Republic of the Philippines
ENERGY REGULATORY COMMISSION
San Miguel Avenue, Pasig City

IN THE MATTER OF THE APPLICATION FOR APPROVAL OF THE ENERGY SUPPLY CONTRACT (ESC) BETWEEN TARLAC ELECTRIC, INC. (TEI) AND AND SAN MIGUEL ENERGY CORPORATION (WITH PRAYER FOR PROVISIONAL AUTHORITY),

ERC CASE NO. 2011-081 RC

TARLAC ELECTRIC, INC. (TEI) AND SAN MIGUEL ENERGY CORPORATION (SMEC),

Applicants.

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DOCKETED
Date: JUN 21 2018
By:

ORDER

Before this Commission for resolution are the following:

1. *Motion for Clarification* dated 09 December 2015 (Motion) filed by Applicant San Miguel Energy Corporation (SMEC) on 10 December 2015 relative to the *Decision* dated 17 August 2015 issued by the Commission in the instant case; and

2. *Motion to Defer Compliance* (Motion to Defer Compliance) dated 11 January 2016 filed by Applicant San Miguel Energy Corporation (SMEC) on 13 January 2016, relative to the *Decision* dated 17 August 2015 issued by the Commission in the instant case.

FACTS

On 26 May 2011, Applicants Tarlac Electric, Inc. (TEI) and SMEC filed the instant *Application* dated 13 April 2011 for the

approval of their Energy Supply Contract (ESC), with prayer for provisional authority.

On 17 August 2015, the Commission issued a *Decision*, the dispositive portion of which reads:

> **WHEREFORE**, the foregoing premises considered, the provisional authority granted to Tarlac Electric, Incorporated (TEI) and San Miguel Energy Corporation (SMEC) on July 18, 2011 in relation to this application, is hereby made **PERMANENT**, subject to the following modifications:
>
> 1. The applicable base rates shall be the Time-of-Use (TOU) rates provided under the ESC, which shall be adjusted in accordance with the Adjustment Formula stated therein; and
>
> 2. SMEC's actual cost of operation and construction shall be audited by an Independent Third Party, in accordance with the rules to be promulgated by the Commission, and the approved rates herein shall be adjusted, if warranted. The test of reasonability shall be "*whether or not such cost is incurred based on a good utility practice and comparable or within the level of the power plants similarly situated to that of SMEC*" and **NOT** the actual cost incurred. The cost of audit shall be shouldered by SMEC.
>
> The Commission further **RESOLVES** to:
>
> 1. **MODIFY** the provision of the ESC under Section 4.3.a (Customer is not a Direct WESM Member), so that: "*In the event that the SUPPLIER provided electricity in excess of one hundred twenty percent (120%) of the contracted energy to the CUSTOMER, the basic energy rate shall be the actual cost incurred by the SUPPLIER in providing such additional energy. For electricity purchased beyond the contracted energy but within one hundred twenty percent (120%) thereof, the rate shall be the approved basic energy rate*";
>
> 2. **DIRECT** PANELCO III and SMEC to **SUBMIT**, within thirty (30) days from receipt hereof, their proposed refund or recovery scheme, as the case may be, for the difference between the final approved rates and the provisionally implemented rates; and
>
> 3. **DIRECT** PANELCO III to **PASS ON** to its member-consumers fifty percent (50%) of the Prompt Payment Discount (PPD) availed from SMEC and fifty percent (50%) of the Collection Efficiency Discount (CED) granted to it.
>
> SO ORDERED.

SMEC then filed the *Motion for Clarification and Reconsideration.* In its *Motion*, SMEC alleged the following:

1. On November 26, 2015 SMEC received a copy of the Decision dated August 17, 2015, which a) made permanent the provisional authority issued on May 28, 2012 b) requiring the audit of SMEC's actual cost of operation and construction by an Independent Third Party c) modifying Section 4.3.a of the ESC d) directing the parties to submit within thirty (30) days the proposed refund or recovery scheme for the difference between the final approved rates and the provisionally implemented rates; and e) directing TEI to pass on 50% of the PPD and 50% of the CED to its consumers.

