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In this edition

In this issue of Lantau Pique we discuss the iceberg that is floating around in the waters off the Philippine coast that has the potential to sink the country's electricity industry. New generation capacity is needed to meet rising power demand. But a number of challenges await the WESM investor. How can the WESM avoid hitting the iceberg?

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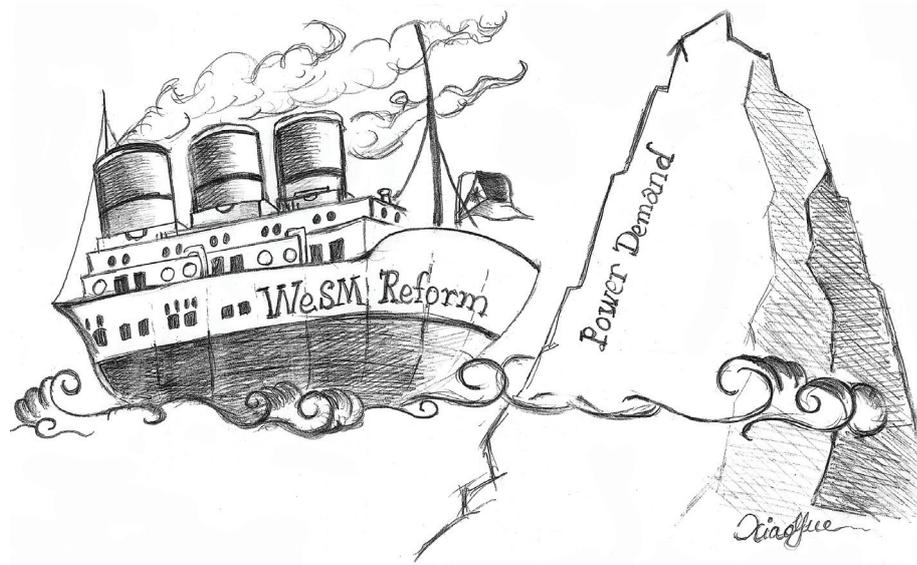
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The WESM and the Titanic

This year, 2012, is the 100th anniversary of the sinking of the Titanic. Plenty of recent articles have highlighted this tragic event as a reminder of the need to exercise care and judgment in making decisions when everything appears to be going well.

In this issue of Lantau Pique we discuss the iceberg that is floating around in the waters off the Philippine coast: Is electricity reform, like the Titanic, going to sink before it reaches its destination?



The Philippine electricity industry reforms started in 2001 with legislation known as the EPIRA. Much has been achieved since then. The WESM has been established in Luzon and the Visayas; most of National Power Corporation's (NPC's) assets have been privatised, and some new generation has been built. Two final planks of the reform are open access and retail competition. The destination of electricity reform can be described as a fully sustainable electricity industry, without reliance on Government guarantees or intervention. The contestable activities of retail and generation would be entirely commercially based. The natural monopolies of distribution and transmission would still be regulated, of course. The forces of supply and demand would signal and support new build in generation. Consumers would pay the retailer of their choice a cost-reflective but reasonable and competitively determined electricity price.

We are, as yet, quite some way from that destination.

While the “big end” of town has been reformed, most consumers still deal exclusively with their local distribution utility, which, outside of Metro Manila, is likely to be a regional Electric Cooperative. Prices for most consumers are still regulated by the ERC.

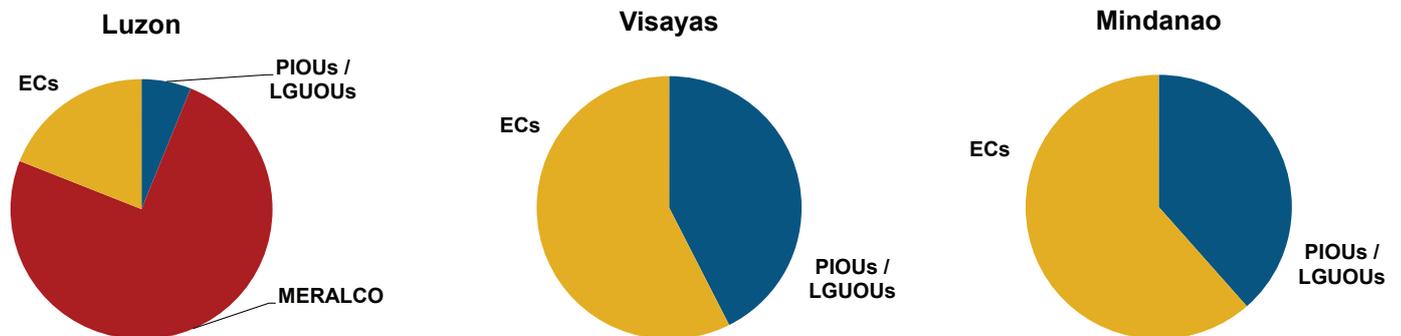
The next wave of reform to hit the WESM will be Retail Competition and Open Access (RCOA), which is scheduled to begin commercial operations on 26 June 2013 after a raft of delays. While RCOA will allow reforms to reach more and more customers, it will not solve one of the fundamental challenges facing the market: regulation.

