of Article III and VI are applied, the external FOREX adjustment shall cease. The automatic CPI adjustment compensates for, amongst other things, the exchange rate changes to the extent that these exchange rate changes effect the changes in general prices within the Philippines.
3.2.1	Price Control Formula	Calculation of the appropriate initial level of revenue (MAR). The revenue cap should clearly define the components of Maximum allowed revenue and set at a level that includes the ordinary revenue requirement of the transmission company plus the estimated costs of congestion, including losses. The cost of congestion and losses would also need to be made the responsibility of the transmission utility. In this way, the cost of all transmission investment and alternatives would be internalized. With this, PBR structure, the transmission utility will have an incentive to address transmission constraint and its associated congestion costs in the most cost-effective manner.	The WESM Rules determine the level of responsibility the Regulated Entity has for congestion and line losses. The AMRt-1 term in Section 3.4, 4.3 and 5.3 provides the mechanism by which the net revenues derived by the Regulated Entity under the WESM Rules are included under the revenue cap. Comments otherwise noted.

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		<p>Could X be positive if Transmission Company is expected to operate more efficiently in the future? Or negative if efficiency declines as expected?</p>	<p>X could be either positive or negative. The value results from the calculations under Article IV, and the X factor outcome is a balance of efficiency improvements in opex and capex required by the ERC, and the growth in peak demand which dictates the expenditure level required to accommodate growth of the transmission network.</p>
3.2	Price Control Formula	<p>ERC should review, evaluate and confirm this figure, and we suggest that when the Financial figures of CY 2002 become final and available ERC should glimpse the initial year financial operation of TransCo. ERC should use the most up to date information when setting the revenue requirement for the first regulatory period. The P20.198Million is a figure which was derived simply by multiplying the 2003 demand forecast, per grid to the ERC approved transmission delivery charge (per grid). This does not include revenue from the following services: System Operation Charge, Supply and Metering Charge, Connection Charge and Subtransmission charge. Also, TransCo's Demand Forecast should be reviewed and updated.</p> <p>In the calculation of the maximum Annual Revenue (MAR) certainly the system loss should be considered in the computation. If the Commission will consider this in the determination of the MARt the derived revenue will be greater than the P20.198Bn. Should the demand and the corresponding revenue forecast be the same with those data submitted to the Department of Budget and Management for 2003? We maintain our position that the Ancillary Services Charges are not revenue of TransCo for several reasons. (see NTC's comments on Regulated Transmission Services)</p>	<p>The base year is 2003. As indicated the P20,198Million is a figure which was derived simply by multiplying the 2003 demand forecast (using HESI independent consultant's forecasts), per grid to the ERC approved transmission delivery charge per grid. This starting number needs to match the forecast revenues for the base year from all of the services to be covered by the guidelines. Currently the available number does not match the services covered. The Regulated Entity has been asked in writing to provide the data required, a proposed calculation and a justification for this calculation so that the ERC can determine this starting number. Transco is requested to elaborate on when its reposnse shall be available.</p> <p>Comment noted, see row 43.</p>
3.2	Price Control Formula	<p>The MAR to be fixed by the ERC for the First Regulatory Period should allow a just and reasonable RORB.</p>	<p>The guidelines specify an incentive based revenue cap methodology, not an RORB methodology.</p>
		<p>The "starting point" of the PBR is very critical. The starting revenues to be earned by the utility must be sufficient to cover its costs and at the same time earn a reasonable return for first year of the PBR period. If at the start revenues are low, then this may distort the necessary investments needed by the utility to operate viably.</p>	<p>Comment noted, see row 43.</p>
		<p>To leap towards PBR, it cannot be over emphasized enough that at the very beginning, the utility must be allowed to earn a just and reasonable return otherwise the industry will be shifting to PBR on the wrong foot negating any benefits the PBR aim to give the various stakeholders.</p>	<p>Comment noted, see row 43.</p>
3.2	Price Control Formula	<p>The guidelines recommends an immediate shift to the Optimized Replacement Cost Approach, if the concessionaire comes in late in the year 2004, it will not have enough time to revalue its assets in accordance with Sec.4.6.7. How could this be addressed? Unless TransCo is allowed to have its assets revalued now, it might meet the required dates in the guidelines. However, TransCo is advised not to revalue its assets and besides it does not have budget for such activity.</p>	<p>Comment noted, see row 22.</p>

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3.2	Price Control Formula	On the so-called MAR of PhP 20.198 Million, where did this number come from? What is the basis?	Comment noted, see row 43.
3.2.1	Price Control Formula	MAR to be fixed by the ERC for the First Regulatory Period should allow a just and reasonable RORB. The starting point of the PBR is very critical. The starting revenues to be earned by the regulated entity must be sufficient to cover its costs and at the same time earn a reasonable return for the first year of the PBR period. If at the start revenues are too low, then this may distort the necessary investments needed by regulated entity to operate viably. On the other hand, if revenues are set too high it may result to excess earnings. Again, to take the leap towards PBR, it cannot be over emphasized enough that at the very beginning, the regulated entity MUST be allowed to earn a just and reasonable return otherwise the industry will be shifting to PBR on the wrong foot negating any benefits PBR aims to give to various stakeholders.	Comment noted, see rows 43 and 45.
3.2.1	Price Control Formula	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. 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.	Comment noted, see rows 43 and 45.
3.2.1	Price Control Formula	On MART-1, should it be worded such that MART-1 will be a value as confirmed & approved by the ERC instead of putting in a value in the guidelines? Will the MART-1 value be subject to public consultation or will ERC decide on the matter without presenting the computation to the public? What is the spirit behind X being equal to zero for the duration of the Regulatory Period?	<p>Comment 1: The provisions on Articles III and VI are to be applied in the 4th quarter of 2003 to set rates for 2004. Delay in the provision of the information on the base year requested under row 43 may jeopardize the timely setting of rates for 2004. Comment 2: During 2003 the costs for setting up the Transco are likely to be higher than the normal running of the business, and as such there is likely to be strong internal pressure on improved cost efficiency to assist with the funding for such changes, even when the X factor is set to zero. Such efficiency improvements will be subject to scrutiny under the regulatory reset for the second regulatory period. Comment otherwise noted.</p>
3.2.1	Price Control Formula	For clarity, we suggest that the formula be expressed as follows: $MAR_t = MAR_{t-1} \times (1 + \text{Inflation}_t - X) - K_t$ We also suggest that the footnote reference 1 be attached to the preceding text rather than to the formula.	No response.

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3.2.1	Price Control Formula	<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 MART-1 for the second year of the First Regulatory Period. This determination will be particularly difficult if Ancillary Services are included in MART-1, and this is one reason why we recommend that Ancillary Services be excluded.</p> <p>An appropriate value for MART-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>Comment noted, see rows 3, 14 & 43.</p>
		<p>The parameters in the price control formula (i.e. the MART-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 MART-1 in the context of the formula proposed in the guidelines.</p> <p>If the value for MART-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>PSALM to elaborate on (1) the demand alternative mentioned here, and (2) the price cap alternative mentioned in the row below (row 56), and provide comment on why it believes either alternative is preferable.</p>
		<p>Alternatively, to avoid the need to determine the starting value for MART-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> $p_1 = p_{t-1} \times (1 + \text{Inflation}_t - X)$ <p>where:</p> <p>p_t is the allowable tariff in the Relevant Year 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 MART-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>	<p>Comment noted, see row above (row 55).</p>
3.2.1 , 4.2.1	Price Control Formula	<p>What is the basis of ACR (actual revenue derived from customers for the provision of Transmission Services)? How is it calculated?</p>	<p>This information needs to be provided from the Transco's financial accounting systems. While the data is needed to be used in a timely manner to implement Article VI, the data should be from systems which are ultimately auditable.</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>This information needs to be provided from the Transco's financial accounting systems. While the data is needed to be used in a timely manner to implement Article VI, the data should be from systems which are ultimately auditable.</p>

