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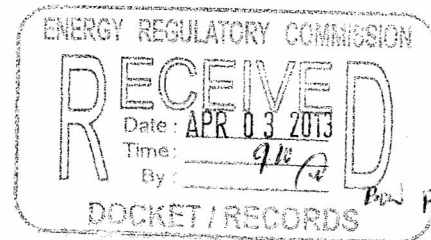
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April 2, 2013
PIPPA 2013-010

ENERGY REGULATORY COMMISSION

Pacific Center Building,
San Miguel Avenue,
Ortigas Center 1600, Pasig City,
Metro Manila,
Philippines



Attention: **Atty. Zenaida G. Cruz-Ducut**
Chairperson and CEO

Re: **Comments on the Proposed Rules Governing the Execution,
Review, and Evaluation of Power Supply Agreements
Entered into by Distribution Utilities for the Supply of
Electricity to Their Captive Market ("Proposed Rules")**

Dear Hon. Chairperson Ducut,

The Philippine Independent Power Producers Association ("PIPPA") extends its appreciation to the Honorable Commission for this opportunity to comment on the Proposed Rules.

PIPPA supports the initiative of the Honorable Commission to establish standards and methodologies that will ensure transparent and reasonable prices of electricity for the distribution utility's ("DU") captive market in terms of the generation component of their retail rates in their various power supply agreements ("PSA").

In this connection, we would like to highlight some observations on the Proposed Rules.

On the Scope of the Proposed Rules

We, as power plant developers, find that the Proposed Rules, as currently drafted, may have a chilling effect on the competitive ideals of the power generation sector and may cause an unwarranted distortion of the power industry's market-oriented design, as envisioned by Republic Act No. 9136, otherwise known as the Electric Power Industry Reform Act of 2001 ("EPIRA").

The government has always been advocating against government intervention acknowledging that the generation sector, in contrast with the transmission and

distribution sectors, is not a natural monopoly. Thus, the government encourages a private and independent power generation sector, as embodied in the EPIRA. In fact, the deliberations in Congress for the passage of the EPIRA support the view that the generation sector is intended to be open and competitive, and that generation charges should be determined by market forces.¹ In particular, during the consideration of the conference committee report for the passage of the EPIRA, the legislators clarified:

REP. ESCUDERO. xxx. Just one final question, Mr. Speaker. Insofar as regulation is concerned, it was specifically provided for that generation and supply would not be subject to regulation except as otherwise provided for in the other provisions of this Act. However, in the latter provisions of the Act, not only generation but also distribution and transmission supply included would be under the jurisdiction of the Commission insofar as price manipulation, monopolies and cross ownership is concerned. And one of the powers provided for by the Act to the Commission would be to set a price ceiling among others and to issue injunctions. **Would this therefore mean, Mr. Speaker, Your Honor, that indeed, generation and supply would still be covered within the power and jurisdiction of the Commission insofar as price fixing is concerned even in areas where it is a contestable market, so to speak?**

REP. ABAD. Well, **the generation and the retail supply sub-sectors are competitive markets and therefore they cannot be subjected to price fixing because it is the market that dictates the price.** Which is not the case of the transmission and distribution sub-sectors which are natural monopolies and therefore they are heavily regulated by the ERC.⁸ (Emphasis supplied)²

We believe that the cost-based approach prescribed by the proposed rules³ is restrictive and prohibitive because it does not provide the proper signals for the market to build the most efficient sources of power. Furthermore, the Proposed Rules in effect dictate the manner by which parties could freely contract, which ultimately discourages power plant developers to invest in new generation capacities.

As you may recall, the EPIRA was enacted to promote competition, encourage market development, and ensure customer choice in a restructured electricity industry³. Also, in the setting of the retail rates, the EPIRA mandates that the rate-setting methodology to be adopted and applied must, ensure a **reasonable price of electricity** and shall not be discriminatory, by taking into account all relevant considerations such as the competitive selection process undertaken by the DUs, as a regulated entity⁴.