2. The Energy Supply Contract (ESC) between SMEC and TEI had a term from December 26, 2010 to December 25, 2012.

3. Applicant SMEC respectfully seeks to clarify certain findings in the Decision on the grounds discussed below.

Capital Recovery Fee

4. The Honorable Commission defined the Capital Recovery Fee (CRF) as referring to "the recovery of SMEC's invested capital as an IPPA plus a recoverable return". Further, the Decision also stated that the "use of the net amount of PPE is similar with the methodology typically adopted by the Commission relative to the IPPs where capital investment for construction of power plant is incurred at the beginning or to those which pay for the plant acquisition cost up front. The CRF was computed using the net amount of Property, Plant and Equipment (PPE) as reflected in SMEC's 2012 Audited Financial Statements (AFS) and a return equal to the previously approved Weighted Average Cost of Capital (WACC) of 13.59% as approved by the Commission in its Decision dated July 30, 2012 in ERC Case No. 2011-138 RC.

5. SMEC respectfully submits that the foregoing basis for computation of the CRF does not apply to it as an IPP Administrator.

   5.1. With all due respect, the Commission may have overlooked the fact that SMEC is only the Administrator of the Net Contracted Capacity of the Sual Coal-Fired Power Plant under an IPP Administration Agreement (IPPAA) with the Power Sector Assets and Liabilities Management Corporation (PSALM). **As such IPP Administrator, SMEC did not make any capital investment for the construction of the Sual Power Plant or pay up-front for the acquisition of the power plant.**

   5.2. SMEC pays to PSALM fixed monthly payments in US Dollars and Philippine Peso components, under the IPPAA. Based on these fixed monthly payments among

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others, SMEC computes the CRF for the months within the supply period under its power supply contracts with its customers. Thus, SMEC recovers only the costs incurred by it for the period during which it supplies power to its customers.

5.3. SMEC would like to call the attention of the Honorable Commission to its Decision dated December 9, 2013 in ERC Case No. 2010-086 RC (*In the Matter of the Application for the Approval of the Energy Supply Contract [ESC] Entered Into By and Between Tarlac II Electric Cooperative, Inc. [TARELCO II] and San Miguel Energy Corporation [SMEC], with Prayer for Provisional Authority*). This involves same Unit 2 of the Sual Power Plant. In this Decision, the Honorable Commission defined the CRF:

a. "**Capital Recovery Fee** – refers to the recovery of the IPPA Monthly Capacity Fees paid to PSALM denominated in Philippine Peso and US Dollars, for both the opportunity to trade, and the payments for the physical assets (based on the bid);"

Further, in the same Decision in ERC Case No. 2010-086 RC, the Honorable Commission also stated that "For typical generation companies, capital investment is incurred at the beginning. <u>On the other hand, IPPAs are not required to pay for the plant acquisition cost up front but they pay the bid price through monthly payments out of cash flow.</u> Given this unique characteristic of the IPPA structure, the <u>**Commission believes that the normal methodology it uses is not applicable**</u>." (underscoring and emphasis supplied)

"The Commission derived the Capital Recovery Fee (CRF) by referring the same to the monthly payments of an IPPA to PSALM under their IPPA Agreement. The computed CRF Fee will allow the IPPA to generate revenue sufficient to cover its required monthly payments plus a margin equal to the 16.44% post-tax cost of equity, as approved by the Commission in ERC Case No. 2011-138 RC."

5.4. SMEC respectfully submits that the above-quoted Decision is the more appropriate definition of the CRF. The above-cited Decision accurately recognizes the structure of the IPPA arrangement, and the nature of the payments made by the IPPA to PSALM. This is also consistent with the previous approvals for Sual such as ERC Case No. 2012-087 RC (In the Matter of the Application for Approval of the Power Supply Agreement [PSA] Between Manila Electric Company [MERALCO] and San Miguel Energy Corporation [SMEC]), and those of other IPP Administrators such as ERC Case No. 2012-035 RC (In the Matter of the Application for Approval of the Power Supply

Agreement [PSA] Between Manila Electric Company [MERALCO] and Therma Luzon, Inc. [TLI]).

6. Applicant SMEC therefore respectfully clarified with the Honorable Commission that the CRF should be computed based on the monthly fixed payments made to PSALM under the IPP Administration Agreement within the relevant supply period under the ESC plus a margin equal to the 16.44% post-tax cost of equity, based on previous ERC approvals.

