COMPETITION IN POWER GENERATION AND SUPPLY: WHAT HAPPENS WHEN ECONOMIC CHOICES CLASH WITH POLITICAL CONTROL?*

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Competition is about creating and making economic choices. For competition to flourish, the political framework and legal structure would have to be supportive of securing property rights and rewards for risk-taking. In contrast, political control often entails the ascendancy of government over economic activities, whereby the dominance of the state could distort the basis of rewards within the economic system.

Politicians often see competition as the panacea for reducing power prices. Hence, when power prices remain high, the exercise of political control could lead to alternating between deregulation and price subsidies for the sole pursuit of cutting prices to calm popular protests. This ignores more than four decades of bitter lessons, perhaps never fully learned, that protective regulation encourages rent accumulation by monopolists to the detriment of the economy.

Rent accumulation through political patronage has a debilitating effect on economic freedom given that it reduces choices. The incentives to invest, and to sustain viable enterprises are greatly eroded. The consequences to the power sector are well known, with "crippling power shortages … in 1992 and 1993 – the very existence of which attests to the extraordinary neglect of the country's infrastructure in the previous

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decade."[1] Extending this to the Philippine economy, the rent-seeking activities of a few and sustained under a protective governing elite may have successfully transformed the Philippines from among Asia's best in the 1960s into Asia's spectacular bust at the dawn of the twenty-first century.

The fixation on short-term power price cuts misses the whole point of embarking deregulation of power generation and supply. Competition is about creating economic choices, and choices are relevant if the people can truly exercise them. This is perhaps only feasible if the people have access to resources and the security of property rights are guaranteed by a sound legal system.

For this reason, I am inclined to examine the impact of power market liberalization on two pivotal conditions of economic freedom. Specifically:

(1) Creation of economic choices and the ability of the economic agents to participate, shape and exercise these choices; and

(2) Soundness of legal structure and the security of property rights that enable equitable allocation of risks and returns amongst the economic stakeholders.

The power sector represents a microcosm of Philippine society, whereby its financial weakness and inefficiency impact on the competitiveness of the economy. With high power prices and practically bankrupt companies, arguably a result of regulatory ineffectiveness and judicial ambiguity, economic freedom could be greatly curtailed by the dwindling economic space in which the Philippines can continue to play a meaningful role.

Thus, when political control frustrates the creation and the exercise of economic choices, competition is unlikely to deliver the benefits that economic freedom has enabled more developed economies to prosper.

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[1] PAUL HUTCHCROFT, BOOTY CAPITALISM (1998).

I. WHY ECONOMIC FREEDOM AND CHOICES?

Classical economists like Adam Smith envisioned a world founded on trade and comparative advantages to create economic choices aimed at achieving mutual prosperity. The invisible hand of the market would direct resources where returns are commensurate to the risks. Over time, as returns in developed economies decline, partly because of rising costs, lower risks, and abundance of capital, resources should move to the developing economies as a self-adjusting mechanism. That is as far as the theory goes … and yet, the growing gap between rich and poor economies over the past two decades appear to contradict this.

Political institutions, however, may unknowingly conspire to frustrate the mobility and deployment of resources. Milton Friedman,[2] 1976 Nobel Prize winner for economics, eloquently articulated the "historical evidence that speaks with a single voice on the relation between political freedom and a free market." He further asserted that he "[knew] of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity."[3]

In a study on the economic freedom of the world,[4] a group of renowned academics examined the objective data comprising 38 indicators on 99 countries from 1980-2000. A number of their findings support Friedman's contention. To highlight:

(1) Long-term difference in institutional quality, as indicated by institutions and policies consistent with economic freedom, account for more than 75% of inter-country variations in per capita income.

(2) Various measures of investment flows and levels are positively influenced by variations in each country's economic freedom index measure. A unit increase in economic freedom measure translated into 1.25% point rise in long-term growth.

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[2] MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962).