Given these, we would like to seek the indulgence of the Honorable Commission to consider the following comments on certain provisions of the proposed rules:

1. *Article IV Section 1. Filing of the PSA – Following the execution of the PSA, the parties thereto shall file with the ERC, within thirty (30) days therefrom, a joint application for its approval of said PSA and for the determination of the*

¹ Sponsorship Speech of Rep. Heherson Alvarez, Consideration of H.B. No. 8457 on Second Reading, Period of Sponsorship and Debate, 8 October 1999

² 31 May 2001

³ Section 43, EPIRA.

⁴ Section 43 (f), EPIRA.

reasonable generation costs that the DU can recover from its captive market as part of its retail rate.

We believe that Article IV Section I, which requires the “joint” filing by the DU and the generator of the PSA application, unduly expands regulatory control over the generation sector. We respectfully submit that the ERC cannot compel the generator to be a joint applicant, with the DU, in applying for approval of the PSA.

We recognize and respect the ERC’s jurisdiction over the regulated sectors of the power industry. However, the generation sector is expressly declared under the EPIRA as not subject to regulation. Specifically, Section 6 of the EPIRA clearly provides that the generation sector shall be **competitive** and **open**. Upon implementation of retail competition and open access, the prices charged by a generator for the supply of electricity shall **not** be subject to regulation by the ERC.

Sections 25 and 45 (b) of the EPIRA likewise provide that while the DU may freely enter into bilateral power supply contracts, it is the **retail rate charged by the DU** to its captive market which is subject to ERC regulation.

Also, under Rule 11 Section 5 of the Implementing Rules and Regulations of the EPIRA, the review of such bilateral power supply contracts entered into by the DUs shall be required only for DUs whose level of Open Access has not reached household demand level.

Hence, to require the generator to file an application for the approval of its generation rates in the PSA, even if made jointly with the DU, runs contrary to the mandate of the EPIRA.

To our mind, a generator does not become subject to ERC regulation by virtue of a PSA it enters into with a DU or other regulated entity. Based on the language of the EPIRA, what is subject to regulation is the price of supply covered by such PSA which the DU intends to pass on to its customers as part of its retail rate. Since it is only the price that goes into the retail rate payable by customers that is regulated, regulation cannot be so extended to include the business of the generators or the non-pricing stipulations of the PSA. Moreover, since the retail rate is the one charged and collected by the DU from the captive market, then it is but proper for the DU to file the PSA application since they can better justify the price they are charging taking into account the thorough and rigorous selection process employed.

The proposed requirement for joint filing unnecessarily shifts regulation to the cost charged by the generator instead of the correctness and efficiency of a “Competitive Selection Process” (discussed further below, in item 3) conducted by the DU in order to arrive at the least cost supply.

2. *Article IV, Section 5, Par. 3*
“...The ERC’s decision and judgment shall bind both parties and shall not be rendered ineffective or nugatory by any termination or “walk-away” clause incorporated in the PSA.”

We believe that the prohibition against termination or “walk-away” clauses incorporated in the PSA impairs the respective parties’ inherent right to freely contract and establish such terms and conditions as they may deem convenient⁵.

Termination or “walk-away” clauses are typically incorporated in PSAs to provide an opportunity for both parties to withdraw from a contractual obligation, where the outcome of external factors have made a particular undertaking (i.e., for the sale and purchase of electricity at a fixed price) different from what the parties have originally intended and agreed upon.

Without the termination or walk-away clauses, generators would be forced to supply electricity to the DU at a rate which is not commercially viable and sustainable. This will create distortions in the market rates since it is no longer the price at which generators are willing to supply and the price at which DUs are willing to purchase.

We wish to reiterate that the absence of such clauses may create a situation where DUs could be seen as less attractive power supply customers. This is in view of the additional risk levied upon supply contracts between generators and DUs brought about by the possibility of being compelled to comply with a rate inconsistent with what the parties have originally agreed. On one hand, low-cost generators would find greater favor in contracting with contestable customers, as they remain unregulated by the ERC. On the other hand, DUs may be left to contract with high-cost generators, where the cost-based methodology would be made to apply, and the absence of a “walk-away” clause would be a non-issue.

