

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



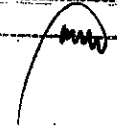
**IN THE MATTER OF THE
APPLICATION FOR
APPROVAL OF THE
ENERGY SUPPLY
CONTRACT (ESC)
BETWEEN ILOCOS SUR
ELECTRIC COOPERATIVE,
INC., AND SAN MIGUEL
ENERGY CORPORATION
(WITH PRAYER FOR
PROVISIONAL
AUTHORITY),**

ERC CASE NO. 2011-096 RC

**ILOCOS SUR ELECTRIC
COOPERATIVE, INC.
(ISECO) AND SAN MIGUEL
ENERGY CORPORATION
(SMEC),**

Applicants.

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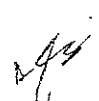
ORDER

Before this Commission for resolution is the *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.

FACTS

On 12 July 2011, Applicants Ilocos Sur Electric Cooperative, Inc. (ISECO) and SMEC filed the instant *Application* dated 21 June 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 Ilocos Sur Electric Cooperative, Incorporated (ISECO) and San Miguel Energy Corporation (SMEC) on December 19, 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 the electricity procured beyond the contracted energy but within one hundred twenty percent (120%) thereof, the rate shall be the approved basic energy rate*";
2. **DIRECT** ISECO 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** ISECO 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.

Subsequently, SMEC filed the *Motion*. 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 September 19, 2011 b) requiring the audit of SMEC's actual cost of operation and construction

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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 NEECO II-Area 1 [sic] to pass on 50% of the PPD and 50% of the CED to its consumers.

2. The Energy Supply Contract (ESC) between SMEC and ISECO had a term from August 26, 2010 to August 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 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. 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. Given this unique characteristic of the IPPA structure, the **Commission believes that the normal methodology it uses is not applicable.**” (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.

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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. ISECO is a Direct WESM Member, and therefore any energy in excess of 100% of its contracted energy is purchased by ISECO from the WESM and was not supplied by SMEC.

Independent Third Party Audit

9. 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".
10. 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.
11. 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.
12. 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.

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 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 approvals¹, 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, to wit:

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.

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)

SMEC alleged that the above provision applies only to SMEC's customers who are not Direct Wholesale Electricity Spot Market (WESM). If the DU is a Direct WESM Member, any energy in excess of 100% of its contracted energy is purchased by the DU from the WESM and was not supplied by SMEC.

The Commission clarifies that said provision applies only to SMEC's customers who are not Direct WESM Members. Considering that ISECO is a Direct WESM Member, said provision does not apply to the subject ESC.

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 RC² 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.

SMEC shall submit the Independent Third Party's report to the Commission which shall be subjected for further review to determine the

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,

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. For clarity, the applicability of Section 4.3.a (Customer is Not a Direct WESM Member) is only for Indirect WESM Members; and

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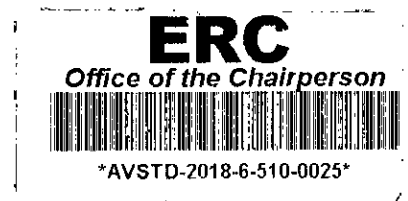
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3. To ensure that operating and maintenance cost incurred are in accordance with good utility practice, SMEC is required to submit an Audit Report prepared by an Independent Third Party on the reasonableness of the annual O&M fees within a period of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

SO ORDERED.

Pasig City, 29 May 2018.

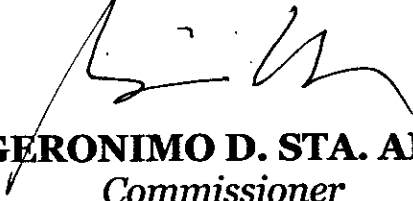

AGNES VST DEVANADERA
Chairperson and CEO




ALFREDO J. NON
Commissioner


GLORIA VICTORIA CAYAP-TARUC
Commissioner


JOSEFINA PATRICIA A. MAGPALE-ASIRIT
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13. Office of the City Mayor
Vigan City, Ilocos Sur
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Vigan City, Ilocos Sur
15. Office of the Municipal Mayor
Alilem, Ilocos Sur
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Alilem, Ilocos Sur
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Banayoyo, Ilocos Sur
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Caoayan, Ilocos Sur
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Cervantes, Ilocos Sur
28. Office of the Sangguniang Bayan
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29. Office of the Municipal Mayor
G. Del Pilar, Ilocos Sur

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San Vicente, Ilocos Sur
54. Office of the Sangguniang Bayan

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San Vicente, Ilocos Sur

55. Office of the Municipal Mayor
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