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		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.	The ERC does not want to encourage the Regulated Entity to excessively over recover its revenue cap. This could occur if the Regulated Entity forecasts of non-coincident peak demand are low during the annual rate adjustment process, which has the effect of boosting the adjusted rates for each customer segment in the following year. Comments otherwise noted.
3.2.1	Maximum Annual Revenue Cap	Limits the revenue potential of the utility to MAR and provides no opportunity for additional income; additional income if any must be given back per K (over or under recovery) What about income (non-electricity related income) from utilization of transmission assets such as equipment rental, other services, etc.? What is the motivation for the utility to maximize revenue if none or E6it may be retained?	The revenue cap is an incentive based approach which should encourage the minimization of costs to improve profitability under the cap. Such cost efficiency improvements are retained by the Regulated Entity for a period of time (see Article IX) which are then passed on to customer through lower prices.
3.2, 4.2	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 Sec.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.	Comment on base year revenue noted, see row 43. MERALCO requested to clarify what the second sentence means and to what tax change event materiality criteria it is referring.
3	Change in CPI	The theory behind the use of the "CPI-X" is that a regulated company must be allowed to recover inflationary increases in its input costs, but should not receive additional benefit from productivity improvements that result in lower operating costs which also offset inflationary increases in input costs. This formula directly limits the total amount of revenue a company can receive.	Comment noted, see row 60.
3.3	Change in CPI	The use of the Consumer Price Index (CPI) in the rate methodology may not be responsive to the actual movements in the market due to the lag time inherent in the said index. We seek clarification on the application of the CPI on the overall methodology.	The lag between the CPI and the time in which adjusted rates are applicable is there so that the need to forecast CPI on a yearly basis is eliminated. The danger is that the use of inappropriate forecasts may lead to unnecessary increases in rates and to excessive over recovery of revenue above the cap. It is noted that the CPI adjustment lag of approximately one year compares favourably to the outcomes experienced under decisions using and RORB methodology.
3.3	Change in CPI	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?	The CPI is the most objective escalation factor available which can be obtained from a source which is independent of the electricity industry.
3.3	Change in CPI	We request that the Commission spell out the method of calculating It. In addition, is it necessary to use CPI per quarter - can the Commission simplify the calculation to refer to the change in the CPI.	Refer Section 3.3. The calculation is based on a quarterly year-on-year average of the CPI measured. This technique partially captures spikes and troughs in the CPI data, but eliminates wild (and sometimes excessive) changes which might otherwise be captured in point-to-point measures of CPI. This appears to be a better balance between rate stability and cost relief.
3.3.1	Change in CPI	Why did the "Calendar Year" computed on ending on September 3rd quarter?	Three months is considered to be the minimum time required to undertake the rate adjustment under Article VI. Refer also to row 63.

Article	Section Title	Comments	Response by ERC Staff / Consultant
3.4	Over / Under Recovery Formula	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.	Comment noted, see row 60.
3.4.1	Over / Under Recovery Formula	What is the basis for the reward mechanism of 4%?	This level should provide an incentive for the Regulated Entity to not over recover its revenue cap. Comment noted, see row 59.
3.4.1	Over/Under Recovery Formula	Over/under recovery formula has to be explained further. On variable i_t , what is the basis of plus 4% and why the period is October 1 to September 30. Are the assumptions realistic to Philippine situation?	Comment on 4% noted, see rows 59, 68 and 74. Lagged data on CPI is available within a three month period within the Philippines. Averaging calculation under section 3.3 of the guidelines provides some CPI smoothing.
3.4	Over / Under Recovery Formula	In given formula to calculate the correction factor for Regulated Year(KT), AMR_{t-1} is defined as "the actual net revenue derived..." There is no clear indication as to what adjustment factors are to be considered to derive the "net revenue".	Refer to clause 3.13.15.1 of the WESM which describes the calculation required. The "net" is as a result of the (a) minus (b) in this clause. Comment otherwise noted.
3.4	Over / Under Recovery Formula	It would be appreciated if the Guidelines will expressly provide if these are calculated on a cash or accrual basis.	Transco to elaborate on whether or not its financial accounting systems are on a cash or accrual basis.
3.4, 4.3	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.	Comment on 4% noted, see row 59, 68 and 74. The preference is to use a liquid market-based instrument as a basis for setting the time-value-of-money adjustment. In principle a Philippines liquid market-based instrument with closest to 12 months duration should be considered.
3.4.1	Over/Under Recovery Formula	Why should there be a penalty of 4% for over recovery? The ARR and the Maximum Transmission Rates for the year are determined by the ERC, which are based on the proposed Rate Setting Guidelines (Article 6.2.1), or are determined by the ERC if the utility fails to submit its proposed rates within the timelines set. Therefore, if the ARR and the transmission rates are determined or set by the ERC, then why penalize the utility if the same ARR and rates will result to an over recovery?	Comment on 4% noted, see row 59, 68 and 74. Comment noted that if ERC are forced to set rates under 6.2.1 then penalty for over recovery appears severe. Also note that an incentive for the Regulated Entity not to provide data in order to side-step over recovery penalty by forcing the ERC to set rates is of concern.
		If the over recovery will be driven by an increase in demand/consumption, why penalize the utility? The growth in demand is not within the control of the utility.	While the actual demand growth measured in the market is outside the control of the Regulated Entity, the forecast of this demand growth is provided by the Regulated Entity. This forecast is required under the annual rate adjustment process under Article VI of the guidelines. Comment otherwise noted.

Article	Section Title	Comments	Response by ERC Staff / Consultant
3.4.1	Over / Under Recovery Formula	In the calculation of the allowable interest rate, why is there a plus 4%? In the case where (ATRt-1 - MART-1) being equal to zero, could it be worded such that the value of the interest rate is not important and need not be calculated since for any value of the interest rate, Kt will still be zero?	Comment on 4% noted, see row 59, 68 and 74. Comments otherwise noted.
3.4.1	Over / Under Recovery Formula	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. 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. 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.	Comments noted.
		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).	No response.
3.4.1, 4.3.1		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.	PSALM is requested to elaborate on alternative mechanisms to ensure the Regulated Entity is incentivised to reduce line congestion and line loss, while ensuring it cannot exploit its monopoly power as the regulated transmission service provider, and recognizing the conflict of interest which exists between the transmission service provider and the system operator. Can PSALM elaborate on where in the WESM Rules such consideration has been addressed.
		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). 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.	Comment on invoiced amount noted. It is noted that the definition and inclusion of working capital in the building block analysis covers the issue of delayed payments from customers. PSALM is requested to elaborate on how it suggests bad debts might be considered under a revenue cap when volume adjustment is under the annual rate adjustment occurs under a separate process.

Article	Section Title	Comments	Response by ERC Staff / Consultant
3.4.1, 4.3.1		<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>	<p>Comment on 2% over recovery penalty noted. Comments otherwise noted.</p>
3.5	Grid Performance Information	<p>For clarity, this statement might be better placed at the start of Article III or Article VIII.</p>	<p>No response.</p>
4	Second Regulatory Period	<p>The proposal calls for forecasting each year in the Regulatory Period and calculating what the revenues should be collected under optimal conditions. This prudent review is tantamount to ERC micro-managing the transmission owner, and will give additional workload to ERC.</p>	<p>Only calculating revenue once every regulatory period, notionally once every 5 years. The price is set every year.</p>
4	Second Regulatory Period	<p>For clarity, the Guidelines should explain the relationship between ARR and MAR, how MART-1 will be set, and how rates will be derived from MART, MART+1, etc. This might be achieved through the provision of a Glossary as suggested in PSALM's first General Comment.</p>	<p>Comment noted.</p>
4.2.1	Price Control Formula	<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 PSALM's comment on Sec.3.4.1-Definition of ATR_{t-1}.</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>	<p>Comment noted.</p>
4.2.1		<p>For clarity, the Guidelines should state that the X factor can be either a negative or positive value.</p>	<p>Comment noted, see row 42.</p>

