

Republic of the Philippines
ENERGY REGULATORY COMMISSION
San Miguel Avenue, Pasig City



IN THE MATTER OF THE
APPLICATION FOR APPROVAL OF
REVISED RATE SCHEDULES AND
APPRAISAL OF PROPERTY, WITH
PRAYER FOR PROVISIONAL
AUTHORITY

ERC CASE NO. 2007-060 RC

PANAY ELECTRIC COMPANY
(PECO),

Applicant.

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Date: NOV 23 2007
By: *mn*

DECISION

Before the Commission for resolution is the application filed by Panay Electric Company (PECO) for approval of its revised rate schedules and appraisal of property, with prayer for provisional authority.

Having found said application sufficient in form and in substance, with the required fees having been paid, an Order and a Notice of Public Hearing, both dated March 20, 2007, were issued setting the same for hearing on April 16 and 30, 2007.

PECO was directed to cause the publication of the Notice of Public Hearing, at its own expense, twice (2x) for two (2) successive weeks in two (2) newspapers of general circulation in the Philippines, with the date of the last publication to be made not later than ten (10) days before the scheduled date of initial hearing. It was also directed to inform the consumers within its franchise

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area, by any other means available and appropriate, of the filing of the instant application, its reasons therefor, and the scheduled hearing thereon.

The Office of the Solicitor General (OSG), the Commission on Audit (COA) and the Committees on Energy of both Houses of Congress were furnished with copies of the Order and the Notice of Public Hearing and were requested to have their respective duly authorized representatives to be present at the said initial hearing.

Likewise, the Office of the City Mayor of Iloilo was furnished with copies of the Order and the Notice of Public Hearing for the appropriate posting thereof on its bulletin board.

On April 11, 2007, PECO filed its "Pre-trial Brief".

During the initial hearing on April 16, 2007 at the Department of Education, Culture and Sports (DECS) Building at Lapaz, Iloilo City, only PECO appeared. No oppositor appeared nor was there any opposition registered.

At the said hearing, PECO presented proofs of its compliance with the Commission's posting and publication of notice requirements which were duly marked as Exhibits "A" to "F-1", inclusive. Thereafter, PECO conducted an expository presentation of its application.

On May 2 to 4, 2007, the Commission conducted an ocular inspection on the assets subject of the instant application.

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At the continuation of the hearing on May 24, 2007, PECO presented the following witnesses who testified in support of the application: a) Mr. Neil V. Parcon, PECO's Head of Accounting Department; b) Mr. Edwin G. Sandagon and Mr. Allan P. Palma, both of Asian Appraisal Company, Inc. (AACI); and Ms. Jessie D. Cabaluna, of SyCip Gorres Velayo and Company (SGV & Co.). In the course of their direct testimonies, various documents were presented and marked as Exhibits "G" to "K-12", inclusive.

The direct testimonies of the said witnesses having been terminated, the Commission propounded clarificatory questions and then directed PECO to submit additional documents.

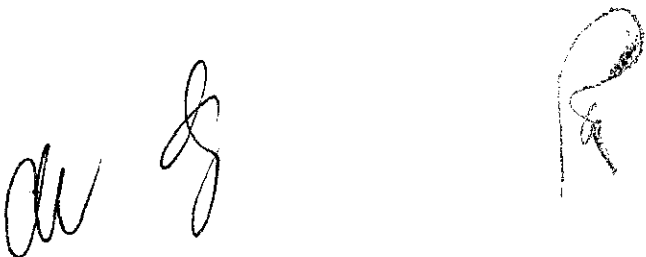
On June 9, 2007, PECO submitted its "Compliance".

On August 14, 2007, PECO filed its "Formal Offer of Evidence" which is hereby admitted for being relevant and material to the final resolution of this application.

DISCUSSION

Proposed Revenue Requirement Based on Test Year 2004

PECO's Audited Financial Statement (FS) for 2004 reflected a total revenue requirement of PhP328,425,167.00. However, it made the following adjustments amounting to PhP98,795,505.00 which resulted to an increase in its proposed revenue requirement of PhP427,220,671.00:

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Account Name	Per Audited FS 2004 PhP	Adjustments PhP	Per Application PhP
Return on Rate Base	57,627,113	104,314,444	161,941,557
Payroll	91,582,515	2,686,478	94,268,993
Operation & Maintenance (less Fuel and PP)	107,800,725	(50,113,518)	57,687,207
Depreciation and Amortization	71,414,814	(16,548,503)	54,866,311
Prompt Payment Discount	-	60,190,901	60,190,901
Other Expenses	-	-	0
Less: Other Revenue Items	-	1,734,297	1,734,297
Total Revenue Requirement	328,425,167	98,795,505	427,220,671

Comparison of Proposed and Existing Rates

PECO provided the estimated impact of its proposed rates on different customer classes, as follows:

Customer Class	Proposed Rates	Existing Rates	Difference
Residential			
PhP/kWh	1.5936	0.9296	0.6640
PhP/cust/mo	5.0000	5.0000	0.0000
Intermediate			
PhP/kWh	1.0246	0.5043	0.5203
PhP/cust/mo	102.2301	83.1200	19.1101
Commercial			
PhP/kWh	1.0162	0.5138	0.5024
PhP/cust/mo	415.7583	396.7100	19.0483
Power			
PhP/kWh	0.9375	0.2658	0.6717
PhP/kW	68.3600	68.3600	0.0000
PhP/cust/mo	909.7350	890.7000	19.0350
City Government			
PhP/kWh	1.0238	0.6163	0.4075
PhP/cust/mo	102.1665	83.1200	19.0465
Streetlights			
PhP/kWh	1.2161	0.6100	0.6061
PhP/cust/mo	102.2403	83.1200	19.1203
Other Government			
PhP/kWh	1.0088	0.7018	0.3070
PhP/cust/mo	102.3061	83.1200	19.1861

Proposed Rates Per Customer Class

The Distribution, Supply, and Metering charges proposed by PECO are as follows:

