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Big fish

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National Power Corporation (NPC), the dominant force in Philippine electricity since 1936, is about to find out what it means to be just another power industry company. Sweeping market reforms mean the dismantling of NPC's electricity empire. The country's transmission infrastructure has already been taken from NPC control and placed under the newly formed National Transmission Corporation and at the end of this year, the majority of the company's generating assets are due be sold to private investors. Rapidly shrinking in size and importance, it is timely to ask what NPC's future role will be.

According to Roland Quilala, the recently retired president and CEO of National Power Corporation, much of the organization's residual function will be a social one. ?Napocor will,? he says, ?continue to be the implementer of the government's missionary electrification program, aimed at providing electricity to remote islands and areas not connected to the main island grids.? The company will continue to build new projects but these projects will be limited in size and scope, in line with the missionary electrification mandate of the government and the aims of the Small Power Utilities Group which NPC, (Napocor as it is often known), will continue to oversee.

But although all NPC's oil-, bunker fuel- and coal-fired power stations will be sold off, the organization will continue to be a sizeable producer of electricity. All Napocor's hydro plants and some geothermal plants will remain in the portfolio. Two points are worth noting with respect to these assets. They too will be privatized, says Quilala, after a period of 10 years. Secondly, although NPC is unlikely to be the sponsor of major programs to expand geothermal and hydro facilities (the Philippines government wants large-scale expansion and new investment to be sponsored by the private sector), it is expected to be a prime mover in seeing that investments are made in timely fashion. For that reason, and because of its ongoing financing needs, Napocor will continue to be an entity of interest to both industry players and the financial markets.

The government plans for electricity produced by Napocor will be dispatched into the wholesale electricity spot market which is currently being finalized by the Department of Energy (the cost of setting up the market is being funded by the Asian Development Bank). Quilala says electricity generated by NPC will, ?either be sold through the spot market or directly to large users of electricity, those consuming a minimum of 1MW?.

In the period until the sale of NPC generating companies, the company will continue to be the Philippines' primary generator of electricity, operating under the corporate charter imposed by the government.

If managing an organization in transition was not already a considerable headache, NPC has serious financial problems to sort out. At the end of 2002, and as a result of the delayed launch of a bond offering that was supposed to cover National Power's additional funding needs for the rest of 2002, Citibank had to put together a $250 million bridge financing to plug a deficit in its cash requirements. The deal, guaranteed by the government and executed on December 4, was syndicated to 15 banks.

The bond deal did eventually close nine days later, on December 13. PSALM was the issuer, putting into the market $500 million equivalent of yen-denominated bonds. Like the bridge loan, the financing was also guaranteed by the Philippine government and containing a partial credit guarantee of the Asian Development Bank. The lead manager was Nomura International.

Even with the bond proceeds, Napocor has deep-seated financial problems. NPC's losses now amount to a staggering P800 billion ($16 billion), and growing. The organization is in no position to cover its spending commitments through its revenue stream, a long term phenomenon exacerbated by new government policies.

The gap between National Power's income and outgoings (amounting to $1.85 billion in 2002) was aggravated by Philippine President Gloria Macapagal-Arroyo's decision to cut NPC's purchased power cost adjustment (PPCA) to provide temporary relief to consumers hit by inflating electricity costs. As a result of the measure an additional $350 million in operating losses were incurred by NPC from the implementation of the rate cut in July to the end of 2002.

But the more serious and long term problem for Napocor has been its highly leveraged financial structure, says Quilala. Since 1986, the national government ceased injecting equity into NPC and, says the company president: ?97% of the company's operations since have been financed by loans, most of which are foreign currency denominated?. Contractual obligations, specifically those with take-or-pay provisions, also account for NPC's losses, particularly in the current economic climate in which demand for electricity output has decreased.

Napocor will have to bear other costs associated with the current restructuring. The bulk of the power company's short term financing programs are to be used to fund severance pay for employees whose contracts are being terminated as a result of the privatization program.

Apart from the bridge loan and the bond, $750 million of the $1.85 billion needed to fund Napocor in 2002 was provided by the national government out of proceeds from previous bond issues. The remaining balance needed (once the NPC bond offering has been sold) was covered through interim arrangements with the Department of Finance, says Quilala.

Napocor will be in very different financial shape once the reform of the electricity industry is complete. Quilala says the government is now absorbing P200 billion of NPC's debts. The Philippine Congress has also passed an act which provides for a universal levy to be collected from all electricity consumers which will be used to finance Napocor's missionary electrification activities. The company will, however, continue to need external financing on an ad hoc basis, for specific projects.