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.3.1	Over/Under Recovery Formula	Why should there be a penalty of 4% for over recoveries? The ARR and the maximum transmission rates for the year are determined by the ERC, based on the proposed rate setting guidelines (Section 6.2.1), or are determined by the ERC if the regulatory entity fails to submit its proposed rates within the timelines set (Section 6.2). Therefore, if the ARR and the transmission rates are determined/set by the ERC, then why is regulated entity penalized if the same ARR and rates result to an over recovery? If the over recovery is driven by an increase in demand, is the regulated entity also penalized? The growth in demand is not within the control of the regulated entity so why is it penalized?	Comment on 4% noted, see row 59, 68 and 74. Comments otherwise noted.
4.4	General Building Blocks	Does the draft Guidelines call for forecasting each year in the Regulatory Period and calculating what the revenues should be collected under optimal conditions? This so called prudence review may be a waste of time and resources. The purpose of the formula should enable the ERC to avoid the unnecessary burden of micro-managing the transmission owner.	Article VI is needed for ERC to meet its responsibility to approve rates before they are applied to customers. Forecast information is required for rate approval.
4.4.1 (a)	General Building Block Principle	As TRANSCO is a regulated activity, the context / meaning of the phrase (a) is not clear and should be clarified.	Market forces should be used whenever possible. This principle should reflect this principle.
4.4.1	General building Block Principle	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.	No subsidies are applied to the Regulated Entity under Rule 18 of the IRR regarding the Universal Charge. Could CK-HEI elaborate on their comments.
4.4.1	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 reasonable recovery of costs, rather than the recovery of reasonable costs.)	Comment noted.
4.4.1	General Building Block Principle	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.	Comment noted.
4.4.1		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. For clarity, the Guidelines should provide further clarification on what is meant by the phrase "above average expenditure on upgrades ...".	Comment on concession contract noted. "Above average expenditure on upgrades .." means the opex and/or capex is significantly below the average for the previous regulatory year, taking into account the changes in forecast growth for the last regulatory period.

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.4.3	General Building Block Principle	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. 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.	Comment noted.
4.4.5	Determination of ARR_t	We recommend that this paragraph be amended to state that the ERC must ensure that its decisions on ARR_t do not under or over compensate for the risks of the electricity transmission business. 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.	Comment noted.
4	Primary Building Blocks	The Annual Revenue Requirement (ARR_t) computation to be applied for the Second and Subsequent Regulatory Period included estimated corporate income tax. Does this provision implies that initial level of revenue also includes corporate income tax to be consistent with the definition?	Comment noted.
		The Working Capital (WC_t) is set at thirty (30) days forecast revenue, but may be changed by ERC. There should be a fixed policy on determining the Working Capital as it may affect revenue requirement.	DALIGHT to elaborate on what they would propose as a policy position.
		Weighted Average Cost of Capital and its components should be studied further, again, are the assumptions used applicable to Philippine Setting? Consultants used Australian and American scenarios. This should be clearly defined and fixed by ERC for consistency as this would increase the level of regulatory risk in the future.	Formulas are standard for finance industry. DALIGHT to elaborate on what parts of Section 4.9 are not clear. Input parameters are to be determined during the regulatory reset process before the second and third regulatory periods.
4.5	Primary Building Blocks	We propose the exclusion of "corporate income tax" from the Annual Revenue Requirement (ARR) to be consistent with the Ruling of the then Energy Regulatory Board (ERB) disallowing income tax as part of the operating expenses of Manila Electric Company. Said Ruling was upheld by the Supreme Court in its Order of November 2002.	
4.5, 4.5.7	Primary Building Blocks, Formula for ARR_t	We surmised that ERC now considers a post-tax approach and considers income tax as part of the operating expense. May we be clarified on the formula of ARR_t , as we read it, we see an apparent mixture of real and nominal terms. Does the regulated depreciation considered in the formula pertain to revalued assets including revaluation increment?	The guidelines do not say taxes are part of operating expenses (refer Section 4.11.1). The components of the ARR are all nominal except the depreciation component which is real. The depreciation includes depreciation of the revaluation increment for the purposes of ARR calculation (refer XX), but excludes it for calculation of the corporate income tax (refer xy).

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.5.7	Formula for ARR_t	For clarity, we suggest that certain subscripts be amended. Subscript c: in Taxc,t refers to corporate (might be replaced with p or □ for profit), in WACCc refers to classical (subscript might be omitted), and in RABci, refers to closing (para 4.7.2) "i" or subscript i (in various sections): 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	Comment noted.
4.5.7	Definition of RAB	For clarity, the Guidelines should provide further clarification on what is included within the Regulatory Asset Base.	Comment noted.
4.5.7	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.	Comment noted.
4.5.7	Primary Building Blocks	What is the basis for fixing the working capital at 30 days? Shouldn't this be based on the actual industry collection performance or actual cash turnover? Philippine jurisprudence has fixed working capital at 60 days.	Working capital allowance of 30 days appears liberal give Regulated Entity only needs to deal with other corporate entities, so the lead-lag allowance does not have to too large. Use of actual data is inappropriate and provides no incentive for improvement. The guidelines set up a new rate setting methodology which ERC is allowed to do under the law.
4.5.7	Primary Building Blocks	What is the basis for fixing Working Capital at 30 days? Shouldn't this be based on the actual industry collection performance or actual cash turnover? Philippine jurisprudence has fixed working capital at 60 days, why the sudden shift to 30 days? There are no discussions on the items to be included in the allowance for working capital.	Comment noted, see row above.
4.5.7	Primary Building Blocks	It seems that income tax paid the previous year is being deferred to the succeeding year. If so, then there is a deferral in the recovery of income tax payments since the income taxes included in the ARR are based on the previous year taxes. In view of this, there are carrying charges that the regulated entity must be allowed to recover.	The tax payments are lagged one year and so are the regulated revenues. PEPOA to elaborate on why it believes there is a carrying charge.
4.6.1	Asset Valuation	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).	The promulgation of the guidelines significantly reduces the risk to potential concessionaires because the approach to asset re-valuation is clearly indicated (refer 4.6). As such the risks to the bidders in getting it their own estimates of the asset value wrong are significantly reduced. Differences between what the Regulated Entity submits and what the ERC approves are possible.
		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.	There is insufficient time for a revaluation to occur and to be considered by the ERC, an independent regulator, before the bidding deadline required by Government occurs.

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.6.2	Asset Valuation	This is like preserving the traditional method of asset valuation used in the Philippines.	Comment noted.
4.6.2	Asset Valuation	In what instances should the ERC must require instead of simply may require ?	Comment noted, need to review for consistency of use.
4.6.2	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.	If the Regulated Entity is willing to accept the output from an independent expert approved by the ERC, then only one independent expert need be retained. ERC must be comfortable that the advice it is receiving is independent. Comment otherwise noted.
4.6.3	Revaluation Methodology	<p>We recommend that the Guidelines specify current cost methodology or simple replacement cost for the Initial Re-valuation. 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>	<p>Comment 1: Methodology preference noted, elaborate on why current cost is preferred over optimised replacement replacement cost, and why latter should be deferred. Comment 2 : Comment noted. Comment 3: Comment noted, elaborate on what date is suggested.</p>
4.6.5, 4.6.6	Asset Revaluation	In effect, exclude value of excess capacity or redundancy in the revaluation of assets? How does excluding excess capacity from regulatory asset base reconcile with the need to ensure SERVICE RELIABILITY? If intent is to safeguard against over-building of installed capacity, we expect application to be prospective; this principle may eventually be applied on the planned acquisition of some redundant NPC sub-transmission assets by distribution utilities.	Application in other jurisdictions ensures that reasonable network capacity and redundancy are included within the regulatory asset base such that the service reliability and performance targets are achievable, and that a reasonable planning horizon can be accommodated with the allowed excess network capacity and redundancy. The guidelines may need clarification in this regard. Comment otherwise noted.

