



First Gas
HOLDINGS CORPORATION

12 February 2003

The Energy Regulatory Commission
Pacific Center Building
San Miguel Avenue, Ortigas Center,
Pasig City
Facsimile No. 631-8641, 631-7287, 631-5879
And through regulatory@erc.gov.ph

Re: **Comments on Draft
Deferred Energy Cost Recovery (DECOR)
and Deferred Incremental Currency Exchange
Recovery (DICER)**

Gentlemen:

We thank you for giving us the opportunity to comment on the draft "Implementing Rules for the Deferred Accounting Procedures for Recovery of Fuel and Independent Power Producer Costs: Deferred Energy Cost Recovery (DECOR) and Deferred Incremental Currency Exchange Recovery (DICER)" (the "Rules") and appreciate the opportunity to participate in the public consultations thereon.

Set forth below are the comments and proposals of First Gas Holdings Corporation ("FGHC").

General Comments

While FGHC commends the Energy Regulatory Commission (the "ERC") for seeking ways to reduce electricity rates (and address price volatilities) for the benefit of consumers, we take exception to the manner by which this laudable objective is sought to be achieved under the Rules.

The Rules negate the original intent of adjustment clauses, which is to allow electric utilities a way of recovering significant and easily verifiable cost items such as fuel (for those generating their own power) and purchased power (for those buying power) or a combination of the two, and foreign exchange losses (on the foreign exchange component of the Operating and Maintenance Expenses as well as the amortization of the principal component of a utility's debt service) without going through the tedious process of, and avoiding the expenses attendant to, a formal rate application.

Most utilities at present already resort to deferring the recovery of these costs and losses over a period of time so as to control revenue swings without passing on the concomitant carrying costs of such deferral to the consumers. The Manila Electric Company (the "Meralco"), for one, had implemented a deferred recovery scheme which was made subject of an ERC Cease and Desist Order (under ERC Order dated May 7, 2002) issued, incidentally, without affording Meralco its right to due process. Under this scenario, the ERC's task would have to be limited to examining and evaluating the formula used by utilities in the recovery process so as to evaluate the legitimacy of cost items and cost increases, to ensure that no margins are added thereon, and to monitor the monthly submissions of the utilities.

What the proposed DECOR and DICER accomplish, however, is the aggravation of the financials of the distribution utilities, especially during periods of fuel / purchased power and foreign exchange volatilities, without providing real relief to consumers, who eventually also shoulder the burden of reimbursing utilities for the carrying costs incurred from the deferral.

The concept of deferrals and the setting of the Recovery Period (to not less than three (3) years) are in themselves subject to question. When costs of fuel / purchased power and foreign exchange are stable, the utility would not need to implement a cost-recovery mechanism. When these cost items become volatile, however, the draft Rules automatically mandate the deferral of recovery of these costs over a three- (3) year period, as a minimum. The utility, in the meantime, must shoulder and account for all monthly movements as well as the interest costs / earnings attendant to the deferral. Under these circumstances, the so-called automatic recovery mechanism loses its meaning.

In economics, this mechanism is equivalent to freezing the price signal for a time period, cutting the link between supply and demand responses (leading to distortions in the supply / demand bids), and thereafter, releasing the same after prices reach an uncontrollable level. The analysis also mirrors the consequence when prices spiral downwards from the base rates.

It is also submitted that the deferral mechanism is contrary to the general aim of deregulation as it effectively discourages, through the resulting uncertainty in the recovery of purchased power, the entry of new players in the generation sector. Added to this is the mandated cap on the generation rate (which artificially lowers electricity prices) to a level which renders the sector unattractive to new investors.