This situation defeats the objective of the EPIRA to promote competition in the power industry as this would discourage private entities – developers and lenders alike – from investing in the generation sector.

Moreover, the modification of contractual stipulations (including the nullification of termination and walk-away clauses and thus effectively compelling the generator and the DU to remain bound to a contract against their will) is no longer be within the scope of judicial or regulatory authority and may not be a valid exercise of police power.

As you may recall, the authority to regulate partakes the nature of police power granted to Congress. The State’s exercise of police power, however, must be tested against strict requisites that have long been established: (1) it must be required to protect the interests of the public generally, as distinguished from those of a particular class, and (2) the means employed must be reasonably necessary to the accomplishment of the purpose sought to be achieved and not unduly oppressive upon individuals. In simpler terms, the police measure, to be valid, must have a lawful objective and a lawful method of achieving it.⁶

However, a review of Article IV, Section 5, where it renders ineffective termination or walk-away clauses, together with Article IV Section 1 in its requirement of a joint

⁵ Article 1306 New Civil Code: “The contracting parties may establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order, or public policy. (1255a)”

⁶ *Lucena Grand Central Terminal, Inc. v. JAC Liner, Inc.* (G.R. No. 148339, 23 February 2005); *National Press Club v. Commission on Elections* (G.R. No. 102653, 102925, 102983, 5 March 1992)

filing by the generator and the DU, leads to an observation that such measures do not have a lawful method.

The method is unlawful for being unnecessary considering that a competitive selection process is already required and, thus, can already bring to fore the best available price and contractual terms, consistent with the policy of the EPIRA to promote open and transparent pricing and guard against anti-competitive behavior.

In addition, the proposed methods can also be found unlawful for being oppressive on the part of the generator and the DU as it subverts their express and clear intent in assuming their mutual obligations in the PSA, and, in certain instances, may amount to a taking or expropriation that would require the payment by the State of just compensation.

It should be remembered that the generator and the DU are allowed to enter into contractual stipulations as they may deem convenient provided that they are not contrary to law, morals, good customs, public order or public policy. This however should not extend to the point that the regulator may substitute its own terms of the PSA, and disregard the contractual stipulations of the generator and the DU.

Thus, we are of the position that Article IV, Section 5, together with Article IV, Section 1, of the Proposed Rules could be said to constitute an overarching exercise of police power by the ERC.

3. *Article IV, Section 2: Pricing Structure*

It appears that the proposed rules, particularly Article IV, Section 2 on the pricing structure, advocates a “cost-based” approach in the pricing of the generation rate, as it principally and strictly takes into account: (i) a capital recovery fee, (ii) operations and maintenance fee, and (iii) fuel fee, and does not lend itself to the determination process brought about by market forces.

We wish to express our reservation in adopting the same due to its inherent inability to incentivize the efficient expansion, operation, and maintenance of systems in the generation sector. In a study, it was observed that the excessive focus on historical costs of generation runs the danger of a misalignment between the optimal level of expansion and the value of investment and O&M costs. Thus, due to the absence of economic signals to allow the load (i.e., generation demand) to adapt with the true conditions of the system (i.e. power supply and demand), over or under-investment may ensue. (Montoya et. Al., 2006)⁷

The Philippine power industry can benefit and learn from the experiences of more advanced and competitive power industries that have preceded ours.

⁷ Montoya, E. and Morales, O., *Three Approaches of Generation Price Regulation: Cost-Plus, Contracts and Marginal Cost. Application to Venezuelan Case*, Transmission & Distribution Conference and Exposition: Latin America, (August, 2006)

Under the United States' Energy Policy Act of 2005 (EPAct 2005) an Electric Energy Market Task Force conducted a study on the importance of competition in wholesale and retail markets for electricity in the US.

