A GOOD PROJECT IN THE PHILIPPINES

FOR SOME TIME, THE PHILIPPINES POWER SECTOR HAS BEEN ONE OF THE MOST COMMERCIALLY ATTRACTIVE IN ASIA – IT IS A MARKET WHERE, WHENEVER ANYONE CARES TO ASK US, WE SUGGEST: WHY NOT TAKE A LOOK? BY **SARAH FAIRHURST**, **MIKE THOMAS** AND **JAMES DOIG**, **THE LANTAU GROUP**.

The Philippines power sector is open to foreign ownership without material restrictions; it has a working spot market with more than seven years of operating history, providing investors with an alternative source of revenues should they run into problems with their commercial contracts; there is an ever-deepening and liquid local banking sector; and a comparatively resilient and robust macro economy is creating steady growth in need for new supply.

The Philippines has so far avoided the kind of regulatory risks that have befallen the once mighty Australian power markets, east and west. Indeed, one might even argue that, at least until more recently, the Philippines was unjustly ignored by investors who seemed to prefer the risk of winners' curse in lifestyle power markets such as Singapore, or the seemingly endless toils and troubles and pain and suffering of birthing a power project in Vietnam; or the exposure to volatile fuel markets without any contractual protection in China.

Meanwhile, a handful of international investors and a growing number of domestic investors have been gaining confidence and experience, building positions, forming relationships and joint ventures, and finding opportunities.

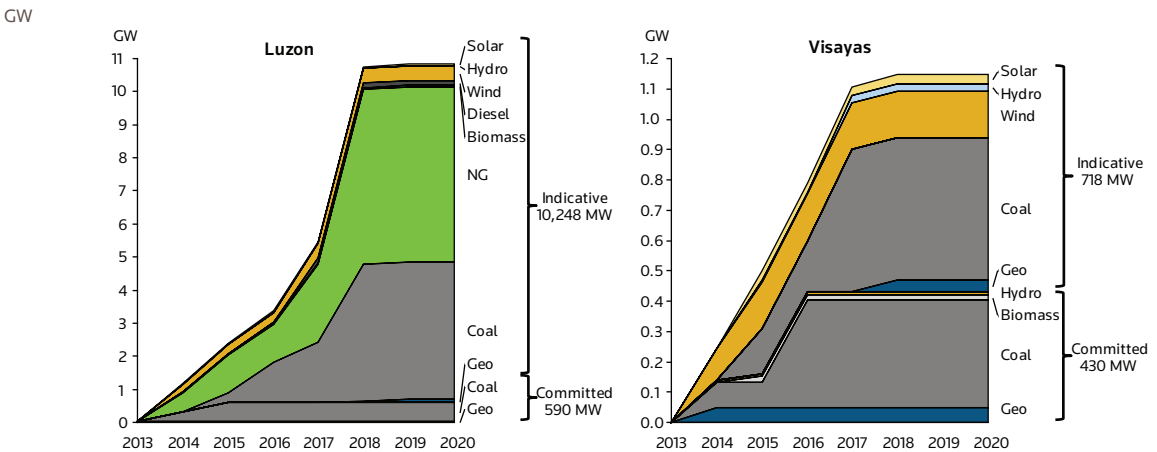
Well, the secret seems finally out. There are currently more than 70 different power projects being pursued by the private sector in the Philippines, ranging from very small renewable projects of a few mega-watts to large coal-fired power stations (Figure 1). And now, perhaps, the pendulum of risk has swung a bit the other way – towards more rather than less. As anyone knows who follows the Singapore market as we do, supply can quickly swamp demand if investors actually do what they say they want to do.

We therefore discuss two key questions: What makes a good power project in the Philippines and what risks should investors beware of when evaluating projects? Obviously, we must make our disclaimer clear: Our answers cannot possibly substitute for proper due diligence, which we leave to readers of this article. As always, measure your own opportunity; take your own risk; and manage through the consequences.

