

Competing Interests in the Reform Process: The Case of the Philippine Power Sector Restructuring

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I. Introduction

The power industry is the most scrutinized industry in the world today. Sweeping reforms are being pushed in many countries even as California, one of the earliest states to adapt similar reforms, comes under attack for its supposed failure to protect consumers and ensure stable power supply. Reform of the power industry has increasingly been used as the basis for the release of funds by multilateral development banks and international financial institutions.

The strong push to reform the industry has been met with jockeying up from private sector interests that see increased earning potentials in a restructured power industry setup. At the same time, long-term fiscal relief encourages governments to support the reform. Unfortunately, such push from many quarters tends to relegate to the backseat equally pressing issues in government participation, regulation, consumer protection, and many other concerns. Expectedly, civil society is again the one who takes the task of mainstreaming these issues in the hope of substantially enriching the reform process, if not steering to an entirely new direction.

In the Philippines, a proposed power reform bill awaits finalization by the bicameral conference committee (a joint committee of the House of Representatives and the Senate). The bill had been in deliberation for the past five years. While a wide segment of civil society has been involved in crafting the bill, their key concerns have been conveniently swept aside or inadequately addressed. No doubt this was due to the successful and powerful lobby of business with vested interests in the passage of the present version of the bill.

On January 20, 2001, the Filipino people have again shown to the world the power of persistent concerted action. On that day, Joseph Ejercito Estrada stepped down from the seat of power. This was at the insistence of the people who would not tolerate another day of his corrupt and immoral administration, following the breakdown of the impeachment process lodged against him. Thus came about EDSA 2, in direct reference to the non-violent people power uprising against the Marcos dictatorship in 1986.

Owing to the events at EDSA, civil society has earned the chance to make substantial changes to an otherwise lopsided power reform bill. Initially, newly-installed President Gloria Macapagal-Arroyo announced a deferment of the passage of the Bill to address the concerns of civil society. However, citing the bill's decisive role in putting on stream several loan commitments from the country's creditors, some members of Cabinet are pushing for the passage of the bill in the present Congress. Upon this urging, the new President took back her word and claimed preference for the passage of the bill, with the condition that civil society will be heard and their concern addressed.

What will ultimately become of the bill is still uncertain. But the Philippine case is instructive, as it puts in perspective the difficult position civil society is thrust into in the general process of reform. While they raise valid issues, it often requires special circumstances before they are given more than the cursory attention they usually get. Philippine civil society is also hailed as among the most vibrant in the Asian region, and the Philippines among the relatively most democratic countries. Imagine another country, say one that is in transition, where a similar push for power sector reform can be felt and you see not a very good picture indeed.

This paper attempts to outline some of the issues raised on power sector reform, and the roles of multilateral actors, the multinational business community and local business elite. While the Philippine case takes center stage, the reform sweeping Asia today follows very clear patterns and similarities. Hence, many of the arguments being raised in the Philippines may also be raised elsewhere in Asia. The paper ends on an upbeat note, encouraging actions by civil society at many levels, in the belief that they are crucial if genuine progress is to be achieved

II. The Philippine Power Industry

Power generation in the Philippines is shared between the National Power Corporation (Napocor) and various independent power producers (IPPs). Transmission is the responsibility of the Napocor. Distribution is spread to 15 private utilities, 11 municipal systems, and 119 rural electric cooperatives (RECs). Total installed capacity in the country is around 12,000 megawatts. Napocor accounts for more than 70% of total capacity, while the IPPs take up the rest.

Generation

The National Power Corporation (Napocor)

Government's direct participation in the power industry began in 1936 with the creation of the National Power Corporation under Commonwealth Act 120. Napocor was given the task to develop hydraulic power, and was given monopoly rights over remaining public waters. The Act also compelled government units and government owned and controlled corporations to buy electricity from Napocor. Napocor was converted into a stock corporation in 1960 under Republic Act No. 2641.

