POWER WITHOUT ACCOUNTABILITY: UNBUNDLING THE MORAL HAZARD PROBLEM IN THE PHILIPPINE POWER MARKET*

*John P. Virgino***

"Pour gouverner mieux, il faudrait gouverner moins"[1]

I. INTRODUCTION: LEVIATHAN OR LAISSEZ FAIRE?

Laissez-faire economics as introduced by Adam Smith more than two centuries ago argues for a limited governmental role in society. It distrusts government intrusion into the marketplace, believing that this is unwarranted in most cases, and only leads to distortions. Free enterprise meant freedom from government in the economic sphere; economic players are better left to their own devices, outside the state's paternalistic embrace. Adherents to this theory place their full faith in market dynamics and in the invisible hand – that economic abstraction that brings about market discipline as well as harmony between private gain and public good.

The importance of defining the parameters of permissible regulation cannot be overemphasized in public utilities. As government shifts gears from heavily regulated, state-owned enterprises to a reformed, market-driven electricity sector, it brings to fore the fundamental need to delineate government's proper role in the public utilities' regulation.

How much of government is too much? This is the lawyer-economist's elusive philosopher's stone, one that has baffled political alchemists for ages.

---

* This article on public utilities draws from the author's experience working in the Philippine Senate, and from research done during his recent masteral studies in the United States. *Cite as* John Virgino, *Power Without Accountability: Unbundling the Moral Hazard Problem in the Philippine Power Market*, 79 PHIL. L.J. 130, (page cited) (2004)

** Member, Student Editorial Board, PHILIPPINE LAW JOURNAL (1999). Deputy Legislative Counsel (Director II), Office of Senator Edgardo J. Angara (2001-present). Deputy Director, Integrated Bar of the Philippines, National Committee on Legal Aid (2001-2002). LL.M., American University, Washington College of Law (Fulbright scholarship) (2004). LL.B., University of the Philippines (2000). A.B. Political Science, *Magna Cum Laude*, University of the Philippines Manila (1996).

[1] "*To govern better, one must govern less*" by Marquis d'Argenson *cited in* John Maynard Keynes, *The End of Laissez Faire* (1926), *available at* http://www.panarchy.org/keynes/laissezfaire.1926.html.

A. THE ECONOMY AS A FUNCTION OF POWER

There is a strong positive correlation between the demand for electricity and economic growth.[2] Energy fuels economic development. Progress hungers for more energy. They are a couple locked in a helical dance, symbiotically reinforcing each other's step.

Beyond personal convenience, a strong electricity base stimulates industry, attracts investments, creates much-needed jobs, and ultimately becomes the foundation for an improved quality of life. However, the reverse is likewise true; failing to tame its savage nature can lead to a country's economic ruin, paralyzing it with crippling power rates that stifle purchasing power and drive away investors. Moreover, an already capital-scarce economy cannot afford to further divert government funds into an inefficient public power sector, crowding out pressing welfare spending for schools, hospitals and public roads.

Power generation and distribution deal with a basic societal need. As held in *Energy Regulatory Board v. Manila Electric Co.*,[3] such operations are "imbued with public interest" for they provide a basic commodity "indispensable to the interest of the general public." Corollarily, whether mistakes are caused by deliberate malice or sheer ignorance, the costs of inefficient decision-making in their operation are inevitably borne by captive consumers. Utilities regulation is important not only because it has direct impact on the people, but on the country's overall economic viability as well.

B. THE HIGH COST OF ELECTRICITY

At present, the Philippines has one of the highest costs of electricity in the world, a damningly clear indication of a failure in governance. In a recent comparative study, in fact, the country ranked seventh highest in residential and third highest in industrial power rates. At twelve United States cents per kilowatt-hour (kWh), the former rates rank behind only Switzerland, Germany, Portugal, Netherlands, Japan and Denmark.[4] In other words, it costs more to power one's home appliances in the Philippines than it would in the United States and most European countries. With respect to industrial rates, the Philippines' are the second highest electricity rate in Asia, next *only* to Japan, at around nine cents/kWh.[5]

---

[2] FINAL REPORT, INTER-AGENCY COMMITTEE ON THE REVIEW OF THE 35 NPC- INDEPENDENT POWER PRODUCERS (IPP) CONTRACTS Part II-B at 6. (hereinafter FINAL REPORT). According to Patrick O'Reilley, it is ideal that every 1% increase in GDP should be accompanied by a 1% growth in generation capacity. *The Power Behind Asia*, 30 ASIAN BUS. ISSUE 8, 49 (August 1994).

[3] G.R. No. 141369, April 9, 2003.

[4] Abigail Ho, *RP Power Rates Among Highest in the World, Says Study*, PHIL. DAILY INQUIRER, March 12, 2004, *at* http://money.inq7.net/topstories/view_topstories.php?yyyy= 2004&mon=03&dd =12 &file=6.

[5] *Id.*

This vividly punctuates the problem of a developing country that charges prohibitive First World power rates to consumers barely making ends meet with their modest Third World salaries.[6] Worse, the service is certainly not of First World quality, as evidenced by frequent blackouts, voltage fluctuations, and other problems that plague businessman and home consumer alike.[7]

II. THE GOVERNMENT TRIPS: A HISTORICAL OVERVIEW

Philippine power rates did not soar to these dizzying heights in a single stroke. Rather, one must carefully look at the confluence of several complex factors,[8] aggravated by a series of government missteps and misguided projections. One cannot begin such scrutiny of the present, however, without exposing its shady past.

A. MARCOS ADMINISTRATION (1965-1986)

On September 21, 1972, President Ferdinand Marcos declared Martial Law in the entire country. Characteristic of his authoritarian regime, the State exerted central control over all public utilities. The power sector became a full monopoly when the private distribution utility Manila Electric Co. (MERALCO) was vertically integrated into the state-run power producer, the National Power Corp. (NAPOCOR).