Evaluation of the Non Rate Provision of the ESC

7. The Honorable Commission modified Section 4.3.a of the ESC and required SMEC to charge the approved basic energy charge for power in excess of the contracted energy within 120% of the contract energy.

8. The above provision applies only to SMEC's customers who are not Direct WESM Members, and SMEC has long maintained its position that if the energy was supplied from the available capacity of the power plant, the customer is billed at the contract rate even if the supply is beyond 120% of the contract energy.

9. Under the ESC, SMEC's obligation to supply is limited to 100% of the Contract Energy, nothing more. However, to address any imbalance caused by the variation of TEI's energy consumption, and since TEI was not a Direct WESM Member at the time, SMEC is responsible for sourcing energy to address any consumption above the Contract Energy. Thus, in the event of overconsumption, Section 4.3.a of the ESC provided that"

   "Whenever available, in accordance with good utility practice, the SUPPLIER **may, but shall not be obliged to** provide electricity to the CUSTOMER in excess of the Contract Energy provided that the CUSTOMER shall pay the appropriate Default Wholesale Supply Arrangement (DWSA) charges for consumption in excess of one hundred twenty percent (120%) of the contract energy level." (emphasis supplied)

   This should not be interpreted to mean that SMEC is obligated to supply up to 120% of the Contracted Energy to TEI. Section 4.3.a of the ESC is clear that SMEC **may**, but shall not be obligated to supply electricity in excess of the Contract Energy only when there is available capacity from the plant.

10. The ESC only contemplates the Contract Energy, and energy over and above the Contract Energy is not covered and therefore subject ort different pricing. SMEC determines the Contract Energy based on the available capacity of the plant, and the needs of its other customers. Therefore SMEC can only supply additional energy if there is available capacity which was not nominated by its other customers. However, during the

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supply period under the ESC there was no available capacity from the plant to supply any additional energy for TEI, as SMEC was constrained to purchase replacement power from the WESM.

11. This additional energy, if sourced from the WES, should be billed at the applicable WESM Price, and fi the additional energy exceeds 120% of the Contract Energy, there is an additional DWSA Charge as required by the ten DWSA rules. Any energy over and above the Contract Energy is billed at the cost of purchase, since there is no available capacity from the Sual. This is the understanding between SMEC and TEI when they signed the ESC. The terms of the ESC, including Section 4.3.a was duly approved by the Board of Directors of TEI and SMEC. Therefore, both parties freely and knowingly entered into the ESC with a complete understanding of Section 4.3.a.

12. SMEC agrees with the ERC's mandate to protect the interest of the consumers insofar as they are affected by the rates. However, SMEC submits that the original Section 4.3.a is not contrary to law, morals or public policy to warrant the interference of the ERC to amend the same to a provision that was not agreed upon by the parties.

    Article 1306 of the New Civil Coode gives contracting parties full freedom to contract provided their agreement is not contrary to law, morals, good customs, public order or public policy. "An agreement is against public policy if it is injurious to the interests of the public, contravened some established interest of society, violates some public statute, is against good morals, tends to interfere with the public welfare or safety, or, as it is sometimes put, if it is at war with the interests of society and is in conflict with the morals of the time. (Carmen dela Paz Vda de Ongsiako vs. Teodorico Gamboa and Pantaleon Gamboa, et. Al., G.R. No. L-1867.April 8, 1950, citing Peope vs. POmar (46 Phil., 440) and in Philippine National Bank vs. Vda. E Hijor de Angel Jose (63 Phil., 814).

13. It is respectfully submitted that the provision in question is not contrary to public policy, but instead was mean to reflect the true cost of electricity beyond the quantity contemplated by the ESC. If SMEC required to price the additional energy at the basic energy charge. SMEC would in effect be subsidizing TEI's overconsumption, and in effect penalize SMEC for the imbalances caused by TEI.

14. SMEC therefore prays for the reconsideration of the Decision insofar as it modifies Section 4.3.a of the ESC.

Independent Third Party Audit

15. The Commission also ordered that "SMEC's actual cost of operation and construction shall be audited by an Independent Third Party, in accordance with the rules to be promulgated by

the Commission, and the approved rates herein shall be adjusted, if warranted".