[3] *Id.*

[4] James Gwartney & Robert Lawson, *What Have We Learned from the Measurement of Economic Freedom* (Oct. 22-24, 2003). This paper was presented at the conference "The Legacy of Milton and Rose Friedman's *Free to Choose*: Economic Liberalism at the turn of the Twenty-First Century," held in Dallas, Texas.

(3) Contrary to classical economic theory on economic convergence, poor countries with low ratings on economic freedom performed worse than those with high ratings on economic freedom. As a result, the income growth from 1980-2000 was farther skewed in favor of the higher income economies.

(4) Soundness and predictability of legal protection of property rights is seen as essential for prosperity.

Gwartney and Lawson[5] contend that without the "legal protection of private property, the incentive of individuals to develop productive resources and engage in entrepreneurial activities is eroded. Correspondingly, without the enforcement of contracts, trade and the accompanying realization of gains from division of labour and specialization are stifled."

At the micro-economic level, a similar pre-condition to economic freedom applies to the financing of power projects. Over the past ten years, Standard and Poor's assessment of the causes of project finance debt downgrades and eventually defaults pointed to similar factors that make countries lag economically.[6] Specifically:

(1) Sovereign-related risks account for 36.8% of defaults with a preponderance of projects located in emerging economies.

(2) Legal or structural deficiencies that legally cannot protect projects from rating downgrades of sponsors, among others, account for 31.6% of defaults.

(3) Counter-party risks, in a number of instances, are *de facto* sovereign exposures through state owned companies. This account s for another 10.5% of defaults.

Perhaps, these consistent findings are not surprising. Investors in "rated project finance debts will likely continue to separate better projects from the weaker ones"[7] with the consequence that countries with sound

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[5] *Id.*

[6] PETER RIGBY, WHEN PROJECTS FAIL: 10 YEARS OF RATED PROJECT FINANCE DEBT AT STANDARD & POOR'S (Jul. 2004).

[7] *Id.*

legal frameworks will continue to attract capital at the expense of higher risks countries.

II. IMPERATIVES FOR PRIVATIZATION AND RESTRUCTURING

Experiences in Europe are encouraging precedents to reaping the significant benefits that power privatization and restructuring have delivered. These benefits include, among others, greater competitiveness arising from higher operating efficiency, lower costs through more effective capital spending, and environmental benefits from substituting gas for coal.

The emergence of gas resulted from the elimination of coal subsidies, which were prevalent in the state-owned power industry. Such subsidies were in reality a transfer of income from power to the coal industry to maintain coal-mining jobs, with the consequent distortions in capital allocation. "The removal of such subsidies in the power-generating industry had the effect of increasing the cost of capital and therefore encouraged the use of low cost efficient technologies such as CCGTs for burning natural gas."[8]

The World Bank[9] undertook costs and benefits analysis on the United Kingdom power privatization and restructuring. The bank concluded that the experiment yielded a net present value of £11.9 billion (USD21.4 billion)[10] in net benefits. This includes a £2.6 billion (USD4.7 billion) net loss to *Electricite de France* because of higher purchase costs of imported electricity. The permanent savings translated into an extra 40% return on assets.

Applied to Philippine power sector, the imperative for restructuring and privatization is a matter of necessity for its economic revival. In this context, a sound and successful programme could potentially deliver a similar outcome with the added benefits of increasing the likelihood that foreign debt could be reduced to a more manageable level. With a pay down of foreign debt with the expected proceeds, variously estimated at around

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[8] OWEN MCQUADE, THE FUTURE ENERGY UTILITY COMPANY: CONVERGENCE OF NATURAL GAS AND ELECTRICITY SUPPLY CHAINS (1996).

[9] David Newberry & Michael Politt, *The Restructuring and Privatization of the U.K. Electricity Supply – Was It Worth It?* WORLD BANK PUBLIC POLICY FOR THE PRIVATE SECTOR NOTE NO. 124 (Sep. 1997).

[10] Converted at current exchange rate of USD1.80 to a £1.00.

USD4.0 to USD5.0 billion, net present value of interest savings alone could be as high as USD5 billion.