In 1971, Republic Act No. 6395 revised the charter of Napocor, and expanded the scope of energy sources for power generation. It also mandated Napocor to establish and operate nationwide power transmission. By 1972, Napocor's monopoly power over the power industry was clinched with the issuance of Presidential Decree No. 40. PD 40 declared the state objective of owning and operating power generation facilities as a single integrated system to the entire area covered by any grid set up by Napocor. Private sector participation in the industry was limited to the areas not covered by the grid, already existing private generating facilities allowed by Napocor, and the distribution of electric power. In 1979, Napocor bought the thermal power plants operated by the Manila Electric Company (MERALCO), bringing government's generating capacity to 90 percent of total installed capacity.

By end-1999, system capacity in Napocor grids totaled 12,050 MW, a 25 percent increase from 1995. Napocor's own generating facilities made up 45 percent (5399 MW) of this capacity. Independent power producers (IPPs) with power purchasing contracts with Napocor took up the bigger part (6650 MW or 55%).

The Independent Power Producers (IPPs)

IPPs have started to mushroom in the early 1990s as the government's quick-fix response to the debilitating power crisis. Failure of government to prudently manage, rehabilitate and add to existing facilities rendered it incapable of meeting energy demands. The country suffered as long as 12 hours of daily power outages, severely impairing economic productivity.

In 1993, Republic Act No. 7648 or the Electric Power Crisis Act of 1993, gave the President power to enter into negotiated contracts for the construction, repair, rehabilitation, improvement or maintenance of power plants, plants and facilities, and to reorganize the Napocor as required to address the crisis. The powers had a limited time of one year. The severity of the power crisis, and the short period of efficacy of the emergency powers, resulted into a near-panic signing of power purchase agreements with IPPs to cover the huge energy shortfall.

Prior to 1993, two crucial laws were passed that made possible the entry of private contractors in the power generation sub-sector. The first was Executive Order 215 issued by President Corazon Aquino in July 1987. EO 215 amended PD 40 to allow private sector participation in electricity generation. Three years after, Republic Act No. 6957, called the Build-Operate-Transfer Law, further expanded private sector participation in the power industry as well as in other infrastructure projects. All government agencies, including government corporations and local government units were authorized to enter into BOT contracts.

The severity of the situation – the crippling power supply shortage was exacerbated by unstable political situation towards the entry of 1990 – led to less than prudent choices. Half of the 46 IPP projects signed between 1988 and 1998 were of the 'fast-track' category, or projects with short gestation periods but not necessarily the cheapest or cleanest sources of energy. These were mostly diesel and bunker fuel generators. Per unit cost of electricity stipulated in the contracts also appeared to have been much higher than the actual cost borne by the Napocor in operating its own generating plans. On top of this, Napocor shoulders most of the reasonable risks (foreign exchange risk, inflation risk), taxes, and for many plants, even fuel costs.

According to the World Bank in its study, *Power Sector Study: Structural Framework for the Power Sector, Philippines* (World Bank, Industrial and Energy Operations Division November 30, 1994), "the average economic cost of the IPP is 11% higher than the estimated base load avoided cost (i.e., cost to the consumer due to the absence of adequate service)". The same report stated that "the average price of all IPPs analyzed of US \$0.0652/kWh is quite high compared to the current average bulk energy tariff of NPC which includes generation, transmission, subsidies for rural and small-island consumers, peak capacity, and the provision of reserve capacity. This indicates that commissioning of these plants (IPPs) has and will continue to put strong upward pressure on tariffs."

True enough, the IPPs have become a great burden to Napocor's finances. They cost Napocor 45 billion pesos a year or nearly \$1 billion a year at today's exchange rate. The huge contractual obligations to IPPs have contributed significantly to inflate Napocor's debt, which currently stands at \$5.6 billion or 1/5 of the country's external liabilities. What makes the situation ironic is that only 20 to 40 percent of minimum off-take requirements of IPPs is actually being used or sold by Napocor.

Almost two-thirds (64.4%) of the total capacity contracted to IPPs were signed during the term of President Fidel V. Ramos, and most are within the period when the emergency powers were in place. Hence, these were not subject to transparent and open bidding processes.

As of end-1999, IPPs account for 6,650 MW or 55 percent of current installed capacity. IPPs still under construction (included in the 46 signed contracts) promise 2,422 MW more.

Industry Self Generation

A very small portion of generated capacity is accounted for by own-generation initiative of some industries, mostly cement manufacturing firms that want to ensure their own electricity supply. They are not necessarily on-site generating facilities. They also use Napocor's transmission facilities and the distribution facilities of private utilities.