According to the "Report to Congress on Competition in Wholesale and Retail Markets for Electric Energy", the Electric Energy Market Task Force found that the introduction of competition in the electric power industry overcomes the shortcomings of a traditional cost-based regulation. The study found that in competitive markets, efficiency in investment and consumption decisions are driven and guided by prices. Furthermore, the study posits that market-based, unregulated pricing of electricity shall lead to a more efficient allocation of electrical resources and lower overall prices through the more accurate reflection of the price of electricity with the value the customers place on electricity (Electric Energy Market Competition Task Force, 2007)⁸

This sentiment was echoed and emphasized in Paul L. Joskow's "Expanding Competitive Opportunities in Electricity Generation". Joskow found that states must employ market-based incentive regulation mechanisms rather than traditional accounting cost-of-service retail rate regulation. In this manner, purchasing utilities are encouraged to search for and contract with the best sources of generation. (Joskow, 1992)⁹

In the Philippine setting, these principles are embodied in Chapter 1 Section 2 (c) and (d) of EPIRA:

"(c) To ensure transparent and reasonable prices of electricity in a regime of free and fair competition and full public accountability to achieve greater operational and economic efficiency and enhance the competitiveness of Philippine products in the global market"

(d) "To enhance the inflow of private capital and broaden the ownership base of the power generation, transmission and distribution sectors;"

4. *Competitive Selection Process*

In lieu of a cost-based methodology, we respectfully propose that the ERC adopt a **strict implementation of a Competitive Selection Process as the basis of reviewing and approving PSA applications, consistent with the mandate of EPIRA.**

It is our view that a Competitive Selection Process is the most effective and sustainable way to ensure that DU's comply with their obligations, pursuant to Section 23 of the EPIRA and Rule 7 Section 4 (h) of its implementing rules and regulations, to wit:

⁸ Electric Energy Market Competition Task Force, *Report To Congress On Competition In Wholesale And Retail Markets For Electric Energy*, (July, 2007)

⁹ Joskow, P. *Expanding Competitive Opportunities in Electricity Generation*, CATO Review of Business & Government, (1992)

“The Distribution Utility shall supply electricity in the least cost manner to the Captive Market within its Franchise Area, subject to the collection of Retail Rates duly approved by ERC.”

This is because through a CSP the focus will be on the manner of procurement of the DU rather than the rate itself. By ensuring that there was a competitive and transparent selection done in the procurement of electricity, then we can be assured that at that point in time and with certain circumstances, the rates of the PSA that the DU entered into is fair and reasonable.

A Competitive Selection Process promotes free and fair competition under Section 2(a) of the EPIRA, by providing interested and qualified generators and/or suppliers an equal opportunity to give their most competitive supply offer while ensuring that such offers represent the price at which they are willing to sell their power for:

“To ensure transparent and reasonable prices of electricity in a regime of free and fair competition and full public accountability to achieve greater operational and economic efficiency and enhance the competitiveness of Philippine products in the global market.”

A Competitive Selection Process, as opposed to a cost-based pricing approach, also implements a “non-discriminatory” rate-setting methodology which places importance and promotes transparency in the interplay between the generators and DUs, which are essential to promoting competition and encouraging market development in a restructured electricity industry.¹⁰

Thus, we would like to offer the attached Annex “A”, supplying the details of a proposed Competitive Selection Process for the ERC’s consideration.

Once again, we wish to thank the Honorable Commission for allowing PIPPA to participate in the consultation process for the proposed rules. PIPPA is hopeful that its comments on the Proposed Rules would be taken by the Honorable Commission into consideration.