Customer Type	Residential	Intermediate	Commercial	Power	City Government	Streetlights	Other Government
<i>Proposed Rates:</i>							
Distribution Charges							
Demand Charge PhP/kWh	1.0783	1.0246	1.0162	0.9375	1.0238	1.2161	1.0088
Distribution System Charge PhP/kW	-	-	-	68.3600	-	-	-
Supply Charges							
Retail Customer Charge PhP/cust/mo	-	56.1801	56.1183	56.1050	56.1165	56.1903	56.2561
Supply System Charge PhP/kWh	0.2594	-	-	-	-	-	-
Metering Charges							
Retail Customer Charge PhP/cust/mo	5.0000	46.0500	359.6400	853.6300	46.0500	46.0500	46.0500
Metering System Charge PhP/kWh	0.2559	-	-	-	-	-	-
Total Energy Charge	1.5936	1.0246	1.0162	0.9375	1.0238	1.2161	1.0088
Total Monthly Customer Charge	5.0000	102.2301	415.7583	909.7350	102.1665	102.2403	102.3061
Total Demand Charge	-	-	-	68.3600	-	-	-

Proposed Changes in Functionalization Factors

The functionalization and allocation factors used by PECO were the default factors provided for in the Uniform Filing Requirement (UFR). However, it proposes to change the factors in some of the sub-category expenses under Administrative and General Expenses, as follows:

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Account Number	Account Name	Proposed Factor	Existing Factor
430-923-00	Outside Services	Payroll, excluding Administrative and General Payroll	Total Operations and Maintenance Expenses, excluding Fuel and Purchased Power
430-924-00	Property Insurance expense	Payroll, excluding Administrative and General Payroll	Net Plant in Service
430-927-00	Franchise requirements and reg. expenses	Total directly assigned to Distribution	Payroll, excluding Administrative and General Payroll
430-932-00	Maintenance of Office and General Plant	Payroll, excluding Administrative and General Payroll	Payroll, excluding Administrative and General Payroll
430-933-00	Taxes on Property	Payroll, excluding Administrative and General Payroll	Payroll, excluding Administrative and General Payroll

Proposed Lifeline Rate Discounts and Subsidy

PECO proposed a rate of **PhP0.1218** per kWh for its lifeline customers up to 100 kWh consumption level, to wit:

kWh Consumption	Approved Unbundled Rates	Proposed Rate Application
	Level of Discount	
75 & BELOW	50%	50%
76 - 80	40%	40%
81 - 85	30%	30%
86 - 90	20%	20%
91 - 95	10%	10%
96 - 100	5%	5%
Subsidy Charge to non-lifeline customers	PhP.0908/kWh	PhP.1218/kWh

PECO claimed that thirty six percent (36%) of the total number of its residential customers will benefit from the lifeline discounts. The kWh consumption represents four percent (4%) of the total kWh sales for the month.

Under a Return on Rate Base (RORB) Methodology, distribution rates are determined using the following formula:

$$\text{Rate} = \text{Revenue Requirement} / \text{Billing Determinant}$$

REVENUE REQUIREMENT

The revenue requirement is determined by adding the following components:

$$\begin{aligned} & \text{Operating Expenses} \\ & \text{(Payroll + O \& M including taxes other than Income Tax)} \\ & + \\ & \text{Return on Rate Base} \\ & \text{(Net Plant In Service + Materials and Supplies + Cash Working Capital) x Rate of} \\ & \text{Return} \\ & + \\ & \text{Return of Capital} \\ & \text{(Depreciation and Amortization)} \end{aligned}$$

The table below shows the revenue requirement as proposed by PECO and the Commission's recommended revenue requirement:

Particulars		Proposed Revenue Requirement	Commission's Adjustments	Revenue Requirement
4.1.1A	Payroll	PhP 94,268,993	(43,966,923)	50,302,069
4.1.1B	Operation & Maintenance (less Fuel and PP)	57,687,207	(15,583,368)	42,103,839
4.1.2	Return on Rate Base	161,941,557	(76,287,331)	85,654,226
4.1.3	Depreciation and Amortization	54,866,311	34,369,322	89,235,633
4.1.4	Prompt Payment Discount	60,190,901	(60,190,901)	0
	Total Revenue Requirement	428,954,968	(161,659,201)	267,295,767
4.1.5	Less: Other Revenue Items	1,734,297	207,315	1,941,612
	Revenue Requirement net of ORI	427,220,671	(161,866,516)	265,354,155
	Adjusted Existing Revenue	* 235,168,820		209,098,522
	Increase/(Decrease) in Revenue	PhP 192,051,851		56,255,633
	Billing Determinant	** 325,253,552		*** 332,669,695
	Overall Average Tariff Adjustment (PhP/kWh)	0.5905		0.1691

*Inclusive of generation revenues

**2004 Actual kWh Sales

***2004 Annualized kWh Sales

Using the RORB methodology under the UFR and based on a 2004 test year, PECO proposed a total revenue requirement of Four Hundred Twenty Seven Million Two Hundred Twenty Thousand Six Hundred Seventy One Pesos (**PhP427,220,671.00**). PECO submitted its Audited Financial Statements (AFS) for the year 2004 including the adjustments for year 2004 in support of its application.

After considering the downward adjustment of **PhP161,866,516.00**, the Commission finds a total revenue requirement of Two Hundred Sixty Five Million Three Hundred Fifty Four Thousand One Hundred Fifty Five (**PhP265,354,155**). The adjustments made by the Commission will be discussed in seriatim.

OPERATING EXPENSES

1. Payroll

PECO proposed a Payroll of PhP91,582,515.00. In its "Compliance" dated July 09, 2007, PECO made an upward adjustment on its proposed Payroll by PhP2,686,478.00 or a total of PhP94,268,993.00. PECO claimed that the adjustment was due to salary increases of employees as provided in its Collective Bargaining Agreement (CBA) and included as part of its budget for the year 2007, as follows:

2005 Salary Increase	PhP1,430,678
2006 Salary Increase	1,255,800
Total Proposed Salary Increase	<u>PhP2,686,478</u>

PECO's actual Payroll expense includes an amount of PhP1,456,106.00 and PhP2,261,275.00 representing Payroll for power production employees involved in the operation supervision and engineering, and maintenance supervision and engineering works, respectively. Moreover, it proposed a profit sharing costs of PhP19,017,945.00 as part of its Administrative and General salaries as an incentive given to its employees.