16. Being an IPP Administrator, SMEC did not incur any cost of construction, actual or projected. This requirement would apply to generation companies who have constructed their own power plants and signed power supply agreements prior to construction for purposes of project finance – their power supply contracts would be adjusted to reflect the actual cost of construction after the plant is constructed. SMEC did not build the Sual Coal Fired Thermal Power Plant, and there would be no basis to further adjust the rates in this case when the ESC has long expired.

17. SMEC's finances are audited by R.G. Manabat and Co., a member firm of KPMG network of independent firms affiliated with KPMG International Cooperatives, a Swiss entity. R.G. Manabat and Co. is an independent auditor which not related to or affiliated with SMEC, SMC Global Power Holdings and San Miguel Corporation. The Audited Financial Statements resulting from its audit are submitted to the Bureau of Internal Revenue (BIR) and the Securities and Exchange Commission (SEC) who are the other regulators having jurisdiction over SMEC.

18. SMEC has therefore already complied with the ERC's requirement of an independent third party audit. With respect to compliance with the rules to be promulgated by the ERC, we will comply when the rules are issued.

PRAYER

WHEREFORE, based on the foregoing premises, applicant SMEC respectfully seeks to clarify with the Honorable Commission the following points:

1. The Capacity Payments are based on the fixed monthly payments to PSALM under the IPPA Agreement, for the supply period under the ESC not on the net PPE under the 2012 AFS.

2. SMEC has already complied with the requirement for an Independent Third Party Audit.

Applicant prays for other just and equitable relief.

Subsequently, SMEC filed the *Motion to Defer Compliance* alleging the following:

1. On 17 August 2015 the Commission rendered a Decision in the above-captioned case (docketed 13 November 2015), the dispositive portion of which reads in part:

WHEREFORE, the foregoing premises considered, the provisional authority granted to Tarlac Electric,

Incorporated (TEI) and San Miguel Energy Corporation (SMEC) on July 18, 2011 in relation to this application, is hereby made **PERMANENT**, subject to the following modifications:

xxx

The Commission further **RESOLVES** to:

1. **MODIFY** the provision of the ESC under Section 4.3.a (Customer is not a Direct WESM Member), so that: "*In the event that the SUPPLIER provided electricity in excess of one hundred twenty percent (120%) of the contracted energy to the CUSTOMER, the basic energy rate shall be the actual cost incurred by the SUPPLIER in providing such additional energy. For electricity purchased beyond the contracted energy but within one hundred twenty percent (120%) thereof, the rate shall be the approved basic energy rate*";

4. **DIRECT** TEI and SMEC to **SUBMIT**, within thirty (30) days from receipt hereof, their proposed refund or recovery scheme, as the case may be, for the difference between the final approved rates and the provisionally implemented rates; and xxx

3. SMEC filed a Motion for Reconsideration, wherein it prayed for a reconsideration of the Decision insofar as it modifies Section 4.3.a of the ESC.

4. In view of the aforementioned SMEC Motion for Reconsideration, TEI cannot comply with the directive to submit within the 30 day period a proposed refund or recovery scheme, as the case may be, for the difference between the final and approved rates and the provisionally implemented rates, because (a) SMEC and TEI have to agree on their proposed refund or recovery scheme; and (b) any resolution on the SMEC Motion for Reconsideration will directly affect the difference between the final and approved rates and the provisionally implemented rates.

5. TEI therefore has no other recourse but to defer its compliance of the Commission's directive; otherwise, a unilateral submission of a proposed refund or recovery scheme prior to the resolution of the SMEC motion for reconsideration will be premature and probably contested.

PRAYER

WHEREFORE, premises considered, TEI respectfully prays that it be granted leave to defer with its compliance of the Commission's directive for TEI to submit a proposed refund or recovery scheme pending resolution of SMEC's motion for reconsideration.

TEI also prays for such other relief or remedy as may be just and equitable under the circumstances.

DISCUSSION

1. Capital Recovery Fee

In the submitted *Motion*, SMEC alleged that the Commission's basis for computation of Capital Recovery Fee (CRF) does not apply to it as an Independent Power Producer Administrator (IPPA). SMEC explained that it did not make any capital investment for the construction of Sual Power Plant or pay up-front for its acquisition. SMEC further claimed that it pays to PSALM fixed monthly payments in US Dollar (USD) and Philippine Peso (PhP) components under the IPPA Agreement.