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.6.5	Asset Revaluation	It must be noted that the regulated entity has/will put in additional investments for compliance with the performance standards set up by the ERC. If these investments are to be approved by ERC, what assurance can the regulated entity get that the same asset/investments will not be classified as excess capacity or over redundancy? This is equally important when there are significant drop in demand AFTER the investments have been put in place. In section 4.6.5, is the averaging of economic life to be done for each group (a to e) or for each sub-group within the group? We suggest that the averaging be done for each sub-group.	Comment 1: PEPOA to elaborate on its alternative arrangements for the treatment of existing asset base. Comment 2: Aged that weighted average age must be done at the sub-category level (eg: at 4.6.5 (a)(l) towers and associated lines, etc). Wording needs attention.
4.6.6			PEPOA to elaborate on their comments.
4.6.6(b)	Network Planning Horizon	We recommend that the network planning horizon be extended beyond 10 years, given the length of the planning, design and investment periods. 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.	Comment noted. PSALM to elaborate why 20 years is preferred.
4.6.6(c)	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.	Section 4.6.6 indicates the independent expert will assist with a review of the level of spares during the reset period for the second regulatory reset. The level of spares and their treatment is related to the service reliability and performance and should be an item of critical importance to the Regulated Entity. The Regulated Entity should be responsible for setting the level of spares and for justifying this to the ERC. No prior guidelines are envisaged under Section 4.6.8(c). Note words in Section 4.7.2 indicate spares are only to be depreciated once they enter service with the implication that if their remaining life is shorter, they should be depreciated at a faster rate.
4.6.8	Asset Valuation	Will the Commission define what it meant of 'reasonable quantities' of spares? Will the Commission provide a guideline on this? And when? Please allow us to inform the Commission, that to date not all easements are documented. We suggest that this be modified (RAB for the Second RP) to recognize the real situation.	Comment 1: These words are to guide the independent expert as much as to guide the ERC. Such decision shall be made with the input of the independent expert at the time of the regulatory reset for the first regulatory period. No prior guidelines on spares are envisaged. Comment 2: Section 4.8.8(d) provides that only those easements which are documents shall be included in the asset base which is to be reviewed by the ERC and the independent expert for inclusion in the RAB. PSALM to elaborate on its concerns. Comments otherwise noted.
4.6.8	Asset Valuation	Will there be specific guidelines that the Commission will provide for the calculation method? Or will the Commission require the regulated entity to submit a calculation method for its approval?	Section 4.6.10 provides the guidance on CWIP. During the regulatory reset the Regulated Entity should submit a calculation method to the ERC for approval meeting the requirements of Section 4.6.10.

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.6.10	Asset Valuation	<p>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 end</p>	<p>DECORP to elaborate on its perceptions of the difference between CWIP and "plant investment ... for new construction". Omission of CWIP on capex in Section 4.10 is noted. Comment otherwise noted.</p>
4.6.10	Construction Work in Progress	<p>Construction Work in Progress (CWIP) should be included in the Rate Base. In addition, plant investment should be handled through a separate allowance established for new construction. Those new construction investments would then go into Rate Base each year, thus increasing allowed revenues independently of the PBR.</p>	<p>Comment noted, see row above (ie: 119).</p>
		<p>In the next year that new construction portion of the revenue requirement would be escalated should be part of the formula. The 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.</p>	<p>Comment noted, see row above (ie: 119).</p>
		<p>If investment is not handled in this fashion, the transmission owner will have little incentive to make the necessary capital investments relieve congestion points in the transmission system, thus frustrating the development of wholesale 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 of the PBR.</p>	<p>Comment noted, see row above (ie: 119).</p>
4.6.10	Construction Work in Progress	<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. 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. 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>	<p>If CWIP is added to a forecast capex for a project of "major importance" which does not then go ahead, both the forecast capex and its associated CWIP shall be removed from the revenue cap under Section 12.8.1. Words shall be altered to make this clear. Comments otherwise noted, see row 119.</p>

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.7	Formula for RAB_t	<p>We recommend that the formula for RAB_t be modified to read as follows: $RAB_t = (RAB_{o,t} + RAB_{c,t}) / 2$</p> <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>	Comment noted.
4.7.1	Regulatory Asset Base	Regulatory Asset Base also includes forecast capital expenditure, of the regulated entity as approved by ERC.	DALIGHT to elaborate on the issue it is raising or the clarification it requires.
4.8.1	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.	Data usually derived during asset re-valuation and the method used for re-valuation to a depreciated value usually determines in what form the end data can be delivered. PSALM to elaborate on why data derived from the one source might disagree.
4.9.1	WACC Determination	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)	Comment noted.
4.9.1, 4.9.3	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.	Comment noted.
4.9	WACC Determination	Does ERC have the needed information, skills and expertise to come up with estimates for WACC computation w/c are risk-free, interest rates, debt margin, equity Beta, long term ave. return to investors (MRP)? Will they be unilaterally determined by ERC or through consultations with the regulatory entity, especially if the entity is not publicly traded? Why must the debt-equity ratio of the regulated entity be pegged at 60:40? What is the basis for such ratio? Is there historical evidence that the WACC for the transmission business in the Philippines will not change for the entire five years of the Second Regulatory Period?	<p>Comment 1: Section 14.1.1(f) allows the ERC to seek independent expert advice on the WACC. The guidelines shall be clarified in Section 4.9 such that the ERC is encouraged to seek such independent expert advice. Comment 2: Most regulatory jurisdictions using an incentive or performance based regulatory regime have adopted an expected value for the 'industry average' gearing for a regulated entity. This way efficiency in financing is encouraged, and but the level of risk adopted through the % of debt assumed is determined by the Regulated Entity. PEPOA to elaborate on what industry average gearing it would prefer. Comment 3: In a general sense WACC does change over time, but for rate setting purposes, the regulatory WACC is set using the market values for certain parameters at the time of reset. The Regulated Entity is then encouraged to re-finance itself to achieve the lowest cost of capital it can achieve which is below the regulatory WACC.</p>
4.9	WACC Determination	The determination of WACC is critical and must be verified by financial experts, specifically on the issue of proper cost of debt and equity. Setting the WACC at an unreasonably low level may result in the system's failure to attract adequate funds to upgrade and extend our transmission facilities.	Comment noted. The approach specified uses a number of external market derived values and a defined formula, which provides an open and objective way to determine the regulatory WACC at the time of regulatory reset.

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.9	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?	Comment 1: Comment on 60:40 noted, see Comment 2 row 129. Comment 2: Prefer to be close to an industry expectation of gearing. MERALCO to elaborate what industry average gearing it would prefer. Comment 3: Sections 4.9 provide guidance and independent expert advice shall be sought to assist the review of the submissions during the regulatory reset.
4.9	WACC Determination	The term 'classical' WACC is not very clear. The guidelines impliedly provide that ERC recognize the use of post-tax WACC, however, it would be highly appreciated if ERC would make it explicitly clear whether it is pre or post tax.	Section 4.5.7 makes it clear the tax components are included separately in the building block. Section 4.9.3 makes it clear the WACC formula does not include a tax component. Section 4.9.8 shall be reviewed to ensure no double count of the tax shield occurs. The WACC as described is a nominal WACC. Comment is otherwise noted.
4.9	WACC Determination	Given that a 6% premium is given for regulated asset in Australia, 6% market premium is too low for a market in Philippines. A market risk premium should be equitably offered to provide a higher return to meet investor's risk compensation.	Comment noted. CK-HEI to elaborate on how it proposes to avoid double compensation for country risk if the MRP is escalated for country risk. The guidelines provide that country risk shall be compensated for in the risk free rate (Section 4.9.5, which impacts return to equity through Section 4.9.4 and return to debt through Section 4.9.10), and debt margin (Section 4.9.10 which also impacts return to debt. CK-HEI to elaborate on what WACC formulae it believes would be more appropriate.
4.9	WACC Determination	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.	Comment noted, see row 129. COLIGHT to elaborate on what industry average gearing it would prefer.
4.9.1	Classical WACC at 40% equity and 60% debt	Why assumed at 40:60 when actual debt-to-equity ratio of the regulated entity could actually be less?	Comment noted, see row 129. ILIGAN to elaborate on what industry average gearing it would prefer.
4.9.1	WACC Determination	On the WACC, why is it based on a 60-40 equity structure instead of what the actual would be?	Comment noted, see row 129. PCCI to elaborate on what industry average gearing it would prefer.