The State heavily subsidized electricity, and the state-owned utilities were never allowed to recover the true cost of their operations since government capped the allowable rate of returns. This was partly due to the volatility of the time, with government forced to ease rumblings of opposition and attempt to gain a mass support base for military rule. However, this condoned horrendous inefficiency in the utilities' operations, resulting in huge losses and insufficient revenue to fund expansion and maintenance.[9]

Armed with plenary powers and having set aside the checks and balances inherent in the tripartite government structure, President Marcos embarked on a foreign borrowing binge to finance infrastructure projects, among them the Bataan Nuclear Power Plant (BNPP). Nuclear power was, at the time, an attractive and fashionable alternative for most countries looking for cheaper energy. It is rumored, however, that the Marcos administration received USD80 million in kickbacks from

---

[6] United States Central Intelligence Agency, CIA WORLD FACT BOOK (2002), *at* http://www.odci.gov/cia/publications/factbook/geos/rp.html. According to 2001 estimates of Index Mundi, 40% of the population is below the poverty line. *Available at* http://www.indexmundi.com/philippines/population_below_poverty_line.html.

[7] Isidro Camacho, *The Politics of Electricity*, BUS. WORLD (Philippines), *at* http://codex1.bworldonline.com/articles/01/01052824.htm.

[8] FINAL REPORT, *supra* note 2, Part II-B, at 1.

[9] ALEXANDER DYCK, NAPOCOR PRIVATIZATION: POWER IN THE PHILIPPINES 8 (1997)

Westinghouse from this shady transaction. A crony was said to have brokered a deal for the President to reverse an earlier final bid award to General Electric. The plant was however, overpriced 150% above projections.[10] The government paid dearly for this change; in effect, it paid for "one reactor for the price of two."[11]

Unfortunately, a group of experts eventually concluded that the power plant was unsafe and inoperable as it was built along an earthquake fault line and near a dormant volcano. Thus, ironically, the touted source of low-cost electricity failed to produce a single watt. This, however, did not stop it from hefting its formidable price tag onto the government's lap, an obligation that continues to be serviced to this day at about USD155,000 a day.[12] In 2002, debt service (principal amortization and interest) for the project reached USD43 million.[13]

B. AQUINO ADMINISTRATION (1986-1992)

President Marcos was overthrown by a popular revolt, following the assassination of opposition senator, Benigno Aquino. Corazon Aquino, his widow, lost in the fraudulent election Marcos called, but was installed to power after the peaceful EDSA Revolution. With no political experience, she took the reins of government as the country's first female president.

With renewed economic optimism, the country's demand for electricity rapidly outpaced supply.[14] However, for all the initial euphoria, the government was not able to sustain the hype of an emerging democracy. Like a new toddler having difficulty walking without help, the government missed critical steps and failed to address key issues and structural reforms. Thus, towards the end of Aquino's term, the country began experiencing widespread power shortages. Industry was

---

[10] Freedom from Debt Coalition, *The Bataan Nuclear Power Plant, Philippines Experience with ECAs Guaranteeing Destruction: The Role of Export Credit Agencies in Guaranteeing Economically, Socially, and Environmentally Destructive Projects*, January 3, 2003, at 4, *at* www.freedomfromdebtcoalition.org/main/pages/BNPP%20-%20Philippine%20experience%20with%20ECAs. "The contract for this project was signed in February 1976 between the National Power Corporation (NPC) and Westinghouse Electric Corporation. Each nuclear reactor cost USD1.2 billion. However, in 1979 the cost was raised by USD1.9 billion. But Westinghouse's price rose after it was awarded the contract. In 1975, it adjusted its price to USD1.2 billion. In September of the same year, the cost of one reactor had jumped to USD1.1 billion. The cost increased further to USD1.9 billion in 1979."

[11] Patricia Adams, *Philippine government to dismantle Marcos' nuclear plant* (1999), *at* http://www.probeinternational.org/pi/index.cfm?DSP=content&ContentID=1142.

[12] Abigail Ho, *Nuclear Plant Conversion too Costly: Industry Exec.* PHIL. DAILY INQUIRER, April 16, 2004, *at* http://www. inq7.net/brk/2004/apr/16/brkpol_7-1.htm. This is according to Thelmo Cunanan, Philippine National Oil Company, President and CEO. Toronto-based think tank Probe International pegged the debt burden from the unused power plant at an even higher USD170,000 per day. Debt payments for the idle plant would last until 2018.

[13] Adams, *supra* note 11.

[14] FINAL REPORT, *supra* note 2, Part II-B, at 2. At the height of the power crisis in 1993, demand overtook supply as the nation's actual demand rose to 4,563 MW while dependable capacity was limited to only 4,239 MW.

paralyzed by daily eight to twelve hour blackouts throughout the country.[15] Exacerbating the irony, the power crisis was aggravated by the controversial BNPP's mothballing. There was no substitute plant to fill the void in generation capacity;[16] the country had no buffer for the increase in power demand.

This hamstrung economic growth and dampened investor interest. After posting an impressive 6.0% gross domestic product (GDP) growth in 1989, this contracted to 2.7% in 1990, and then dropped to .70% in 1991 and to -.04% in 1992.[17] During this period, it was estimated that the country lost PHP3.5 billion in opportunity costs.[18] A World Bank study estimated that the 1990 power outages reduced economic output in Metro Manila alone by USD2.4 billion.[19]

One bright spot in all this, however, was Executive Order No. 215,[20] issued towards the end of Aquino's administration. This ended Napocor's monopoly by opening electricity generation to the private sector.

C. RAMOS ADMINISTRATION (1992-1998)

President Fidel Ramos enjoyed the first peaceful transition of leadership since Martial Law, but he inherited a power crisis at its height along with the presidency.[21] Specifically, he had to address a country that needed an immediate boost in its power supply, yet lacked sufficient capital to directly construct power generation facilities in time to meet present and future demands.[22] Private sector participation was viewed as the only viable method of quickly addressing the power shortage.

Congress responded by passing key power sector reform laws. First, it approved the Build-Operate-Transfer law,[23] which provided the necessary policy framework and clear-cut guidelines for contractual arrangements between the national government and private sector proponents in undertaking, financing, constructing, operating and maintaining infrastructure projects.[24] Second, it granted Ramos broad emergency powers through the Electricity Crisis Act,[25] designed to give him enough latitude to solve the power crisis at the soonest possible time. The emergency powers fast-tracked the entry of the private sector to the power industry

---

[15] Pamela Sio, *Changes and Challenges in the Electricity Sector, All Charged Up*, MBC RESEARCH REPORTS, April 2002, ¶7, *at* http://www.mbc.com.ph/economic_research/mbcrr/no38/default.htm.