The fundamentals

It goes without saying that a good project needs good fundamentals. In this context it is important to understand the Philippines electricity market, called the WESM. The WESM is a wholesale (energy-only) spot market loosely modelled along the lines of the New Zealand market, the Australian NEM, and the Singapore NEMS. That said, there many differences, particularly around

FIGURE 1 - RATED CAPACITY OF COMMITTED AND INDICATIVE PROJECTS IN THE WESM

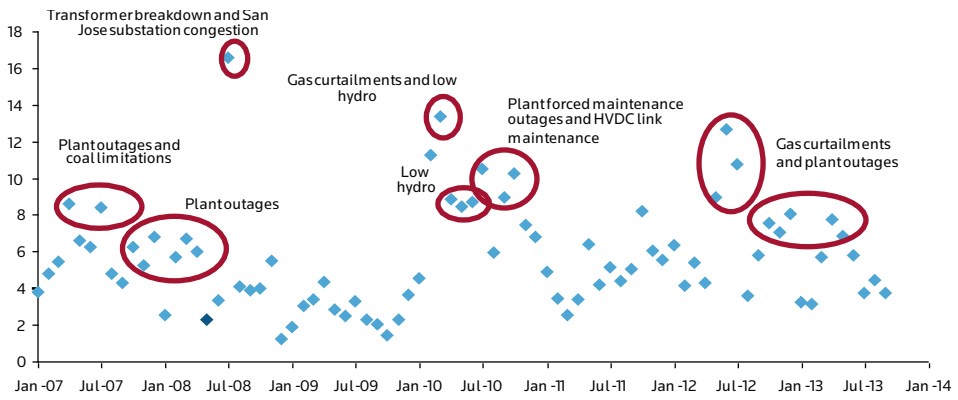


Note: Where the DOE has indicated that commitment is subject to FIT for three projects, these have been reclassified as indicative

Source: DOE

FIGURE 2 - AVERAGE MONTHLY WESM SPOT SETTLEMENT PRICE*

GW



Note: *Buying price (with 100% surplus)

Source: DOE

contracting, between the WESM and those markets.

We call the WESM an event-driven market. This is because WESM spot prices are strongly driven by events – such as typhoons, station breakdowns or fuel shortages – much more than time of day or seasons in other markets. Other markets are more heavily influenced by seasonal or diurnal cycles or simple demand and supply. Not so, the WESM. This is illustrated below.

A key question therefore is: How exposed to events is your project? A peaking project can capture significant value from events in the market, but that value will be highly uncertain. A baseload project will probably sell most of the output under contract, meaning the impacts of the events on the average price will affect contracting strategy.

The latest and biggest event to affect the market is obviously Typhoon Haiyan (Yolanda in the Philippines) – but data on the impacts of this will not be available for some months. Both supply and demand have been affected – with homes and businesses that were previously demand destroyed but also a key power station supplying much of the region badly damaged. Before Haiyan, demand was growing strongly:

Sarah Fairhurst

Steady, robust, economic growth has been working down the excess capacity that resulted from urgent IPP development programmes in response to major outages in the 1990s. In 2012 and through 2013, the outlook for demand growth signalled the need for new supply – potentially an urgent need – some point between 2015 and 2017. With electricity demand that can be materially influenced by periodic El Nino climate events (in which temperatures increase and rainfall decreases), the prospect of more event-driven outcomes continues.

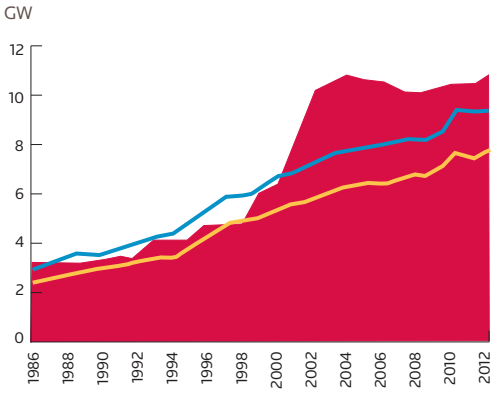
Regulation and counter-party offtake risks

In our view, investors viewing a generation investment opportunity in a deregulated merchant power market too often discount their exposure to regulatory risk, and then express utter disbelief when something bad happens later. Often, the highest pool price forecasts in any modern merchant market invariably develop base cases that omit regulatory risk, focusing mainly on supply, demand, fuel prices, heat rates, and competitive activity (and sometimes transmission).