Transmission

Transmission is the monopoly of Napocor. There are four grids: Luzon which accounts for 73 percent of total power sales; Visayas, 12 percent; Mindanao, 13 percent; and the Small Islands Grid, 2 percent.

Distribution

Private Distribution Utilities

The Manila Electric Company (MERALCO) is the largest distribution company. It is private and operates in Metro Manila, the capital region, and its immediate environs. It accounts for bulk (62% as at end-1998) of Napocor's total deliveries. MERALCO is able to service/electrify 98 percent of its franchise area (as of January 2001).

Other private distributors operate in the rest of Luzon, the main island, and in the two other major islands of Visayas and Mindanao. They account for less than 20 percent of sales and together with municipal systems have an electrification rate of 95 percent in their franchise areas (also as of January 2001).

Rural Electric Cooperatives (RECs)

More than 100 rural electric cooperatives account for around 15 percent of Napocor sales. As of January 2001, the RECs' electrification rate was 80 percent.

Policy and Regulation

The ***National Electrification Administration (NEA)*** is responsible for financing and providing technical assistance to RECs.

The ***Department of Energy (DOE)*** is responsible for energy policy and coordination with other government institutions for its implementation.

Price and price-related regulations are the domain of the ***Energy Regulatory Board (ERB)***. It fixes all tariffs from generation to distribution, except the price of power being sold by IPPs to its direct customers.

Pricing of bulk electricity from Napocor is regulated and includes both transmission and generation costs. The basic rate consists of generation fixed and variable costs, subsidy to small power utility group, and return on rate base (RORB) for replacement and expansion of systems. An inter-grid subsidy and small islands grids subsidy are also embedded. On top of this, a cost adjustment mechanism is in place to account for fluctuations in fuel prices and foreign exchange rates.

The design and component costs in distribution differ according to utility. For example, MERALCO will have a structure where the first 50 kWh of household consumption is subsidized. Cost structure for industrial, commercial and residential users also carries implicit cross subsidies.

The ERB was created by Executive Order 172 in July 1987. The Board is composed of a Chairman and four members, all of whom are Presidential appointees. Their appointment is supposed to be on the basis of their “recognized competence in the field of law, economics, finance, banking, commerce, industry, agriculture, engineering, management or labor.”

Civil society, particularly consumers’ groups’ participation in the ERB is weak. It is limited to publication of notice and appearances before adjudication hearings for petition of price changes, issuance of franchise to operate electric power utilities and services, zoning, and introduction of rules.

III. The Restructuring

The government envisions a radical restructuring of the industry. The basic premise of the restructuring is unbundling, or the separation of the three power sub-sectors of generation, transmission and distribution, for the purposes of operation and pricing.

Government intends to fully dismantle its monopoly, exercised thru Napocor, over the generation of electric power. Napocor will privatize its generation assets, and entry in power generation will be liberalized.

Power transmission, while remaining a regulated monopoly, will be privatized over time. Ultimately, government aims that end users will be free to choose their suppliers of electricity. Delivery from the suppliers to the end users will be made feasible by giving suppliers open access to transmission and distribution lines, for a fee that will be fixed by a regulatory agency called the Energy Regulatory Commission (ERC), to replace the ERB.

Like transmission, the distribution sub-sector shall be a regulated common carrier business that requires a franchise. Distribution may be done by private utilities, cooperatives, and local government units, who shall provide open and non-discriminatory access to users of the system in their franchise area.

There shall be a contestable market, or the group of end-users who have a choice of electricity suppliers. Some threshold consumption determines which consumers qualify in the contestable market. Those not qualifying remain the captive market of the distribution company that operates the franchise in their areas. Those in the contestable market may deal directly with generating companies or other formations authorized by the ERC. Outside negotiated contracts, there shall be a wholesale spot market where price setting will be determined. The Department of Energy is responsible for formulating the rules that will govern the spot market.

These restructuring features are the main selling points. But there are two aspects of the present version of the bill that make the scenario unlikely at least in the medium term.