Very truly yours,

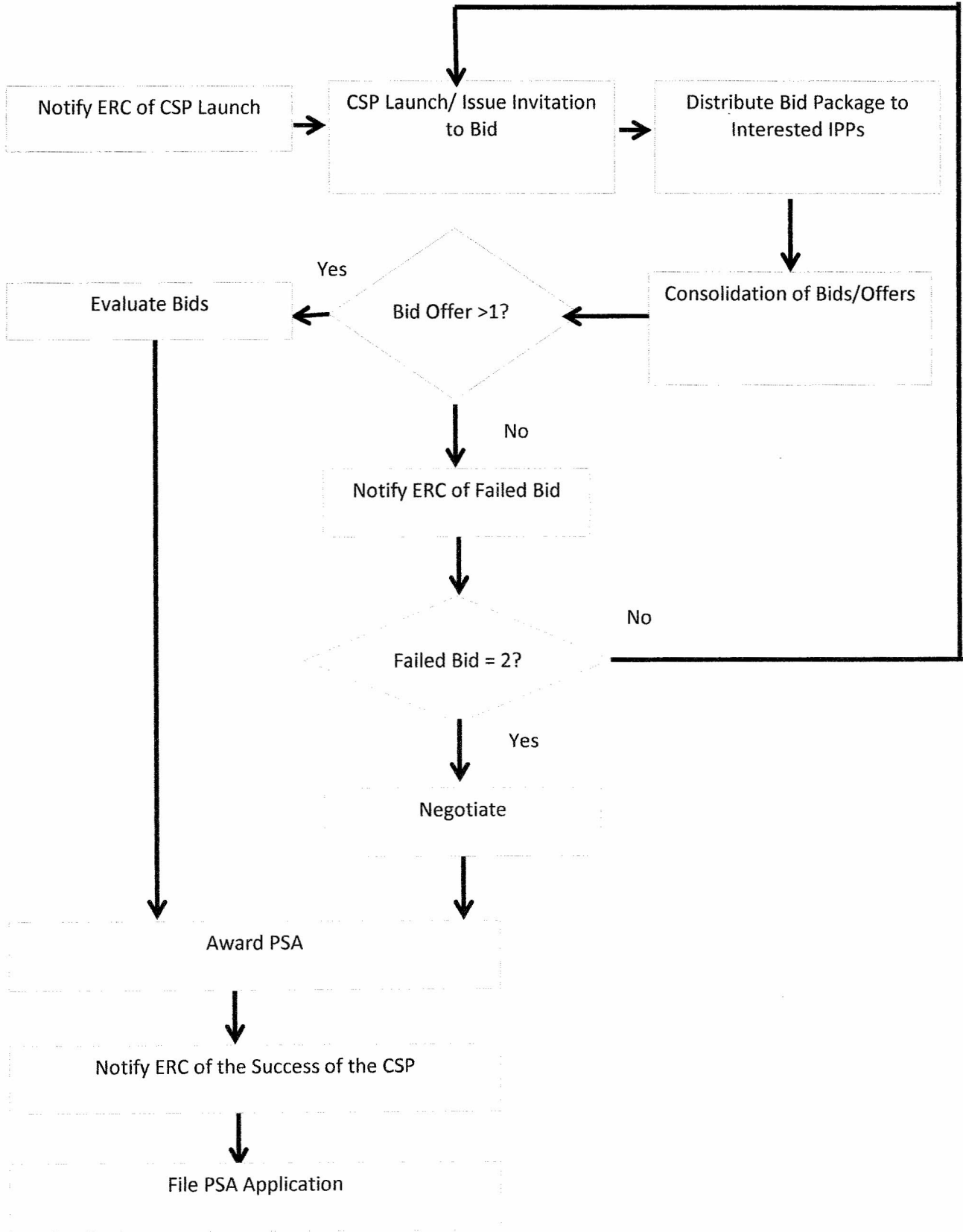
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ERNESTO B. PANTANGCO
President