Regulatory risk may be incorporated in sensitivity analyses or scenarios, but rarely in a base case. Yet a base case is supposed to be an expected case, in which it is proper to include an assessed weighted average of all risks. Innocent shaving of risks here and there when formulating base cases is one of the most prevalent biases of pool modelling throughout the region. Is it any wonder that five or so years after they spend their money, relatively few investors in any merchant market seem all that happy?

Regulatory risk is important. Ignore it at your peril, whether investing in Australia or in the Philippines. Don't fall into the trap of thinking developed markets are somehow more protected than developing or emerging markets, as that has not proven to be the case anywhere in our experience. The risks may be different, but investing in a developed economy is no secret

FIGURE 3 - SUPPLY AND DEMAND IN LUZON (1986-2012)



Note: *Philippine Grid Code previously mandated 23.4% reserve be available, since 2011 it has required 4% for frequency regulation, a quantity equal to the most loaded unit for contingency and a quantity equal to the second most loaded unit for dispatchable.
** Dependable capacity is the maximum capacity factoring plant reliability and ambient llimitations.

handshake that allows passage to some risk-free nirvana.

The nature of electricity regulation in the Philippines affects all parts of the electricity supply value chain – from generation to retail. The way retail costs are regulated has a direct flow through to power projects, as without regulatory approvals most buyers of power for franchise consumers will not contract with a generator for power.

We have written much about regulatory risk in the Philippines[1]. Two issues are particularly pertinent to new generation projects: that of contracts underpinning power station new-builds and the creditworthiness of the counterparties signing those contracts.

Figure 4 highlights the market share in Luzon – split into private investor-owned utilities (PIOUs, such as Meralco), not-for-profit electric co-operatives (ECs) and local government unit-owned utilities (LGUOUs).

Clearly, in Luzon, the market is dominated by Meralco – claimed by many observers to be "the only creditworthy counterparty in the market". What to make of this?

The sheer size of Meralco is part of the answer, but for the rest we need to dig deeper into the structure of the ECs and how they are regulated. Most ECs are small and cover a small geographic region. Some operate in a financial Kanban style – collecting revenues just in time to avoid trouble with debts. These are not problems unique to the Philippines – collection challenges and non-technical losses are issues in many developing countries – but problems are compounded in the Philippines by how many ECs are constrained by their charters.

The not-for-profit nature of these ECs, together with strict cost-only pass-through regulation, mean that the ECs can neither save for rainy day nor conserve surplus funds for expenses such as force majeure allowances or the costs of security deposits and prudential requirements. Unlike many regulatory frameworks that allow normal operating expenses to be passed through, the regulatory environment in the Philippines is such that even funding the prudential requirement needed to join the market is a struggle for some. Some are unable to meet the credit security requirements necessary to enable them to participate in long-term contracts. Of the 86 ECs in Luzon and the Visayas; 15 are not even members of the WESM.

The smaller ECs are simply not set up to be obvious counterparties for contracts in a market-based environment such as the WESM. It is said that no international bank will lend to new power projects underwritten by contracts with a non-creditworthy EC, and we understand that even local banks need something extra to lend to projects that rely heavily on contracts with ECs (such as the Sinosure involvement in GN Power).

Yet, while Meralco may be seen as creditworthy simply for being so large and unencumbered by a non-profit organisational structure, it currently supplies only about 60% of peak demand. The other 40% of the market also needs new power stations to be built to meet growing demand.

The situation is especially challenging in the Visayas and in Mindanao. Figure 4 shows how these regions are supplied primarily by ECs. Furthermore, in Mindanao, there is no spot market to fall back on[2] in the event an EC has over- or under-contracted.

Unfortunately, the ERC's (regulator's) contract approval process has not helped. At one point earlier in 2013, a quick count of work-in-progress cases on the ERC website suggested that 26 approvals of power supply agreements (PSAs) were outstanding from 2005–2009 (18 from 2009). The ERC does not appear to evaluate contracting and EC cost structures and risk management capacity holistically, nor does it appear to differentiate between when it is necessary to regulate outcomes and when it is better to regulate the processes by which outcomes are achieved. Instead, the ERC seems to examine each contract on a case-by-case basis. This may seem admirable, but it results in costly delays and evidences a fundamental disconnect between the ERC as regulator and the WESM as competitive market.