SMEC manifested that the CRF should be computed based on the monthly fixed payments made to PSALM under the IPPA Agreement, within the relevant supply period under the ESC, plus a margin equal to the 16.44% post-tax cost of equity based on previous Commission's approval.

For purposes of revisiting the applicable CRF, the Commission determined the capital cost for recovery, a return on working capital and the saleable generation (Billing Determinant) of the Sual Power Plant.

The Commission deemed it appropriate to consistently use the net amount of Property, Plant and Equipment (PPE) reflected in SMEC's Audited Financial Statement (AFS) as the appropriate asset base or capital cost.

The Commission noted that SMEC, in accounting in its books the IPPA Agreement, considered the same as an agreement that contains a lease, since it has substantially acquired all the risks and rewards incidental to the ownership of a power plant. Consequently, SMEC accounted the said agreement as a finance lease and recognized the power plant in its books as non-current asset under PPE.

The power plant was valued equal to the present value of SMEC's future payments to PSALM using the PhP and USD discount rates.

For the Weighted Average Cost of Capital (WACC), the Commission considered a reasonable Cost of Debt ranging from 6.5% to 8.75% based on previous approvals[1], and a Cost of Equity (COE) equivalent to the applicable COE approved by the Commission per year.

Consistent with the previous approvals, the Commission used the actual kWh sales of Sual Power Plant as the Billing Determinant.

For measuring the reasonableness of the rates as proposed, the Commission utilized the parameters as discussed above. The Commission found that the proposed rate under the ESC is at par with the calculated rates evaluated by the Commission. Hence, the proposed rate is found to be reasonable.

2. Evaluation of the Non-Rate Provision of the ESC

The Commission modified Section 4.3.a of the ESC and required SMEC to charge the approved basic energy charge for power in excess of the contracted energy within 120% of the contract energy, as discussed in the dispositive portion:

> The Commission further **RESOLVES** to:
>
> **1) MODIFY** the provision of the ESC under the Section 4.3.a (Customer is not a Direct WESM Member), so that: "In the event that the SUPPLIER provided electricity in excess of the 120% of the contracted energy to the CUSTOMER, the basic energy rate shall be the actual cost incurred by the SUPPLIER in providing such additional energy. For the electricity procured beyond the contracted energy but within 120% thereof, the rate shall be the approved basic energy rate.

The above provision applies only to SMEC's customers who are not Direct Wholesale Electricity Spot Market (WESM) Members. If the DU is a Direct WESM Member, any energy in

[1] ERC Case No. 2013-021 RC (DLPC-TSI), ERC Case No. 2013-051 RC (ZAMCELCO-SRPI), ERC Case No. 2013-134 RC (CEPALCO-MINERGY COAL), ERC Case No. 2013-205 RC (NORECO I-PCPC), ERC Case No. 2014-076 RC (MERALCO-SBPL), and ERC Case No. 2014-129 RC (DORECO-FDC MISAMIS)

excess of 100% of its contracted energy is purchased by the DU from the WESM and was not supplied by SMEC.

If the DU is not a Direct WESM Member, SMEC's obligation to supply is limited to 100% of the Contract Energy only. However, to address any imbalance caused by the variation of those that are not Direct WESM Members, SMEC is responsible for sourcing energy to address any consumption above the Contract Energy. Thus, in the event of overconsumption, Section 4.3.a of the ESC applies, which provides:

> Whenever available, in accordance with good utility practice, the SUPPLIER **may, but shall not be obliged to** provide electricity to the CUSTOMER in excess of the Contract Energy provided that the CUSTOMER shall pay the appropriate Default Wholesale Supply Arrangement (DWSA) charges for consumption in excess of one hundred twenty percent (120%) of the contract energy level. (Emphasis Supplied)

SMEC alleged that the afore-quoted provision should not be interpreted to mean that it is obligated to supply up to 120% of the Contracted Energy to TEI. Section 4.3.a of the ESC is clear that SMEC may, but without any obligation, provide electricity in excess of the Contract Energy only when there is available capacity from the plant.