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.9.4	WACC Determination - Cost of Equity	Beta (the risk measure of the Capital Asset Pricing Model - 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. The data to measure beta of the Philippine utilities may or may not exist in sufficient quantity and quality to accurately calculate beta. 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 beta should not be used.	Comments noted. Refer to Section 4.9.8 where ERC indicates how it shall approach the issue of lack of Philippines statistical data. COLIGHT to elaborate on what internationally accepted method to determine the regulatory cost of capital it believes should be used.
4.9.4, 4.9.10	Risk-free rate	<p>We recommend 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>We recommend 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>	PSALM to elaborate on how its suggestions on "a Philippine country risk premium based on the Philippines default spread and a currency premium based on inflation differentials" should be added to the risk free rate. Comments otherwise noted..
	Risk-free rate	<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 rf. 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>	Comments noted.

Article	Section Title	Comments	Response by ERC Staff / Consultant
	Risk-free rate	<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 ex</p>	Comments noted
4.9.12`	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 durin</p>	PSALM to elaborate on what (if any) additional trigger condition it is proposing for Section 12.2. Comments otherwise noted.
4.10.	Capital Expenditure Forecast	The regulator should address the volatility of price in the country, since it is difficult to estimate the costs of project way into the future.	Section 4.10.6 requires the Regulated Entity to separately identify the escalation indices used in preparing the capex forecasts by project. This includes escalation for CPI and/or exchange rates. Where these are separately identified the issue of volatility can begin to be addressed. NTC to elaborate on what (if any) additional adjustments for forecast capex it is proposing.
4.10.2	Capital Expenditure Forecast	Please clarify the meaning of 'prioritized above other projects'? Does it mean prioritization of such projects to other projects included in the CAPEX forecast, or ERC has another reference to it?	
4.10.2(b)	Prioritization of Projects	For clarity, we suggest that the Guidelines explain that priorities must be assigned to projects within the capital expenditure program	

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.10.2(f)	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.	
4.10.4, 4.10.9, 4.11.4	Independent Expert	We recommend that the ERC clarify in the Guidelines the circumstances under which the Regulated Entity may or must retain an independent expert. These Sections 4.10.4 and 4.11.4 state that "The ERC must require the Regulated Entity to retain an independent expert ..". However, other Sections (for example Section 4.6.2) state that "the ERC may require the Regulated Entity to retain an independent expert ..". Section 7.1.4 states that the ERC must 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".	
4.10.6	Capital Expenditure Forecast	To report a CAPEX forecast in nominal terms would mean a consideration of an inflation factor in the forecast. Will the Commission provide the inflation forecast? The Guidelines provide that the capital expenditure forecasts would only include costs for assets that come into service during the year or simply the commissioning date. It is suggested that the Commission adopts a rolling forward of forecast capital expenditure on an ex-ante basis to the asset base annually.	
4.10.1, 4.10.6	Capital Expenditure Forecast	We recommend that the Guidelines require the Regulated Entity to provide information on the expected annual disbursements under the proposed annual capital expenditure program. 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. 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. 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).	
4.10.6	Capital Expenditure Forecasts	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. Such forecast should reflect inflation in the country from which the item is being purchased.	
4.10.8	Capital Expenditure Forecast	Will ERC be issuing guidelines on what it will consider as projects of 'major importance', and why Leyte-Mindanao Interconnection was given as an example?	

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.10.8	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>	
4.11	Operating and Maintenance Expenditure	<p>This requires voluminous data, what does ERC intend to do with all these 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 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 this. The key to PBR is prices, not costs. No one cares about costs if prices are reasonable. It is worth mentioning that it 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 these 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.</p>	
4.11	Operating and Maintenance Expenditure	<p>To benchmark all these data against utilities in other countries may not be helpful. The characteristics of transmission service in other countries are not likely to resemble the Philippines. The ERC should stick with the PBR formula and benchmark Transmission Wheeling Rates against other ASEAN nations to see if the transmission owned is at least commensurate with other utilities. If prices are significantly higher (assuming the data is available for transmission only) than other ASEAN nations, then the transmission owner should be required to justify why this is so. The key to PBR is PRICES, not costs. A primary goal of PBR is to break the cost-price link.</p>	
		<p>It should be noted that it also costs money to collect this data - money that most be paid by the transmission customer. It is likely that the transmission 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.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.11.1	Operating and Maintenance Expenditure	Could you expound more on what is (o)net foreign exchange?	
4.11.1	Operating and Maintenance Expenditure	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 Trancso rate methodology with the DECOR and DICER?	
4.12	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.	
4.12	Calculation of Corporate Income Tax	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. 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.	
4.12.3	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.	
4.13	Revenue Smoothing	If $ARR_t > MAR_{t-1} \times (1 + \text{inflation})$, then does it mean that the Efficiency Factor (X) will be negative.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.13	Revenue Smoothing	<p>How is the efficiency factor (X) related to productivity? From the formulas, it would seem that the X factor is influenced only by assets & ARR. Why was it called efficiency or productivity factor if it is influenced by such? Could the formula for PVt 1 be reformatted such that it would be easier to see the groupings in the parenthesis (i.e. which terms are grouped, which terms are not.)</p>	
4.13	Revenue Smoothing	<p>What would be the basis for negotiating "Productivity and Efficiency" to fill in the factor "X"? Is that going to be a case-to-case basis or period-to-period basis?</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.13.1	Revenue Smoothing	<p>We recommend that the ERC retain the right to introduce a small step change in revenue / price (or “Po adjustment”) at the start of any Regulatory Period so that it has maximum flexibility in setting the smoothed revenue requirement.</p> <p>Po 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 the document submitted by PSALM 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>	
4.13.2	Revenue Smoothing	<p>It cannot be understood as to how an Industry Efficiency Performance standard can be correctly arrived at by the formula presented. With the exception of inflation, the variables used are company specific, thus not resulting in an industry-wide productivity index against which utilities are benchmarked.</p>	
4.13.2	Formula for PVt-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): $MAR_{t-1} + [\text{sum from } j=0 \text{ to } j=4 \text{ of } \{ (ARR_{t+1} + 1) / (1+WACC)^{j+1} \}]$</p> <p>The long form of the equation could be spelt out as a footnote.</p>	
4.13.3	Formula for PVt-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> $MAR_{t-1} \times [\text{sum from } j=0 \text{ to } j=5 \text{ of } \{ (1+Inflation_t - X) / (1+WACC) \}^t]$	
4.13.4	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> $SMAR_{t+1} = SMAR_t \times (1+Inflation_{t+1} - X)$	