Napocor generation assets destined for privatization will be in much better financial shape than Napocor itself is now. The gencos will be sold debt free, confirms Quilala.

Investors who will have expected nothing less are looking for more tangible reasons to bid for the power stations for sale. As Quilala makes clear, a lot will depend on convincing investors that electricity demand can grow at high and sustainable levels.

Quilala says that the Philippine economy will recover at a fast rate over the next five years, spurring a rapid increase in electricity consumption. The current slump in demand is expected to be remedied by a series of measures that the government is now implementing, notably the Special Program to Enhance Electricity Demand (SPEED) program. ?We expect this to impact positively on the marketability of NPC's generation and transmission assets,? says Quilala. Overall, Napocor predicts that the electricity sector will post an average growth rate of about 9.7% per year.

NPC and other market players such as Manila Electric Co (Meralco) have stated that they can implement the price incentive program for big industrial users soon, despite delays in the submission of their proposals to the Energy Regulatory Commission (ERC).

At present, Napocor and Meralco are still finalizing the provisions of the implementing rules and regulation for SPEED, and formulating a common agreement on the mechanics of the system.

Once complete, SPEED will be implemented in three phases in the next two years. In phase one, a fixed discount rate will be set for industrial customers with 1,000kW demand and above. This phase is scheduled to be implemented before the end of the year. In phase two another discount rate will be set for industrial consumers with 500kW demand. Phase three will provide a discount for commercial users with electricity needs of 1000kW and above.

But analysts will no doubt question Quilala's optimism in the light of recent energy sales announced by NPC Corp. Sales for the first quarter of 2002 dipped to a record low of 18.6%. While the reduction was primarily the result of reduced offtake from Meralco, NPC's biggest customer, the drop in sales highlights the overcapacity problem in the Philippine market.

The 18.6% fall was the biggest fall since 1985 and a fall unmatched even during the Asian financial crisis. Luzon area sales dropped by 24.7% largely due to a 33% reduction in the purchases of Meralco. Napocor officials say that Meralco's new independent power producers, the 1,000MW Santa Rita gas-fired plant and the 500MW San Lorenzo gas plant, started to replace Napocor output with the commercial operation of the Malampaya natural gas fields early this year.

The only bright light in the sales figures were the sales figures for the interconnected Visayas grid and the Mindanao grid but even in these less developed regions, sales growth was modest (2.3% for Mindanao). Moreover, the release of Napocor's next sales figures will show the company has been hit even harder by the full operation of San Lorenzo from the second half of this year.

While investors cautiously consider new investment opportunities in the Philippine power sector, existing IPP players have had to renegotiate PPA contracts previously struck with Napocor. The government has now managed to renegotiate 16 contracts in its favour, saving the taxpayer $850 million on a NPV basis, says a source at the Department of Energy.

The principle targets for the renegotiation drive were IPP contracts put in place during an era of chronic undersupply (during the tenure of President Ramos). These PPAs, signed in a producers market, compelled NPC to pay highly unfavourable rates for electricity supply.

If the Ramos era was a period of severe electricity shortage it can also be blamed for much of the electricity industry's current oversupply problems, says a power industry consultant. The total volume of new capacity mandated by the Ramos administration was about 10,000MW compared to current demand for additional power of less than half that.

Quilala says it should not be automatically assumed that unfavourable contracts are renegotiated. He says: ?there is an ongoing review of the various IPP contracts by a inter-agency committee comprised of members from the Department of Justice, Department of Finance, and Department of Energy. The purpose of the review is to determine whether these remaining contracts need to renegotiated, or if they require some other action.?

What is clear is that expiring contracts of independent power producers with NPC will not be renewed. The retirement of expiring IPPs will have the overall effect of lowering the Purchased Power Adjustment, a charge that NPC collects from consumers to pay for electricity contracted with IPPs. ?One reason the government is doing this,? says a banker, ?is that it wants popular support for the electricity reforms in general. This is a good way of getting that support.?

While the government has said that it will not unilaterally abrogate its contracts with the IPPs, because of the signal this would send to potential investors in the Philippine power sector, market observers note the government did put considerable if indirect pressure on the power producers, to force a lowering of electricity supply rates. ?Moral suasion was one term used by the government for the way they have gone about renegotiating the PPAs, but whatever you call it, it was pretty hard for the IPP operators to say no,? says a power industry consultant.

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