[16] FINAL REPORT, *supra* note 3, Part II-B, at 1.

[17] *Id.*

[18] SIO, *supra* note 15, ¶7

[19] WORLD BANK, BUREAUCRATS IN BUSINESS 35 (1995), *cited in* DYCK, *supra* note 9, at 4

[20] Exec. Order No. 215, July 10, 1987 (amending Pres. Decree No 40 and allowing the private sector to generate electricity)

[21] FINAL REPORT, *supra* note 3, Part II-B, at 1

[22] SIO, *supra* note 15, ¶7

[23] Rep. Act No. 6957 (1990), *amended by* Rep. Act No. 7718 (1994).

[24] FINAL REPORT, *supra* note 2, Part II-B, at 4

[25] Rep. Act No. 7648 (1993).

and bypassed certain governmental processes. It also enabled the president to enter into negotiated contracts for power plant construction and repairs with the Independent Power Producers (IPPs).[26]

Theoretically, IPPs provided access to project finance capital and best practice technology.[27] By introducing the profit motive, operational efficiencies could lower electricity costs and lessen the need for government subsidy.[28] This would unshackle the government's finances and reduce its exposure in power infrastructure, thus allowing resources to be rechanneled and redirected to other economic sectors.

Thus, Ramos relied heavily on the private sector. However, in view of the high country and sector risks, the government needed to provide generous incentives. As a result, despite the theoretical distancing by the government from the financial outlays involved, it nevertheless assumed substantial risks and provided extraordinary credit support to entice the desired private sector participation[29] in a very unfavorable investment environment.

Investors responded enthusiastically, pouring billions of dollars in new power plants. The power crisis was solved in the record time of eighteen months.[30] During this period, the government entered into contracts with 26 IPPs, increasing the country's power generation capacity by 3,835 megawatts (MW).[31]

To Ramos's credit, he was able to make the most of a bad situation, a time when government was desperate and had few bargaining chips left on the table Had he not engaged the IPPs, the economy would have fallen altogether instead of merely stumbling hard. At the time these contracts were undertaken, given the unfavorable position of the government relative to these crucial investors, it was given that the latter could easily negotiate generous concessions. In this context, one must accept the contracts inked in this period as justifiable and acceptable, again given the immediate need to stimulate the power sector.

Ramos's ultimate vision was to make the Philippines the next tiger economy. The enhanced electric capacity would have provided a solid foundation had Fate been kinder. As it turned out, the Philippines suffered yet another severe economic downturn when it was caught in the Asian financial crisis' riptide Although spared from the worst effects of the economic woes that afflicted most of Southeast Asia, the Philippines' electricity projections were nevertheless derailed.

---

[26] FINAL REPORT, *supra* note 2, Part II-B, at 5.
[27] *Id.* at 13
[28] *Id.*
[29] *Id.* at 5
[30] SIO, *supra* note 15, ¶8.
[31] FINAL REPORT, *supra* note 2, Part II-B, at 1.

In concrete terms, the financial crisis short-circuited the country's growth prospects. In 1998, at the end of Ramos's term, GDP fell to -0.5%.[32] Electricity demand forecasts were downgraded.[33] With the decrease in economic activity, there was a severe mismatch between current electricity projections and actual electricity consumption. Ironically, this now resulted in a severe energy oversupply, and the country found itself with 35-45% excess capacity.[34]

One criticism leveled against President Ramos was that his administration continued to enter into contracts with IPPs despite warnings from the World Bank of an impending power oversupply. In December 1994, according to Senator Edgardo Angara, the Bank stated that the installed capacity was already 43% beyond the actual demand.[35] The Ramos administration inked eleven additional IPP contracts in its last days, including two that were signed a few days before Ramos stepped down from office.[36]

According to one report, President Ramos "personally pushed for the speedy approval of some of the most expensive power deals." In Senator Sergio Osmeña's words, "the kindest thing that I can say is that this is gross mismanagement. They overcontracted overpriced power plants. The IPPs probably provided government officials then with 'incentives to allow such onerous contracts.'"[37] Arguably, while the IPPs were a necessary evil, the crisis may nevertheless have been a pretext for questionable contracts in some cases.

With the devaluation of the peso against the US dollar from 26.47 in 1997 to 50.99 in 2001,[38] the Philippine government was further burdened by the price escalation clauses of IPP tariff rates, as stipulated in the dollar-denominated contracts. These made debt repayments higher, and made fuel and other dollar-denominated costs more prohibitive.[39]

One study concluded that the IPP contracts had controversial provisions that were extremely onerous for the government. Some of the notable provisions included "take-or-pay" or contracted minimum energy off-take (MEOT) clauses that required NAPOCOR to pay the IPPs for a regular 70-85% off-take. The period was also locked-in for a long term to ensure the level of return for producers, even if such foreclosed much renegotiation due to volatility in prices and currency risk

---

[32] INTERNATIONAL MONETARY FUND, STAFF COUNTRY REPORT 99/93 (August 1999), Philippine Statistical Appendix, at 3.

[33] DYCK, *supra* note 9, at 2.

[34] *Id.*

[35] *No Budget For PPA Suspension*, THE PHILIPPINE STAR, May 27, 2004, *at* http://www.newsflash.org/2002/05/h1/h1015754.htm.

[36] *Id.*

[37] Luz Rimban & Shiela Samonte-Pesayco, *Trail Power Mess Leads to Ramos*, Philippine Center for Investigative Journalism, August 5-8, 2002, ¶14, *available at* www.pcij.org/stories/2002/ramos.html.

[38] Historical foreign exchange rate of the Philippine Peso to the US Dollar (Average): 25.7144 (1995) 26.2157 (1996) 29.4707 (1997) 40.8931 (1998) 39.0890 (1999) 44.1938 (2000) 50.9927 (2001) 51.6036 (2002) 54.2033 (2003) 56.2950 (April 2004). Bangko Sentral ng Pilipinas, *at* www.bsp.gov.ph.