Article	Section Title	Comments	Response by ERC Staff / Consultant
4.13	Revenue Smoothing	The exponential factor of the (1-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 $(1+\text{inflation} - X)^n / (1+WACC)^n$. This should be consistent with the procedure of SMAR in Sec.4.13.4.	
4.14.1	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.	
4.16.1	Service Quality Measures and Targets	PBR is intended to reward those utilities that do well and punish those who do poorly. Performance incentives must be a 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 should consider.	
4.16.1	Service Quality Measures and Targets	Are the service quality measures & targets (and respective values) a subject of another public consultation? How do service performance enter into the MAR formulas? Does it enter in the X factor or in the Kt term?	
4.16.1, Article VIII	Service Quality Measures and Targets	The ERC should come up with a framework that will capture the objective of modernizing the transmission sector and which will be included in the MARR or ARR (Annual Revenue Requirement) calculation. This should be done before the finalization of this guideline as this will significantly affect the integrity of 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.	
4.18.2	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.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
5.1	Subsequent Regulatory Periods	<p>Why should ERC change from Optimized Replacement Cost in the Second Regulatory Period then change to the Optimized Deprival Value on the Third (Subsequent) Regulatory Period. Experience from other regimes that have adopted this method shows that it is problematic and is only best appreciated in a well established transmission network, not like in the Phils. Changes should be effected only after consultation with the regulated entities</p> <p>The change in the approach to regulatory depreciation should also ensure that the regulated entity does not under-recover</p>	
5.1	General Price Control Principles	<p>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.</p>	
5.2.1	Price Control in Subsequent Regulatory Periods	<p>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.</p>	
5.2.1	Price Control Formula	<p>What will be the mechanism of the purchase power of Peso pr Exchange Rate is considered as part of the price control formula. 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>	
5.3.1	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 AMRt-1 factor. 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>	
5.3.3	Over / Under Recovery Formula	<p>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.</p>	
5.5	Primary Building Blocks	<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. 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>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
5.6.1	Asset Valuation	We are just wondering why ERC should change from Optimized Replacement Cost in the Second Regulatory Period then changed to the Optimized deprival value on the Third (subsequent) regulatory period. We learned that experience from other regimes that have adopted this method shows that it is problematic and is only best appreciated in a well-established transmission network, not like in this country. We recommend that changes (anywhere in this regime: formula or otherwise) would require public consultation with the regulated entity(ies).	
5.6.1	Asset Valuation	We strongly recommend that the Guidelines not restrict the ERC to using a particular valuation method for the Third Regulatory Period. 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). 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.	
5.6.2(a)	Asset Valuation	There may be an error in the stated formula, since it appears that “asset value” will be multiplied by “asset value”.	
5.8.1	Regulatory Depression	The change in approach to regulatory depreciation should also ensure that the regulated entity does not under-recover.	
5.8.1	Regulatory Depreciation	We recommend that this clause be amended to read ‘... so that the Regulated Entity does not under or over recover the value of its regulatory asset base’, for the reasons given in our comment above on Section 4.2.1.	
5.14	Revenue Path Transition	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.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
5.14.1	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>	
5.14.1	Revenue Path Transition	<p>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 ERC reckon if it was not due to low sales volume? Will the regulated entity have to absorb such losses?</p>	
5.17	Efficiency Carry Over	<p>Items in (a) are 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, and may also suffer from it. 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.</p>	
5.17.1(a)	Efficiency Carryover	<p>We suggest that the wording of this paragraph be amended to clarify the treatment of any "windfall gains" and any "windfall losses".</p>	
5.17.1(c)	Efficiency Carryover	<p>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.</p>	
5.18.1	Financial Ratios Analysis	<p>What are the details of the financial ratios of a kind and manner of calculation to be specified by ERC for the process? Will there be any limitation posted in these financial ratios? CKI/HEI considers excessive stringent limitation may restrict financeability of the business.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
6.2	Annual Rate Setting Timetable	We propose that maximum transmission wheeling rates proposed by the regulated entity be supported with calculations and submitted to the ERC in both written and electronic copies. This shall serve as ready reference for the ERC and a vehicle for the regulated entity to explain the details of its proposal.	
6.2	Annual Rate Setting Timetable	We suggest that additional information required by the ERC be covered by a written request and delivered to allow receipt by the regulated entity at least ten (10) days before the November 30 deadline. This would provide ample time for the regulated entity to prepare the requested information.	
6.2	Annual Rate Setting Timetable	We suggest that should ERC fail to render its decision on or before January 1 of the application year on the proposed maximum transmission wheeling rates submitted by the regulated entity, the proposal should be deemed provisionally approved until such time that the ERC renders its Decision.	
6.2	Annual Rate Setting Timetable	We propose that the new rates should take effect on the 26th day of the month following the ERC decision, considering that it is the start of billing cycle / period of the regulated entity, the National Transmission Corporation (TransCo). Imposition of fractional billing may cause billing problems for TransCo, unless it adopts a new billing period starting from the first day of every month.	
6.2	Annual Rate Setting Timetable	The guidelines do not provide any provisions in case of late filing by the regulated entity.	
6.2.1(a)	Annual Rate Setting Timetable	The cross-references in sub-paragraphs (vi) and (vii) do not seem to be correct	