PECO proposed a payroll of PhP94,268,993.00. However, the Commission made downward adjustments amounting to PhP43,966,923.00. Thus, the recommended payroll for consideration of the Commission is PhP50,302,070, as shown below:

Particulars	Amount
Proposed Payroll	94,268,993
Adjustments:	
Power Production Payroll:	
Operation Supervision and Engineering Expense	(1,456,106)
Maintenance Supervision and Engineering Expense	(2,261,275)
Profit Sharing Costs-Distribution Payroll	(19,017,945)
Proposed Salary Increase	(2,686,478)
Salary of confidential employees	(18,545,119)
Sub-total	(43,966,923)
Adjusted Payroll	50,302,070

The following are the reasons for the disallowances:

A. Power Production Payroll

The Commission disallowed the item on the Payroll pertaining to PECO's power production employees amounting to PhP3,717,381 (1,456,106 +



2,261,275) as it is generation related and thus, should not be considered for purposes of fixing rates for its distribution operations.

It should be noted that the Commission excluded PECO's own-generation plant as well as corresponding operation and maintenance expenses thereon from the distribution revenue requirement in its Decision on PECO's unbundling application in ERC Case Nos. 2001-903 and 2002-07. In the said Decision, PECO was directed to file an application for the approval of its proposed rate for the recovery of its own generating assets and expenses based on the type of service provided (ancillary/back-up/standby/spinning reserve/voltage correction). To date, however, PECO has not yet complied with the said directive. Said policy was consistently applied to other similarly situated distribution utilities such as Angeles Electric Corporation (AEC), Cotabato Light and Power Company (CLPC) and Davao Light and Power Company (DLPC).

B. Profit Sharing Costs-Distribution Payroll

The Commission disallowed the provisions pertaining to profit sharing as the same should not be recovered from consumers. Being a management prerogative, profit sharing benefits should be sourced from net income/savings and should not form part of the revenue requirement to be recovered from customers.

C. Proposed Salary Increase

The Commission disallowed PECO's proposed salary increases of PhP2,686,478.00 considering that the same have already been incorporated.



D. Salary of Confidential Employees

PECO's proposed payroll included provisions for the salary of "Confidential Employees". However, it failed to substantiate its claim that these confidential employees are necessary in its operation as a distribution utility and will redound to the benefit of its customers.

Accordingly, the 2004 Payroll expense of PhP50,302,070.00 was adjusted covering 128 filled-up positions for Commission's consideration.

OPERATION AND MAINTENANCE (O & M) EXPENSE

PECO's AFS for 2004 reflected a total Operating and Maintenance Expenses (O&M) of PhP2,340,604,241.00. However, it made downward adjustments resulting to a proposed O&M of PhP57,687,207.00, as shown below:

Particulars	Amount (in PhP)
Total O & M Per Audited FS	2,340,604,241
Less: Exclusions	
Fuel expense	243,091
Purchased Power	1,957,491,394
Maintenance-General and Electric Plant	469,317
Prompt Payment Discount	60,190,902
Primary Voltage Discount	51,880,801
Payroll	91,582,515
Depreciation	71,414,814
Total Exclusions	2,233,272,834
Total O & M Per Audited FS, net of exclusions	107,331,407
Add/(Less) PECO Adjustments:	
Miscellaneous General Expenses	(59,415,227)
Maintenance of structures	9,497,552
Maintenance of meters	273,475
Total Adjustments	(49,644,201)
Proposed O & M	57,687,207

Generally, the allowable operating expenses are those which are reasonably incurred in connection with business operations to yield revenue or income. It should be necessary in the operation of a distribution utility, recurring and should redound to the service or benefit of end-users.

Distribution utilities are expected to incur only "prudent and reasonable costs" for inclusion in the determination of retail rates and while they enjoy the benefit of passing their costs of purchased power and other reasonable costs to end-users, they are duty-bound as a public utility to ensure that their costs of operations, including payroll, are kept at a minimum.

The Commission deducted a total amount of PhP15,583,368.00 from PECO's proposed O&M. Hence, the adjusted O&M amounted to PhP42,103,839.00, broken down as follows:

Particulars	Amount (PhP)
Proposed O & M	57,687,207
Add (Deduct) adjustments	
Generation Expenses	(52,597)
Informational and Instructional Advertising Expenses	(709,550)
Uncollectible Accounts	(10,657,851)
Outside Services	(52,000)
Travel Expenses	(209,225)
Training Expenses	(7,690)
Associations and Membership Dues	(97,472)
Miscellaneous General Expense	
(1) Payment for priest stipend	(24,925)
(2) Payment for tax delinquency	(1,419,846)
(3) Other expenses	(2,352,212)
Total Adjustments	(15,583,368)
Adjusted O & M	42,103,839

Note: O & M per book is net of power costs and depreciation expenses

The following are the adjustments made by the Commission relative to PECO's proposed O & M:

A. Generation Expenses

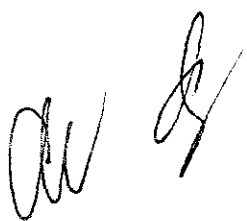
In its approved unbundled rate per the Commission's Decision dated May 19, 2004, PECO was directed to file an application for the approval of its proposed rate for the recovery of its own generating assets and expenses. However, to date, it has not yet complied with the said directive. Nevertheless, Commission maintains that said expenses should be disallowed considering that the instant application is for the approval of its distribution rate and therefore, the O & M expenses related to generation should be excluded.

B. Informational and Instructional Advertising Expenses

The Commission verified the ledger account of PECO and found that PhP709,550.00 of said account represents donations given to different foundations, company celebrations, solicitations and fund raising campaigns, institutional membership fee and subscription fees. Expenses of such nature have always been disallowed since they are not necessary in the operation of distribution service and do not redound to the benefit of the consumers.

C. Uncollectible Accounts

For purposes of providing an allowance for uncollectible accounts, it has been the policy of the Commission to set it at a level equivalent to the annual accounts written-off or 1% of accounts receivable, whichever is lower.



PECO's Accounts Receivable is PhP282,162,762.22, 1% of which is PhP2,821,628.00 with the accounts written off amounting to PhP3,586,032. Comparing the written-off amount as against the 1% AR, it is very apparent that the 1% AR is lower than the accounts written-off. Thus, only the amount of PhP2,821,628.00 should be considered.

D. Outside Services

Upon verification of the ledger account of PECO, the Commission found that part of the expenses pertained to the litigation expense involving an estafa case and therefore, has no relation to its operations as a DU. Thus, said expenses should be disallowed.

E. Travel Expenses

The Commission, upon scrutiny of PECO's declared travel expenses, found that the same included golf clubs and credit card payments of two (2) members of its Board of Directors and its Chairman. Said expenses should be disallowed because they are unnecessary in the operations of the DU.

