

## Toward a Financially Sound and Efficient Power Sector

*The large and growing deficit of the Philippine power sector is a major factor in the country's deteriorating fiscal position. In the short term, price increases—which will need to be managed carefully to minimize adverse effects both on the poorest groups and on the competitiveness of Philippine industry—are needed to stem losses. As planned, the Government needs to take on a substantial part of NPC debt to place its electricity businesses on a sounder financial foundation. The challenge now is to reduce financial losses, successfully pursue the implementation of reforms, and urgently improve the business environment. This is needed to attract investors, both to ensure the successful privatization of NPC assets and to increase electricity supply in the final years of the decade. In the medium to longer term, greater competition, increased participation by the private sector, and better regulation will be key elements in stopping the drain on the country's finances and sustain recovery in the power sector.*

### A. Background

The Philippines is facing an immediate financial crisis in the power sector. The cash deficit of the National Power Corporation (NPC), the state-owned generation and transmission company, increased sharply from P19 billion (\$500 million) in 1999 to about P86 billion (\$1.5 billion—including loan repayment and capital expenditures) in 2003. This cash deficit is projected to rise to about P114 billion (\$2 billion) in 2004 and to continue rising beyond that if no remedial action is taken.<sup>1</sup>

While the financial condition of the sector is extremely weak, there is no immediate risk of country-wide electricity supply shortages of the kind experienced in the early 1990s. Currently, there are pockets of generation shortages in Mindanao and the Visayas, as well as some transmission bottlenecks in the network. Relatively modest investments would be sufficient to eliminate the generation shortages for the next 5 years and to remove the transmission constraints. More substantial investments (around 600 megawatts of new base load capacity) are, however, likely to be needed by 2010.

The Government has launched an ambitious reform program. The Electric Power Industry Reform Act (EPIRA), approved in

June 2001, provides the framework for the restructuring, recapitalization, and privatization of NPC assets and for reform of the industry as a whole. While the target dates set for implementation of these reforms were challenging and have not been met, substantial progress is now being achieved in the establishment of the wholesale market and the unbundling of network services from retail supply.

The challenge now is to reduce financial losses, successfully pursue the implementation of these reforms, and urgently improve the business environment in the sector. This is essential in order to attract investors back to the Philippine power market in time to ensure the successful privatization of NPC assets envisaged under EPIRA, and to increase electricity supply in the final years of the decade. At the same time, it would foster efficient performance by all market participants.

### B. Main Issues

#### *Sector financial crisis*

To cope with the power crisis of the early 1990s, NPC entered into power purchase agreements (PPAs) with a large number of independent power producers (IPPs). However, in hindsight, NPC overcontracted with IPPs and incurred huge liabilities. The slowdown in demand growth that followed the 1997 Asian financial crisis and the

<sup>1</sup> Subtracting loan repayments from this leaves an expected deficit of about P90 billion for 2004.

recent steep increases in fuel prices also contributed to raise NPC's costs, while regulated generation and retail prices have failed to reflect these costs. Indeed, retail rates have in fact fallen in US dollar terms in recent years, and at P5.53 per kilowatt-hour (kWh) on average in 2003, they are no longer among the highest in the ASEAN region.

NPC has had to increasingly rely on external borrowings to cover its rising debt service requirements. By end-2003, its aggregate long-term liabilities (largely guaranteed by the Government) had reached P1.17 trillion (\$20.9 billion, including IPP financial obligations) and the company had a negative net worth of P327 billion (\$5.84 billion).

#### ***Investment needs***

High system losses and frequent supply interruptions suggest that some investments are required in the short term, though as mentioned above, they are modest: maintenance and rehabilitation of some of NPC's plants, as well as transmission projects, would amount to about \$400 million over the next 4 years.

Given the difficult fiscal situation of the Government, it is essential to correctly identify the priorities and to limit investments to these priorities in the short term. At present, both NPC and the National Transmission Corporation (TRANSCO) have investment plans that seem to go much beyond immediate priority requirements.

More substantial investments will, though, be needed toward the end of the decade, and the key challenge in that regard is to urgently reduce the regulatory uncertainty that constitutes, at present, the key barrier to investment in the sector, as now discussed.

#### ***Ambitious market restructuring***

Successful implementation of the planned wholesale electricity spot market (WESM) will be critical for the success of the reforms. Although WESM's basic design is sound and is based on functioning markets in Australia and New Zealand, much

remains to be done to ensure success in implementation.

Many potential market participants are unprepared for the market and some of—the electric cooperatives (ECs)—may need considerable technical support. The poor credit rating of some ECs will also be an obstacle to their participation in WESM.

A major advantage of competitive wholesale markets is that investment decisions are no longer dictated by government planning. As in many other countries, evolution of the energy sector over the past decade in the Philippines is testimony to the failure of the monopoly/central planning approach. In principle, WESM should provide good price signaling for new capacity to come into the market. In the absence of a sufficiently attractive business climate, however, such advantages may not fully materialize, and commercial investment in new capacity may prove insufficient.

#### ***Stalled privatization program—TRANSCO and NPC generating companies***

Sales of NPC assets have not happened as previously forecast and the current expectations of sale of all the generation assets in 2–3 years appear optimistic. The concessioning of TRANSCO has also been repeatedly delayed and is still awaiting completion. In both cases, political and regulatory uncertainty has been the key reason for the delays.

As far as the privatization of generation assets is concerned, transitional supply contracts are key to limiting direct exposure to the market in the early years. These contracts will in effect determine the value of the generating companies and the risks faced by the distributors as retail suppliers. Negotiation of these contracts is proceeding. Some important issues are yet to be fully addressed, though—arguably the most important relates to the way in which these contracts will take into account the impact, on generators and distributors, of the transition to retail competition.