Article	Section Title	Comments	Response by ERC Staff / Consultant
6.2.1(g)	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>	
6.3.3	Demand projection	<p>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).</p>	
6.4.1	Side Constraints	<p>For clarity, we recommend that the formula be expressed as follows: $[(FCR_{k,t} / ACR_{k,t-1})] \leq [(1+i_t + SC_t) \times FQ_{k,t} / AQ_{k,t-1}]$</p> <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>	
6.4.1	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>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
6.4	Side Constraints on Proposed Maximum Transmission Wheeling Rates	<p>After one (1) year from imposition of Universal Charge, a portion (e.g. one third) of the Intra-Grid Regional Cross-Subsidy Charges shall be removed and recovered through the Universal Charge in order to mitigate sudden price shocks to affected customers. Assuming the Performance Based Regulation (PBR) will only be adopted / implemented after the above-stated period, will the remaining Intra-Grid Cross-Subsidy Charges be automatically removed?</p> <p>The Intra-Grid Regional Cross-Subsidy Charges in the unbundled power rates cover both NPC (Generation) and TransCo revenue requirements. Gradual removal of the same, in accordance with Section 43 (g) of the EPIRA, will affect revenues of both entities. Bearing in mind that the PBR is only applicable to TransCo, how will these cross-subsidies be reasonably considered? There may be a need for a simultaneous revision of power rates for both NPC (Generation) and TransCo upon adoption of PBR.</p>	
6.4.1	Side Constraints on Proposed Maximum Transmission Wheeling Rates	<p>What is the basis of fixing the Side Constraint for the First Regulatory Period at 0.01? What is the basis for the subsequent adjustment in the subsequent Regulatory Period? Why is it that only the needs of the users are being considered? What about the regulated entity?</p>	
6.4.1 to 6.5.1	Side Constraints on Proposed Maximum Transmission Wheeling Rates; and Reduction of Cross-Subsidies Over Time	<p>Based on the ERC ruling on the Unbundled Power Rates of NPC, the cross-subsidies under the Transmission charges will be phased out by the end of 2005. This does not coincide with the provisions of the EPIRA which provides among others, that the removal of cross subsidies should be within three (3) years from the imposition of the Universal Charge. It is most likely to happen that TransCo will have removed the cross subsidy ahead of the provision of the law. It is suggested that the Commission amending Sec.6.5.1 to include the provision for cross subsidy removal scheme already imposed by ERC, in ERC Case No. 2001-901.</p>	
7.1.2	Regulatory Reset Process Timelines	<p>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, '</p>	
7.1.4	Independent Expert	<p>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).</p>	
7.1.7	Reset Process Timeline	<p>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.</p>	
7.1.9	Reset Process Timeline	<p>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.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
7.1.9	Regulatory Reset Process Timelines	Will the Commission consider a longer period because the one month time is too short?	
8.1	Establishment of Transmission Reliability Standards	Should the standards established be also power quality standards aside from reliability standards?	
8.1	Establishment of Transmission Reliability Standards	It should be noted that the regulated entity is to propose a capital expenditure forecast for the second regulatory period for the reset process. We suggest that the performance targets be set sooner in order for the regulated entity to develop a capital program to deliver them.	
8.1.1	Establishment of Transmission Reliability Standards	One big question probably is whether data, which would serve as the basis of determining standards of industry performance, are valid or reliable.	
8.1.1	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.	
8.1.3	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).	
8.2	Performance Incentive Scheme	In a performance-based rate setting, efficiency in the performance and utilization of assets should be underscored. Since both transmission and utilization (consumers) sectors can contribute to such efficiency, a reward/penalty system should be devised for both sectors.	
8.2	Rewards and Penalties	Who would end up paying the incentives? Increase transmission rates? Who will pay for the inefficiencies of TRANSCO and the Distribution Utilities?	
8.2.1	Performance Incentive Scheme	It is important that regulation encompasses an appropriate incentive framework, encouraging regulated company to strive for efficient costs without necessarily relying on heavy-handed regulation. As soon as Performance Incentive Scheme is developed, there is scope for them to be incorporated into the regulatory cap.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
8.2.3	Performance Incentive Scheme	If caps are imposed on awarding performance incentives to avoid rate shock, then the award should be fully awarded over an estimated period to mitigate its impact on the rates.	
8.2.3(c)	Performance Incentive Scheme	We recommend that the maximum limit of rewards and penalties be 3% of ARRt (paragraphs (c)(i) and (c)(ii)(B)), and 10% under paragraph (c)(ii)(A). It is unlikely that a reward of 10% of ARRt 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.	
9.2	Definition of Net Efficiency Gain	The net efficiency gain is not explicitly shown in the ARR Building Block formula.	
9.2.4	Definition of Net Efficiency Gain	The Commission should reconsider the underlined phrase, as this may create uncertainty. It is something undesirable for ERC to adjust the capital expenditure forecast in light of the expenditure savings in the middle of the regulatory period. It is suggested that this can be handled as part of each process when setting the allowed revenue for the forthcoming review period.	
9.2.4	Definition of Net Efficiency Gain	We recommend that the materiality band of $\pm 1.5\%$ be increased to $\pm 3\%$ 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. Demand could fluctuate by more than 1.5% from forecast due to economic factors or weather, without any impact on capital or operating expenditures. 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.	
9.3.1	Mechanism for Carrying Over Net Efficiency Gains	Issue is similar to that of "pass through". While the NEG is added into the ARR, which becomes the basis for setting the maximum transmission charge, it is not clear if the MAR will be adjusted to factor in the NEG. If not, then the addition to the ARR is meaningless as this will only translate to a recovery beyond the MAR when actual revenues are compared against the cap.	
9.3.1	Carrying Over Net Efficiency Gains	We suggest that this section be amended for greater clarity in the treatment and carry forward of Net Efficiency Gains.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
10	Force Majeure Event Regulated Pass Through	How is a "pass Through" factored into the MAR during the regulatory year? If the pass through is included in the Annual Revenue Requirement then an adjustment in the MAR is necessary or there will be an over recovery on the part of the regulated entity	
10.2.4	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>	
10.2.4	Claim for a Force Majeure Event	May we request for the rationale and basis of the PhP0.02 / PkWh	
10.5.2	Application of Approved 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?	
11.1.1	Tax Event Regulated Pass Through	In utility's income tax as an expense that can be passed on to the consumers is, we believe, not in order. We fully agree with the recent Supreme Court ruling that income tax should be borne by the income earner and in this case, the stockholders of the utility and not the consumers.	
12.1.1	Conditions for Revenue Cap Re-Opening	<p>The allowable change in the NCP as computed under Sec. 12.7.1 is too high and unrealistic. This means an increase in the NCP of 100%! Article XII also fails to include a discussion of how change in NCP, which means an increase in demand that will trigger an increase in capex, shall be factored into change in MAR formula. Does this mean that under the proposed method, changes in the MAR formula that can be accommodated under Article XII are recalculation of the I and X variable only? If so, then is it presumed that the X factor - as computed by the formula prescribed under Sec. 4.13 - takes into consideration the increases in capex and opex due to system expansion and load growth. Is this correct? If not, then a factor must be added into the formula to provide incremental investments. If the X factor is assumed at zero for the 1st period & if there are no separate factors to address the need for expansion, then new investments will come into 2nd regulatory period.. Should a separate allowance for new construction be allowed in the formula?</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
12.2.1	Triggers Allowing Regulated Entity to Apply for Re-Opening		
12.2.1(a)	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>	
12.2.1(b)	Peak Demand Trigger	<p>We recommend a trigger of \square20% 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>	
12.2.1	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>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		<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. 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 cost of the risk 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 risk 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>	
12.6.1	Formula for Quarterly Change in CPI	<p>For clarity, the formula should be expressed as follows (with corresponding adjustments in the preceding text):</p> $dCPI (\text{delta CPI}) = [(CPI_{Q_t}) / (CPI_{Q_{t-1}})] - 1$	
12.7.1	Formula for Three Month Average of Non-Coincident Peak Demand	<p>For clarity, the formula should be expressed as follows (with corresponding adjustments in the preceding text):</p> $dNCPD (\text{delta NCPD}) = [(NCPD_t) / (NCPD_{t-1})] - 1$	