[39] FINAL REPORT, *supra* note 2, Part II-B, at 7.

fluctuations. Also, NAPOCOR was made responsible for IPPs' fuel supplies, with on-site delivery, considering its tax exemption privileges in fuel oil purchases.[40] The government traded lower installation costs for the higher fuel costs it would inevitably incur in the long run. In addition, NAPOCOR also had to bear currency risk from dollar-denominated payments made to IPPs. Undertakings were also guaranteed by the full faith and credit guarantee of the national government – in short, by every Filipino taxpayer.

On July 21, 2002, an inter-agency committee was tasked to inventory the IPP contracts. The Committee used contractual benchmarking processes where key contract provisions that allocated project risks were identified, studied, and evaluated to ascertain the fairness of the allocations and their consistency with international and Philippine practices.[41] The committee report revealed that only six out of the thirty-five contracts presented no legal or financial issues that required further investigation.[42]

A related four-country World Bank study relating to risk exposure and the impact of IPP costs, pointed to the Philippines as having the "greatest overall exposure"[43] in terms of exchange and market risks. The study compared it to Indonesia, Malaysia, and Thailand using the following indicators:

(a) exchange rate exposure through origin of fuel supply;

(b) exposure to exchange rate through currency of wholesale tariff;

(c) exposure to exchange rate through foreign debt for project financing;

(d) exposure to market risk through proportion of domestic power needs supplied by IPPs; and

(e) exposure to off-taker payment problems through margin of retail tariffs over wholesale prices.

The Philippines was a dubious topnotcher, consistently rated "High" in all the determinants of risk assessments.

---

[40] SIO, *supra* note 15, ¶10.

[41] FINAL REPORT, *supra* note 2, Part II-B, at 2.

[42] SIO, *supra* note 15, Table 3. "A *legal issue* related to supplemental agreements that changed the burden of the government in the contract without going back to the Investments Coordination Committee. ICC Review is required for all contracts for huge government projects as well as supplemental agreements. A *financial issue* refers to an instance where a government agency entering a contract agreed to shoulder financial obligations beyond what is necessary."

[43] R.W. BACON & J. BESANT-JONES, WORLD BANK ENERGY & MINING SECTOR BOARD DISCUSSION PAPER SERIES, PAPER NO. 2, GLOBAL ELECTRIC POWER REFORM, PRIVATIZATION AND LIBERALIZATION OF THE ELECTRIC POWER INDUSTRY IN DEVELOPING COUNTRIES 13 (2002).

The depressing bottom-line, however, is that despite all the government hedging in every foreseeable risk area, the IPPs' pricing structure has still not improved, to the detriment of the government and end-users.[44]

D. ESTRADA ADMINISTRATION (1998-2001)

The term of President Joseph Estrada was cut short after another popular uprising ousted him. Calls for his resignation were followed by his aborted impeachment trial in relation to his alleged corrupt dealings and connections to gambling. However, only one IPP contract was signed during his term.

E. ARROYO ADMINISTRATION (2001-2004)

Vice-President Gloria Macapagal-Arroyo assumed office as Estrada's constitutional successor. Under her term, Congress passed the Energy Power Industry Reform Act (EPIRA),[45] which aimed to introduce competition and market discipline in the power sector, and to further facilitate foreign and private sector investments into the country.

The law has the following salient points:

1. The creation of key structures and institutions

- the privatization of state-owned National Power Corporation (NAPOCOR)[46]

- the creation of Power Sector Liabilities and Assets Management Corporations (PSALM) which would take ownership of all existing NAPOCOR generation assets, liabilities, IPP contracts, real estate and all other disposable assets.[47]

- the creation of the National Transmission Company (Transco) which shall assume the electrical transmission function of the NAPOCOR.[48]

- the creation of a new Energy Regulatory Commission which is an independent body in charge of the regulation of the electric power

---

[44] FINAL REPORT, *supra* note 2, Part II-B, at 6.

[45] Rep. Act No. 9136, June 8, 2001. "An Act Ordaining Reforms in the Electric Power Industry Amending for the Purpose Certain Laws and for Other Purposes."

[46] *Id.* § 47

[47] *Id.* § 49.

[48] *Id.* § 8

industry.[49] It shall handle consumer complaints and ensure the adequate protection of consumer interests[50]

b. The promotion of competitive processes

- the establishment of the Wholesale Electricity Spot Market (WESM) to make power rates competitive[51]

- retail competition and open access section[52]

- unbundling of rates between transmission and generation rates to reflect the respective costs of providing each service.[53]

c. Transitory costs

- condonation of the loans of the National Electrification Administration[54]

- the absorption by government of Php200 billion of Napocor loans[55]

- the review of IPP contracts[56]

- universal charge[57]

d. Social costs

- the mandated 30 centavo/kWh reduction for residential customers[58]

- lifeline rate provided to marginalized end-users [59]

- gradual phase-out of cross subsidies after implementation of universal charge[60]

- the promotion of the use of indigenous energy sources[61]

---

[49] *Id.* § 38.
[50] *Id.* § 42.
[51] *Id.* § 30.
[52] *Id.* § 31.
[53] *Id.* § 36.
[54] *Id.* § 60.
[55] *Id.* § 32.
[56] *Id.* § 68.
[57] *Id.* §' 34.
[58] *Id.* § 72.
[59] *Id.* § 73.
[60] *Id.* § 74.
[61] *Id.* § 35.

e. Externalities

- environmental charge[62]

- The principal driving forces behind the reform were: [63]

- the poor performance of NAPOCOR

- inability of the state to finance needed expenditure on new investment and to continue subsidy

- the need to remove subsidies to the sector in order to release resources for other pressing social needs

- the desire to raise immediate revenue for a cash-strapped government sector

NAPOCOR was forced to embrace privatization not quite with open arms, but as the only viable option left to it. It is saddled, for example, with a USD6.7 billion debt, a leverage ratio of 90%, as well as a host of contingent liabilities. Being over-leveraged, financing costs constitute a major component of its operating costs and foreign exchange denominated obligations. Since 1993, the basic rates, which it must pay, as well as servicing interest and principal payments have doubled.[64] By 2005, the government needs to allocate PHP36.7 billion[65] for it. This figure represents interest payments alone, not any part of the outstanding PHP1.4 trillion principal.[66] Addressing the Napocor problem, therefore, would partially ease the looming budgetary deficit of PHP197 billion[67] facing the country at present.

