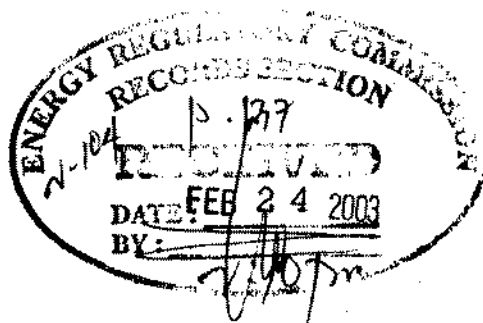




February 21, 2002

ATTY. MARINA C. BUGAYONG
Regulatory Operations Services
Energy Regulatory Commission



Dear Atty. Bugayong,

Attached are our additional comments on the “Draft Implementing Rules for the Deferred Incremental Currency Exchange Recovery (DICER) and Deferred Energy Cost Recovery (DÉCOR).”

Yours truly,

IVANNA G. DELA PEÑA
Senior AVP & Head
Utility Economics

ADDITIONAL MERALCO COMMENTS ON DÉCOR AND DICER

The proposed deferred recovery schemes are viewed with concern as these dilute the price signals to the consumers, make electricity expensive for future consumption, and impose substantial capital requirements for the utility. Meralco, thus, continue to opt for an automatic monthly cost recovery mechanism as the other utilities.

The deferral of costs has always various implications that have to be considered in designing a recovery mechanism. The equity issue should be addressed as charging of today's cost to the future will mean passing on costs to customers that may not have incurred such costs. The customers will end up paying more because rates will already include carrying charges on piling up deferrals.

On the side of the utility, carrying charges as prescribed in the draft rules are not sufficient to compensate for the additional interest costs the utility will incur to finance its purchased power costs beyond the base levels. The utility would need additional working capital to be able to meet all its supplier and creditor obligations when they fall due. With the ERC thrust of lowering the working capital associated with purchased power in the unbundling rate approvals, the utility will be left to finance its own working capital requirements for purchased power. This is a big concern for creditors who are competing for the limited utility funds. The creditors feel that the power rates issue has become so politicized that they foresee uncertainty in the full recovery of deferred costs. For a utility with stockholders, this is a major concern as decision such as this is affecting share values. With the onset of open access, large customers can opt to transfer to another utility leaving behind deferred costs that were not billed to them when the costs were incurred. This will leave captive customers, largely residential, shouldering the deferred cost.

Impact of the Deferrals on Meralco's Borrowings and Interest Expense

We made a simulation of DÉCOR implementation assuming that Meralco can only adjust its DÉCOR after one year, assuming a 5% increase in purchased power cost over a 12-month period. Using very conservative assumptions, Meralco will incur additional borrowings of almost P4 billion in 2003 just to fund the deferred purchased power cost it will incur during the period. In 2004, assuming again that Meralco will only be allowed to increase its DÉCOR after one year, it will need another P2.4 billion in borrowings just to fund the deferred costs for the period. Such a cycle will persist indefinitely, with Meralco needing to provide additional working capital every year just to fund the deferrals. The additional borrowings could have been put to better use by the utility such as funding its annual capital expenditures, electrification of depressed and rural areas, improvement of quality of service, etc. instead of funding purchased power requirements.

Assuming a funding cost of 10% per annum (which is the average fund cost at present) for both years, as compared to the 91-day T-Bill rate of 5.67%, Meralco will absorb about P200 million a year in additional interest expense. It is more likely that the borrowing cost of any distribution utility will continue to increase every year considering that it has no automatic mechanism to recover deferred costs. Moreover, the utility's credit rating will continue to deteriorate because of the increased risks of not being able to recover its costs, and consequently pay off its creditors obligations. There will come a time when creditors may decide to cease lending any funds to the utility. Such a scenario could have a detrimental impact on the thrust of the government to prioritize certain sectors of the power industry as foreign investors would be hesitant to invest their funds in a business where cost recovery is uncertain.