Article	Section Title	Comments	Response by ERC Staff / Consultant
12.8.1	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.	
12.8.1	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 Po 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>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
12.8.1	Deferred Capital Expenditure on Projects of Major Importance	Could ERC provide a definition of "Projects of Major Importance"? May we be clarified on the reason on why would ERC alter the value of X in the formula for calculating the MAR cap as already set out in 4.2.1, by recalculating the X factor based on the exclusion of the forecast capital expenditure (project of major importance not undertaken within 18month of the time it was forecasted)? We understand that ERC can address this at the time of each reset. Regulatory intervention during a regulated period may create uncertainty.	
14	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?	
14.1.2	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.	
14.2.5	Appointment of independent expert to undertake particular work	We would highly appreciate if the guidelines will make it clear that the ERC will ensure that the allowed revenue will take into account the expected cost that the regulated entity will incur in appointing all these independent experts.	
Appendix A	Performance Indices and Metrics	Could you expound more on accumulated time error? Should the performance indices also include other indices like power quality indices (e.g. voltage unbalance) and system loss?	
		<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> <p>The need for large capital expenditures to upgrade and expend the network;</p> <p>the lack of an adequately deep local currency capital markets; and</p> <p>the highly extensive use of cross-subsidies in the system.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		<p>From a practical perspective, concerns may include: (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>	
		<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>	
		<p>Given that the Php20,198 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 (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.</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 more discretion under the proposed Guidelines.</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>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		<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 to 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 PhP1-2 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>	
		<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>	
		<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>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>	
		<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>	
		<p>Many of the assumptions needed to calculate RegLi,t 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>	
		<p>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) in 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 and determination of the final figure for CWIP appears to be purely subject to the discretion of the ERC.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		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 Regulatory 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).	
		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.	
		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 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.	
		Section 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.	
		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, CK/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)).	
		Definition of "relevant taxes" and materiality requirement mean that Tax Change Events pass through mechanism is likely to have no substantive operation	
		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: (1) services standard event-allowing or requiring the Transco to pass through increases in costs resulting from regulatory changes after the date of 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.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		<p>In Australia, in addition to similar provisions relating to false or misleading information, the ACCC may revoke a revenue cap if: (1) there is material error in setting the cap and if the ACCC has obtained consent of affected parties to revoke the cap; or (2) there is substantial ownership change which may lead to a material change in the revenue requirement of the Transco; or (3) there is material change in Government policy which leads to a material change in the revenue requirement.</p>	
		<p><u>Demand Risk</u>: 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 transition. This poses a delayed regulatory risk. Adjustments to methodology based on Peso movements and inflationary environments also pose risk. Lack of clarity on the triggers for such adjustments is cause for concern. <u>Cross Subsidies</u>: 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>	
	General Comment	<p>Performance Based Regulation (PBR) is all about prices, not costs, not ratebase, not regulatory management, 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.</p>	
	General Comment	<p>There must be clear understanding between the regulator and the regulated company as to the application of the proposed revenue cap regulation. It could be better if simulation be made and understand the effect of this methodology to the existing rate level of the regulated company.</p>	
	General Comment	<p>ERC should also think and go slow in the proposed shift to PBR scheme, because even the more advanced power markets like Australia and United States are encountering problems on implementing such methodology.</p>	
	General	<p>As proposed in the draft guidellines, the ERC will be shifting from the current practice of cost-of-service (COS) or more popularly known as Return on Rate Base (RORB), to a Performance-Based Ratemaking (PBR) for the setting of the Transmission Wheeling Rates charged by the Transco. The issue of which method is more appropriate is debatable and hence the need for an explanation from the ERC on the purpose of abandoning RORB in favor of PBR. If the ERC believes that the RORB has some inherent flaws, then these flaws must be pointed out. How the proposed method can correct these flaws must also be explained.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		The need for a detailed justification from the ERC is to convince all stakeholders that the proposed shift is anchored on the right reasons, and not on what may be a misconception on the current method being used. There were some criticisms against RORB, focusing on revaluation, rate of return, income taxes; these issues are still to be addressed by PBR.	
General Comment		The proposed rate regulatory system (as with the RORB system) can be successful only where the ERC demonstrates a strong will to strictly and consistently implement its rules and procedures. These rules and procedures include proper and timely determination of the composition and prudence of assets forming the rate base (using the "used and useful" test and the 60-day working capital rule), the composition and prudence of operating expense components (which should include corporate income tax), the integrity of the asset appraisal, and the normalization of significant cost items (such as fuel and/or purchased power) which exhibit price volatility. The ERC is likewise urged to impose the RORB cap (post-tax) which is deemed fair and reasonable in this jurisdiction. We urge the ERC to keep in mind that as regulator, it is duty-bound not only to protect consumers, but also to secure the continuing viability of utilities.	
General Topic	Pricing	More extensive discussions must be conducted as to whether a postage stamp or other model (i.e. nodal) is to be applied. This matter cannot be left simply to the workings of the wholesale electricity spot market (WESM) which should be limited only to generation cost. This is to discourage cross-subsidization in the transmission costs.	
General Topic		We hope that the ERC would be consistent in applying the approaches / principles used under the Guidelines, such as adequate return on source of capital (WACC), forecasted Operations and Maintenance Expenses and Capital Expenditures, inclusion of all taxes including corporate income tax, and a predictable timetable for review, in deciding on the unbundling cases of the Distribution Utilities.	
	Benchmarking/ Yardsticks to Use	Benchmarking against historical records may reward regulated entity for past inefficiency or penalize it for past efficiency. Benchmarking against other companies in the industry or regional/ national averages may require adjustments to obtain a comparable benchmark or yardstick and handicapping.	
EPIRA IRR Rule 6, Sec 10c	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.	
EPIRA IRR Rule 6, Sec 10	TRANSCO Related Businesses	How will net income derived from other related businesses be included in the rate selling methodology? The rate selling methodology should include a mechanism for the regulated entity to engage in related business with the end view of reducing its transmission wheeling charges.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
General Topic		The successful adoption of Incentive Based Rate Regulation relies heavily on skilful 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 the CPI has remained relatively stable in recent months, inflation rates of around 10% were common in the not so distant past.	
	General Comment	A performance-based methodology of rate setting is preferable to the existing Return on Rate Base (RORB) methodology. However, since it is a new concept that will affect all electricity users, we feel that the three-day hearing set by ERC may be inadequate to comply with the "due notice" requirement for laws and ordinances. The Guidelines are too complicated, containing as it does, technical formulae that only electrical engineers can fathom. The process would need an educational phase and for this reason, we suggest taht the first day of the hearing (February 19, 2003) be exclusively devoted to that phase. It may extend even to the second day and we propose that it be held in a larger forum than the ERC session hall, with the support of hardware, (projectors, power point presentation, sound system, etc.) and simulations to show the comparative advantages over the existing RORB methodology. The third day can be devoted to discussion and comments.	
	General Comment	The Postage Stamp methodology presently used in pricing transmission service runs counter to the mandate of EPIRA to restructure rates on the basis of true costs in rendering the service, as well as, the mandate to eliminate subsidies. The Postage Stamp method of setting a uniform rate regardless of distance makes the customer (power user) nearest the source of power, bear the cost of service to the distant power customer. Note that distance involves capital cost and line losses. The inclusion of a provision expressly revoking the Postage Stamp methodology and adoption of a distance related one is proposed.	
Others		There is no mention in the guidelines on Connection Charges, will the Commission consider this in the MAR calculation of the regulated entity?	
Others	Re-opening Trigger Events	The change in CPI to exceed 10% in 2 consecutive quarters rarely happens in the country.	
Others		We suggest that a collaborative / consultative meeting be conducted to determine the standards and indices to measure reliability.	
General Comment		A PBR methodology is preferable to the existing RORB methodology. However, since it is a new concept that will affect all electricity users, the 3-day hearing set by ERC may be inadequate to comply with the "due notice" requirement for laws and ordinances. The Guidelines are too complicated. The process would need an educational phase such that the first day and maybe even the second day must be devoted to that phase. The third day can be devoted to discussions and comments.	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		<p>Transmission charges should reflect closer the true cost of providing such service by taking into consideration distance or length of transmission lines used in the transmission of power from one point to another. This can be captured in a method called "nodal" or "zonal" pricing. With nodal pricing, nodal points or nodes are identified and designated in the transmission system, wherein the charges are computed based on node-to-node service. In similar manner, with zonal pricing, the transmission system is divided into zones wherein transmission lines in a contiguous area are lumped together to form zones. In this case, pricing is based on a zone-to-zone service.</p>	
		<p>In view of the transition from government bureaucracy to private management, there should be standard parameters for efficiency to be followed by the transmission provider that is comparable with those utilities in deregulated markets like New Zealand, Great Britain or Argentina.</p>	
General Topic		<p>Where does this fit into the EPIRA's assurance that the tariff would eventually be lower and suffer least political distortion as it is today?</p>	
General Topic		<p>With the apparent application of the "Postage Stamp" mechanism, how shall this process assure elimination of "subsidies" as mandated by the EPIRA?</p>	
General Topic		<p>Perhaps, a Simulation Study should be presented as part and parcel of this Case showing the advantage of the proposed formula versus the current RORB and projecting the key items that could drive the tariff whichever way.</p>	
General Topic		<p>Studies and available samples appear to show that the proposed formula or process are currently adopted by developed economics, where there are already established hard, reliable and progressive data available on the subject, which are not generally true in developing economies like our country, where all corporate data are somewhat contentious and where SEC is not even able to compel or even validate and challenge submitted corporate information. Could we ever locally develop a concrete case against corporations like an ENRON or WORLCO as they have done in the US?</p>	
General Topic		<p>The formula or process appears to be quite complex and difficult for even the large consumers to understand. There would be a need to present a comparative advantage and disadvantage of the current RORB versus the Proposed Formula in order for the consumers to appreciate what would drive the "wheeling charges" up or down and to achieve more competent consensus and also avert future "finger pointing" between the TRANSCO and the Distributors and the Generators as what is now happening between the MERALCO, NPC and DOE regarding the PPA and the PPCA, etc. due to poor consumer information programs.</p>	
		<p>If ERC believes that the RORB has some inherent flaws, then these flaws must be pointed out and proposed methods to correct these flaws must also be explained.</p>	

Article	Section Title	Comments	Response by ERC Staff / Consultant
		<p>The use of Revenue Cap may be disadvantageous to the regulated entity in the sense that an increase in demand/consumption - a factor not w/in the control of regulated entity - will ultimately translate into more revenues. This would mean that under Revenue Cap prices would have to dip very sharply so that the maximum revenue cap will not be breached. Demand is a major cost driver, using Revenue Caps may result to a deficiency in revenues for the regulated entity. On the other hand, with he Price Cap, as demand grows, revenues increase while the price remains the same, giving the regulated entity a better opportunity to cover costs and earn a reasonable return.</p>	
		<p>Present the pros and cons of using Revenue Caps vis-à-vis Price Caps.</p>	
		<p>The methodology presented requires the use of forecasted figures; figures that are even more controversial or contestable than past yet audited figures. This will result to an even heavier or closer style of regulation never before experienced by the industry and even runs counter to the public announcements of the policy makers.</p>	
General		<p>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.</p>	
General		<p>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.</p>	