

# **THE PHILIPPINES RE-ENERGIZES: PRIVATIZATION OF THE NATIONAL POWER CORPORATION AND THE RED FLAG OF POLITICAL RISK**

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## I. INTRODUCTION

After over a decade of timorous steps in reforming its power industry, the Philippine Government ("Government") approved bold legislation that overall augurs well for both the public and private sectors. The new law—the Electric Power Industry Reform Act of 2001 ("EPIRA")—calls for the restructuring of the power industry, including the total privatization of power generation and transmission, which previously had been the exclusive domain of the state-owned Philippine National Power Corporation ("NPC," also referred to as "Napocor").

The term "privatization" can have different meanings, and implicate the use of different techniques. Privatization, in a narrow sense, can mean the *permanent* transfer of control of a public enterprise to the private sector.<sup>1</sup> In a broader sense, privatization can mean varying degrees of private sector participation, or "any measure that results in *temporary* transfer to the private sector of activities exercised . . . by a public agency."<sup>2</sup> The level of privatization, then, can range from build-own-and-transfer ("BOT") arrangements, representing temporary privatization, to complete divestiture.<sup>3</sup>

The objectives of privatization make eminent sense, and include: promotion of competition, especially by abolishing monopolies; promotion of domestic and foreign investment; introduction of new technologies and the promotion of innovation; upgrading of plants and equipment; introduction of new management methods and teams; maximization of net privatization receipts to fund government expenditures, trim the public sector deficit, or pay off public debt; reduction of the financial drain of state-owned enterprises on the state; and reduction of the opportunities for corruption and misuse of public property by government officials and managers.<sup>4</sup>

To be sure, the foregoing objectives are relevant to the privatization efforts now underway in the Philippine power industry; and especially relevant if the country is to measure up to the economies of its APEC<sup>5</sup> and ASEAN<sup>6</sup> partners.

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<sup>1</sup> PIERRE GUISLAIN, *THE PRIVATIZATION CHALLENGE* 10 (The International Bank for Reconstruction and Development/The World Bank 1997).

<sup>2</sup> *Id.* (emphasis added).

<sup>3</sup> *Id.* at 11-12.

<sup>4</sup> *Id.* at 18-19.

<sup>5</sup> Asia Pacific Economic Cooperation ("APEC"). An organization consisting of twenty-one mostly Asia-Pacific "member economies" whose primary purpose is to act as a regional vehicle for promoting open trade and practical economic and technical cooperation. See Official Web Site of the Asia Pacific Economic Cooperation, at <http://www.apecsec.org.sg/> (last visited Nov. 8, 2002).

<sup>6</sup> Association of Southeast Asian Nations ("ASEAN"). An organization consisting of ten Southeast Asian "member countries" whose primary purposes include economic growth, social progress,

Part II of this paper provides a brief country overview of the Philippines, while Part III provides an essential historical perspective of the Philippine power industry. Part IV discusses and comments on the general restructuring and privatization plan envisaged by the EPIRA, with particular emphasis in the generation and transmission sectors. For completeness, Part IV also discusses the distribution and supply sectors, as well as "open access."

Aside from the soundness of the privatization law itself, the question of "political risk" will also be an important consideration for investors in the power industry. Accordingly, Part V discusses political risk in the context of (1) the Government-mandated review of independent power producer ("IPP") contracts, and (2) the legislative imbroglio regarding the National Transmission Corporation ("Transco") franchise. Part V argues that these two factors work at painful cross-purposes with the Government's goal of attracting private capital to the power industry and, unwittingly, raise the red flag of political risk.

## II. COUNTRY OVERVIEW

The Philippines, an archipelago of approximately 7,100 islands in Southeast Asia,<sup>7</sup> is geographically divided into three main island groups: Luzon (in the north), Visayas (the central islands), and Mindanao (in the south).<sup>8</sup> The country is predominantly Roman Catholic,<sup>9</sup> has a population of 84.5 million, a functional literacy rate of 83.8%,<sup>10</sup> and boasts a highly skilled and educated workforce.<sup>11</sup> The country's official language is Pilipino, and its unofficial one, English.<sup>12</sup> The national currency, the Philippine Peso (PhP), currently has an average dollar exchange rate of PhP51.24 per US\$1.00.<sup>13</sup> As of July 2002, the country reported an unemployment rate of 11.2%.<sup>14</sup>

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cultural development, and regional stability. See Official Web Site of the Association of Southeast Asian Nations, at <http://www.asean.or.id/> (last visited Nov. 8, 2002).

<sup>7</sup> SONIA M. ZAIDE, *THE PHILIPPINES, A UNIQUE NATION* 6 (All-Nations Publishing Co., Inc. 1999).

<sup>8</sup> Official Web Site of the Philippine Board of Investments, at <http://www.boi.gov.ph/basicfacts.html> (last visited Nov. 19, 2002).

<sup>9</sup> Central Intelligence Agency (CIA) - The World Fact Book 2002, at <http://www.odci.gov/cia/publications/factbook/geos/tp.html> (last updated Jan. 1, 2002) [hereinafter World Fact Book].

<sup>10</sup> Official Government Portal of the Republic of the Philippines, at <http://www.gov.ph/aboutphil/general.asp> (last visited Feb. 6, 2003) [hereinafter Government Web Site]; Official Web Site of the National Statistics Office, Republic of the Philippines, at <http://www.census.gov.ph/> (last updated Nov. 7, 2002) [hereinafter National Statistics Office].

<sup>11</sup> ZAIDE, *supra* note 7 at 18-24.

<sup>12</sup> Government Web Site, *supra* note 10.

<sup>13</sup> Official Web site of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines), at <http://www.bsp.gov.ph/> (last visited Nov. 8, 2002).

<sup>14</sup> National Statistics Office, *supra* note 10.

The country's main export partners are the United States (30%), Japan (15%), Netherlands (8%), Singapore (8%), Taiwan (8%), and Hong Kong (8%).<sup>15</sup> Its main import partners are Japan (19%), United States (16%), the European Union (9%), South Korea (8%), Singapore (6%), and Taiwan (6%).<sup>16</sup>

The 1987 Constitution provides for an American-style republican form of government consisting of the Executive, Legislative, and Judicial branches. The president is elected by popular vote and limited to one six-year term.<sup>17</sup> The national bicameral legislature consists of the Senate with 24 senators who serve for six-year terms, and the House of Representatives with 214 members who serve for three-year terms.<sup>18</sup> The Judiciary consists of the Supreme Court and various lower courts.<sup>19</sup> The Supreme Court is made up of the chief justice and 14 associate justices, who are appointed by the president and serve until the age of 70.<sup>20</sup>

By and large, the Philippines has experienced relative political stability since the People's Power Revolution (or "EDSA Revolution") that toppled President Ferdinand E. Marcos in 1986, and which catapulted Corazon M. Aquino to the presidency. The greatest achievement of the Aquino presidency was the restoration of peace, democracy, freedom, and justice in the Philippines.<sup>21</sup> However, Aquino's successor, Fidel V. Ramos, is widely regarded as the post-Marcos president whose progressive economic reforms and Western-oriented policies increased investor confidence in the country during his presidency (1992-1998).<sup>22</sup> Significantly, President Ramos's foreign trips generated US\$20 billion in new investments in the Philippines.<sup>23</sup> In 1998, President Ramos was succeeded by a populist politician, Joseph E. Estrada, whose administration represented a brief return to the ignominy of an earlier time.

The current president, Gloria Arroyo, was hastily sworn in on January 20, 2001 to complete the term of President Estrada, who was forced out of office in a "soft coup" amid persistent allegations and mounting evidence of official corruption.<sup>24</sup> President Arroyo took office

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<sup>15</sup> World Fact Book, *supra* note 9.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> ZAIDE, *supra* note 7, at 404.

<sup>22</sup> *Id.* at 408-10.