III. UNPLUGGING THE CONTROVERSY

Despite key reforms, Arroyo was hounded by massive protests due to rising electricity rates. The latter resulted from the controversial Purchase Power Adjustment (PPA),[68] rooted in "stranded costs" which is shorthand for every act of government power mismanagement since the Marcos administration. The tainted

---

[62] *Id.* § 34 (d).

[63] BACON & JONES, *supra* note 43, at 1.

[64] Camacho, *supra* note 8.

[65] Michael Lim Ubac & Christine Avendaño, *Government prescribes higher power rates, new taxes*, PHIL. DAILY INQUIRER, August 31, 2004, at A1.

[66] *Id.* This year, forty-nine government owned and controlled corporations will post a Php135 billion net loss. 85% of this amount belongs to NAPOCOR alone.

[67] *Id.* These figures were cited by the Department of Finance during a presentation before the Philippine Senate last August 30, 2004.

[68] Bert Dalusung, *Philippine Energy Situation, Seminar on Cogen*, 3 BUS. FACILITATOR, August 20-21, 2002, *available at* www.cogen3.net/presentations/asean/philippines_energy_situation.pdf. Purchase power adjustments are automatic cost recovery mechanism to cover adjustments not included in the basic charge/rate (cover operating expenses and attain a reasonable return on investment, foreign currency changes, purchase changes).

seeds were planted in corrupt transactions surrounding a nuclear power plant, and germinated with onerous sweetheart deals for IPPs. These have now bloomed and manifest themselves in the higher tariff and electricity costs passed to consumers The PPAs are the epitome of this "pass-through mechanism,[69] and it would seem that government drank too much bad wine, leaving the people to suffer the terrible hangover.

A. WHY AN OVERSUPPLY OF ENERGY HAS FAILED TO LOWER POWER RATES

As discussed, the country is still paying for the electricity oversupply due to the IPP contracts the government was forced to enter into.[70] As of 1992, the country's total installed capacity was 13,380 MW, with an actual dependable capacity of 11,191 MW. However, the current peak demand is only 7,297 MW, or 67% of dependable capacity. Factoring the required buffer, the Philippines still has an excess capacity of roughly 11%.[71]

Ordinarily, the law of supply and demand pushes commodity prices downwards to dispose of an excess. The reverse is true in the Philippine electricity market because of its historical development, excess energy generated actually means higher electricity rates[72] due to the risk-free take-or-pay clauses in IPP contracts. Committed minimum purchases have introduced much imperfection and distortion in pricing electricity, since electricity payments remain guaranteed to the producers, whether used or not.[73]

B. THE ROLE OF GOVERNMENT IN RESOLVING THE DILEMMA

The history of electricity regulation showcases the pivotal role played by government Since the earliest days of civilization, its primordial role has been to distribute resources in order to achieve the greatest good for the greatest number.[74] With respect to power and given the historical development, it must now play a balancing role. It must weigh the factors, and reconcile the need to provide investors a reasonable return on investment *vis-à-vis* the needs of the consumers.

Should government strip away all forms of regulation in favor of *laissez faire*? This would be an option if true market competition would be guaranteed. However, such a simple Utopian result does not exist in the real world, and continued regulation on the part of government will be inevitable, justified partly as a way of coping with inherent market imperfections. Government regulation may

---

[69] SIO, *supra* note 15, ¶9

[70] *Id.*

[71] *Id.*

[72] Rimban & Pesayco, *supra* note 37, ¶8.

[73] Camacho, *supra* note 8.

[74] Calalang v Williams, 70 Phil 726, 733 (1940)

thus help ensure that business does not maximize profits at consumers' expense, and that consumers in turn shoulder their fair share.

The challenge to the government thus lies in fostering an environment where private sector participation can flourish. The Constitution provides that "[t]he State recognizes the indispensable role of the private sector, encourages private enterprise, and provides incentives to needed investments."[75] Private capital is the key that will "unlock the growth potential of the economy."[76] Failure to facilitate this nurturing regulatory framework means that the government will continue to bear the ironic twin burdens of having difficulty in attracting private investments on one hand, and carrying the lion's share of investment risks on the other, absorbed as premiums, performance and payment guarantees.[77]

Of course, it is important that government protect utilities from volatility. There is a clear public interest in preserving their viability, and this cannot be safeguarded directly through a government takeover of these critical functions, given its shallow pockets. However, government must protect its own interests, as well, and conserve its resources. To reiterate the most important lesson learned from the power crisis, it must uphold contracts validly entered into and execute them unimpaired, but it should be more vigilant and carefully review all provisions of the contract before sealing deals. Otherwise, in the name of developing the energy sector, it will be caught in a straitjacket of narrow vested interests, and bound to defend these while compromising the interests of the greater majority.

The key, again, lies in placing the fulcrum equitably between two competing objectives, to balance the interests of consumer and investor alike

IV. KEY CHALLENGES

A. THE MORAL HAZARD PROBLEM

When misallocation of risks between two parties results in a burden, borne far too heavily by one, a phenomenon called the moral hazard enters the scene. This hazard lies when such inequity modifies the parties' behavior. The side freed from risk through none of its effort is encouraged to engage in riskier behavior than normal, because they will not bear the brunt of the consequences should the enterprise fail.[78] In the Philippine power sector, moral hazards arise when incentive

---

[75] CONST. art. II, § 2.

[76] WORLD BANK, PHILIPPINES GROWTH WITH EQUITY: THE REMAINING AGENDA 92 (May 3, 2000) (a World Bank Social and Structural Review).

[77] BACON & JONES, *supra* note 43, at 14.