The ERC has approved contracts based on a cost-plus concept. As a result, it has disallowed a number of contracts negotiated in the competitive market environment. For example, Trans-Asia offered to supply energy sourced from the market and other suppliers to BATELEC II, a direct EC that did not wish to be exposed to WESM spot prices. Trans-Asia offered BATELEC II the prevailing NPC "Time of Use" rate plus a two percent margin. In exchange, Trans-Asia, a private sector company, proposed to take the risk associated with WESM price volatility as well as the responsibility to manage an overall supply contract portfolio for a price slightly more than the minimum in the market, saving the EC the cost of joining the WESM in the bargain.

The ERC disallowed the two percent uplift – effectively forcing Trans-Asia to supply BATELEC II at the same price as the government-owned NPC, whose prices have no reason to necessarily be right. This highlights a potentially serious lack of recognition of risk/reward trade-offs inherent in energy contracting and a poor understanding of the role aggregators can play in the market.

In another example, Green Core Geothermal signed a number of contracts for the sale of the output from Palinpinon and Tongonan in the Visayas. However, in its latest contracts with Ceneco and Veco (two utilities operating in the Visayas), the proposed steam price differed from what it had been in some earlier contracts. The ERC ruled that there was "no reason to deviate from the previously approved fuel fee" – ignoring, it would seem, commercial realities or other matters that might have affected two different negotiated outcomes that took place at different points in time.

Of the pricing terms in 15 contracts in Luzon submitted to the ERC for approval in 2011, more than 25% were reduced in some way and none were increased. Therefore, potential investors need to carefully consider where any potential project will fit in the regulatory mix in the Philippines and consider early how to manage any approvals that may be required. It may not be a good market to simply swoop into and expect to develop projects rapidly (and profitably). But of all markets in Asia, the steady growth expectations would seem to support investors willing to make permanent their interest and their presence, and to take the time and put in the effort to understand the market and the essence of WESM-related opportunities and risks.

One approach to mitigate or avoid some of these risks is to contract with parties that need no regulatory approvals – such as contestable customers. Retail Competition and Open Access (RCOA) commenced on June 26 2013 after a raft of delays. RCOA opens up the market to allow certain customers the ability to buy power directly from generators and other retailers. While this gives new power stations a range of alternative customers, it also adds a risk to existing retailers – that of losing key customers in the future and thus being less confident about their future demand for power.

One approach to mitigate or avoid some of these risks is to contract with parties that need no regulatory approvals - such as contestable customers

Indeed, eligible customers are already starting to flex their muscles: In November while Typhoon Haiyan was damaging the Unified Leyte power station, Waterfront Hotels and Casino's was winning a 3MW share of the output of the plant in a PSALM bidding process in Manila. While the outcome of that transaction is now very unclear (mainly due to the tragic storm), the result highlights the desire of large consumers to improve their lot with or without the assistance of incumbent retailers. After all, the Philippine customer pays some of the highest electricity prices in all of Asia.

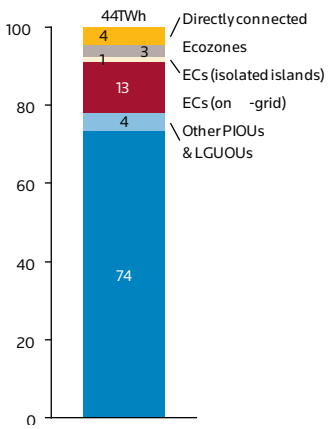
The ERC's unfortunate focus on specific outcomes rather than on constructive regulation and approval of process is a significant ongoing risk to the WESM, one that has already had a negative impact. In Mindanao, a group of ECs came together for the very first time to run an innovative and major tender for 300MW of new baseload generation capacity. While there were a number of issues that caused the failure of this particular tender process, a major problem was that the ERC did not provide the ECs with any form of "in-principle" regulatory approval prior to the bid.

As the bid was to be competitively tendered, the key economic issue should have been whether the tender was well-structured and whether the level of competition would have been sufficient to establish a credible outcome. In short, the key economic regulatory issue concerns the process. But this is not how the ERC approached the situation, consequently fostering perceptions of significant regulatory risk.