<sup>23</sup> *Ramos Says Foreign Trips Achieved 20 Billion Dollars in Investments*, DEUTSCHE PRESSE-AGENTUR, Apr.19, 1998.

<sup>24</sup> Mark L. Clifford, *Not A Moment Too Soon*, BUS. WK. INTERNATIONAL EDITION, Feb. 5, 2001, at 20; Al Labita, *Arroyo Fires Opening Shots in Campaign for 2004 Polls*, THE BUSINESS TIMES

prior to a formal resignation or removal of President Estrada.<sup>25</sup> She has thus had to struggle with claims of an illegitimate presidency. Although she had long signaled her desire to seek the presidency in 2004, President Arroyo—in a surprise announcement in late 2002—declared that she would not be seeking the presidency for the sake of national unity.<sup>26</sup> Many had argued that President Arroyo's virtual non-stop politicking since becoming president had been adversely affecting her administration's ability to focus on the social and economic concerns of the country.

### III. OVERVIEW OF THE PHILIPPINE POWER INDUSTRY

#### A. *The National Power Corporation*

The public sector made its initial foray into the power supply business in 1935 through the creation of the National Power Corporation ("NPC," also referred to as "Napocor").<sup>27</sup> The Philippines—then a commonwealth of the United States and still eleven years from independence<sup>28</sup>—had created the NPC in part to develop its hydroelectric resources.<sup>29</sup> Additionally, at the time of the NPC's creation, the Manila Electric Railroad and Light Company (now Meralco) was the only other major participant in the power industry after it had secured a 50-year franchise in 1903.<sup>30</sup> In 1972, President Marcos issued Presidential Decree No. 40, which required the NPC to install generation and transmission facilities in the three major islands.<sup>31</sup> The NPC was then designated exclusive owner and operator of the integrated generation and transmission grid in its exclusive area.<sup>32</sup> In compliance with the 1972 decree, the NPC purchased all Meralco power plants in 1979.<sup>33</sup>

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SINGAPORE, Aug. 30, 2002; Emily Tapaoan, *Report on Arroyo's Performance*, GULF NEWS, July 7, 2002.

<sup>25</sup> *Id.*

<sup>26</sup> Carmelito Q. Francisco, *Businessmen Favor GMA Declaration to Skip 2004 Elections*, BUSINESS WORLD (Manila), Jan. 2, 2003.

<sup>27</sup> Richard Mogg, *The Philippines Reorganises to Free Market Power*, POWER ECONOMICS, Oct. 31, 1998, at 16.

<sup>28</sup> ZAIDE, *supra* note 7, at 312-322.

<sup>29</sup> Mogg, *supra* note 27.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

B. *Arrival of the Independent Power Producer*

1. Executive Order 215

Privatization in the Philippine power industry came almost by historic accident. Signal changes can be traced to the period of the late 1980s to the early 1990s. During this period, the country suffered from massive power shortages that caused daily blackouts—some lasting eight to twelve hours—and which plunged the country into both a power and economic crisis.<sup>34</sup>

In 1987, in response to the impending power crisis and with the Government financially unable to undertake the building of new plants, President Aquino issued Executive Order 215, which abolished the NPC's long-standing monopoly on power generation.<sup>35</sup> Under the Executive Order, independent power producers ("IPPs") were authorized to build plants and supply power to both the NPC and distribution utilities.<sup>36</sup>

2. The Build-Own-and-Transfer Law & The Power Crisis Act of 1993

Most of the new power plants contracted out to the private sector during the power crisis were constructed under a BOT arrangement, or some variant thereof.<sup>37</sup> Under the BOT concept, a project company obtains a concession from the host government to build and operate project facilities for a period of between 10 to 30 years.<sup>38</sup> During this period, called the concession period, the goal of the project company is to generate adequate revenue to repay its debt, and realize a reasonable return for its equity investors.<sup>39</sup> At the end of the concession period, the project's assets are transferred to the host government.<sup>40</sup> This arrangement thus benefits both the private and public sectors. The private sector generates returns on its investment during the concession period,

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<sup>34</sup> Cecille E. Yap, *Focus IPPs-Saviors Turning Into Power Villains?*, BUSINESS WORLD (Manila), May 30, 2002.

<sup>35</sup> PUBLIC-PRIVATE INFRASTRUCTURE ADVISORY FACILITY AND THE WORLD BANK, PRIVATE SOLUTIONS FOR INFRASTRUCTURE: OPPORTUNITIES FOR THE PHILIPPINES 9 (The International Bank for Reconstruction and Development/The World Bank 2000) [hereinafter PRIVATE SOLUTIONS FOR INFRASTRUCTURE].

<sup>36</sup> Evangeline L. Moises, *So Power Rates Will Be Lower . . . Not Quite*, BUSINESS WORLD (Manila), June 15, 2001.

<sup>37</sup> Mogg, *supra* note 27.

<sup>38</sup> LARRY H.P. LANG, PROJECT FINANCE IN ASIA 16 (Elsevier 1998).

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

while the public sector benefits through the financing, development and/or modernization of infrastructure.

Pursuant to Executive Order 215, the NPC signed its first BOT contract in 1988 with Hopewell Energy Management Ltd. for the building of two turbine power plants in Luzon.<sup>41</sup> Legislative imprimatur for the BOT concept did not arrive, however, until 1990 when the Philippines approved Asia's first BOT law.<sup>42</sup> This law was substantially amended in 1994 by Republic Act No. 7718 which increased the permitted variants of the BOT arrangement.<sup>43</sup>

The BOT law applies to a broad range of infrastructure or development projects.<sup>44</sup> Authorized BOT variants include: build-own-and-operate, build-lease-and-transfer, build-transfer-and-operate, contract-add-and-operate, develop-operate-and-transfer, rehabilitate-operate-and-transfer, and rehabilitate-own-and-operate.<sup>45</sup>

Executive Order 215 was then followed by The Power Crisis Act of 1993, which authorized then President Fidel Ramos to directly enter into "emergency" contracts with private companies for the construction, repair, rehabilitation, and maintenance of power plants.<sup>46</sup> This legislative authorization bypassed the usual but time-consuming process of public bidding.<sup>47</sup> Additionally, had the Government itself decided to undertake the construction or overhaul of plants, bids would have been required for each component of a construction or rehabilitation project—a process that would have been even more time-consuming.<sup>48</sup> Most of the plants contracted out pursuant to The Power Crisis Act were constructed or rehabilitated under a BOT arrangement.<sup>49</sup>

Thus, by the early 1990s, privatization was slowly taking root in the power industry, and was viewed as a desirable alternative to state ownership and management.

### 3. Supply Restored & The Asian Financial Crisis

It surely cannot be gainsaid that a reliable supply of electricity is a prerequisite for economic prosperity. During the darkest days of the

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<sup>41</sup> PRIVATE SOLUTIONS FOR INFRASTRUCTURE, *supra* note 35 at 18-19.

<sup>42</sup> *Id.* at 9. The law was Republic Act No. 6957 (Phil.).

<sup>43</sup> Republic Act No. 7718, § 2 (Phil.), available at <http://www.chanrobles.com/otherlaws.htm>.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Republic Act No. 7848; Yap, *supra* note 34.

<sup>47</sup> INTERNATIONAL FINANCE (Scott & Weldon ed., Foundation Press 2002).