With respect to TRANSCO, a key outstanding issue relates to the adoption of the Franchise Bill currently with the legislature. The absence of the Bill increases uncertainty and therefore reduces the value of the concession for potential concessionaires.

### ***Energy Regulatory Commission capacity and performance***

The restructuring of the industry and the introduction of competition are creating demanding new tasks for the Energy Regulatory Commission (ERC), yet ERC is already struggling with its current responsibilities. While it has started to develop more professional capabilities, it is still losing staff to the regulated companies. ERC has been unable to adhere to the deadlines set down in EPIRA, which set out that the unbundling decisions for the 140 distributors—now almost complete—should have been made by 2002. In addition, ERC suffers from perceptions that it does not always strike a reasonable balance between the interests of the various stakeholders. For example, the delays and discretion in price adjustments for foreign exchange rate and fuel cost fluctuations might create the impression that ERC favors consumers' interests.

Better ERC performance is essential for the success of the reform program. ERC therefore needs to retain its highly qualified staff, streamline its processes, and address perceptions of bias.

### ***Impact of reforms on the poor and on industrial competitiveness***

Implementation of the electricity price increases required to improve the financial situation of NPC will undoubtedly constitute a political challenge, especially since taxes will also have to rise to improve the overall macroeconomic situation and since fuel price increases—stemming from the high world price of oil—are already raising the costs of a wide range of goods.

Industrial users will be protected to some degree by the removal, currently under way,

of various cross-subsidies that have increased electricity prices for industry. Residential users, on the other hand, will be negatively affected, both by the required price increases and by the removal of these cross-subsidies. Subsidized “lifeline rates” (applied to consumption up to 100 kWh per month) are, however, generous by regional standards: they afford substantial protection to a large number of users well beyond the poorest groups.

### **C. Options for Reform**

There is no quick fix to the huge cash deficit of NPC or to the poor performance of the power sector. The reform program that is being prepared by the Government is generally well designed. The challenge is implementation. Taking the various steps outlined below would help in that respect and could achieve a substantial turnaround in performance. These actions need to be complemented by measures, not specific to the power sector, that are aimed at stemming the fiscal deficit and at improving the overall investment climate.

#### ***Improving financial performance***

Immediate actions:

- Demonstrate political will at the highest level to restore the financial viability of the sector. A major policy statement by the President could set quantitative targets to reduce NPC's deficit.
- Increase NPC's generation tariffs to cover at least operating costs. This would imply an increase of at least P1.56 per kWh in 2004.
- Substantially reduce NPC debt by transferring debt to the Government and take other debt management measures as needed to eliminate NPC's cash deficit (including loan repayment, excluding capital expenditures, and before any external financing).

Medium-term actions:

- Implement universal charge for recovery of stranded costs of NPC and the Power

Sector Assets and Liabilities Management Corporation(PSALM) .

- Implement other tariff increases and/or debt transfers if needed to ensure that NPC does not generate a cash deficit.

#### ***Focusing investments on key priorities***

Immediate actions:

- Establish a capital expenditure plan that focuses on priority investments only. The planned investments of both NPC-Small Power Utilities Group (SPUG) and TRANSCO (about \$3 billion over the next 10 years) warrant careful scrutiny.
- Introduce time-of-use (TOU) pricing for electricity generation.

Medium-term actions:

- Review capital expenditure priorities to ensure focus on priority investments only.

#### ***Implementing successful market restructuring***

Immediate actions:

- Prepare support programs for WESM participants, especially the ECs.
- Consider hiring top notch expertise to advise on a broad set of technical issues associated with WESM implementation.

Medium-term actions:

- Establish a mechanism to address the poor creditworthiness of many ECs.
- Consider imposing capacity contracting obligations upon distributors if serious concerns arise as to whether there will be enough investment in new capacity.
- Commence WESM operation in 2006 at the latest.

#### ***Maximizing benefits from private participation***

Immediate actions:

- Finalize and secure ERC's approval of the transitional supply contracts.

- Secure adoption of the Franchise Bill.
- Entrust an independent third party with the task of evaluating assets to be privatized or concessioned, in order to obtain realistic estimates of their value in the current market environment.

Medium-term actions:

- Award TRANSCO concession.
- Sell majority of generating assets of PSALM.

#### ***Improving regulatory performance***

Immediate actions:

- Allow ERC to use its own revenues to fund part of its budget requirements (in order to increase ERC's resources and autonomy).
- Revert to automatic foreign exchange and power purchase price adjustments (in order to increase regulatory certainty and lighten ERC's workload).
- Review ERC structure, capacity, and resource needs.

Medium-term actions:

- Implement performance-based regulation for electricity distribution (in order to lighten ERC's workload while providing stronger incentives for efficiency).
- Adopt standardized approach to the regulation of distribution companies rather than highly individualized price reviews for each company (in order to lighten ERC's workload).
- Publish detailed guidelines on processes and methodologies to be used to approach specific regulatory issues of concern to investors (e.g., evaluation of usefulness of investments) regarding the setting of price or revenue caps (in order to increase regulatory certainty).

***Ensuring adequate consumer and industry protection***

Immediate actions:

- Carry out a forceful, and professionally managed, public information campaign to (i) explain the reasons why price increases and market reforms are essential and (ii) highlight the impact of the social protection mechanisms that are in place (such as lifeline rates).

Medium-term actions:

- Finalize the elimination of cross-subsidies to provide better price signals and improve the competitiveness of industrial users.
- Review existing social protection mechanisms in the power sector and determine whether such mechanisms could be improved, for example by ensuring better targeting of the poorest or by enhancing incentives for efficient service delivery.