First, the end-users are segmented so that a large portion, the small ones, will not be able to participate in the competitive transactions for a potentially long-drawn transition period. The competitive market will operate once the open access to distribution wires is implemented, which will not be later than three (3) years after the efficacy of the Act. It will initially consist of end-users with energy demand of at least two (2) megawatts. This threshold will be reduced further by June 2003 and for at least two years thereafter. Only after then will the ERC determine if the threshold can be further decreased until it reaches household demand level.

Those that do not qualify will remain the captive market of the distribution utility with the area franchise. This brings us to the second defect of the bill from a competition perspective.

It is silent on the issue of cross-ownership. A forum with representative from the DOE even revealed that it is not explicitly discouraged. This means that the distributor can freely contract with an allied generation firm, even if it is not the cheapest supplier in the market.

Already, the big distribution outfits have stakes in different independent power production activities. Some IPPs and allied interests also enjoy seats in the Board of big distribution companies. The issue of conflict of interest, therefore, is very real.

Consider, for instance, the following. Six of the eleven directors of MERALCO are also in the Boards of power generating companies like Panay Power Corporation and Bauang Private Power Corporation, or holding companies which have stakes in power generation like First Philippine Holdings Corporation and First Private Power Corporation. Information from its website also reveals that “MERALCO has also signed agreements with six IPPs for a cumulative capacity of 2,174 MW from 1999 to 2004”.

Several other related issues arise. To be able to liberalize and deregulate the generation sub-sector, it is imperative that the Napocor privatize its generation assets. For this to happen, three important questions must be asked: (1) how much and what

are the sources of the losses?; (2) are there ways of mitigating losses to bring down the cost of restructuring?; and, (3) how will costs be distributed among stakeholders?

There are two things being contemplated to cover the losses. One is for the National Government to absorb 100 billion pesos (around two billion dollars) of Napocor's liabilities. The other is the imposition of the so-called Energy Industry Reform Charge (EIRC) that will cover part of the stranded costs, as well as pay for missionary electrification, etc.

Losses come in two forms: stranded liabilities or that part of the Napocor debts that will not be assumed by the National Government, and stranded costs or loss incurred when existing contracts are privatized at less than guaranteed price. Under the current bill, these costs shall be managed by a power sector assets and liabilities management (PSALM) group, using recoveries from the EIRC and other authorized acts (borrowings, etc.).

Two related issues on stranded costs arise. One questions whether private distribution utilities with existing power purchase agreements (PPAs) with IPPs should be allowed to recover their stranded costs from the EIRC. It is the very strong contention of civil society that they should not, because they were not compelled to take on the PPAs in the first place. They were simple private investment decisions. The second argument is that, if in the current version of the bill they are not required to divest, why should they be allowed to recover stranded costs at all?

The second question is whether a renegotiation of Napocor's PPAs with the IPPs, or otherwise an orderly workout may be feasible. It has been shown that for many of the PPAs, the government has been compelled to pay highly uneconomic prices. While a big part of this may be considered as premiums (perceived investment risks were translated into part of the price), there just might be cases that parties representing the government abused their discretion. Therefore, all PPAs should be reopened and reviewed, giving priority to those that were not subject to open bidding.

IV. The Wider Context

The deregulation and privatization of a big section of the electricity industry is not isolated. It follows a very visible and systematic path of scaling down the scope of government activities beginning in the structural adjustment era in the 1980s.

If one examines when the start of the focus on the power sector begun, it will be revealed that it coincided with the big glut in the international equipment market in the early 1990s. Further, power sector reform studies have been done at almost the same time, particularly between 1992 and 1996. Most have been done in 1994. The World Bank funded these studies.

The model proposed is the same for all cases, irrespective of current/prevaling market structures and viability of national and state utility companies. The push also came with the introduction of Build-Operate-Transfer (BOT) and related schemes in the legal framework of Asian countries, particularly in power and general infrastructure. In Asia, the biggest players were/are the World Bank, the International Finance Corporation, the Asian Development Bank, big multinational energy suppliers, and export credit agencies.

The strategy almost always starts with “state-bashing”, or highlighting the inefficiencies of state enterprises, while keeping mum on proven successes. And lately, multinational institutions have started to concentrate on the so-called “constituency-building”. Huge resources are poured into private foundations and even NGOs to help ‘advertise’ the reform process. In India, you have the Rajiv Gandhi Foundation. In the Philippines, we have the Foundation for Economic Freedom who ran a two-part series of television advertisement enjoining the audience to support the power reform bill. Of course it did not hurt that perhaps they are fully convinced of the reform agenda.