<sup>48</sup> *Id.*

<sup>49</sup> Alfredo A. Delgado, *More Than Electric Power, Energy*, BUSINESS WORLD (Manila), Aug. 13, 2002, at 10.



power crisis, new investments declined to PhP3.35 billion (Philippine Pesos), trade was at a virtual standstill, factories closed their doors, and Filipinos lost their jobs.<sup>50</sup> The IPPs stabilized the country's power supply and, in turn, the economy. There would soon be excess capacity to support what was, by the mid-1990s, a growing economy.<sup>51</sup> Aside from its role in ending the power crisis, the private sector invested approximately US\$5 billion for the construction in only 12 to 18 months of power plants that would have normally taken five years to build.<sup>52</sup>

By 1996, things were even looking up for the NPC. In the first nine months of 1996, revenues totaled PhP45.26 billion, an increase of 13.4% (from PhP39.90 billion) grossed for the same period the year before.<sup>53</sup> The state-owned firm reported net income of PhP4.12 billion, slightly higher than the PhP4.117 billion earned for the same period in 1995.<sup>54</sup> Meanwhile, the NPC's net operating income was reported at PhP9.09 billion, 15% higher than the targeted PhP7.92 billion for the period.<sup>55</sup>

The Asian Financial Crisis in 1997, however, dealt a crushing blow to the feverish optimism brought by the end of the power crisis. The financial crisis caused a sharp reduction in energy consumption and the devaluation of the Philippine Peso.<sup>56</sup> Yet, despite softening demand, Filipinos were paying more for electricity, prompting much indignation in the polity that politicians could not ignore.<sup>57</sup>

While the private sector had played the featured role in addressing the country's energy woes, it would soon be reviled as villains who sought to take advantage of the country during a time of emergency.

### C. *The Power Industry Today*

Today, electricity rates in the Philippines are among the highest in Asia.<sup>58</sup> As the power industry prepares for a major overhaul, the NPC is still the Philippines's largest generator of electricity, producing

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<sup>50</sup> *Id.*

<sup>51</sup> Yap, *supra* note 34.

<sup>52</sup> *Id.*

<sup>53</sup> Marga G. Moreno, *National Power Corporation: Privatization Brightens NPC's Business Prospects*, BUSINESS WORLD (Manila), Nov. 25, 1996.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> Moises, *supra* note 36.

<sup>57</sup> *Id.*

<sup>58</sup> Tetsuro Matsuno, *Philippines Struggles With Power*, THE NIKKEI WEEKLY, Sept. 3, 2001.

approximately sixty percent of the country's power.<sup>59</sup> The NPC's asset base is valued at PhP980 billion, funded by PhP876 billion in debt and PhP104 billion in equity.<sup>60</sup> Moreover, 35 of the 43 IPP supply contracts forged during the power crisis remain in effect.<sup>61</sup> Currently, there are no plans for the construction of new power plants beyond 2005.<sup>62</sup>

The NPC generates electricity from its power plants, and also purchases electricity from independent power producers.<sup>63</sup> The firm then sells electricity wholesale to various distributors through its own transmission networks.<sup>64</sup> Distribution utilities—which obtain their electric supply from both the NPC and IPPs—in turn supply power to end-users, such as households and industry.<sup>65</sup> The Manila Electric Company (“Meralco”) is the country's single largest private distributor of electricity, covering the capital city of Manila and surrounding areas.<sup>66</sup> The remaining participants in the distribution sector consist of smaller distribution utilities and electric cooperatives.<sup>67</sup>

In 2000, the country produced 40.667 billion kWh, and consumed 37.82 billion kWh of electricity.<sup>68</sup> The country's major sources of power are fossil fuel and hydroelectric power, consisting of 57.57% and 19.85%, respectively, with other sources comprising the remaining 22.85%.<sup>69</sup> In a speech delivered in early 2003, President Arroyo stressed the need to increase power generation by about 6,000 MW to address future power shortages. Such an undertaking could cost upwards of US\$6 billion.<sup>70</sup>

#### IV. THE ELECTRIC POWER INDUSTRY REFORM ACT OF 2001

After languishing in the Philippine Congress for seven years, the EPIRA<sup>71</sup> was signed into law by President Arroyo on June 8, 2001, and became effective on June 26, 2001.<sup>72</sup>

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<sup>59</sup> PRIVATISATION, THE ASEAN CONNECTION 179 (B.N. Ghosh ed., Nova Science Publishers, Inc. 2000) [hereinafter PRIVATISATION]; PRIVATE SOLUTIONS FOR INFRASTRUCTURE, *supra* note 35 at 17.

<sup>60</sup> Delgado, *supra* note 49.

<sup>61</sup> Delgado, *supra* note 49; Elizabeth L. Sanchez, *Only 6 of 35 Power Deals Pass Review*, BUSINESS WORLD (Manila), July 5, 2002.

<sup>62</sup> Matsuno, *supra* note 58.

<sup>63</sup> PRIVATE SOLUTIONS FOR INFRASTRUCTURE, *supra* note 35, at 17.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 18; PRIVATISATION, *supra* note 59, at 179.

<sup>67</sup> *Id.*

<sup>68</sup> World Fact Book, *supra* note 9.

<sup>69</sup> *Id.*

<sup>70</sup> Ruffy L. Villanueva & Karen L. Lema, *GMA Unveils Priorities in Energy Sector Program*, BUSINESS WORLD (Manila), Jan. 29, 2003.

<sup>71</sup> Electric Power Industry Reform Act of 2001, Republic Act No. 9136 (2001) (Phil.) [hereinafter R.A. 9136].

The EPIRA establishes the general framework for the restructuring of the power industry.<sup>73</sup> The new law divides the power industry into four sectors: generation, transmission, distribution, and supply.<sup>74</sup> Both generation and supply will be primarily deregulated sectors, while transmission and distribution will be regulated by the newly-created Energy Regulatory Commission (“ERC”).<sup>75</sup>

Additionally, the EPIRA provides for the total privatization of the NPC, and a structured transition into a competitive environment. The law thus requires absolute divestiture of the NPC’s generation and transmission assets to private investors.

While the role of the NPC has been diminished, it has not been abolished. It will be in charge of “missionary electrification” through the Small Power Utilities Group (“SPUG”).<sup>76</sup> Missionary electrification refers to the Government’s goal of providing basic electricity service to unviable areas, with the goal of eventually bringing operations in these areas to viability levels.<sup>77</sup>

The EPIRA declares it the Government’s policy

[t]o ensure and accelerate the total electrification of the country; . . . [t]o ensure the quality, reliability, security and affordability of electric power; . . . [t]o *enhance the inflow of private capital and broaden the ownership base of the power generation, transmission, and distributions sectors*; . . . [and] [t]o establish a strong and purely independent regulatory body and system to ensure consumer protection and enhance the competitive operation of the electricity market.<sup>78</sup>

#### A. *Framework for Privatization*

“Privatization” is defined by the EPIRA as “the sale, disposition, change and transfer of ownership and control of assets and IPP<sup>79</sup> contracts

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<sup>72</sup> Cecille S. Visto, *Power Bill Signed Into Law Today*, BUSINESS WORLD (Manila), June 8, 2001; *Power Coops to Sue DOE Chief*, at <http://www.globalpinoy.com/news/business/2002/aug/08/08busi3.htm> (Aug. 8, 2002).

<sup>73</sup> R.A. 9136, § 3.

<sup>74</sup> *Id.* § 5.

<sup>75</sup> *Id.* §§ 6, 7, 22, 29.

<sup>76</sup> *Id.* § 70.

<sup>77</sup> Rules and Regulations to Implement Republic Act No. 9136, entitled “Electric Power Industry Reform Act of 2001” [hereinafter IRR], Rule 4(ddd).

<sup>78</sup> R.A. 9136, § 2 (emphasis added).

<sup>79</sup> Independent power producer, defined as “an existing power generating entity which is not owned by NPC.” *Id.* § 4.bb.

from the government or a government corporation to a private person or entity.”<sup>80</sup>

The major entities involved in the privatization endeavor are: (1) the Department of Energy, (2) the Energy Regulatory Commission, (3) the Joint Congressional Power Commission, (4) the Power Sector Assets and Liabilities Management Corporation, and (5) the National Transmission Corporation.

