# Nothing vanilla in Manilla

01/05/2000

The Philippines' drawn out energy sector reform process was given a big boost last month when the Philippines' House of Representatives passed its power sector restructuring legislation under House Bill 8457 (better known as the Omnibus Power Restructuring Bill). The passage of this legislation has been hailed, both in the Philippines and abroad, as another significant step on the road to the deregulation of the country's power market.

Although deregulation is generally applauded, it is a two-edged sword. As one development manager at a major US power company says about Philippine deregulation: ?It has created an enormous amount of uncertainty in the market. No one knows exactly what the power market will be like a year or two from now. This has pretty much brought a lot of new development to a halt.?

Market uncertainty, in turn, is producing significant challenges for the financiers of those power projects that are still going ahead in the Philippines. Bankers note that this is particularly true in the case of independent power producers (IPPs) that have entered or will enter into power purchase agreements (PPAs) with Napocor, the state-owned utility, as Napocor is the principle focus of the power sector restructuring process. There is a real possibility that Napocor will have to renegotiate PPAs as the new energy environment slowly unfolds. When these renegotiations take place, and with what outcome, is unclear.

Although Napocor is likely to remain the off-taker for a large number of generating plants, ultimately the utility is expected to sell off most of its generating business, only retaining power plants unattractive to the private sector.

A new system will have then been created; one of privatized generators selling electricity directly to private distribution companies. It is because Napocor will need to transfer its existing power purchase obligations to private distributors that it will also need to renegotiate high priced contracts. Naturally, private distributors will be unwilling to enter into agreements that are well above current market rates.

Which projects will be affected? Some of the older IPP developments, almost certainly. Older IPPs were able to negotiate extremely generous power purchase agreements (PPAs) due to the fact that, from the Ramos era extending to the early 1990s, the Philippines suffered acute power shortages. To alleviate the supply problem as fast as possible, Jeff Edwards, Associate Director, of Asia Pacific Energy Service at Cambridge Energy Research Associates (CERA) says Napocor was forced to reel out very attractive PPAs to persuade power companies and financiers to commit to new power projects and commit quickly.

In the wake of the economic crisis, these PPAs have put a considerable financial strain on the state utility. Though automatic adjustment mechanisms are present in many of the existing PPAs to deal with changes in fuel costs and principal payments which are the result of interest or exchange rate fluctuations, seven of the PPAs outstanding do not feature these mechanisms. For those seven projects there has been a substantial rise in payments owed by Napocor. ?It is highly likely that at least seven PPAs will therefore be adjusted or bought out as Napocor moves to privatization,? says a Philippine-based banker.

In contrast to the older IPPs, the current round of new power plant developments, including the upgrade of the 350MW Caliraya-Botocan-Kalayaan (CBK) hydroelectric power complex, are now being built in an environment of energy oversupply. For that reason, and because most of the power stations use more modern and efficient generating technologies, new PPAs are better value for the distributor and less likely to be revised, says the same Philippine source.

Nevertheless, worries remain. It is interesting to note that the $340 million debt financing for CBK is expected to feature extended political risk insurance (PRI), provided, says a banker close to the deal, by the Japanese Ministry of International Trade and Industry (MITI).

Political risk insurance is a standard feature of project financings in the Philippines. The majority (about 75%) of the debt in the recently closed San Lorenzo power deal, for example, was covered by political risk insurance. But the extension of PRI to cover all of Napocor's obligations under the power purchase agreement does partly reflect the level of market concern over deregulation.

This more comprehensive PRI package comes despite the fact that the power purchase agreement attached to the CBK deal is already supported by the full sovereign credit of the Philippines. Moreover financiers have a relatively favourable view of Philippine government guarantees. In Indonesia, by contrast, the vagueness of so-called comfort letters offered in support of the state owned electricity company, PT PLN Persero, have proven weak instruments in compelling the national government to offer support to the ailing utility, much to the dismay of IPP investors.

It is also revealing, say financiers, that the CBK deal is likely to be priced in the same territory (or only a fraction lower than) comparable elements in the San Lorenzo financing, notwithstanding CBK's more comprehensive insurance package.

That, says one banker involved in the San Lorenzo transaction, a $375 million facility to fund the construction of the 500MW San Lorenzo power station, is because the San Lorenzo deal hinges on a PPA not with Napocor but with Manila Electric Company (Meralco). As Meralco is a private operator, the assumption is that deregulation risks are less than in deals involving Napocor. Meralco is also, quite simply a better credit.

San Lorenzo's financing was priced at, 215 basis points over Libor for the $115 million for the ECGD-supported commercial bank tranche, 55 basis points over for the second tranche, including a 12-year syndicated loan and a loan direct from Hermes, between 215 basis points and 225 basis points for the third tranche, a $50 million revolving credit facility. Pricing for the fourth tranche was not revealed. According to Rene Kassio, director of project finance Asia at Credit Lyonnaise, the margins on the San Lorenzo deal demonstrates that pricing on Philippine projects is now close to pre Asian-crisis levels.

What will make the expected pricing similarity more striking is the fact that CBK will provide, say the bankers involved, certain services that are crucial to the regulation of the Luzon grid, therefore putting the CBK power complex in a favourable position within a deregulated market. ?Amongst other things, CBK provides frequency and voltage regulation in Luzon, as well as spinning reserve,? a source close to the deal states.

The CBK deal, led by DKB, BNP, IBJ, ING Barings and Societe Generale is expected to go to syndication shortly.