The repeated prospects of sovereign credit rating downgrades could starve the industry of capital to sustain its long-term viability. As under-investment accelerates asset and infrastructure degradation, the Philippines could be in for a dual hit: power prices are raised higher to fund a faltering industry with supply reliability continuing to deteriorate.

Compounded with a USD9 billion debt burden, accounting for about 15% of foreign borrowings, National Power Corporation (or Napocor, the state-owned power company) is hardly in any position to create economic choices in the power market under the status quo. By absorbing Napocor's debt, the government is indeed passing on the obligation to repay by raising taxes to the very consumers that are already burdened by high power prices.[11]

Notwithstanding the good intentions of the government, the relief from debt absorption will be temporary for Napocor.[12] Perhaps, it is naïve of the government to "hope that by absorbing the debts of Napocor, the firm's power generation and transmission assets will attract favourable bids,"[13] also in thinking that "handing over the power generation business to the private sector will also help prevent a power crisis, which has been projected to start in Mindanao ... by next year."[14]

III. REVERSING A CYCLE OF FAILURES: CREATING ECONOMIC CHOICES

In an earlier article, I highlighted that the "three structural ills of the energy industry – cost-plus regulatory regime, financially weak energy firms, and energy policy driven by populist agenda – feed on each other.

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[11] *Gov't to absorb Napocor debts by '05 – energy chief*, PHIL. DAILY INQUIRER, Sep.22, 2004.

[12] Rep. Act No. 9136, § 32 (2001) stipulates that a maximum amount of PHP200 billion (USD3.6 billion) of the debt of National Power Company that the government could assume as part of the national government borrowings.

[13] *Gov't to absorb Napocor debts*, *supra* note 11.

[14] *Id.*

Consequently, the energy industry is locked into a vicious cycle that saps its commercial vigour."[15]

For confidence to be restored, the conduct of energy policies and regulation should be de-politicised. In my view, this has a better chance of success by pursuing a three-point agenda for action – revamp regulatory structure, support market mechanism to flourish and encourage private ownership.[16]

The three-point agenda for turning the cycle of failures in power, and more broadly in the conduct of energy policies, into a virtuous circle of heightened profitability and enhanced consumer services relies on three interrelated action points. Start by revamping the regulatory framework—from cost-plus to incentive-based tariff mechanisms. This measure is a prerequisite to creating a competitive market that can thrive. For this effort to be sustained, privatization is contemplated as a means of recapitalizing the power companies to strengthen their parlous finances. Financially viable companies provide better prospects of ensuring that supply security is achieved through the continued investments in infrastructure. As an added benefit, power firms that rely on their competitive strengths to thrive, rather than on political patronage, are seen to be less susceptible to political expediencies in driving their business agenda.

I anticipate a successful implementation of the three-point agenda of transforming the power industry to yield the following benefits:

(1) Greater efficiency reduces costs of service delivery. With power firms encouraged to operate efficiently under a transparent regulatory framework, there is greater impetus to reduce the total costs of delivering its services. Part of this benefit will redound to lowering the prices that consumers pay for their power supply, balanced by improving returns to the power firms.

(2) Lower capital outlay for achieving supply security. The present equipment and installation costs for a standard combined cycle gas turbine have fallen from USD1 million to less than USD500,000 for every megawatt

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[15] Ricardo Barcelona, *Power Short Circuit: Biting the power bullet*, 23 UA&P SCHOOL OF ECON. STAFF MEMOS 1 (2002).

[16] *Id.*

installed over the past decade. Higher-risk countries, where extra judicial costs are incurred as a matter of routine, are faced with significantly higher bills, given their more expensive financing costs and opaque business practices. According to some estimates, transparency and political credibility can shave more than 30% off project costs.

(3) Fresh capital infusions and entry of new investors can rejuvenate the industry's fortunes. Taking the cue from the successful telecommunications market liberalization, power generation and to a great extent, transmission and distribution, can see their fortunes revive with an injection of entrepreneurial flair and flourish.

Given this prospect, lower power prices achieved through efficiency gains are definitely more sustainable than repeated bouts of subsidies. The question is, how are the regulatory regime and the legal framework rising to the challenges of this radical transformation envisioned for the Philippine power industry?