### 1. The Department of Energy

The Department of Energy (“DOE”) is charged with overall supervision of the restructuring mandated by the EPIRA.<sup>81</sup> Among other things, the DOE is required to:

- develop the policies for a comprehensive program regarding the efficient supply and economical use of energy;
- develop and update the Philippine Energy Plan;<sup>82</sup>
- prepare and update the Power Development Program;<sup>83</sup>
- ensure the reliability, quality, and security of electricity supply;
- develop policies, programs, and incentives for private sector participants in order to meet consumer demand;
- monitor private sector activities in energy projects in order to attain the goals of restructuring, privatization, and modernization;
- encourage private entities already engaged in the industry to further broaden their investments in the industry; and
- coordinate a public information campaign regarding the restructuring of the electricity industry.<sup>84</sup>

In addition, the DOE, in consultation with government agencies, power industry participants, non-governmental organizations, and end-users, was to promulgate the EPIRA’s Implementing Rules and Regulations (“IRR”), which it did on February 27, 2002.<sup>85</sup>

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<sup>80</sup> *Id.* § 4.pp.

<sup>81</sup> *Id.* § 37.

<sup>82</sup> The Philippine Energy Plan (“PEP”) is the Department of Energy’s overall energy plan which is updated yearly and submitted to the Philippine Congress. *Id.* § 4.mm.

<sup>83</sup> The Power Development Program (“PDP”) is the Department of Energy’s plan for managing electricity demand through energy-efficient programs. The PDP also incorporates plans for the upgrading, expansion, rehabilitation, repair, and maintenance of power generation and transmission facilities. *Id.* § 4.nn.

<sup>84</sup> *Id.* § 37.

<sup>85</sup> See generally IRR, *supra* note 78.

## 2. The Energy Regulatory Commission

In a competitive environment, regulatory oversight is crucial in order to monitor the activities of industry participants and, as well, to safeguard the interests of consumers.

The Energy Regulatory Commission (“ERC”) is the independent, quasi-judicial regulatory body, which supplanted the Energy Regulatory Board (“ERB”).<sup>86</sup> The ERC is responsible for issuing certificates of compliance to new generation companies, setting voltage standards for the NPC’s transmission and subtransmission assets, regulating both the transmission and distribution sectors, and issuing licenses to suppliers.<sup>87</sup> Additionally, the ERC will:

- handle consumer complaints;
- enforce the IRR;
- promulgate the National Grid Code and Distribution Code;<sup>88</sup>
- establish and enforce a methodology for setting transmission wheeling rates;<sup>89</sup>
- monitor and penalize abuses of market power, cartelization, and anti-competitive or discriminatory conduct by an industry participant;
- impose fines and penalties for non-compliance;
- report annually to the President on matters and cases that have come before the ERC; and
- inspect the books and records of industry participants.<sup>90</sup>

## 3. The Joint Congressional Power Commission

While the EPIRA is a relatively structured statute, it is likely that additional legislation will be required to amend or augment certain areas of the new law in the future. This is especially so considering the

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<sup>86</sup> R.A. 9136, § 38.

<sup>87</sup> *Id.* §§ 6, 7, 22, 29.

<sup>88</sup> The National Grid Code are the rules and regulations established by the ERC relating to the safe and reliable operation, maintenance, and development of the high-voltage backbone transmission system and its related facilities. *Id.* § 4.aa. The Distribution Code are the rules and regulations established by the ERC relating to the operation and maintenance of an electric utility’s distribution system, including standards for service and performance. *Id.* § 4.m.

<sup>89</sup> “Wheeling” is an industry term for the transmission of power over transmission lines. Electricity can be wheeled from the generating plant directly to the wholesale or retail consumer, or can be wheeled to the consumer through interconnected transmission facilities of one or more intermediate utilities. DENISE WARKENTIN, *ELECTRIC POWER INDUSTRY IN NONTECHNICAL LANGUAGE* 192-93 (1998).

<sup>90</sup> *Id.* §§ 41, 43.

complexity entailed in restructuring an entire industry. The statute thus provides for a legislative organ to oversee the law's implementation.

The Joint Congressional Power Commission ("Power Commission") consists of members of the Senate and the House of Representatives.<sup>91</sup> It is responsible for enacting necessary or remedial legislation to achieve the EPIRA's goals, endorsing both the *generation* and *transmission* privatization plans proposed by the Power Sector Assets and Liabilities Management Corporation ("PSALM"), requiring the submission of reports from government agencies regarding public bidding during privatization, evaluating compliance with the EPIRA by the various entities, and submitting reports to the President.<sup>92</sup> The Power Commission has a statutory lifespan of ten years, subject to extension by concurrent resolution of both the Senate and the House of Representatives.<sup>93</sup>

#### 4. The Power Sector Assets and Liabilities Management Corporation

The Power Sector Assets and Liabilities Management Corporation is a new state-owned corporation, whose preeminent purpose is to assume—and then dispose of in open competitive bidding—the NPC's generation assets, liabilities, IPP contracts, real estate, and other disposable assets.<sup>94</sup> The privatization of the NPC's transmission assets, however, will be undertaken by its wholly-owned subsidiary, Transco.<sup>95</sup> Moreover, the NPC's outstanding obligations from loans, bonds, securities, and other instruments of indebtedness are to be transferred to PSALM.<sup>96</sup> Consistent with its limited purpose, PSALM has a corporate lifespan of 25 years, subject to possible extension.<sup>97</sup>

##### a. *The Generation Sector*

"Generation" is defined as "[t]he process of producing electric energy by transforming other forms of energy."<sup>98</sup> Aside from the privatization of transmission, the privatization of generation is sure to garner interest from private investors. As the DOE projects that demand

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<sup>91</sup> *Id.* § 62.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* §§ 49, 50.

<sup>95</sup> See discussion *infra* Part IV.A.4.b.

<sup>96</sup> R.A. 9136, § 49.

<sup>97</sup> *Id.* § 50.

<sup>98</sup> WARKENTIN, *supra* note 91, at 176.

for electricity will increase at a rate of nine percent annually in the next ten years,<sup>99</sup> power producers and investors who enter the market now stand to gain the most from the anticipated upswing.

Privatization of the generation sector will be governed by (1) the EPIRA, (2) the IRR, and (3) the generation privatization plan proposed by PSALM.

In order to coordinate the orderly disposal of the NPC's assets, PSALM is required to develop and implement a comprehensive privatization plan for the NPC's generation assets and IPP contracts. PSALM is also to develop and implement a plan for the liquidation' of the NPC's debts and stranded contract costs during PSALM's lifetime.<sup>100</sup>

As part of the privatization plan, the NPC's power plants are to be grouped in a manner that will promote their future viability as they are sold off to investors and reincarnated as private generation companies ("gencos").<sup>101</sup> At the same time, IPP contracts are to be transferred to IPP administrators after public bidding.<sup>102</sup> IPP administrators are independent entities who will be responsible for the administration, conservation, management, and sale of the contracted energy output.<sup>103</sup> The generation privatization plan must be endorsed by the Power Commission and approved by the President.<sup>104</sup>

The EPIRA requires the privatization of seventy percent of the NPC's total generating capacity and the power capacity under IPP contracts in Luzon and Visayas within three years of the law's effective date (i.e., by June 26, 2004), but not later than the initial implementation of "open access."<sup>105</sup> Finally, any unsold capacity is to be privatized by June 26, 2009.<sup>106</sup>

Upon privatization, the generation sector will consist of new gencos, the NPC's genco spin-offs, and gencos owned or operated by distribution utilities.<sup>107</sup> Moreover, most of the power plants constructed under BOT contract will be transferred to the Government by 2020.<sup>108</sup>

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<sup>99</sup> Official Web Site of the Philippine Department of Energy, at <http://www.doe.gov.ph/> (last visited Nov. 8, 2002) [hereinafter DOE Web Site].

<sup>100</sup> R.A. 9136, § 51a. The NPC's "stranded contract costs" refers to the excess of the contracted costs of electricity under eligible contracts over the actual selling price of the contracted energy output of such contracts in the market. *Id.* § 4.uu.

<sup>101</sup> R.A. 9136, § 47.

<sup>102</sup> *Id.* § 51c.