Bidders incurred substantial costs to submit compliant tenders, including the expense of evaluating the opportunity and developing their proposals and meeting the various requirements. The cost and financial commitments required to prepare and submit compliant tenders for competitively tendered power opportunities can run into the millions of dollars. Yet, the ERC provided no assurance that it would approve the winning bidder's proposal. Looking forward, with new commissioners recently appointed to the ERC, one can hope for a fresh approach.

FIGURE 4 - MARKET SHARE BY SALES IN LUZON (2012 EST)

%



Note: * Including Subic Enerzone Corporation

Source: DOE; Meralco; NEA

Other bankability issues

The issues of project fundamentals and regulation are key to bankability of projects in the WESM, but they are not the only issues to be considered. In our experience, there is a significant difference between the way local firms (and to some extent local banks) view projects compared with international investors.

International investors have enormous experience with international power across a wide range of developed and developing countries and across regulated and merchant markets. With experience comes a degree of respect for prudence (though we would surely not be overstating matters to suggest that bankers sometimes selectively exhibit astonishingly short memories). In the Philippines, by contrast, no one has yet been burned by a power sector investment gone very badly.

In contrast to international banks, local banks have so far tended to ignore (or not demand) significant analytical due diligence. They have neither known as well what to ask for, nor worried as much about what they do not know. Project sponsors faced with easier access to money can quickly get sloppy. So at least one risk to the prudent investor is to consider whether investments might actually happen that you think ought not to.

Perhaps unsurprisingly, financing from local banks seems to rely more on historical experience and relationships. Right or wrong, these local relationships have been cosy enough that some local investors have been able to avoid the tough questions that international banks sometimes ask. On the other hand, some local investors have consistently demonstrated world-class analysis and strategy. Smarter analysis does not always beget near term wins, but it remains the only long-term strategy that makes any sense.

It is therefore important to keep in mind that nobody has yet experienced a significant financial failure. PSALM (which owns some residual power plants destined for privatisation) has acted as a de facto supplier of last resort and PEMC (the market operator) has not disconnected delinquent customers. So most players that should have failed (most notably some small co-operatives that failed to pay for the power they purchased from the market) have not been commercially penalised.

This is changing: Aleco (one such co-operative with large debts) has been forcibly sold to a private sector entity and the board dismissed. PSALM has almost completed its privatisation activities, so its ability to act as a de facto balancing party is nearing an end. As the market evolves, project sponsors should focus more on proper due diligence and analysis to ensure their projects are robust in the face of the increasing risks of the market, and especially open access and retail competition. While local sponsors have certain advantages in the market, international sponsors have experience and insight that is equally relevant. More often we are seeing combinations of local and international partners – perhaps they seek the best of both worlds.

Looking ahead, the Philippines offers some of the strongest fundamentals of supply and demand but growing investor interest has yielded a growing backlog of potential projects. There is not room for all of those projects in the near term, so a key issue is how these projects might actually gain financing support.

The WESM is gaining years of operational maturity, but commercial behaviours in the WESM are still pretty embryonic. The ERC's strong interventionist behaviour – understandable given the relatively high prices of Philippine electricity prices compared with the rest of Asia – has had the unfortunate side effect of delaying commercial maturity. Investors still look to traditional PPA type contracts and many have not quite got their heads around how to incorporate the WESM spot market into their commercial assessments. Other risks also abound, for which space is too short to do much more than briefly mention. Grid connection agreements and grid performance risk remains a concern – not surprisingly given that some of the biggest "events" that affect WESM prices have been grid-related.

That said, there is no free lunch. You could be facing a potential a lifetime waiting for approval for a new build opportunity in Vietnam or watching government policy destroy (at high cost) any semblance of demand growth in Australia. The WESM remains one of the unpolished gems of the region. ■

Footnotes

1 – Go to www.lantaugroup.com and review our publications, called piques, of which there are two on the Philippines, one on the general market (2011) and another more specifically on regulatory risk (2013)

2 – An interim market has just commenced but remains untested.

That said, there is no free lunch. You could be facing a potential lifetime waiting for approval for a new build opportunity in Vietnam or watch government policy destroy any semblance of demand growth in Australia