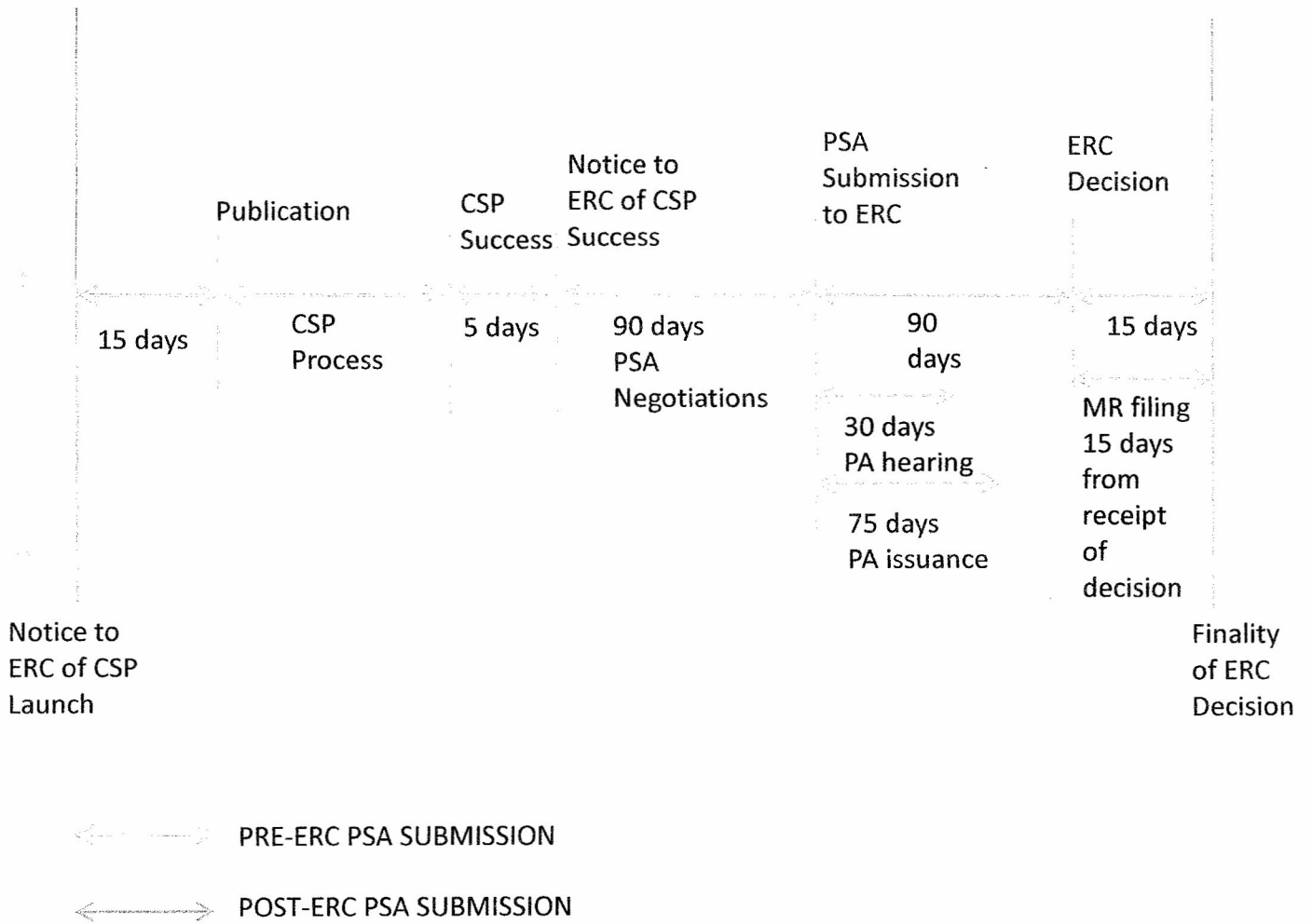
¹⁰ Section 43 and 43(f) EPIRA.

ANNEX "A"

FLOWCHART OF THE COMPETITIVE SELECTION PROCESS (CSP)



TIMELINE OF THE CSP AND THE PSA APPLICATION



DETAILED PROCESS OF THE CSP

Notify ERC of CSP Launch

The CSP Process shall be initiated at least twelve (12) months before the expected date supply from the PSA will start. The CSP Process is deemed to have been started from the date of the notice letter to the ERC, below.

Fifteen (15) business days before the publication of the invitation to bid and sending of the letters of invitation to IPPs, DU shall send a letter notifying ERC that it will launch a CSP.

Launch CSP/ Issue Invitation to Bid

The DU shall publish the invitation to bid in at least one (1) newspaper of general circulation and send written letters of invitation to bid to more than one (1) Generator or Supplier.

The DU may also publish via emails or postings in the DOE or ERC websites.