<sup>103</sup> *Id.* §§ 4. ff, 51c; IRR, Rule 4(xx).

<sup>104</sup> R.A. 9136, § 47.

<sup>105</sup> *Id.* § 47g. Open access is discussed *infra* Part IV.B.3.

<sup>106</sup> *Id.*

<sup>107</sup> IRR, Rule 5, § 2.

<sup>108</sup> Yap, *supra* note 34.

These plants will ultimately be sold to private investors.<sup>109</sup> Significantly, power generation is not considered a public utility operation; and, therefore, will not require a national franchise.<sup>110</sup> However, a new generation company is required to obtain a certificate of compliance from the ERC.<sup>111</sup>

The success of the generation privatization effort will ultimately be measured by (1) the certainty and predictability of the law (i.e., the EPIRA and the IRR), (2) the generation privatization plan proposed by PSALM, (3) the nature and pace of the transmission privatization effort, and (4) the identity of the investors in the transmission assets.

As to the certainty and predictability of the law, the EPIRA (supplemented by the IRR) generally plots a coherent framework for the interplay of the various entities, and transparently sets forth the law's expectations of industry participants. The IRR also augments the EPIRA section-by-section. Among other things, a genco must comply with certain technical, financial, and environmental standards, and comply with Rule 11 relating to cross-ownership, market abuse, and anti-competitive behavior.<sup>112</sup> As discussed in greater detail in Part V.B, a more important consideration relative to the issue of legal certainty is the Government's view regarding the sanctity of contracts.

Additionally, whether generation assets will be grouped in a way deemed profitable for investors remains to be seen. As of this writing, a generation privatization plan has not yet been approved by the Power Commission.<sup>113</sup> The Power Commission had earlier rejected a draft proposal submitted by PSALM.<sup>114</sup> The Government has also made clear that the sale of generation assets will take place only *after* the privatization of the transmission system.<sup>115</sup> However, since the Government can only get optimal returns if assets are showcased in a way investors consider attractive, this area will probably not create the same difficulties that the transmission privatization effort is now experiencing—particularly as it relates to the Transco franchise. President Arroyo has set June 2004 as the targeted completion date for the privatization of the NPC's generation assets.<sup>116</sup>

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<sup>109</sup> *Id.*

<sup>110</sup> R.A. 9136, § 6.

<sup>111</sup> *Id.*

<sup>112</sup> IRR, Rule 5, § 4(b), (j).

<sup>113</sup> Ruffy L. Villanueva, *Joint Power Council Fails To Okay Napocor Sale Plan*, BUSINESS WORLD (Manila), Aug. 30, 2002.

<sup>114</sup> *Id.*

<sup>115</sup> Cecille E. Yap, *Transco Bill Facing Rough Sailing*, BUSINESS WORLD (Manila), Sept. 26, 2002.

<sup>116</sup> Villanueva & Lema, *supra* note 71.



Clearly, however, the nature and pace of the transmission privatization effort, as well as the identity of the investors in the transmission system, will in many respects dictate the success of the generation privatization plan.

*b. The Transmission Sector*

The Government has also pinned high hopes on the privatization of the Philippine transmission system. Transmission privatization could fetch the Government as much as US\$2.1 billion from the sale of transmission assets, and an additional US\$2.9 billion in concession fees.<sup>117</sup> Investors stand to benefit from, among other things, transmission fees from a growing population and an expanding system. Among the companies that have expressed interest in the transmission assets are: ABB Equity Ventures (Switzerland), CKI/HKE (Hong Kong), EdF (France), Hydro Quebec Trans Energie (Canada), National Grid (United Kingdom), RED Electrica (Spain), RWE Group (Germany), and Singapore Power.<sup>118</sup>

“Transmission” refers to “[t]he movement or transfer of electric energy over an interconnected group of lines and associated equipment between points of supply and points at which it is transformed for delivery to consumers, or is delivered to other electric systems.”<sup>119</sup>

The privatization of the transmission sector will be governed by (1) the EPIRA, (2) the IRR, and (3) the transmission privatization plan proposed by PSALM.

Under the EPIRA, operation of the transmission system by a private entity will require a public utility franchise.<sup>120</sup> During the initial phase of privatization, the NPC’s transmission and subtransmission facilities, assets, and national transmission franchise were to be transferred to Transco,<sup>121</sup> a wholly-owned subsidiary of PSALM;<sup>122</sup> at that point, Transco was to assume the electrical transmission functions previously provided by the NPC.<sup>123</sup> However, all of the NPC’s transmission and subtransmission *liabilities* were to be transferred to PSALM.<sup>124</sup> Transco is also required to transfer its *subtransmission*

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<sup>117</sup> Jeffrey O. Valisno et al., *House Ok’s Transco Bill*, BUSINESS WORLD (Manila), Sept. 4, 2002.

<sup>118</sup> Yap, *supra* note 118.

<sup>119</sup> WARKENTIN, *supra* note 91, at 191.

<sup>120</sup> R.A. 9136, §§ 7, 8.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* § 8.

<sup>123</sup> *Id.*

<sup>124</sup> R.A. 9136, § 8.

facilities to qualified distribution utilities by June 26, 2003, or the start of "open access," whichever is earlier.<sup>125</sup>

Additionally, prior to privatization, Transco's main functions include acting as the system operator of the national transmission and subtransmission networks, providing open and non-discriminatory access to the transmission system, improving and expanding transmission facilities, and developing the Transmission Development Plan ("TDP")<sup>126</sup> in consultation with electric power industry participants and end-users.<sup>127</sup>

For its part, PSALM is required to submit a transmission privatization plan for endorsement by the Power Commission, and approval by the President.<sup>128</sup> If the plan is approved, the President is to instruct PSALM to award Transco's transmission facilities either by outright sale or concession contract to a qualified party.<sup>129</sup> Finally, if a concession contract is awarded, the concession is to last for 25 years, subject to a one-time renewal for another 25 years.<sup>130</sup> A transmission privatization plan was approved in March 2002. However, as discussed in greater detail in Part V.C, the disagreement over an assignable Transco franchise has delayed the privatization timetable.

## *B. Distribution, Supply, and Open Access*

### *1. The Distribution Sector*

A "distribution system" refers to "the system of wires and associated facilities belonging to a franchised distribution utility extending between the delivery points on the transmission or subtransmission system or generator connection and the point of connection to the premises of the end-user."<sup>131</sup> Under the EPIRA, the distribution sector will consist of electric cooperatives, private corporations, government-owned utilities, and existing local government units.<sup>132</sup> Additionally, the distribution of electricity, like the transmission of electricity, will require a national franchise.<sup>133</sup> A distribution utility is

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<sup>125</sup> *Id.*

<sup>126</sup> The Transmission Development Program ("TDP") is the program for the managing of the transmission system through efficient planning for the expansion upgrading, rehabilitation, repair, and maintenance. R.A. 9136, § 4.bbb.

<sup>127</sup> *Id.* § 9.

<sup>128</sup> *Id.* § 21.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* § 4.o.

<sup>132</sup> *Id.* § 4.q.

<sup>133</sup> *Id.* § 22.

required to provide open and non-discriminatory access to end-users,<sup>134</sup> and its wheeling charges and retail rates are subject to regulation and approval by the ERC.<sup>135</sup>

## 2. The Supply Sector

The “supply of electricity” is defined as “the sale of electricity by a party *other than a generator or a distributor in the franchise area of a distribution utility* using the wires of the distribution utility concerned.”<sup>136</sup> Additionally, the term “supplier” refers to an individual or entity authorized by the ERC to sell, broker, market, or aggregate electricity to end-users.<sup>137</sup> A supplier’s fees consist of the charges for the sale of electricity, and exclude generation, transmission, and distribution wheeling charges.<sup>138</sup>

Under the EPIRA, the supply of electricity to the “contestable market” is not a public utility operation and, accordingly, does not require a national franchise.<sup>139</sup> The contestable market refers to electricity end-users who have a choice of a supplier of electricity.<sup>140</sup> The contestable market is to be distinguished from the “captive market” of a distribution utility consisting of end-users who do not have a choice of an electricity supplier.<sup>141</sup>

## 3. Open Access and Retail Competition

The EPIRA provides for retail competition and “open access.” Open access is “the system of allowing any qualified person the use of the transmission, and/or distribution system, and associated facilities subject to the payment of transmission and/or distribution retail wheeling rates duly approved by the ERC.”<sup>142</sup> Open access and retail competition will not only benefit consumers through lower power rates, but also power producers who are guaranteed non-discriminatory access to the transmission and distribution systems.