IV. PILLARS OF REGULATORY PRACTICES AND JURISPRUDENCE

In the majority decision of the Supreme Court in *Energy Regulatory Board v. Manila Electric Co.*,[17] Justice Reynato Puno articulated a legal position that underlines the existing jurisprudence on public utilities, to quote: "The business and operations of a public utility are imbued with public interest … is engaged in public service providing basic services indispensable to the interest of the general public … For this reason, a public utility submits to the regulation of government authorities and surrenders certain business prerogatives, including the amount of rates that may be charged by it." As to the role of the state, Puno[18] recognizes that the state has a duty to "interpose its protective power whenever too much profits become the priority of public utilities."[19]

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[17] G.R. No. 141314, April 9, 2003.

[18] *Id.*

[19] The Supreme Court ruled against the Manila Electric Co. for overcharging consumers by including income taxes as part of its operating expenses.

Existing legislation, particularly the Electric Power Industry Reform Act (popularly known as EPIRA),[20] appears to perpetuate the following pillars to energy regulatory principles and control:

(1) Mega-control and micro-management by government, providing the executive branch discretion to intervene in the public interests across the full spectrum of the energy industry.

(2) Economic choices created by competition in power generation and supply could be curbed as the government extends its duty to interpose its protective power beyond the regulated public utilities.

The EPIRA and the work on creating the competitive power market framework are steps in the right direction. I see this as part of an ongoing process that is likely to require a number of revisions to existing laws and implementing rules.

Philippine progress towards power privatization and deregulation can be characterised as a step forward, followed by two steps backward. Specifically:

(1) Structural changes to the National Power Corporation that split its businesses into power generation (with the Independent Power contracts), transmission's conversion into a corporate entity TRANSCO, and the creation of the market and systems operator;

(2) Privatization of the TRANSCO and the power generation assets continue to be plagued by regulatory concerns, credit risks of distribution companies as counter-parties, and the delays in resolving tariff issues involving Napocor's generation charges; and

(3) Repeated failures to attract credible investors, partly because of the approach taken to privatization. [21]

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[20] Rep. Act No. 9136 (2001).

[21] Myrna Velasco, *3 major concerns stalling privatization of NPC gencos*, THE MANILA BULLETIN, Sep. 14, 2003.

The experiences in failed attempts at privatization, and the slow pace of deregulation may highlight some lessons to be learned. When regulatory practices and institutional boundaries among the executive, legislative, and judiciary remain blurred in practice, with the inability of the jurisprudence to adapt to the requirements of a competitive power market, the experiment with deregulation is likely to be fraught with difficulties.

V. MEGA-CONTROL AND MICRO-MANAGEMENT

Power generation and supply are not classified as public utilities, and as such, are exempt from the constitutional restrictions on foreign ownership and the licensing through a national franchise.

EPIRA recognizes the power generation sector[22] and the supply sector[23] as a competitive business but "affected with public interest." As a principle, market forces are relied upon to set the price levels for consumers, with the regulator promoting a legal framework that can support a rapid evolution of a competitive market.

In practice, the transition to a competitive power generation and supply market is impeded by an apparent desire of the government to retain control over pricing and to exert its influence on the power industry. Examine for instance the following:

- The president ordered cuts in purchased power adjustments (PPAs) in 2003, with the "independent" regulator readily complying. The relief to consumers was short-lived as power prices for generation was increased sharply in 2004 to cover the significantly higher losses of Napocor.

- Under EPIRA, the Department of Energy, Power Commission at Congress, and the Executive continue to formally exert its political influences on what is set out as the independent regulator.[24]

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[22] Rep. Act No. 9136, § 6.

[23] § 29.