[78] *Financial Crises and the Challenge of "Moral Hazard,"* chap. 3, at 19 (1999), *available at* www.rand.org/publications/MR/MR1571/MR1571.ch3.pdf.

structures are skewed, and countervailing penalties are absent. In short, they arise when decisionmakers easily shift responsibility for their actions to another entity.[79]

This article has hinted at the following strands of the web:

1. government operates utilities inefficiently, and there is a lack of accountability;

2. the incumbent administration too easily leaves critical problems for the next; and

3. IPPs enjoying lopsided take-or-pay provisions and dollar-denominated payments are immunized to most of risks, which are borne by the government, and ultimately by taxpayers

Moral hazard analysis is an appropriate framework for gauging public utility regulation because governance is, after all, founded on a social contract. Aside from distributing resources, it ultimately distributes economic risk among various stakeholders. The problem is very real given wide information asymmetries in the power sector. Regulation is shrouded in technicalities and complex law, engineering and economic issues. A successful regulation scheme must thus be able to effect informational opacity for government, public utilities, and the people.

1. Moral hazard on the part of public utilities

Again, the power regulation framework must be reformed so that public utilities are no longer cloaked in immunity from the consequences of inefficient administration and imprudent investment. In the case of state-owned NAPOCOR, its extreme inefficiency is unsurprising, given that it was never held to account for this. The government continues to bail it out today, absorbing all manner of costs and losses. The pernicious moral hazard is clear, since billions of pesos siphoned into this seeming fiscal black hole must be redirected from somewhere else, particularly already scarce allocations for social services.

Moving to another segment of the problem, NAPOCOR was in turn made to shoulder virtually all the risks in the IPP contracts, with the exception of construction costs and some risks associated with operational efficiency.[80] "Indeed, it is fruitless for the government to have a policy of private sector participation and subsequently provide broad guarantees for market risks."[81] Participation by the private sector must successfully bring market forces into play and free the government from the financial burdens of maintaining the sector, and these will only be realized if the private investors both participate in gains and assume risks and losses.

---

[79] *Id.* at 2.

[80] WORLD BANK, *supra* note 76.

[81] Cecille Yap, *World Bank Presses Gov't on Provision of Guarantees*, BUS. WORLD (Philippines), June 23-24, 2000, at 6.

Thus, government's role in providing stability in the business environment should not be misconstrued to mean making the business environment completely risk-free. When government assumes all the risks including those that investors are supposed to assume, this would provide a misalignment of interests, which would breed the moral hazard problem on the part of IPP contractors, and results in inefficiencies.

2. Moral hazard on the part of government

> But what is a government itself but the greatest of all reflections on human nature. . . In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed, and in the next place oblige it to govern itself.[82]

With respect to government, specifically, one must critically focus on the interplay of moral hazards and the broader problem of corruption. A lack of accountability easily reinforces a type of kleptocratic[83] governance where corruption thrives. The historical analysis shows that electricity has been intertwined with corruption and politics, from the controversial BNPP contract to sweetheart deals entered into with IPPs under the cloak of a power crisis.

Moral hazard issues again return to the fundamental issue of accountability, or rather the lack of it in the energy sector. Administrations easily avoid these issues or effect mere palliatives, since the need for painful reforms can always be conveniently swept under the rug for the next president to find, effectively "passed-through" to him. Commitment to the people is artificially tied to the sitting president's term of office, which provides an incentive to focus on short-term but more popular, or at least less unpopular, measures.

It is not that politicians are clueless as to their actions. In their defense, running a government is different from running a business because one must address far more than the bottom-line and operational efficiency. There are many other factors, particularly social and political pressures.[84] Therefore, it is far more difficult to act decisively based purely on market signals. Governments are

---

[82] ALEXANDER HAMILTON OR JAMES MADISON, *The Federalist No. 51 ("The Structure of Government Must Furnish the Proper Checks and Balances Between the Different Departments")*, *in* 38 GREAT BOOKS OF THE WESTERN WORLD 163 (Encyclopedia Britannica, Inc., Maynard Hutchins ed. 1982).

[83] ROBERT HARRIS, POLITICAL CORRUPTION IN AND BEYOND THE NATION STATE 31 (2003) "A kleptocracy is defined here as a state viewed by its rulers solely as a maximizing unit and run as a business designed to extract the highest possible rents from its subjects, unconstrained by any consideration, other than their own power." The moral hazard phenomenon which poses a dichotomy in terms of benefits and accountability makes this possible.

[84] Camacho, *supra* note 8. President Guido Delgado of NAPOCOR said, "It's difficult running a government corporation, because it's so unlike a private company. When I worked in the private sector, my only concern was return on equity, and the rest of investors could do what they wanted to do. But in government.... Boy, you don't have to worry about returns, you have to worry about the politics. I have 254 congressmen, each of whom have different required returns, in different forms and shapes. You're bound to step on other people's toes." DYCK, *supra* note 9, at 9.

especially sensitive to popular pressure and a sense of political self-preservation, factors which cloud even the best judgments.

Addressing moral hazard issues in utility regulations requires apolitical, technocratic decisions. However, this is easier said than done, since the delivery of basic services is inherently a delivery of a political commodity. This leads to the great challenge of divorcing energy issues from politics.

B. DEPOLITICIZING POWER PLAY: THE NEED FOR INSULATION

There is no denying that the present regulatory landscape is highly politicized, an incident of past and continuing government intervention. Instead of attracting new capital, certain government decisions on power contracts have driven away prospective investors, and made existing investors think twice. Excessive politics works against reforms because it disrupts market certainty. Given that power generation is capital intensive, investors demand a certain level of stability in the country's legal and regulatory framework. "Capital is a coward. It only goes where it is safe, where it is welcome and where it is profitable."[85]

Stability is not attained simply through press releases,[86] and government must decisively eliminate barriers that hamstring new investment by both foreign and domestic businesses. The government regularly pays lip service to the need to attract investments, yet its recent flip-flops specifically in related public utilities have undermined investor confidence. Specifically, the government recently took over a water concession it privatized six years ago. Last year, President Arroyo declared the nullity of five government contracts after a German firm invested USD650 million for an airline terminal.[87] This executive decision was affirmed by the Supreme Court, which paved the way for a government confiscation and takeover.[88] These actions all had powerful repercussions on the government's reputation and perceived sincerity.