Currently, Filipino households and commercial establishments do not have the freedom to choose their supplier. Power companies are

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<sup>134</sup> *Id.* § 23.

<sup>135</sup> *Id.* §§ 24, 25.

<sup>136</sup> *Id.* § 4.zz (emphasis added).

<sup>137</sup> *Id.* § 4.xx.

<sup>138</sup> *Id.* § 4.yy.

<sup>139</sup> *Id.* § 29.

<sup>140</sup> *Id.* § 4.h.

<sup>141</sup> *Id.* § 4.c.

<sup>142</sup> *Id.* § 4.ll.

prohibited from selling power directly to consumers, but must instead sell power to distribution utilities, which in turn re-sell to end-users.<sup>143</sup> Accordingly, most consumers can only purchase power from their local power distributor.<sup>144</sup> Under the EPIRA's open access system, consumers will be able to purchase power from the supplier—a power generator, a distribution utility, or independent aggregator<sup>145</sup>—that provides the most efficient service at the most reasonable cost.<sup>146</sup>

Implementation of retail competition and open access are subject to the following: establishment of the wholesale electricity spot market ("WESM"); approval of unbundled transmission and distribution wheeling charges; privatization of at least seventy percent of the NPC's total generating capacity in Luzon and Visayas;<sup>147</sup> and transfer of the management and control of at least seventy percent of the total energy output of power plants under contract with the NPC to IPP administrators.<sup>148</sup>

## V. THE GOVERNMENT RAISES THE RED FLAG OF POLITICAL RISK

### A. *Categories of Risk in International Power Projects*

Aside from considering the fairness and attractiveness of the underlying privatization law, potential investors in the Philippine power industry will surely weigh the standard risks associated with international power projects. Such risks are generally classified into construction risk, operating risk, fuel risk, market risk, and political risk.<sup>149</sup> Political risks include *changes in law*, inconvertible or nontransferable currency, expropriation, and political violence or war.<sup>150</sup>

Change in law risk exists where a host government takes some action regarding a law or regulation that has the effect of making a project

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<sup>143</sup> *Id.*

<sup>144</sup> DOE Web Site, *supra* note 101.

<sup>145</sup> An aggregator is a person or entity, engaged in consolidating electric power demand of end-users in the contestable market, for the purpose of purchasing and reselling electricity on a group basis. R.A. 9136, § 4.a.

<sup>146</sup> DOE Web Site, *supra* note 101.

<sup>147</sup> Luzon and Visayas are the northern and central islands of the Philippines, respectively.

<sup>148</sup> R.A. 9136, § 31.

<sup>149</sup> John G. Mauel, *Common Contractual Risk Allocations In International Power Projects*, 1996 COLUM. BUS. L. REV. 37, 42 (1996).

<sup>150</sup> *Id.*

unprofitable.<sup>151</sup> Insurers will generally not insure this type of risk unless a host government agrees not to take certain action.<sup>152</sup>

This part discusses change in law risk in two contexts: a provision in the EPIRA requiring a review of all IPP contracts, and the legislative intransigence on the Transco franchise. The Government's heightened attention to these two issues are patent clues for investors as to the level of political risk that persists even as the Philippines strives to reform its power industry. At bottom, controversy over these two issues only compromises the integrity of the overall privatization undertaking.

### B. *Inter-Agency Review of IPP Contracts*

While the EPIRA's first sixty-seven sections generally craft an exciting blueprint for privatization and restructuring, Section 68 may well cause investor consternation. Specifically, Section 68 mandates the review of all IPP contracts, stating:

An inter-agency committee . . . shall immediately undertake a thorough review of all IPP contracts. In cases where such contracts are found to have provisions which are *grossly disadvantageous, or onerous to the Government*, the Committee shall cause the appropriate government agency to file an action under the arbitration clauses provided in said contracts or initiate any appropriate action under Philippine laws.<sup>153</sup>

The EPIRA thus contemplates the possible filing of an arbitration claim, formal legal action or the renegotiation of contracts. Of the 42 contracts forged during the power crisis, 35 remain in effect.<sup>154</sup> The inter-agency committee has concluded that only six of the 35 contracts are not "onerous" or without "legal or financial issues."<sup>155</sup> A "legal issue" refers

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<sup>151</sup> Peter F. Fitzgerald, *International Project Financing: An Overview*, 1240 PLI/CORP 407, 411 (2001).

<sup>152</sup> *Id.*

<sup>153</sup> R.A. 9136, § 68 (emphasis added).

<sup>154</sup> Sanchez, *supra* note 61.

<sup>155</sup> The six "clean" plants are: Limay Bataan Combined Gas Turbine A, Navotas Gas Turbine Unit 4, Limay Bataan Combined Cycle Gas Turbine B, Ambuklao Hydroelectric Plant, Toledo Thermal Plant, and Paragua Diesel Plant. The five projects said to contain "onerous terms" are: Binga Hydroelectric Plant, Cavite EPZA Diesel Plan, Sual Coal-Fired Thermal Plant, Casecnan Multipurpose Project, San Roque Multipurpose Project. Projects said to have "financial issues" are: Pagbilao Coal-Fired Plant, Pinamucan Diesel Power Plant, Leyte Cebu Geothermal Plant, Mindanao Geothermal Plant, Naga Power Plant Complex, Leyte Luzon Geothermal Plant, Malaya Thermal, Zamboanga Bunker C-Fired Diesel Plant, Gen-San Bunker C-Fired Diesel Plant, Bakun

to supplemental agreements to a contract that changed the burden or obligation of the Government.<sup>156</sup> A “financial issue,” on the other hand, refers to a situation where the Government was asked to shoulder financial obligations beyond what was necessary.<sup>157</sup> The chief reason for the review is—if for no other reason—the considerable outcry of Filipinos who are now paying more for electricity even as consumption has dropped.<sup>158</sup>

It is worth noting that the increased electricity costs are due to the purchased power cost adjustment (“PPCA”<sup>159</sup>). The PPCA is an automatic cost-recovery mechanism approved by the now-abolished Energy Regulatory Board (“ERB”), and designed to recover stranded contract costs paid by the NPC<sup>160</sup> and Meralco pursuant to “take-or-pay” provisions in power supply contracts.<sup>161</sup> The NPC’s selling rate to Meralco thus reflects the basic rate (consisting of the NPC’s operating expenses and reasonable rate of return) *plus* the automatic price adjustments (consisting of the foreign exchange adjustment and the PPCA).<sup>162</sup> Additionally, distributors like Meralco, who were also authorized under Executive Order 215 to enter into supply contracts with private power producers, also pass on their stranded contract costs to consumers.<sup>163</sup>

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Hydroelectric Plant, and Mindanao Coal-Fired Thermal Plant. Plants with “minor problems” are: Benguet Mini-Hydro Plant, Caliraya-Botocan-Kalayaan Plant, Navotas Gas Turbine Plant Units 1-3, Mindanao Power Barges, Ormat Binary Cycle Geothermal Plant, Bunker C-Fired Diesel Generating Plant Iligan I, Bunker C-Fired Diesel Generating Plant Iligan II, Subic Bunker-Fired Diesel Plant, Bauang Diesel Plant, Bataan EPZA Power Plant, San Pascual Cogeneration Plant, Ilijan Natural Gas, and Mindanao II Geothermal Plant. Carlito Pablo and Clarissa Batino, *5 IPP Contracts Defective-Macapagal*, PHILIPPINE DAILY INQUIRER, July 5, 2002.