The most blunt action yet was the alleged bribery of the House of Congress in the Philippines. At the time that the Power Reform Bill was heatedly being discussed in the Lower House, congressmen and women were suddenly given at least half a million pesos (ten thousand dollars) from out of nowhere. Up to this day, no investigation has been done. When the matter was brought up to the ADB – who incidentally is financing the Power Sector Restructuring Program – it conveniently washed its hands and took cover with the “we do not want to be perceived as meddling” stance.

It is unfortunate that such action indicates that the ADB is not really concerned about the integrity of the reform process. This smacks of intellectual dishonesty. It is not belief in the market, in competition, in reform per se that drives them. It is business! They actually act as proxies for big business in the region. They finance public and private power-related projects thru its various co-financing and guarantee schemes. They do not have the money to leverage actual projects. Instead, they mobilize private capital and just charge premiums over that. (Of course it is not this simple. But the point that the ADB is constrained to follow even its own anti-corruption policy is a glaring indication of how limited its power is in the face of big business.)

V. Doing Reforms Right

Reform must be done right. The cost implication of bad privatization, for instance of Napocor in the case of the Philippines, may be staggering, not only in relation to the privatization process but also in relation to the building of a constituency for genuine reforms. If reforms are designed haphazardly, or if they are so slanted as to favor entrenched interests, the promise of reform is compromised and support for it is diluted.

That the basic assumption that government cannot run public utilities effectively commercially is **WRONG** needs to be emphasized. Examples from South Korea, Malaysia, Indonesia, Singapore, even Hong Kong, would show that it is not public control and ownership per se that is the problem, but the specific inefficiencies prevailing in many utilities. Often, it is also lack of capital.

There is market failure as much as government failure. In situations where competition cannot obtain, as in the case of natural monopolies, there is need for strong government regulation. Even in a privatized setup, regulation is crucial to ensure that no single player will gain substantial power so as to reverse the gains of competition. Or in the absence of a market, there is need for government intervention.

Divestiture to private hands need not be the only solution to inefficiency problems. The important thing is to work out appropriate alternatives, which also includes divestiture too, but with stringent regulatory handles in place.

Finally, even in a privatized regime, pressing issues like subsidy, ecological costing, missionary service, pricing, and regulatory capture can be addressed, at least during the period of transition, or even longer for identified “vulnerable” or “non-market” groups. The point being that the power of policy remains in the hands of government.

VI. Imperatives of Strategy

On the broader issue of strategy, there is need to work on many different levels. Internationally, it has to be exposed that how meddlesome international development and financial institutions have been, and that how irresponsible they have been for being doctrinaire in their approach.

Regionally, it is very important to link the uncannily very similar issues obtaining in the reform process. It may be said that the state’s performance has not exactly been exemplary in the region, and that people are clamoring for reform. Unfortunately, these are the states where democratic processes are also not in full play, such that multilateral development banks and international financial institutions have become the battering ram for reforms to take place. Still, even granting that certain reforms are needed, so many issues – like appropriateness, sequencing of reforms, etc. – have to be dealt with. And no international institution can ever claim they have the answers to these, having failed as they have so many times in the past.

And locally, the movement for change should be broadened. The Power Sector Restructuring Program cannot be isolated from the wider development context.

Building alliances and coalitions between and among the progressive opposition and reformers, the basic sectors, and the most critical groups in the campaign for change is needed. Expectedly each will employ their specific approach, but it is always possible to agree on a minimum agenda while pushing for the wider goal.

In the Philippines, the campaign against the one peso oil levy was a big success. The campaign was led by the Freedom from Debt Coalition, abroad coalition of individuals and groups representing people’s movements, NGOs, the academe, and labor unions. It was able to mobilize the basic sectors, academics, business and other interest groups, and succeeded in making the government scrap the one peso levy imposed on oil products.

Massive information work on various aspects – the techno-economic, the moral, etc.—is imperative. This should be done in the most sympathetic manner and the most accessible language.

And finally, we need to put to task the different players in the reform process: the government, the industry (power sector), the creditors, and the regulators.

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