The nature of electricity regulation in the Philippines affects all parts of the electricity supply value chain – from generation to retail. In some instances, the way regulation is applied makes existing problems worse rather than better, as we discuss below.

While there are many issues that require attention, two are particularly pertinent to ensuring new generation continues to be built in the market: That of contracts underpinning power station new-builds and the credit-worthiness of the counterparties signing those contracts.

Figure 1 highlights the market share by peak demand of Luzon, the Visayas and Mindanao split into private investor-owned utilities (PIOUs, such as Meralco), not-for-profit distribution cooperatives (ECs) and local government-owned utilities (LGUOUS).

Figure 1: Market share by peak demand of Luzon, Visayas and Mindanao



Source: DOE DDP 2010 - 2019

Clearly, in Luzon the market is dominated by Meralco – noted by most observers as “the only credit worthy counterparty in the market”. Why is this?

The sheer size of Meralco is part of the answer, but for the rest we need to dig deeper into the structure of the ECs and how they are regulated. Most ECs are small and cover a small geographic region. Some struggle to collect revenues and pay debts. These are not problems unique to the Philippines—collection challenges and non-technical losses are issues in many developing countries—but problems are compounded in the Philippines by the EC structure as enshrined in their charters. The “not-for-profit”

nature of these ECs, together with strict “cost only” pass-through regulation, mean that the ECs can neither save for rainy day nor conserve surplus funds for expenses such as force majeure allowances or the costs of security deposits and prudential requirements. Unlike many regulatory frameworks that allow normal operating expenses to be passed through, the regulatory environment in the Philippines is such that even funding the prudential requirement needed to join the market is a struggle for some. Some are unable to meet the credit security requirements necessary to enable them to participate in long-term contracts. Of the 86 ECs in Luzon and the Visayas; 17 are not even members of the WESM.

The smaller ECs are simply not set up to be attractive counterparties for contracts in a market-based environment such as the WESM. No international bank will lend to new power projects underwritten by contracts with a non credit worthy EC, and we understand that even local banks need something extra to lend to EC contracted projects (such as the Sinasure involvement in GN Power).

So, while Meralco may be seen as creditworthy, it only supplies 55 percent of peak demand. The other 45 percent of the market also needs new power stations to be built to meet growing demand.

The situation is especially challenging in the Visayas and in Mindanao. Figure 1 shows how these regions are supplied primarily by ECs. Furthermore, in Mindanao, there is no spot

market to fall back on in the event an EC has over- or under-contracted.

Unfortunately, the regulator’s (ERC’s) contract approval process worsens the situation. A quick count of work-in-progress cases on the ERC website suggests that 26 approvals of Power Supply Agreements (PSAs) are outstanding from 2005-09 (18 from 2009). The ERC does not appear to evaluate contracting and EC cost structures and risk management capacity holistically, nor does it appear to differentiate between when it is necessary to regulate outcomes and when it is better to regulate the processes by which outcomes are achieved. Instead, the ERC seems to

examine each contract on a case-by-case basis. This may seem admirable, but it results in costly delays and evidences a fundamental disconnect between the ERC as regulator and the WESM as competitive market.

The ERC has approved contracts based on a “cost-plus” concept. As a result, the ERC has disallowed a number of contracts negotiated in the competitive market environment. For example, Trans-Asia offered to supply energy sourced from the market and other suppliers to BATELEC II, a direct EC who did not wish to be exposed to WESM spot prices. Trans-Asia offered BATELEC II the prevailing NPC “Time of Use” rate plus a two percent margin. In exchange, Trans-Asia, a private sector company, proposed to take the risk associated with WESM price volatility as well as the responsibility to manage an overall supply contract portfolio for a price slightly more than the minimum in the market, saving the EC the cost of joining the WESM in the bargain. The ERC disallowed the two percent uplift – effectively forcing Trans-Asia to supply BATELEC II at the same price as the government-owned NPC, whose prices have no reason to necessarily be right. This highlights a potentially serious lack of recognition of risk/reward trade-offs inherent in energy contracting and a poor understanding of the role aggregators can play in the market.