To demonstrate the specific influence of political considerations on energy policing, at the height of the PPA controversy, the groundswell of protests from consumers prompted government to intervene and execute the populist yet myopic response of imposing a 40-centavo/kWh price cap. NAPOCOR, however, had to absorb a PHP113 billion net loss to accommodate this.[89] The administration's policy of capping rates and borrowing money to cover the difference has further

[85] Marvin Sy, *US: Corruption hurting RP*, PHIL. STAR, March 29, 2004, ¶14, *reprinted at* http://www.newsflash.org/2004/02/hl/hl100153.htm (quoting United States Embassy Charge d'Affaires Joseph Mussomeli).

[86] *Id.* ¶18

[87] Adm. Order No. 75 (2003).

[88] Agan v. Philippine International Air Terminals Co., Inc., G.R. No. 155001, May 5, 2003, 402 SCRA 612 (2003)

[89] Abigail Ho, *Energy chief warns of power rate hikes after polls*, PHIL. DAILY INQUIRER, April 2, 2004, *available at* http://www.inq7.net/nat/2004/apr/02/nat_8-1.htm.

bloated NAPOCOR's debt. In the end, this only postpones the burdens, and only results in higher rates for consumers in the future.[90] The present administration has so far demonstrated its unwillingness to make unpopular choices.

Palliatives such as setting price ceilings are an immediate accomplishment that is easy to explain and scores good publicity.[91] But it surely "will not create and sustain good infrastructure in the long run."[92]

There is a need to make a serious commitment to power sector reforms without inhibiting potential future foreign and private-sector investments in the country's power industry. This is because the private sector will undoubtedly play a major role in the future not only in the energy sector but also for the entire industry as a whole. In the case of electricity, specifically, government must bear in mind that the oversupply that it is presently enjoying will not last long. It is estimated that overcapacity will end by 2008 in Luzon, by 2006 in Mindanao and by *this year* in Visayas.[93] Thus, the government must do away with actions that unduly jeopardize the fragile working relationship between it and the private sector.

Thus, a long-term view is called for. Again, regulation cannot be disentangled from politics overnight, and excising uncertainty from the market structure will be a long process.

C. REWIRING PRIORITIES

Government must sort through all the wires of confusion and competing interests. They must look beyond the politics of the moment and critically assess long-term measures for the country's sake.

As the government changes polarity from monopoly to competition, it must brace itself for the rough and bumpy terrain ahead. The ride will be far from painless, for the road to privatization is not paved smoothly. Restructuring the electricity sector involves both benefits and costs.[94] While introducing competitive but potentially unpopular reforms, it must be able to muster enough political will to face opposition and swallow the bitter pill of reform. There will certainly be painful transitory costs, but the government must accept the magnitude of these and resist the temptation to return to heavy-handed regulation despite initial setbacks.

---

[90] Ricky Carandang, *When darkness falls*, NEWSBREAK (Philippines), *available at* http://www.inq7.net/nwsbrk/2003/jul/07 /nbk_6-1.htm (last visited August 30, 2004).

[91] *Electricity Markets: Lessons Learned from California, Hearing before the Subcommittee on Energy and Air Quality of the Committee of Energy and Commerce House of Representatives*, 107th Cong. (113) (statement of Adrian Moore), Honey Madrilejos-Reyes, *Lopez chief slams govt tack*, August 16, 2003, MANILA TIMES, *available at* http://www.manilatimes.net/national/2003/aug/16/business/20030816bus1.html.

[92] Madrilejos-Reyes, *supra* note 91, ¶11 (quoting industrialist and Lopez clan patriarch Oscar Lopez).

[93] Federico Pascual, *Postscript: PPA cut evades key issue, may trigger bigger crisis*, PHIL. STAR, April 3, 2003, *at* http://www.manilamail.com/archive/apr2003/03apr03.htm.

[94] PAUL JOSKOW, THE DIFFICULT TRANSITION TO COMPETITIVE ELECTRICITY MARKETS IN THE U.S. 1 (2003).

Nothing less will enable the sector to make the desired paradigm shift, from a culture of corruption to one of accountability.

Though the road to reform is paved with good intentions, one may yet detour to Hell if one is not conscious of long-term sustainability. Successful implementation must not only attract but sustain investment. Failure to attract this critical capital will plunge the country into another set of Dark Ages, pardon the pun. Another power crisis coupled with a ballooning debt crisis[95] could lead to the country's economic meltdown.

D. DEVELOPING DEEP ANTITRUST LAWS AND JURISPRUDENCE

Effective competition benefits consumers with low prices, high quality products and a wide selection of goods and services. Given this, antitrust analysis is important as a credible check to the power industry's natural tendency to move towards oligopolistic abuses of market dominance.

The Philippines however has a fairly immature and underdeveloped anti-trust legal regime.[96] It is argued that EPIRA's antitrust provisions are insufficient if left uncomplemented by a judicial culture that appreciates the complex nuances of promoting competition.

One potential flashpoint is the cross-ownership provisions with associated firms, allowed under EPIRA.[97] This maybe justified if such structures would address market inefficiencies. Unchecked, however, these could serve as potential vehicles for self-dealing and coordinated actions, which smack more of monopoly than competition.

---

[95] CIA, *supra* note 6, *available at* http://www.odci.gov/cia/publications/factbook/fields/2079.html USD60.3 billion. In Philippine peso, the country's national debt as of January 2004 has reached Php3.41 trillion.

[96] CONST. art. XII, § 19. The Philippine Congress has yet to enact an antitrust law similar to that of the United States. The Philippine Antitrust law could be loosely found in the Constitution, which prohibits monopolies "*when the public interest so requires*," and a restraint of trade prohibition, REV. PEN. CODE, art. 186. Philippine antitrust jurisprudence has yet to fully mature.

[97] Rep. Act No. 9136, § 45.

"To promote true market competition and prevent harmful monopoly and market power abuse, the ERC shall enforce the following safeguards:

. . .