[24] Rep. Act No. 9136 Implementing Rules and Regulations (hereinafter "Rep. Act No. 9136 IRR"), Rule 3 defines the roles of the Department of Energy (DOE) and

- Energy Regulatory Commission still has to demonstrate instances where its independent status can withstand political pressures. Its roles as tariff setter, adjudicator of disputes, promoter of competition and policing anti-trust behaviour appear to entrust tremendous powers to an entity that inadvertently perpetuates the politicized approach to energy regulation.[25]

- The Board of Directors of the various legal entities created under EPIRA, and the manner they are constituted and operated, only leads to one conclusion. The government, by legislating how the legal entities are staffed and operated, instead of leaving such stipulations under the corporation's articles of association, potentially removes a large degree of flexibility that the management may otherwise enjoy.

The concept of "businesses affected with public interests" could be interpreted broadly as extending the obligations of public utility regulation to power generation and supply[26] without the benefits of protected returns. Before long and not surprisingly, competition becomes a burden given that any upside achieved from superior competitive positioning are arbitrarily eroded by regulatory actions, while extra burdens to meet "public interests" measures, in practice, can hardly be recovered. The PPA cuts in 2003 is a case in point – Napocor is still reeling from that presidential decision, with losses mounting in excess of PHP113 billion (USD2.0 billion) with debt spiralling to more than PHP500 billion (USD9.0 billion).

The seeds for such a misalignment between operating under a competitive structure and the government's penchant for exerting its political control may have already been planted in the Supreme Court ruling on Meralco. In the opinion penned by Justice Puno, he ruled that: "Rate regulators should strain to strike a balance between the clashing interests of the public utility and the consuming public and the balance must assure a reasonable rate of return of public utilities without being unreasonable to the

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Energy Regulatory Commission (ERC), while Rep. Act No. 9136, chap. 2 describes the areas where government continues to exert its influence in the organisation and operation of the power industry.

[25] For an extensive assessment of this issue, *see* Barcelona, *supra* note 15.

[26] Rep. Act No. 9136 IRR, Rule 2 (f) is among a number of examples where public interests obligations, in a public utility sense, may be extended to power generation and supply, activities that are recognised by the EPIRA as competitive and open.

consuming public."[27] Up to this point, it is hard to disagree with Justice Puno. However, his qualification of what is reasonable may suggest that the deep-seated *ad hoc* approach to energy policy has crept into jurisprudence as well. To quote: "What is reasonable or unreasonable depends on a calculus of changing circumstances that ebb and flow with time. Yesterday cannot govern today, no more than today can govern tomorrow."[28] For investors seeking predictability on the legal framework, such flexible legal doctrine on reasonableness of rate setting does not provide much comfort.

Governance is another weakness that manifests itself in a rigid specification of the board members of the various entities created under the Power Reform Act. Cabinet members appear to be given the right to sit on the boards of companies that are being prepared for privatization.

The success of European privatization, subsequently replicated by countries such as New Zealand and Chile, was rooted in providing a strong governance framework for the newly created entities. Specifically:

(a) Unlike the Philippines, companies being prepared for privatization were organized under a corporate structure that resembles a private enterprise.

(b) Chief Executives, Board members and senior management are drawn from the best-qualified pool of private sector executives.

(c) Corporate charters or articles of associations are drafted to fit the specific circumstances of the companies that will enter a future life in the private sector.

By providing a private sector framework, the entities are insulated to a large extent from direct political control of the government. Such insulation was important in allowing a smoother transition from state to private ownership.

The Philippine approach appears to solidify political control by specifying the structure and the corporate governance of the legal entities slated for privatization under the EPIRA. Therefore, instead of allowing the management greater commercial freedom, government has made sure that

[27] G.R. No. 141314, April 9, 2003.
[28] *Id.*

they conform to the strictures of government-owned and controlled corporations (GOCCs).

In my view, this is where the limits of jurisprudence and legislation are deeply felt. Passing a piece of good legislation is in itself a great challenge given the nature of Philippine politics. However, whatever gains the passage of EPIRA may have achieved, this could be readily dissipated by political expediency.