Further, the concept of deferrals is objectionable on the ground that it assumes that every distribution utility would have access to financing. It is doubtful, for example, whether even the largest utility, Meralco, with its creditworthiness now put in question by recent events, would be able to secure substantial amount of funds via



viably until it is able to fully recover its deferred costs. This may not entirely be a realistic assumption, particularly for distribution utilities with no sound credit standing, and considering that the market currently pegs commercial rates at a premium over the T-Bill rates, it is only reasonable to peg the carrying charge at a premium over the T-Bill rate, say T-Bill+3% (the grant of a sovereign rate by any financial institution virtually impossible to procure). Further exacerbating the situation is the current volatility of the exchange rate and fuel prices. For utilities unable to secure favorable financing, an inability to tap sources of funding at the pegged rate may result in their failure to honor their contractual commitments to their power suppliers and, ultimately, a serious dent on their financials. FGHC strongly believes that the ERC cannot allow this to happen for it is duty-bound to ensure, not only the affordability of electric power to consumers, but also the utility's continuing viability.

2. **Deferred Accounting Adjustment.** The Rules are unclear as to the period for reconciliation of the DAA. The Rules would mandate a utility to submit monthly reports of "all transactions and calculations affecting the deferred accounts" but fail to state how often the DAA is reconciled, audited or reckoned.

3. **Allowable Costs.** Under the DICER, the rate of DICER must be based on "allowable costs" for a test period designated by the ERC. The Rules, however, fail to provide details on items deemed "allowable costs".

4. **Regulatory Lag.** The Rules provide that a deferred generating cost accounting or a currency exchange accounting application must be filed not later than "one year from its last filing" or "whenever there is a significant change of five percent (5%) or more in the P/kWh in the cost of fuel and purchased power from its last filing". Where there is a "significant" change in the cost of fuel and purchased power "from [the] last filing", the Rules fail to address how costs which cannot be recovered from the time they are incurred up to the time of their approval for deferred recovery shall be paid or financed.

5. **Currency Exchange Adjustment.** The Rules are silent on the nature of currency exchange adjustment (i.e. currency exchange adjustment on foreign currency loans or operating expenses denominated in foreign currency).

6. **Generally Accepted Accounting Principles (GAAP).** The Rules are silent on which GAAP (i.e. Philippine GAAP) should be followed.

7. **Accounting for Deferred Accounts.** The nature of Purchased Power accounts, Fuel accounts, Accrued Utility Revenue accounts were not defined in the Rules. To facilitate easier monitoring and reporting, the term "Generation Costs" may be changed to include all allowable purchased power costs and fuel costs, net of any refunds, including interest, if applicable, received from the fuel or purchased



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power supplier. The term "Accrued Utility Revenue" may be used to take up all revenue billed for the month computed using the prevailing Generation Rate and kWh sales for the month. At the end of each month, any outstanding balance in the "Generation Costs" account and "Accrued Utility Revenue" account may be closed to the "Deferred Generation Costs" which shall be the basis for computation of any Carrying Charges, if necessary, and the basis for computation of "Deferred Accounting Adjustment".

8. **Reconciliation of Actual Costs Incurred versus Amount Recovered.** There is no clear provision for reconciliation of actual costs incurred versus amount recovered and the subsequent recovery or refund of any excess or under recovery.

9. **Recovery Period.** A three-year recovery is too long a period for recovery. The long recovery period would result in deferred charges accumulating into insurmountable levels virtually negating the main purpose of deferment. Further, these deferred charges are normally funded through short-term debt, and hence the recovery should not exceed a period of one year.

10. **Accounting.** The degree and volume of accounting required, particularly in the case of small distribution utilities, is so overwhelming that such submissions will also overwhelm the ERC.

11. **Exceptions.** The exception clause is so nebulous that it provides the ERC with too much latitude to interfere with the workings of the market.

12. **Timing.** The Rules are silent on the timing applicability of the DECOR and DICER. Under a fully deregulated market, it is expected that no artificial "cap" should be placed on the generation cost to ensure genuine competition.

FGHC trusts in the ERC's appreciation of the foregoing concerns and looks forward to participating in the scheduled public consultation on the Rules on February 17, 2003 and to continuing its involvement as the process moves forward.

Very truly yours,

FIRST GAS HOLDINGS CORPORATION

By:


VICTOR B. SANTOS, JR.
Vice President