In another example, Green Core Geothermal signed a number of contracts for the sale of the output from Palinpinon and Tongonan in the Visayas. However, in its latest contracts with CENECO and VECO (two utilities operating in the Visayas), the proposed steam price differed from what it had been in some earlier contracts. The ERC ruled that there was “no reason to deviate from the previously approved fuel fee” – ignoring, it would seem, commercial realities or other matters that might have affected two different negotiated outcomes that took place at different points in time. Of the pricing terms in 15 contracts in Luzon submitted to the ERC for approval in 2011, over 25 percent were reduced in some way and none were increased. Either the ERC is overlooking commercial realities and applying a relatively heavy-handed regulatory hammer or the ERC is failing to deal constructively with the underlying problem. After all, if so many commercially negotiated contracts are turning out to be inappropriate in the ERC’s view, then something more significant is wrong, and the ERC should be providing guidance or pointing the way towards a solution.

The ERC’s focus on specific outcomes rather than on constructive regulation and approval of process is a significant risk to the WESM, one that has already had a negative impact. In Mindanao a group of ECs came together for the very first time to run an innovative and major tender for 300MW of new baseload generation capacity. While there were a number of issues that caused the failure of this particular tender process, a major problem was that the ERC did not provide the ECs with any form of “in-principle” regulatory approval prior to the bid. As the bid was to be competitively tendered, the key economic issue should have been whether the tender was well-structured and whether the level of competition would have been sufficient to establish a

credible outcome. In short, the key economic regulatory issue concerns the process. But this is not how the ERC approached the situation, consequently fostering perceptions of significant regulatory risk.

Bidders were required to incur substantial expense to submit compliant tenders, including the expense of evaluating the opportunity and developing their proposals and meeting the various requirements. The cost and financial commitments required to prepare and submit compliant tenders for competitively tendered power opportunities can run into the millions of dollars. Yet, the ERC provided no assurance that it would approve the winning bidder’s proposal. What is the point of using a competitive process if the regulatory focus is going to be on the outcome rather than on the process itself? Indeed, how is it possible to evaluate an outcome of a competitive process without considering first and foremost whether the process was itself suitably competitive! And, if it is deemed competitive, then what is the logic of reserving the right to alter the outcome after the fact? If bid participants expect such risk, then they will either not participate (which is what happened in this instance in Mindanao) or they will strive to incorporate their best estimates of regulatory risk in their bids, raising costs. An economic regulator needs to be seen as supporting competitive processes and providing clear guidance as to what constitutes appropriate processes. When every outcome is to be separately adjudicated, the process slows down, investors lose interest, competition weakens and investment is delayed. Such outcomes in the dynamic Philippine economy would be tantamount to the WESM hitting an iceberg.

Banks are also increasingly aware of the risks faced by their clients and can be expected to limit access to funding accordingly. The amount of equity required to support a project is a function of, among other things, the amount of debt that banks will provide, and the terms of that debt. If banks make less financing available, equity must step in to plug the gap for projects to go ahead. Regulatory risk increases the costs of projects. For retail competition and open access to succeed, retailers need sufficient financial headroom to be able to manage risk efficiently.

These are some of the reasons we argue that the Philippine WESM faces an iceberg of growing demand that may not be met by a corresponding growth in supply. If impact occurs, like the Titanic, it will be too late to change course and the reform could be doomed to sink in a sea of urgent new-build directed by Government and most likely funded by it too: exactly as occurred in the late 80’s and 90’s resulting in the current fleet of over-priced power purchase agreements that have caused NPC and PSALM such losses.

However, the WESM need not hit an iceberg. Relatively modest changes in the direction of regulation such that the ERC focuses more on promoting and ensuring appropriate incentives and processes rather than on reviewing and revising so many commercial contracts. Streamlined processes that focus on what is important and valuable contribute to increased security of supply by reducing delay and project risk.

There are other potential benefits to regulatory streamlining and refocusing. At the start of electricity reform in New Zealand, some 60 electricity supply authorities (distribution companies) served a population of less than four million people. New Zealand avoided many of the problems we see in the Philippines, however. New Zealand's regulatory framework was once famously known for its commitment to a "light-handed" regulatory regime known, colloquially, as the "threat of regulation". While regulatory developments in New Zealand have moved beyond those old "light-handed" days, New Zealand has retained a commitment to incentive-oriented regulation rather than line-item-review regulation. When distribution and retail functions were formally separated, the regulatory framework for the industry as a whole facilitated a number of mergers, creating a more cost-efficient industry over time.

The purpose of the EPIRA was to foster economic efficiency and improvement in the electricity sector. But regulation is like the hand of the Captain on the tiller of the Titanic – we would not have expected Captain Smith to change direction as each wave passed the bow but rather to set a course and check it periodically to be sure the way forward is clear. This is not what is happening.

The EPIRA reform in the Philippines is, like the Titanic, a marvel to behold. A functioning electricity market in a developing country is a rare and precious achievement; one worth saving from the depths.

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