The Commission recognizes that the ESC only contemplates the Contract Energy. Thus, the energy over and above the Contract Energy is not covered by the ESC, and therefore, subject to a different pricing. SMEC determines the Contract Energy based on the available capacity of the plant and the needs of its other customers. Therefore, SMEC can only supply additional energy if there is available capacity, which was not nominated by its other customers. However, if during the supply period under the ESC, there was no available capacity from the plant to supply any additional energy for TEI, SMEC will be constrained to purchase replacement power from WESM.

This additional energy, if sourced from WESM, should be billed at the applicable WESM price. Further, if the additional energy exceeds 120% of the Contract Energy, there is an additional DWSA Charge as required by the then DWSA Rules. Any energy over and above the Contract Energy is billed at the cost of purchase price since there is no available capacity from the Sual Power Plant.

This is the understanding between SMEC and the Indirect WESM Members when they signed the ESC.

Further, if SMEC will be required to price the additional energy at the basic energy charge based on the ESC, SMEC would be subsidizing TEI's over consumption, and in effect, penalize SMEC for the imbalances caused by TEI as an Indirect WESM Member.

Hence, the Commission finds merit on the Motion. Section 4.3.a of the ESC is hereby reconsidered.

3. Independent Third Party Audit

SMEC believes that it has already complied with the Commission's requirement of an Independent Third Party Audit. SMEC's finances are audited by R. G. Manabat and Co., a member firm of KPMG network of independent firms affiliated with KPMG International Cooperatives, a Swiss entity. Hence, R.G. Manabat and Co. is an independent auditor which is not related to or affiliated with SMEC, SMC Global Holdings and San Miguel Corporation. The AFS duly audited by R. G. Manabat and Co is submitted to the Bureau of Internal Revenue (BIR) and the Securities and Exchange Commission (SEC), the other regulatory agencies having jurisdiction over SMEC.

The Commission, in its Order dated 17 August 2015 in ERC Case No. 2010-086 RC[2] resolved SMEC's *Motion for Partial Reconsideration and Clarification*, in this manner:

> The Commission believes that an Independent Third Party may be SMEC's external auditor or other independent firms that would be able to issue a report categorically stating their opinion whether such costs are reasonable and incurred based on good utility practice or within the costs incurred by the power plants similarly situated with that of SMEC. Moreover, SMEC's cost of operation shall be audited in accordance with the rules to be promulgated by the Commission.

[2] Application for the Approval of the Energy Supply Contract (ESC) Entered Into BY and Between Tarlac II Electric Cooperative, Inc. (TARELCO II) and San Miguel Energy Corporation (SMEC), with Prayer for Provisional Authority,

> SMEC shall submit the Independent Third Party's report to the Commission which shall be subjected for further review to determine the reasonableness of the annual O&M Fee. Accordingly, the O&M Fee shall be adjusted, if warranted.
>
> Unless otherwise adjusted by the Commission, TARELCO II should continue to implement the approved rates, as stated in the Decision dated December 9, 2013.

To clarify, the Commission is merely directing the engagement of a third party auditor to focus its audit on the reasonableness of the annual O&M in order to ensure that the cost incurred are in accordance with good utility practice.

WHEREFORE, the foregoing premises considered, the Commission hereby resolves the following:

1. The approved Capital Recovery Fee (CRF) is retained;

2. Section 4.3.a (Customer is Not a Direct WESM Member) of the subject ESC is reconsidered; and

3. To ensure that operating and maintenance cost incurred are in accordance with good utility practice, SMEC is required to submit an Audit Report prepared by an Independent Third Party on the reasonableness of the annual O&M fees within a period of no less than six months from receipt of this Order.

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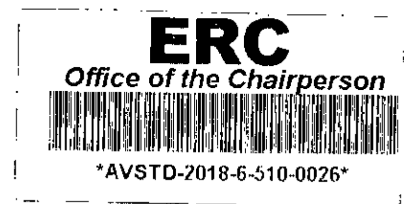
ACCORDINGLY, Applicants are hereby directed to comply with the submission of their proposed refund or recovery scheme, as the case may be, for the difference between the final approved rates and the provisionally implemented rates within thirty (30) days from receipt hereof.

SO ORDERED.

Pasig City, 29 May 2018.



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