<sup>156</sup> Sanchez, *supra* note 61.

<sup>157</sup> *Id.*

<sup>158</sup> Moises, *supra* note 36.

<sup>159</sup> The acronym “PPA” is used in the Philippine power industry to refer to the purchased power adjustment. However, this article uses the acronym “PPCA” to avoid confusion with “power purchase agreement,” also referred to as “PPA” in the power industry.

<sup>160</sup> NPC’s stranded debt refers to the “excess of the contracted cost of electricity under eligible IPP contracts of NPC over the actual selling price of the contracted energy output of such contracts in the market.” R.A. 9136, § 32.

<sup>161</sup> Moises, *supra* note 36. It should be noted that the contracted cost of electricity in the IPP contracts was based on an ambitious projected demand growth of 11%, consistent with the relative prosperity of the early 1990s. However, the Asian Financial Crisis of 1997, and the subsequent prolonged economic slowdown resulted in a reduction in consumption which, in turn, created overcapacity in the system. *Id.* It should also be noted that in May 2002 President Arroyo announced the temporary suspension of the PPCA. Instead, the NPC’s stranded costs from power purchases from IPPs will be defrayed through a universal levy, that is considerably less than the PPCA currently being charged to Filipinos. Daxim L. Lucas and Ma. Elizabeth L. Sanchez with Nelson V. Constantino, *Palace Admits Public To Bear Napocor Costs (As It Orders Renegotiation of Two Napocor Contracts)*, BUSINESS WORLD (Manila), May 29, 2002.

<sup>162</sup> Moises, *supra* note 36.

<sup>163</sup> *Id.*

The apparent official goal of the inter-agency review is to reduce the costs that are now being passed on to consumers due to alleged onerous terms. This exercise, however, is nothing more than an attempt to back out of contracts negotiated, and entered into in good faith, between equally sophisticated parties during the power crisis. In a way, the Government is experiencing something akin to “buyer’s regret” and, in contract law, this reason has never served as a sufficient defense. Private power producers had effectively rescued the Philippines from a major crisis that could have economically crippled the country indefinitely had new private power plants not been constructed or rehabilitated in very little time. Power producers are entitled to the benefit of their bargain, which included the take-or-pay provisions that are now at the very heart of the Government’s grievances.

In fact, take-or-pay provisions are standard features in power purchase agreements (“PPAs”).<sup>164</sup> Under the take-or-pay concept, a power purchaser agrees to make pre-determined payments even when there is no delivery of power.<sup>165</sup> These agreed payments are typically linked to a price escalation formula in order to protect the real value of revenues from increased costs of operating an ageing power facility.<sup>166</sup> Take-or-pay provisions operate as an indirect guarantee—guaranteeing adequate revenues for the project company’s operating expenses, debt service, and return on equity.<sup>167</sup> These off-take provisions were necessary in the Philippines because, under the old framework, power producers did not have a public utility franchise to sell directly to consumers, and thus had no other market for their output.<sup>168</sup> A take-or-pay provision thus shifted market risk to the NPC (backed by the Government) and distribution utilities.

It should also be noted that just days before the passage of the EPIRA, President Arroyo issued an order creating a similar inter-agency committee to review the same contracts.<sup>169</sup> President Arroyo’s move was clearly designed to upstage the Legislative branch on a highly charged issue. This “executive” review was eventually superseded by Section 68 of the EPIRA. However, it is clear that both the Executive and Legislative branches are capitalizing on this issue in part to satisfy their political needs.

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<sup>164</sup> LANG, *supra* note 38, at 19.

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> Delgado, *supra* note 49.

<sup>169</sup> Evangeline L. Moises & Cecille S. Visto, *Gov’t to Start Drafting Power Bill Guidelines*, BUSINESS WORLD (Manila), June 6, 2001.

The Government's policy toward IPP contracts, however, is both confounding and disturbing—serving only as a red flag to investors and coming at a time when the Government seeks to attract new investments. What is particularly unusual is that Section 68 is embodied in the very legislation that aims to restructure the power industry through privatization and, hence, through the necessary participation of the private sector.

First, the contract review policy contained in Section 68 portrays a Government unwilling to honor its contracts, and easily willing to effect changes in law to satisfy public outcry. Power producers who had entered into the contracts during the power crisis, after all, had believed those contracts to be sacrosanct. While Finance Secretary Jose Camacho has stressed that the Government does not intend to repudiate the contracts,<sup>170</sup> the express insertion of a provision in the new law calling for a review of contracts, coupled with the President's order for a review of these same contracts, only raises eyebrows. It begs the question: for what other reason, then, does the EPIRA call for a review of the supply contracts? It is one thing to approach individual power producers for a possible renegotiation of a supply contract, but quite another to make it official policy to review *all* contracts. Even so, the Government would be hard pressed to find a power producer willing to accede to a substantial renegotiation of an existing contract. One could argue, perhaps, that Section 68 is designed more like a trial balloon to identify power producers who may be willing to consider renegotiation in the face of possible repudiation by the Government. This technique, however, will not sit well with potential or existing investors in the power industry. For politicians, Section 68 may well give some political cover so that it can at least be said that an attempt was made to alleviate the high costs of electricity borne by Filipinos. But, without real and actual relief from high electricity costs, Filipinos will likely not bite.

Second, the adverse conclusions reached by the review committee on so many of the projects (29 out of the 35 contracts) will surely not gain the confidence of investors. The committee's conclusions are tantamount to an indictment, and investors may fear that any future contract entered into with the Government could likewise be held up for public opprobrium and possibly repudiated.

Third, the Government's policy could significantly reduce the field of qualified companies interested in investing in both the generation and transmission sectors. With the looming specter of a possible change

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<sup>170</sup> Clarissa Batino, *IPP Report Out This Week-Camacho*, PHILIPPINE DAILY INQUIRER, June 23, 2002.



in law that could affect contractual obligations, investors may simply decide against investing in the Philippine power industry. The Government may thus be jeopardizing its goal of attracting the best qualified partners to invest in the country's future.

Fourth, the filing of an arbitration claim, formal legal action or renegotiation of contracts only retards the privatization effort. Moreover, such action may actually be a prod for investors involved in any such actions to exit the industry once proceedings or discussions have concluded, or to refrain from broadening their investments in the power industry.

Fifth, while the concept of paying for unused electricity (embodied in a take-or-pay provision) may, concededly, not make intuitive sense for most laypeople, the Government should do a better job educating the public rather than seeking to renegotiate or repudiate the contracts. As previously mentioned, take-or-pay provisions are standard features in international power projects, and clearly not designed to take advantage of the Philippines during a national emergency (the power crisis). The Government's insistence on the review of IPP contracts contributes to unfounded fears and negative public perceptions of private—mostly foreign—investors in the power industry. In turn, any goodwill between the Government and investors (as well as the general public and investors) will inevitably suffer, at a time when such goodwill should be shored-up, rather than broken down.

Sixth, the Government's policy regarding the contracts is disheartening not only because of its negative effect on new investments in the power industry, but also for its negative effect on new investments in *other* Philippine industries.

While the lure of lucre in a deregulated power industry may, in any event, be too strong to resist, the seemingly hostile attitude by both the Executive and Legislative branches toward contractual obligations may have a perverse effect on new investments in the power industry, new investments in *other* industries and, ultimately, the success of the privatization effort.

### C. *The Transco Franchise*

On March 13, 2002, the Power Commission endorsed, and the President thereafter approved, PSALM's transmission privatization plan.<sup>171</sup> The plan calls for privatization by concession contract, rather than

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<sup>171</sup> Iris C. Gonzales, *Transco Sale Plan Ok'd*, BUSINESS WORLD (Manila), Mar. 15, 2002.

by outright sale.<sup>172</sup> Significantly, the concessionaire will take over from the Government approximately 12,500 circuit kilometers of transmission lines and 7,500 kilometers of subtransmission lines in three grids.<sup>173</sup> The winning bidder would thus have great opportunities over such a vast transmission system. As previously discussed, however, the transmission of power will require a public utility franchise.<sup>174</sup> Thus, without such a franchise the private concessionaire would effectively be prevented from realizing any profits and enjoying the full benefits of its concession.