Excess capacity

Added to deregulation, the oversupply of electricity represents another major risk factor in the Philippine power business, evidenced by the fact that average reserve margins are in excess of 40% and possibly as large as 45%.

Energy demand in the Philippines was not as badly hit by the Asian economic downturn as in other emerging economies in the region. While demand in Thailand, for example, contracted 7% in 1998, a source at the Department of Energy (DOE) says that Philippine demand grew 4%. Yet, at the same time, demand growth over the last two years has not been as rapid as had been previously expected. In fact, CERA estimates that demand actually declined 0.5% in 1999.

The latest economic data is more encouraging, the DOE reports that demand growth in the first quarter of 2000 was about 5% to 6%. CERA expects an average of about 4.6% for 2000 as a whole. Projecting out to 2010 CERA also forecasts that electric power demand will be between 7% to 8% per annum, (slightly less than DOE forecasts).

Nevertheless, Edwards says, ?the overcapacity situation will only be exacerbated by the fact that between 2000 and 2002 a significant amount of new gas and coal-fired capacity will enter the market.? The new developments, (see below for details), will substantially boost current generating capacity; 3,000MWs will be added during the next two years. To put this in some perspective, the Philippines total system capacity is only 13,600MWs as of April, 2000.

The addition of new generating capacity will be partly counterbalanced by the Philippine government's intention to retire approximately 3,000 MW of largely oil-fired capacity by 2010. In addition, Napocor has indicated that it will not renew certain power purchase agreements with IPPs that will are reaching the end of their contract life. By and large the IPPs in this category are diesel-fired power barges that sprang up to meet the chronic power shortage under President Aquino Ramos. According to a source close the Philippine DOE, about 2,900 MW of oil fired generating capacity will be retired by 2006.

Taking into account the retirement of some power plants, incremental capacity will still to more than sufficient to meet expected demand in the short to medium term. The over supply problem will not be corrected any time soon.

Deregulation timetable

Deregulation is likely to happen faster than many bankers have anticipated. Close on the heels of the Omnibus Bill, this year is likely to yield other important developments related to deregulation. The Philippine Senate, which has taken a different tack to the House of Representatives in dealing with key restructuring issues by pursuing five separate bills, is expected to pass the two bills that it has not passed, later this year. ?Our best case scenario is that all five could be passed by late summer,? says Edwards.

When the bills are all passed the restructuring process moves to a bicameral conference committee whose job it will be to iron out any differences between Senate and House legislation regarding power privatization. Market watchers now expect the conference committee to sit in the fall of 2000 or possibly, early 2001.

Once the committee has concluded the synthesis of House and Senate legislation, Edwards says specific enabling legislation will be needed to actually implement each phase of privatization and deregulation. ?As the corporatization of individual Napocor entities will take some time, we think the actual sale of assets and implementation of a new energy regime will not take place until 2002 to 2003,? says a banker in Hong Kong.

The establishment of a wholesale pooling mechanism will also take time to develop. Edwards believes that an energy pool is not likely to be established until after the full corporatization of Napocor's privatization assets in 2002 or 2003. Under the version of the Omnibus Bill recently passed by the House, retail competition and open access are required to come into effect within 3 years of the implementation of the Act. But initially, the contestable market will include only those customers consuming more than 2MW of power.

Movers and shakers in the Philippine power market

According to CERA the Philippines has licensed 15 (not yet operational) IPP projects totaling approximately 6,000 MW of generation capacity. Of that total, 2,300 MW of planned IPP capacity is now under construction or has recently entered operation, including:

? 1,200 MW Sual, Luzon coal-fired IPP, sponsored by Southern Company

? 1,000 MW Santa Rita, Luzon gas-fired IPP, sponsored by First Philippine Holdings and British Gas

? 500 MW San Lorenzo gas fired IPP, sponsored by First Philippine Holdings and British Gas

? 340 MW San Roque hydroelectric IPP, sponsored by Sithe and Marubeni

? 140 MW Cascenan hydroelectric IPP, sponsored by CalEnergy

? 400 MW Quezon Power coal-fired IPP, sponsored by InterGen and Ogden

? 100 MW Zamboangan fuel oil fired IPP, sponsored by Tomen, Alsons and Aboitiz

? 70 MW Bakun hydroelectric IPP, sponsored by Aboitiz

In addition to these projects under construction, a number of major projects are currently under development, these include:

? 1,200 MW Ilijian, Luzon gas-fired IPP, sponsored by KEPCO

? 304 MW San Pascual LSWR/gas-fired IPP, sponsored by Texaco and Edison Mission

Banks are already lining up for the financing of the Ilijian project. Citibank is believed to be close to a mandate, if it does not have one already (what the Citibank mandate comprises has not yet been revealed). A source at the bank says that participants in the $470 million funding package want to close the deal by the third quarter of this year.

Although it has been suggested that the deal will feature a $70 million direct loan from the Korean Export-Import Bank, a $250 million tranche guaranteed by Japan Bank of International Cooperation and a $150 million Exim tranche. The source at Citibank says that the overall financial structure is still up in the air. ?There will be a commercial tranche but the size is also still under discussion,? says the financier.

The 304MW LSWR [low-sulfur waxy residue]-fired San Pascual project in Batangas has been delayed until 2003 at the earliest, and will not be of interest to the financial community until late 2001 or early 2002.

However, the San Pascaul project may be the project bankers last chance to get a slice of the Philippine action for some time. Due to the uncertainty over the shape of the market after deregulation and privatization, there is now a moratorium on Napocor entering into new PPAs. Additional greenfield power developments are therefore out of the question for the foreseeable future.