F. Training Expenses

The Commission found that PECO's training expenses included those incurred for the renewal of driver's license and freight charges. Since said expenses are not necessary in the operations of the DU, the same should be disallowed.

G. Association and Membership Dues

Upon verification of said account, it was shown that payments for membership dues of its lawyers, accountants and engineers, and membership



dues to a golf and country club of an officer of PECO were included. The Commission believes that these additional benefits should not be passed on to the consumers as they do not redound to their benefit.

H. Miscellaneous General Expenses

Upon examination of the ledger account on its miscellaneous general expenses, the Commission found that it included: (1) payment for priest stipend; (2) payment for tax delinquency; and (3) other expenses which PECO failed to substantiate. The Commission disallowed these expenses as these are not necessary in the operation of the DU. Moreover, the Commission maintains that unsubstantiated expense shall not be allowed as a legitimate cost to discourage the DUs from claiming expenses which they cannot support with verifiable documents.

The Commission, thus, adjusted PECO's O & M in the amount of PhP42,103,839.00.

RETURN ON CAPITAL

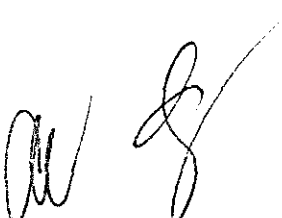
The Return on Capital, as a component of the revenue requirement, is arrived at using the following formula:

$$\text{Return on Rate Base} = (\text{Net Plant In Service} + \text{Materials and Supplies} + \text{Cash Working Capital}) \times \text{Rate of Return}$$

A. Net Plant in Service (NPS)

The following are considered in determining a DU's Net Plant in Service:

- a) Sound Value of the assets as reflected in the Appraisal Report of an ERC accredited appraiser;
- b) the Inspection Report prepared by the ERC personnel



who made an ocular inspection of the relevant assets of the DU; and c) Construction Work in Progress (CWIP).

In support of its application, PECO submitted the Appraisal Report of the Asian Appraisal Company, Inc.'s (AACI) AACI File No. FAM05-C02602-001 dated November 16, 2005. Based on the said report, PECO's existing property, plant and equipment as of December 31, 2004 had a total cost of reproduction new of PhP2,358,260,000.00 and a sound value of PhP909,632,000.00. However, PECO made a downward adjustment on the sound value as reflected in the amount of PhP219,501,452.00, which resulted to an adjusted sound value of PhP690,130,548.

Particulars	PECO (in PhP)
Sound Value per Appraisal	909,632,000
Adjustments:	
Excluded Distribution and General Assets	(26,270,000)
Generating Assets	(206,006,801)
Excess of book value over sound value	12,775,349
Total Adjustments	(219,501,452)
Adjusted Sound Value per PECO at 12/31/04	690,130,548

In the computation of its NPS, PECO excluded the distribution and general assets from the total amount of the sound value as indicated in its Appraisal Report, to wit:

Excluded Assets	Sound Value (PhP)
Distribution Transformers	1,188,000
Bunta Tala Substation	591,000
Poles and Fixtures spare	2,944,000
Transmission and Distribution wires-spare	9,309,000
Distribution Transformers-spare	8,735,000
Meters	3,503,000
TOTAL	26,270,000

Further, PECO made adjustments to reflect the excluded generating assets amounting to PhP206,006,801.00 in order to be consistent with the Commission's Decision in its unbundling application.

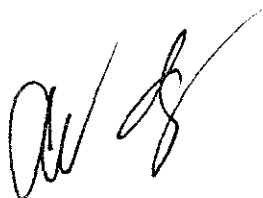
PECO included the excess amount of PhP12,775,349.00 representing the assets with sound value lower than the book value, broken down as follows:

Assets with Sound Value lower than Book Value	Book Value (PhP)	Sound Value (PhP)	Excess (PhP)
Tools, Shop and Garage Equipment	12,080,593	2,404,900	9,675,693
Communications Equipment	492,914	198,000	294,914
Furniture and Office Equipment	5,100,862	2,296,120	2,804,742
TOTAL	17,674,369	4,899,020	12,775,349

The Commission conducted an ocular inspection on the assets of PECO subject of the instant application and listed in the Appraisal Report dated November 16, 2005 to verify its existence, use and usefulness, and legal ownership. As a result thereof, the Commission made a downward adjustment of PhP5,282,700.00 pertaining to assets which were found to be not in service during the time of inspection. Thus, the total amount of distribution and general assets excluded from the sound value as per appraisal is PhP31,552,700.00.

Consistent with the policy of the Commission, generation related asset and expenses were deducted from the sound value reflected in the appraisal report. Hence, PECO's proposed net plant was correspondingly adjusted by PhP206,006,801.

The Commission found no merit on PECO's proposal to include in its NPS the amount of PhP12,775,349.00 representing the excess of the book



value over the sound value of certain assets due to the fact that, for rate making purposes, the sound value should be applied instead of the book value.

The Commission disallowed the following assets from the sound value as indicated in the Appraisal Report:

Asset Categories	Sound Value (PhP)
Land	PhP27,510,000
Buildings	745,601
Machinery and Equipments	177,751,200
Electrical Equipments	30,010,800
Transportation Equipments	1,530,000
Furniture and Office Equipments	11,900
TOTAL Disallowances	PhP237,559,501

After considering the disallowances amounting to PhP237,559,501.00, the Commission adjusted the sound value per appraisal of assets amounting to PhP672,072,499.00 which was used as basis for computing the return on rate base and determining the corresponding allowable depreciation included in the revenue requirement, to wit:

Particulars	PECO (PhP)	ERC (PhP)	Difference (PhP)
Sound Value per Appraisal	909,632,000	909,632,000	-
Adjustments			
Excluded Distribution and General Assets (Pls refer to Table 11)	(26,270,000)	(31,552,700)	5,282,700
Generating Assets	(206,006,801)	(206,006,801)	-
Excess of book value over sound value (Pls refer to Table 12)	12,775,349	-	12,775,349
Total Adjustments	(219,501,452)	(237,559,501)	18,058,049
Adjusted Sound Value per PECO at 12/31/04	690,130,548	672,072,499	18,058,049

B. Construction Work In Progress

PECO's "Compliance" dated July 09, 2007 showed that its CWIP pertains to the 69kV Loop System Phase D classified as major project as approved by the Commission in ERC Case No. 2001-375. As of December 31, 2006, the project was already 98% complete and had a total cost of PhP3,239,633.00.

The Commission included the said project as CWIP to form part of PECO's rate base.