Distribute Bid Package to Interested Generators or Suppliers

The DU shall facilitate the distribution of Bid Package to Interested IPPs. The Bid Package shall include, but not limited to, the following:

- Terms of Reference;

The "Terms of Reference" shall be established prior to the bidding and shall be included in the bid package. At the minimum, the Terms of Reference to be used by the DU shall include, but not limited to, the following terms of reference that will be regarded as mandatory:

- a. Rate Scheme and Adjustment
- b. Discounts
- c. Contracted Capacity and Type of Supply
- d. Minimum Energy Off-Take (MEOT)
- e. Cooperation/Contract Period
- f. Maintenance Allowance / Service Interruption Adjustment
- g. Replacement Power
- h. Inclusion of specific events to be classified as Force Majeure and Effect of Force Majeure
- i. WESM Membership

- Timeline of the Bidding;
- Standard Response Form ; and,
- Documentary Requirements for the Bidders.

Consolidate Bid Offers

If the DU receives more than one (1) bid, then the DU shall proceed in the Evaluation of the bids.

Otherwise, the DU must declare a Failed Bid. Upon the declaration, the DU shall launch another CSP (see diagram above). Furthermore, within five (5) business days after the declaration, the DU shall send a letter notifying ERC of the Failed Bidding.

After two (2) Failed Biddings, the DU may enter into negotiations with any interested generator or supplier for the supply of energy, until a PSA is awarded to an interested generator or supplier.

Evaluate Bids

At the minimum, the evaluation should meet the objective of the CSP as defined above, focusing on the technical and commercial impact to the Captive Customers.

All bids/offers must be treated fairly and equitably, and must be consistent with the mandatory terms of reference of the DU. If a bid/offer deviates from any of the mandatory terms of reference, and then the bid/offer of the BIDDER shall be deemed NON-COMPLIANT.

The basic principle of bid evaluation is that all rate and non-rate factors should be given proper consideration based on their respective impact on the Captive Customers. Rate factors are factors that can be translated to a PhP/kWh value, while non-rate factors are factors that has no direct effect on the rate but may benefit the DU and its Captive Customers (i.e. Value-Adding Services).

Award the PSA

Once all bids are evaluated and ranked, the DU shall select the best bid/offer award the PSA, accordingly.

Notify ERC of the Success of the CSP

Five (5) business days after the declaration of the Success of the CSP, DU shall send a letter notifying ERC to whom the PSA is awarded.

File PSA Application

Ninety (90) business days after the declaration of a Success of the CSP, DU shall file with ERC an application for the approval of the Power Supply Agreement between the DU and the generator or supplier which is recipient of the awarded PSA.

ERC may issue a provisional authority within seventy-five (75) days from such filing. ERC shall render a decision on the application within ninety (90) days from the time the application is formally offered for resolution, otherwise the application shall be deemed approved upon the lapse of such period.

All final orders, resolutions or decisions of the Commission shall become final and inappealable upon the expiration of fifteen (15) days from notice thereof to all parties.

File Motion for Reconsideration

The DU may, within fifteen (15) days from receipt of the order, resolution, or decision, file a motion for reconsideration.

The filing of a motion for reconsideration shall stop the running of the fifteen-(15) day period and prevent the final order, resolution or decision of the ERC from becoming final and inappealable.

EVALUATION OF THE CSP CONDUCTED BY THE DU

ERC shall evaluate the success of the CSP based on the following conditions:

- The DU is able to provide the following documents must be included in the filing of application for the approval of the PSA:
 - Notification Letter to ERC re: Launch of CSP
 - Proof of CSP Launch
 - Certification of Publication;
 - Copy of Publication, if applicable; and,
 - Copy of Invitation Letters to IPPs.
 - Notification Letter to ERC re: Failed bid, if any
 - Notification Letter to ERC re: Success of the CSP
 - Copy of the PSA

- The DU is able to submit and Bid Evaluation Summary, which includes the following:
 - Checklist containing a summary of compliance of the bids to the mandatory Terms of Reference;
 - Comparison of rate impact to Captive Customers; and,
 - Rationale of the Award of PSA.