VI. COMPETITION TRANSFERS CHOICES FROM POLITICS TO ECONOMICS

The Energy Regulatory Commission (ERC) is in an enviable position of being saddled with the responsibilities of (a) consumers' champion;[29] (b) promoter of competition and builder of market institutions;[30] (c) tariff-setter and enforcer as judge and jury;[31] and (d) policing anti-competitive behaviours of power generator.[32]

The independence of the regulator may be already compromised under the compensation system[33] where Congress and the President of the Philippines to large extents determine the Commission's appointment and pay scales. The question therefore arises: While independence is well recognized as a pre-condition for success, are there incentives for the regulator to exert its independence notwithstanding its apparent security of tenure?[34]

In my view, the implications of regulatory independence on political control may still have to be explicitly recognised. In a fully functional competitive power generation and supply market, the exercise of economic choices resides in the economic agents, with the regulator and government providing a framework that makes such choices possible. In essence, a government that is not prepared to relinquish its traditional controls over

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[29] Rep. Act No. 9136, § 41.

[30] § 43.

[31] Rep. Act No. 9136 IRR, Rule 3 § 4.

[32] IRR, clauses A and I.

[33] Rep. Act No. 9136, § 39.

[34] § 38 – among the job security provided, "members of the Commission shall enjoy security of tenure and shall not be suspended or removed from office except for just cause as specified by law."

the industry may set up the experiment in deregulation to failure at the outset.

Under the EPIRA, this transfer of control points and influences may have been inadvertently concentrated in the persona of the ERC, thereby forcing a set of roles and responsibilities that puts the regulatory body into conflicts of interest with itself. Examine, for instance, the following:

(a) The ability to set rules and adjudicate appears to endow the regulator with powers that are legislative and judicial in nature.

(b) Policing power is likewise given to the same entity that sets the rules, balances the consumer and power generator's interests, and renders a judgment on the actions of the police and the respondents on anti-competitive behaviour.

Could you imagine the enormous conflicts of interest that would arise if we lump the legislators, judiciary and the police forces – not to mention creating a competitive market – under one agency?

Perhaps, this is where the politicians' desire to retain tight political control is manifested in the Power Crisis provision[35] – giving Congress the authority to establish additional power "generation capacity under such terms and conditions as it may approve." Given the real prospects of a looming power crisis, the spectre of politics interfering in the economic allocation of risks and returns could readily turn this exercise into another rent accumulation opportunity where economic choices clash with political control.

For power regulation to work, less may result in more insofar as the assignment of formal roles and powers to the regulator is concerned. Specifically, effective regulation could be achieved by segregating the following roles and responsibilities:

(1) ERC focuses on power rate-setting in transmission and distribution, and establishing the rules on competition in power generation and supply;

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[35] Rep. Act No. 9136 IRR, Rule 24.

(2) Anti-competitive behaviour and market abuse – both the investigative and enforcement functions – are the remits of the antitrust body that EPIRA did not contemplate in creating;

(3) Litigations involving contractual disputes, challenges to regulatory actions and similar cases are probably better handled by the judiciary, precisely to minimize the scope for the regulator to be judge and jury on cases concerning its competence; and

(4) Building of the institutions and mechanisms supportive of a competitive power market could be apportioned to the wholesale power market, comprising under the EPIRA the Wholesale Electricity Spot Market,[36] and the market operator.

European power deregulation benefited from such separation of power between the Energy Directorate and its equivalent for European competition. This has the advantage of focusing the specific competencies in energy policy and regulation under a competent authority, while entrusting the competition issues to an agency with broader authority that transcends the energy industry.

There is a saying that "who pays the piper calls the tune." The regulator is funded through an appropriation from the Office of the President, with subsequent funding subject to regular or special appropriations.[37] Perhaps, independence is best served and interests better aligned with consumers and the power industry if funding is derived as part of a specific levy on tariffs. The amount can be capped. By making the regulator's funding separate from any government appropriations, the political control on price setting and regulatory actions may be less subject to the influence of a government's populist agenda.

Ironically, by distancing the government from the rate-making process, the pressure on the government to pander to popular protests may be lessened.

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[36] Rep. Act No. 9136, § 30 defines its role that includes the market operator and the role of National Electrification Administration as "guarantor for purchases in the wholesale electricity spot market by any electricity cooperative or small distribution utility to support their credit standing."

[37] § 42.