"(b) For the purpose of preventing abuse between associated firms engaged in generation and distribution, no distribution utility shall be allowed to source bilateral power supply contracts more than fifty (50%) of its total demand from an associated firm engaged in generation but such limitation, however shall not prejudice contracts entered into prior to the effectivity of this Act. An associated firm with respect to another entity refers to any person which, alone or together with any other person, directly or indirectly, through one of the intermediaries, controls, or is controlled by, or is under common control, with, such entity . . ."

E. RETHINKING PRIVATIZATION AND LIBERALIZATION

Privatization could stamp out corruption by "forcing the rigors of the market into economic transactions previously subject to distortion as a result of monopoly state activity."[98] It may encourage a brand of economic Darwinism, a natural selection through the survival of the most efficient.[99] But one must be careful not to imbue privatization with any talismanic significance, and it is simply not a panacea for any and all past mistakes.[100] Such blind faith may only cause problems to be overlooked later on.[101] Privatization, for example, will not eliminate corrupt politicians, but will only force these to consolidate their rent-seeking channels, while at the same time aggressively move to exploit opportunities presented by liberalization.[102]

The road to privatization will actually offer new avenues for corruption, for the same kind of plunder now associated with state-sponsored monopolies.[103] In the absence of effective regulatory structures, non-accountable corporations may "simply replicate the functions and ethos of government,"[104] and merely shift corrupt practices into a new venue.

Thus, depoliticization is not achieved through privatization alone, but the government must have the vision to craft an entire framework to support it. This must define the scope and nature of permissible government intervention.[105] While many assume that the words privatization and deregulation are intimately linked to *laissez faire*, they must be executed in the context of appropriate market and regulatory legal frameworks – privatization *cannot* exist in a regulatory void.[106]

More legislation is needed, for in the end, "the antidotes for corruption do not inherently rise from privatization,"[107] but privatization itself must bring about a hospitable milieu where "market forces would reduce the need for government intervention, and where business could be conducted transparently."[108]

Finally, it is easy to extol the virtues of the competitive market enterprise yet lose sight of the ultimate social good sought. Competition must be harnessed to

---

[98] *Id.*

[99] Harris, *supra* note 83, at 33

[100] FRED BOSSELMAN ET AL., ENERGY ECONOMICS AND THE ENVIRONMENT CASES AND MATERIALS 724, 731 (2000).

[101] JANICE BEECHER, PRIVATIZATION, MONOPOLY, AND STRUCTURED COMPETITION IN THE WATER INDUSTRY: IS THERE A ROLE FOR REGULATION 19, *available at* www.ucowr.siu.edu/updates/pdf/V117_A3.pdf.

[102] Harris, *supra* note 83, at 49.

[103] *Id.* at 47

[104] *Id.* at 51.

[105] Ashley Brown, *Confusing Means and Ends: Framework of Restructuring, Not Privatization, Matters Most*, 1 INT. J. OF REGULATION AND GOVERNANCE 115, 126.

[106] BROWN, *supra* note 104 at 116.

[107] *Id.* at 127.

[108] *Id.*

promote efficiency that ultimately benefits consumers. Thus, while competition is driven by the profit motive, government regulation must ensure that society reaps its own share of these.

IV. RECOMMENDATIONS

In addressing the problems in the electricity sector, this author reiterates the following recommendations.

First, to address the problem of moral hazards, government must align consumer interests with those of producers as closely as possible. This may be done, for example, by shifting from the traditional rate of return to a performance-based computation of profits. This encourages efficiency by providing a direct incentive to improve performance. Moreover, this equitably spreads the risks and returns between consumers and producers alike.[109]

Second, if there is one painful lesson that the government must take to heart from past debacles, it must learn how to prudently employ borrowing and sovereign guarantees. The indiscriminate and wanton use of these in the past significantly increased the government's risk exposure and threatened the economy's overall fiscal stability, as shown by the expensive and onerous IPP contracts. The government must develop transparent and suitably restrictive guidelines on their use,[110] and strive to forge a business environment that greatly minimizes the need for such distortions. Such an environment must have clear rules, exhibit stability, and be independently administered.[111]

Third, government must avoid using price-caps as a shortsighted, politically motivated stopgap. These only introduce market distortions by degrading investors' ability to recover costs, which could lead to the disastrous path of the California Power Crisis.

V. CONCLUSION

Since the 1970s, Philippine utilities have been mismanaged and inefficiently operated, as evidenced by the country's stratospheric power rates. These problems are only exacerbated by an inadequate legal and regulatory structure. For the most part, not only has government failed to adequately address the electricity sector's problems, its active participation has been a large part of the problem. Its past

---

[109] BEATRIZ ARIZU ET AL., WORLD BANK ENERGY AND MINING SECTOR BOARD DISCUSSION PAPER NO. 10, PASS THROUGH OF POWER PURCHASE COSTS, REGULATORY CHALLENGES AND INTERNATIONAL PRACTICES 35 (February 2004).

[110] Gilberto Llanto, *Managing Government Guarantees and Contingent Liabilities*, PIDS POLICY NOTES (2000)

[111] WORLD BANK, *supra* note 76, at 93.

profligacy is now borne by present consumers in the form of "stranded costs" and other accounting euphemisms.

Regulation involves issues such as corruption and moral hazards. In order to address these twin problems, the government must provide a stable environment. Depoliticization is the key to reform, and government must untangle the web of influence it has spun around the sector. This would pave the way for a transparent and competitive marketplace, greater private sector participation, and less government intervention.

However, one must likewise beware of putting full faith in market dynamics. If accountability cannot be fostered through a holistic regulatory framework, the same problems will easily rear their ugly heads in different places after privatization efforts. Put in another way, the private sector is just as vulnerable to moral hazards as the government is. A complementary restructuring, particularly strengthened antitrust legislation, is called for.

Thus, even under privatization, the government must ensure that effective firewalls are instituted to insulate new actors from moral hazards. Regulations must calibrate incentives and penalties to spread risks equitably among stakeholders, as well as rewards.

Finally, one key point must be underscored: the litmus test of true governance lies in readiness to undertake unpopular and apolitical choices. Only by mustering this kind of steely resolve will genuine reforms be generated in the electric sector.

- o0o -