C. Materials and Supplies

PECO included in its rate base the materials and supplies amounting to PhP24,311,157.00. However, as verified from its ledger accounts, the amount of PhP768,786 was used for the purchase of lubricants, gasoline and diesels for PECO's generating plants. Thus, the same was disallowed for purposes of determining the rate base. This resulted to an adjusted materials and supplies amounting to PhP23,542,371.00.

D. Cash Working Capital (CWC)

PECO proposed a two (2) month CWC for Operating and Maintenance expenses and twenty (20) days for power costs.

Working capital is a fund that a business must have available, to meet its payroll and expenses until the services or products are paid by the customers. Utilities are usually allowed an amount for working capital as part of their rate base.



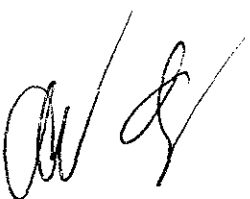
The cash working capital allowance should approximate the cash requirements based on an estimated net lag in the cash flow of a distribution utility. The Commission took into consideration PECO's proposed CWC, Cash Flow, availment of the Prompt Payment Discounts (PPD), collection efficiency, indebtedness pertaining to its cash flow problems or any current liabilities, and Average Collection Period (ACP).

The Commission calculated the net lag days of PECO based on the submitted sample bills and supplier invoices (Panay Power Corporation). It was determined that PECO has a negative 12 net lag days. This means that it is able to collect 12 days in advance before its outstanding purchase power obligations become due.

	PECO	PPC
Billing Cycle	15	15
Invoicing Period	9	10
Payment Period	19	30
	43	55
Net Lag Days	-12	

Moreover, the Commission noted the following additional related facts:

1. Using PECO's AFS, the calculation of ACP which measures how promptly other entities pay their bills from the time PECO issues the same, resulted in an average collection period of 60 days, even when government accounts are included in the analysis;
2. PECO's current ratios (2004 and 2005) showed that its current assets are sufficient to pay its current liabilities; and



3. PECO continuously avails of the PPD from PPC which means that it can collect power charges from its consumers very efficiently, even before the 10th day of each month.

In view of the above lead-lag study and additional related facts, the Commission finds no basis for PECO to be granted a CWC provision for purchased power. Consistent with its policy, the Commission granted PECO a 2-month CWC for O & M amounting to PhP14,930,713.00 which will be included in its rate base, computed as follows:

Computation of Cash Working Capital	Amount (in PhP)
Adjusted O & M	42,103,839
Adjusted Payroll	50,302,069
Total	92,405,908
Less: Taxes and Non-Cash Items	
Provision for Bad Debts	2,821,628
O & M - net of taxes & non-cash items	89,584,281
2-Months CWC provision on O & M (PhP89,584,281 x 2/12)	14,930,713

Summary of the Rate Base

After the adjustments made on all the components of the rate base, the following summarizes the corresponding adjusted figures to come up with the final amount of PhP713,785,217.00:

Particulars	PECO (in PhP)	Commission's Adjustments (in PhP)	Difference (in PhP)
Adjusted Net Plant In Service	690,130,548	(18,058,049)	672,072,499
Construction Work In Progress	3,239,633	-	3,239,633
Cash Working Capital	134,194,290	(119,263,576)	14,930,714
Materials and Supplies	24,311,157	(768,786)	23,542,371
Total	851,875,628	(138,090,411)	713,785,217

E. Return on Rate Base (RORB)

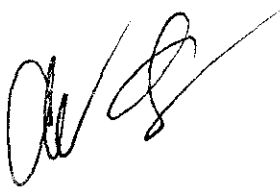
For the privately-owned electric utilities, a cost base method known as the return on rate base (RORB) methodology is being adopted. Power rates are set to recover the cost of service prudently incurred plus a reasonable rate of return. The rate of return pertains to the percentage which, when multiplied by the allowed rate base, provides a return that will fairly compensate the company for the risk inherent to the investment of capital. This simply means that a regulated utility is allowed certain rates that will cover its operating costs and provide it an opportunity to earn a reasonable rate of return on the assets utilized in the business.

PECO proposed a 19.01% Weighted Average Cost of Capital (WACC) adopted from the Performance Base Rate (PBR) application of CEPALCO except that PECO considered only the return on equity because it has no outstanding obligations.

On the basis of existing jurisprudence, the 12% rate of return will be maintained in this case.

The Commission approved the return on rate base amounting to PhP85,654,226.00 computed as follows:

Particulars	PECO (in PhP)	Commission's Adjustments (in PhP)	Difference (in PhP)
Adjusted Total Rate Base	851,875,628	138,090,411	713,785,217
Rate of Return	19.01%	-7.01%	12%
Return on Rate Base	161,941,557	(76,287,331)	85,654,226



F. Return of Capital (Depreciation and Amortization)

PECO calculated its proposed depreciation of PhP54,866,311.00 based on its AFS for 2004. It disclosed that it computed its depreciation on a straight line basis adopting the depreciation rate used in its rate unbundling application.

Depreciation is allowed as a component of the revenue requirement to provide a return of capital. This is required to be set aside by the DU specifically for the purpose of rehabilitation, upgrading and replacement of assets.

The Commission recalculated the depreciation expense net of the disallowances made in the net plant in service. Depreciation is calculated on a straight line basis since this is a generally acceptable method of computing depreciation for rate making purposes and consistent with the methodology used by independent appraisal companies and auditors. Further, the Commission utilized the estimated useful life of the asset used by its independent appraisal company as this is within the standard asset lives of the assets allowed for rate making purposes. Shown below is the computation of the depreciation:

Computation of Depreciation (in PhP)