Notwithstanding the recent approval of the transmission privatization plan, the legislative debate over an assignable Transco franchise has thrown the entire effort into disarray. Specifically, while the EPIRA provides for the transfer of the NPC's transmission franchise to Transco, the law neither expressly grants a franchise to the concessionaire nor authorizes Transco to assign its franchise to the concessionaire.<sup>175</sup>

The House of Representatives passed a bill in early September 2002 authorizing the assignment of the Transco franchise to a yet-to-be-determined investor.<sup>176</sup> However, the bill has received stiff opposition in the Senate.<sup>177</sup> Many senators find it particularly unpalatable and a dereliction of their duties to authorize the assignment of a franchise to a yet-unknown entity.<sup>178</sup> Many senators thus express the view that the concessionaire return to Congress and formally apply for a franchise.<sup>179</sup>

The legislative fandango on the franchise issue—like the review of IPP contracts—only raises the red flag of political risk. First, a successful bidder could potentially be left in the lurch if Congress, swayed as it is by political and local passions, refused to grant the concessionaire a franchise. This would be tantamount to a change in law, and many potential investors may not be willing to take the risk of bidding for the concession in the first place. Clearly, a concession without a public utility franchise would be worth absolutely nothing to the concessionaire.

Second, a concessionaire would have to go through a separate franchise application process after having just undergone the tedious and costly process of competitive bidding. Given the difficulty in even

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<sup>172</sup> *Id.*

<sup>173</sup> Valisno, *supra* note 120.

<sup>174</sup> See discussion *supra* Part IV.A.4.b.

<sup>175</sup> R.A. 9136, § 8.

<sup>176</sup> Valisno, *supra* note 120.

<sup>177</sup> Yap, *supra* note 118; Cecille E. Yap, *Senate Transco Bill Drops Disputed Franchise Proviso*, BUSINESS WORLD (Manila), Oct. 18, 2002.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

passing a franchise bill, there is no guarantee that the Congress will necessarily give top priority to a franchise application. There is also the possibility that Congress could seek an *additional* price from the concessionaire in order to award the franchise. The granting of an assignable franchise, however, would allay investor concerns.

Third, an assignable Transco franchise would allow the Government to seek higher bids during the bidding process, as the concession would be worth more to investors if a franchise were guaranteed. The virtually zero cost (other than political cost) in granting such a franchise should be, standing alone, sufficient motivation for legislators to support such a franchise.

Fourth, if the Senate's main concern is that it would otherwise be granting a franchise to an anonymous entity—not sufficiently vetted by the Congress—the EPIRA already provides at least two safeguards designed to identify the best party (or parties): (1) the competitive bidding process and (2) the EPIRA's requirement that:

[the] awardee shall be financially and technically capable, with proven domestic and/or international experience and expertise as a leading transmission system operator. Such experience must be with a transmission system of comparable capacity and coverage as the Philippines.<sup>180</sup>

Thus, PSALM is legally required to award the concession based on the foregoing criteria.

Fifth, since the Government has opted to pursue the concession option, rather than outright sale, a public utility franchise is necessary. To be sure, a transmission concessionaire *will need* a franchise in order to operate and manage the transmission system. The debate over the franchise, then, only postpones the inevitable.

Sixth, the debate over the transmission franchise may have the effect of reducing the pool of investors, and the country may be deprived of the best qualified transmission operator.

Seventh, the identity and reputation of the private transmission concessionaire may be particularly important for investors in the generation sector. Potential investors in generation will be interested in knowing whether the concessionaire has a reputation for *independence* and *efficiency*, so as to be assured of non-discriminatory access to the transmission system and the reliable flow of electricity. However, with the field of investors in the transmission sector potentially reduced

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<sup>180</sup> R.A. 9136, § 21.

because of uncertainty over a franchise, investors in the generation business may themselves decide not to participate in the purchase of generation assets, in the first instance.

Eighth, in light of strong Senate opposition, any Senate franchise bill will likely provide only tepid approval to the House version, and thus require substantial legislative reconciliation of the two versions. This, too, will delay the privatization effort.

In the meantime, pending the Senate's further deliberations on the Transco franchise bill, and with investor patience wearing thin, President Arroyo recently approved an alternative privatization plan for the transmission assets. Under the alternative plan, privatization of the transmission assets will occur in two phases. In phase one, PSALM will award the concession to a qualified concessionaire.<sup>181</sup> However, until the concessionaire obtains a public utility franchise from the Congress, it will not engage in activities that require a franchise, such as system operations.<sup>182</sup> Presumably, in this first phase, the concessionaire will be expected to begin financing the maintenance, rehabilitation, and expansion of the transmission system. Phase two will begin when Congress approves a franchise; at which point the concessionaire would then be able to assume the role as grid operator and run the transmission system.<sup>183</sup> This alternative plan is flexible; and, should Congress approve a franchise during the bidding process, Transco and the winning bidder could immediately enter into a fully operational concession agreement.<sup>184</sup> Under the alternative plan, the concession is to be awarded by July 2003.<sup>185</sup> However, this plan—while moving the process along—scarcely addresses investors' concerns over a transmission franchise. How many investors would be truly willing to advance the significant sums in the first phase of this alternative plan for maintenance, rehabilitation and expansion, only to have the Government remain as transmission operator indefinitely, pending the approval of a franchise that is far from guaranteed.

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<sup>181</sup> Ruffy L. Villanueva, *Palace Approves Alternative Plan for Transco Sale*, BUSINESS WORLD (Manila), Jan. 28, 2003.

<sup>182</sup> *Id.*

<sup>183</sup> *Id.*

<sup>184</sup> *Id.*

<sup>185</sup> Ruffy L. Villanueva, *PSALM Opts for Alternative Transco Sale*, BUSINESS WORLD (Manila), Jan. 24, 2003.

## VI. CONCLUSION

Bereft of funds, and with its National Power Corporation financially prostrate, the Philippine Government has opted to privatize the power industry. Spawned almost by historic accident, privatization was seen as a desirable and, some say, the only real alternative available for the Government. At the Government's invitation, the private sector came to the aid of the country during a crippling power crisis that began in the late 1980s. In the interregnum, the country warmed to the virtues of privatization, culminating with the Electric Power Industry Reform Act of 2001. Privatization of power is now a desideratum for economic prosperity. Clearly, an affordable and reliable supply of electricity is indispensable as the Philippines re-energizes, and if the country is to effectively compete with its APEC and ASEAN partners and attract new investments in Philippine industries.

The EPIRA broadly provides for an ambitious and optimistic blueprint for the restructuring and privatization of the power industry. As the law is gradually implemented, investors and the general public will surely be keeping a watchful eye. In fact, a deregulated industry not only provides vast bounties for investors, but also for the general public and Philippine industries to whom the benefits of a modern and sound power industry ultimately redound. As of this writing, despite the chronic delays that plagued the year-and-a-half after the EPIRA's passage, meaningful progress in the privatization efforts appears to be truly in the offing in 2003-2004.

At the same time, while the Government turns to the private sector yet again for help—just as it did during the power crisis—the statutorily required review of contracts and the legislative reticence on the franchise issue reek of political risk. Specifically, the foreboding possibility of a change in law, as evidenced by these two issues, will have a considerable impact on the individual and collective investment decisions of the private sector.

If the Government is to achieve its goals, and if it is to attract the *most* qualified parties to invest in the country's future, it should honor its contractual obligations and break the stone wall on the franchise issue. With uncertainty about the law, investors may simply bide their time or, worse, turn their interests elsewhere.