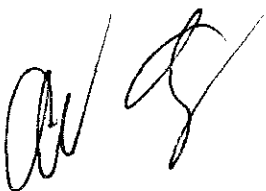
ASSET CATEGORY	1997 SOUND VALUE (a)	INCREMENTAL APPRAISAL INCREASE, NET (b)	2004 SOUND VALUE c=(a-b)	DEPRECIATION RATE (d)	DEPRECIATION EXPENSE - APPRAISAL e=(c x d)	DEPRECIATION EXPENSE - COST (f)	DEPRECIATION EXPENSE - TOTAL g=(e+f)	Per UFR-PECO (h)	Commission's Adjustments (g-h)
Land	17,515,975	70,140,782	87,656,757						
Building & Improvements	13,315,776	370,268	13,686,045	5.00%	684,302	374,296	1,058,598	843,035	215,563
Electrical Equipments	115,637,622	51,755,850	167,393,479	8.33%	13,943,877	3,975,942	17,919,819	8,689,250	9,230,569
Transportation Equipment	4,993,793	8,228,734	13,220,527	20.00%	2,644,105	741,638	3,385,744	1,520,616	1,764,928
Furniture & Equipment	1,013,998	(272,182)	1,013,998	5.00%	50,700	912,464	963,163	914,919	48,244
Station Equipment	130,901,788	66,761,740	197,663,527	8.33%	16,465,372	9,072,133	25,537,505	18,222,823	7,314,682
Poles & Fixtures	102,251,358	104,920,546	207,071,905	8.33%	17,249,090	4,100,985	21,350,075	9,209,597	12,140,478
O.H. Conductors & Devices	102,946,903	(21,732,369)	102,946,903	8.33%	8,575,477	5,397,450	13,970,927	10,705,245	2,424,894
Line Transformers	29,213,414	9,017,392	38,230,806	8.33%	3,184,626	1,504,344	4,688,970	2,990,724	1,698,246
Tools, Shop & Garage Equipment						678,872	580,895	404,611	176,384
Misc. Equipment							44,233	627,566	(583,333)
St. Lights & Signal System							791,956	837,726	154,230
GRAND TOTAL	517,790,626	289,038,768	828,883,945		62,797,549	26,708,124	89,461,194	54,866,311	34,584,883

As can be gleaned from the foregoing table, the Commission computed the total depreciation expense of PhP89,451,194.00 instead of the proposed depreciation by PECO which is PhP54,866,311.00. The Commission took into consideration the sound value of the assets. On the other hand, PECO's proposal was based on the depreciable cost of the asset using the 1997 appraisal values plus asset additions less asset disposals until 2004 exclusive of the appraisal increase as of December 31, 2004. The Commission is of the view that the previous approach is more appropriate because it reflects the current market value of the asset consistently considered for purposes of rate making. Thus, the Commission computed the depreciation expense of PECO in the amount of PhP89,451,194.00.

G. Prompt Payment Discount (PPD)

PECO included PPD as part of its revenue requirement. The PPD component has been adjusted upward to represent the inclusion of 100% of the PPD in distribution charge. PECO claimed that the reinstatement of the PPD in the unbundling Decision and the implementation of the Automatic Generation Rate Adjustment (AGRA) resulted to a double deduction on the part of the DU.

The Commission disallowed the PPD of PhP60,190,901.00 to form part of the revenue requirement. PPD pertains to an incentive for paying in advance or making payments before the bill becomes due. It is being availed by PECO as a deduction from its total generation cost from PPC. The Commission believes that the treatment of PPD and the effects thereof should be considered in the AGRA and not in the instant application.



H. Other Revenue Items (ORI)

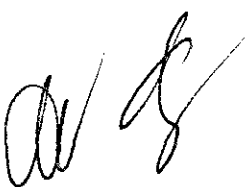
In its application, PECO's ORI component has been adjusted upward because of the exclusion of pole and transformer rental from the revenue requirement amounting to PhP1,734,297.00.

The Commission considered Other Revenues as items to be deducted from the revenue requirement used to calculate the rates for the end-users. Since all the expenses associated with the provision of the services that gave rise to these items of revenue are included in the revenue requirement, the income generated thereof should also be considered.

Moreover, since the assets (pole & transformer) that gave rise to these items of revenue (rentals) are allowed as return and depreciation allowance in the revenue requirement, the revenue generated must be fully deducted from PECO's revenue requirement.

In addition to ORI, the Commission found that PECO likewise earned reconnection fees in the amount of PhP207,315.00. Thus, the Commission deducted from PECO's revenue requirement the amount of PhP1,941,612.00 representing its ORI.

Other Revenue Items (ORI)	PECO's Proposal (in PhP)	ERC Adjustments (in PhP)	Adjusted ORI (in PhP)
Pole Rental	1,720,104	-	1,720,104
Transformer Rental	4,768	-	4,768
Other Income	9,425	-	9,425
Reconnection Fees	-	207,315	207,315
Total	1,734,297	207,315	1,941,612



FUNCTIONALIZATION, CLASSIFICATION AND CUSTOMER CLASS ALLOCATION

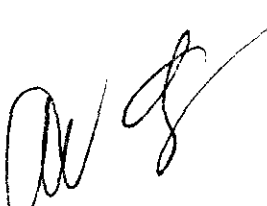
I. Functionalization and Allocation Factors

The functionalization and allocation factors used by PECO were the default factors set forth in the UFR, as amended in its rate unbundling Decision. At present, the Commission sees no cogent reason for it to deviate from the existing functionalization and allocation factors as contained in the UFR.

However, PECO proposed the sub-categories under Administrative and General Expenses to be functionalized by using Payroll (excluding Administrative and General Payroll) to replace the Total O & M (excluding fuel and purchased power) and the Total O & M directly assigned to distribution to be used for the franchise requirements and regulatory expenses.

PECO used its actual kWh sales for the test year 2004 as billing determinants. Although it submitted its Non-Coincident Peak Demand (NCP) and Coincident Peak Demand (CP), it utilized demand allocation factors from the resulting kWh sales ratio per customer class.

The Commission found no merit on PECO's proposed changes in its functionalization factor. Said proposal can not be accepted as it will be contrary to the rate making principle that the cost drivers should match the particular expense. Thus, the Commission maintained the functionalization factors used in its rate unbundling Decision.



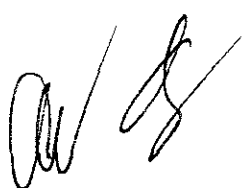
PECO, in its *Compliance* dated July 09, 2007, manifested that Philippine Foremost Milling Corporation (PFMC) is already directly connected to NPC. Consequently, it excluded the actual kWh consumption of PFMC in computing for its billing determinants.

The Commission used the 2006 actual kWh sales of 332,669,695 as reflected in its 2006 Annual Report to account for the exclusion of the kWh sales to PFMC.

On the demand allocation factors (NCP and CP), the Commission made a simulation of the resulting rates using the data submitted by PECO. The simulation resulted to significant differences in rates among customer classes. It was also determined that the data do not reflect the typical load factors for commercial and streetlights customers. For this reasons, the Commission adopted the demand allocation factors used in the unbundling Decision.

SUMMARY OF RESULTING REVENUES PER FUNCTION AND PER CLASS

Based on the functionalization, classification and allocation of the recommended revenue requirement for PECO, the table below provides the following revenues functionalized by customer category:



Customer Class	Total Revenue (PhP)	Distribution Related Revenue (PhP)	Supply Related Revenue (PhP)	Metering Related Revenue (PhP)
RESIDENTIAL SERVICE	125,631,904	77,202,845	20,020,690	28,408,369
INTERMEDIATE	1,174,035	1,020,484	63,478	90,072
COMMERCIAL	50,952,079	37,475,645	1,115,462	12,360,972
POWER	73,877,413	63,843,484	367,505	9,666,423
CITY GOVERNMENT	2,859,542	2,754,481	43,432	61,629
STREET LIGHTS	4,591,417	4,231,785	148,673	210,959
OTHER GOVERNMENT	6,267,766	6,102,093	68,490	97,183
TOTAL	265,354,155	192,630,818	21,827,730	50,895,608

RATE DESIGN

The above discussion on functionalization, allocation and customer classification yielded the following rate design:

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Customer Type	Residential	Intermediate	Commercial	Power	City Government	Streetlights	Other Government
<i>Proposed Rates:</i>							
Distribution Charges							
Distribution System Charge PhP/kWh	1.0783	1.0246	1.0162	0.9375	1.0238	1.2161	1.0088
Demand Charge PhP/kW	-	-	-	68.3600	-	-	-
Supply Charges							
Retail Customer Charge PhP/cust/mo	-	56.1801	56.1183	56.1050	56.1165	56.1903	56.2561
Supply System Charge PhP/kWh	0.2594	-	-	-	-	-	-
Metering Charges							
Retail Customer Charge PhP/cust/mo	5.0000	46.0500	359.6400	853.6300	46.0500	46.0500	46.0500
Metering System Charge PhP/kWh	0.2559	-	-	-	-	-	-
Total Energy Charge	1.5936	1.0246	1.0162	0.9375	1.0238	1.2161	1.0088
Total Monthly Customer Charge	5.0000	102.2301	415.7583	909.7350	102.1665	102.2403	102.3061
Total Demand Charge	-	-	-	68.3600	-	-	-

<i>Per Unbundling Decision (2000):</i>							
Distribution Charges							
Distribution System Charge PhP/kWh	0.5591	0.5043	0.5138	0.2658	0.6163	0.6100	0.7018
Demand Charge PhP/kW	-	-	-	68.3600	-	-	-
Supply Charges							
Retail Customer Charge PhP/cust/mo	-	37.0700	37.0700	37.0700	37.0700	37.0700	37.0700
Supply System Charge PhP/kWh	0.1758	-	-	-	-	-	-
Metering Charges							
Retail Customer Charge PhP/cust/mo	5.0000	46.0500	359.6400	853.6300	46.0500	46.0500	46.0500
Metering System Charge PhP/kWh	0.1947	-	-	-	-	-	-
Total Energy Charge	0.9296	0.5043	0.5138	0.2658	0.6163	0.6100	0.7018
Total Monthly Customer Charge	5.0000	83.1200	396.7100	890.7000	83.1200	83.1200	83.1200
Total Demand Charge	-	-	-	68.3600	-	-	-

<i>Recommended Rates:</i>							
Distribution Charges							
Distribution System Charge PhP/kWh	0.6321	0.6397	0.7388	0.2485	0.3982	0.9971	0.3457
Demand Charge PhP/kW	-	-	-	98.5750	-	-	-
Supply Charges							
Retail Customer Charge PhP/cust/mo	-	34.8016	34.8016	34.8016	34.8016	34.8016	34.8016
Supply System Charge PhP/kWh	0.1639	-	-	-	-	-	-
Metering Charges							
Retail Customer Charge PhP/cust/mo	5.0000	49.3818	385.6537	915.3810	49.3818	49.3818	49.3818
Metering System Charge PhP/kWh	0.2326	-	-	-	-	-	-
Total Energy Charge	1.0286	0.6397	0.7388	0.2485	0.3982	0.9971	0.3457
Total Monthly Customer Charge	5.0000	84.1835	420.4553	950.1826	84.1835	84.1835	84.1835
Total Demand Charge	-	-	-	98.5750	-	-	-

<i>Variance: Recommended Rates vs Proposed Rates</i>							
TOTAL PhP/kWh	(0.5650)	(0.3849)	(0.2774)	(0.6890)	(0.6256)	(0.2190)	(0.6631)
PhP/kW	-	-	-	30.2150	-	-	-
PhP/cust/mo	-	(18.0466)	4.6970	40.4476	(17.9830)	(18.0568)	(18.1226)
<i>Variance: Recommended Rates vs Unbundling Decision</i>							
TOTAL PhP/kWh	0.0990	0.1354	0.2250	(0.0173)	(0.2181)	0.3871	(0.3561)
PhP/kW	-	-	-	30.2150	-	-	-
PhP/cust/mo	-	1.0635	23.7453	59.4826	1.0635	1.0635	1.0635

I. Distribution Charge

The distribution charge shall be billed on a fixed rate per kilowatt-hour for Residential, Intermediate, Commercial, General Power, City Offices and Streetlights and Government Buildings' customers.

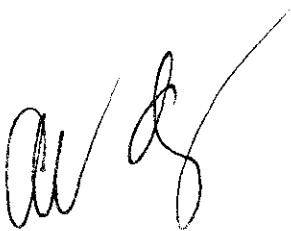
Relevant to distribution charge, the Commission has resolved that the distribution wheeling rates to be charged by PECO to the future contestable market should be the same as that provided in the Rate Schedule, comprising of its proposed distribution and supply charges. The Commission believes that wheeling rates are parallel to the cost of service functionalized under Distribution. Thus, the Distribution charge provided in the Rate Schedule is likewise utilized as Distribution Wheeling Charges available to the future contestable market.

II. Metering Charge

PECO proposed to bill its metering charge a fixed monthly rate per customer for all its customer classes except residential. For its residential customers, PECO proposed to bill its metering charge using a combination of fixed monthly rate per meter of Php5.00 and fixed monthly rate of per kilowatthour (kWh). The Commission adopted this rate design consistent with PECO's approved unbundled rate.

III. Supply Charge

PECO proposed to bill its supply charge a fixed monthly rate per customer for all its customer classes except residential. For the residential customers,



PECO proposed to bill its supply charge using a fixed monthly rate per kilowatthour (kWh).

The Commission also adopted this rate design consistent with the PECO's approved unbundled rates.

IV. Estimated Impact on Average Residential Customers

Shown below is a comparison of the estimated impact of all the adjustments on the revenue requirement on the monthly bill of a residential end-user consuming 109 kWh a month using PECO's existing rates as of May 2007 against the recommended revised rates:

Based on Actual Existing Rate 109 kWh			Revised Rates		
	PhP/kWh	PhP		PhP/kWh	PhP
Distribution Charge	0.5591	60.94	Distribution Charge	0.6321	68.90
Supply Charge	0.1758	19.16	Supply Charge	0.1639	17.87
Metering Charge			Metering Charge		
Retail Customer Charge/Month		5.00	Retail Customer Charge/Month		5.00
Metering System Charge	0.1947	21.22	Metering System Charge	0.2326	25.35
Total Distribution Charge		106.32	Total Distribution Charge		117.12
Universal Charge			Universal Charge		
Missionary	0.0373	4.07	Missionary	0.0373	4.07
Environment	0.0025	0.27	Environment	0.0025	0.27
Total Bill		110.66	Total Bill		121.46
PhP/kWh		1.02	PhP/kWh		1.11
Inc./(Dec.) in Pesos					10.80
Inc./(Dec.) in Rates					0.099

V. Other Rate Related Items

1. Removal of Inter-Class Cross Subsidy

In the Commission's Decision dated February 4, 2005 (ERC Case Nos. 2002-07 & 2001-903), PECO was directed to phase out its inter-class cross subsidy within a period of three (3) years starting with a one-third (1/3) removal in

the first year and the remaining two-thirds (2/3) corresponding to the 2nd and 3rd years at an annual rate similar to that of the first year.

PECO started implementing its removal of inter-class cross subsidy in August 2005, as shown in its monthly submission of its customer bills. Using this schedule as basis, PECO should have completed the removal of its inter-class cross subsidies by July 2007. However, upon verification of sample bills, PECO has not yet completely removed its inter-class cross subsidy as of September 2007.

2. Lifeline Rate and Level

The Commission denied PECO's proposed Lifeline Consumption Threshold and Discount Levels for being inconsistent with its policy of granting lifeline subsidy charge of not more than PhP0.10 per kilowatt-hour to non-lifeline customers.

The Commission instead approved the following Lifeline Consumption Thresholds and corresponding Discounts:

kWh Consumption	Per Approved Unbundled Rates	Proposed in this Rate Application	ERC Approved Consumption Threshold and Discount Levels	
	Level of Discount		kWh Consumption	Level of Discount
75 & BELOW	50%	50%	75 and below	50%
76 - 80	40%	40%	76 - 80	40%
81 - 85	30%	30%	81 - 85	30%
86 - 90	20%	20%	86 - 90	20%
91 - 95	10%	10%	91 - 95	10%
96 - 100	5%	5%		
Subsidy Rate to non-lifeline customers	PhP.0908/kWh	PhP.1218/kWh	Subsidy Rate to non-lifeline customers	PhP.0999/kWh

SCHEDULE OF RATES

After considering all the adjustments made on PECO's application, the Commission approved the following rate schedule:

Customer Type	Residential	Intermediate	Commercial	Power	City Government	Streetlights	Other Government
Distribution Charges							
Distribution System Charge PhP/kWh	0.6321	0.6397	0.7388	0.2485	0.3982	0.9971	0.3457
Demand Charge PhP/kWh				98.5750			
Supply Charges							
Retail Customer Charge PhP/cust/mo		34.8016	34.8016	34.8016	34.8016	34.8016	34.8016
Supply System Charge PhP/kWh	0.1639						
Metering Charges							
Retail Customer Charge PhP/cust/mo	5.0000	49.3818	385.6537	915.3810	49.3818	49.3818	49.3818
Metering System Charge PhP/kWh	0.2326						
Total Energy Charge	1.0286	0.6397	0.7388	0.2485	0.3982	0.9971	0.3457
Total Monthly Customer Charge	5.0000	84.1835	420.4553	950.1826	84.1835	84.1835	84.1835
Total Demand Charge	-	-	-	98.5750	-	-	-

WHEREFORE, the foregoing premises considered, the application filed by Panay Electric Company (PECO) for approval of its revised rate schedules and appraisal of property, with prayer for provisional authority, is hereby **APPROVED** with modification.

Accordingly, PECO is hereby granted a Total Revenue Requirement of **PhP265,354,155.00** equivalent to an average rate adjustment of **PhP0.1691/kWh**, and Appraisal of Property with a Reproduction Cost New of PhP1,208,084,897.00 and Adjusted Sound Value of PhP672,072,499.00. The corresponding Rate Schedule, lifeline levels, discounts and lifeline subsidy charge, are shown as follows:

Rate Schedule

Customer Type	Residential	Intermediate	Commercial	Power	City Government	Streetlights	Other Government
Distribution Charges							
Distribution System Charge PhP/kWh	0.6321	0.6397	0.7388	0.2485	0.3982	0.9971	0.3457
Demand Charge PhP/kWh				98.5750			
Supply Charges							
Retail Customer Charge PhP/cust/mo		34.8016	34.8016	34.8016	34.8016	34.8016	34.8016
Supply System Charge PhP/kWh	0.1639						
Metering Charges							
Retail Customer Charge PhP/cust/mo	5.0000	49.3818	385.6537	915.3810	49.3818	49.3818	49.3818
Metering System Charge PhP/kWh	0.2326						
Total Energy Charge	1.0286	0.6397	0.7388	0.2485	0.3982	0.9971	0.3457
Total Monthly Customer Charge	5.0000	84.1835	420.4553	950.1826	84.1835	84.1835	84.1835
Total Demand Charge	-	-	-	98.5750	-	-	-

Maximum lifeline level : 95 kWh
 Maximum % of discount : 50%
 Subsidy to Non-lifeline Customers : PhP0.0999/kWh
 % of Residential customers who will benefit : 29.54%

SO ORDERED.

Pasig City, October 24, 2007.

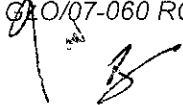

RODOLFO B. ALBANO, JR.
 Chairman


RAUF A. TAN
 Commissioner


ALEJANDRO Z. BARIN
 Commissioner


MARIA TERESA A.R. CASTAÑEDA
 Commissioner

(On Official Business)
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Iloilo City