

Opening Remarks by Former Philippine Energy Secretary Vincent S. Perez on "The Experience of Independent Power Projects in Developing Countries" Seminar sponsored by the Program on Energy and Sustainable Development of Stanford University, June 2-3, 2005

Renegotiations of IPP Contracts: The Philippine Experience

Section 68 of the Electric Power Industry Reform Act of 2001 mandated a review of all IPP contracts by an Inter Agency Committee consisting of three government agencies: the Department of Finance, Justice, and the National Economic Development Authority.

This provision naturally created anxiety among IPPs in the Philippines. The Arroyo Administration assured the IPP sponsors that it would be fair in the re-negotiation process. In her first major power policy speech at a Philippine Electricity Conference on December 1, 2001, President Gloria Macapagal Arroyo announced:

"The Philippines is firm in its belief in the sanctity of our legal contracts, unlike some of your unfortunate experiences I understand in other countries. Hence, the Philippines will uphold legal contracts..."

"Let me take this opportunity to deliver some words of assurance to our investors. The government is currently reviewing all IPP contracts. But I would like to deliver the message that there shall be no unilateral renegeing of any contract. Any renegotiation to be undertaken shall be mutually agreed upon."

When the results of the initial review of the IPP contracts were released in July 2002, the task of pursuing appropriate action was given to the Power Sector Asset Liabilities Management (PSALM) Corporation, a government agency created to manage the privatization of the assets and the management of the liabilities of Napocor.

In pursuit of the mandate, we at the Department of Energy and PSALM began from a position that all contracts are valid, and that the sanctity of contracts are protected under the Philippine Constitution.

The Department of Energy again assured the IPP community that there would be no unilateral action nor abrogation of contracts, and that it would pursue mutually agreed concessions.

In a public statement given on July 9, 2002, I reiterated:

"We would like to sit down with the IPPs and discuss with them that we really would like their support in helping the country reduce the cost of electricity."

"I am enlightened to hear that some of them (IPPs) have publicly stated that they are willing to cooperate and that they are here to stay for the long run and if they could help reduce the cost of electricity, they would. That is encouraging news."

"Our position is that we will always honor these contracts, to the extent that we could reduce our financial obligations we would like to explore it on a mutually agreeable basis. Once again, I will reiterate that it is not the position of the DoE to unilaterally cancel or abrogate or renege on any of these contracts. We feel that by sitting down with them and explaining to them that this is an issue that affects each one of every Filipino, I think that they will understand that it. I think it is also in their long time interests to help us find ways to reduce the cost of electricity."

I also announced that one-on-one consultation with the IPPs were necessary because the DoE and PSALM were not part of the Inter-Agency Committee headed by the Department of Finance in the review of the 35 IPP contracts entered into by Napocor,

“We also believe that one-on-one discussions with the IPPs are the most effective way to ensure the cooperation of the IPPs to achieve our goal of lowering electricity rates and easing the financial burden of Napocor.”

The formal renegotiation process started on July 19, 2002 in a meeting called by my office with all the IPP sponsors in attendance. The meeting discussed the methodology and the framework adopted by the Inter Agency Committee in reaching its initial findings. The detailed findings were discussed in subsequent bilateral meetings between PSALM and the individual IPP sponsors.

Subsequently, more than 100 negotiating sessions were held between the government panel and the IPP sponsors. Representatives from Napocor, the Department of Finance, Department of Justice, and Finance Secretary Camacho and I attended many of the sessions. PSALM, which is charged by the EPIRA to seek to reduce stranded costs, became the action panel for the government side.

There are two points worth noting in the renegotiations. First, PSALM recognized that IPP contracts have debt and equity stakeholders that must be taken in consideration. In the case of operating IPPs, most of the savings was in the form of concessions from the IPP sponsors within the letter of the relevant IPP contract. This approach precluded the need to obtain lenders' consent, which can be a long process with uncertain outcome, given the reluctance of creditors to disturb the “waterfall” of revenues that flow from the IPP contracts. For publicly listed IPPs, shareholder consent could also be an issue as the renegotiated terms require formal contract amendment. The IPP sponsors, therefore, preferred to explore opportunities for savings in ways that would not involve an amendment of their contracts.

The single largest source of savings on these operating IPP contracts is the voluntary limitation on capacity nomination on the part of the IPPs. As long as the sponsor can demonstrate its capacity to deliver power at the nominated capacity, Napocor is bound to pay fixed monthly capacity fees based on that level. Mirant, the first IPP to come to terms with PSALM after the IAC released its initial report, offered to waive its entitlement to nominate 105% of 700 MW capacity for its Pagbilao Coal plant. San Roque, also offered to use a stepped-up nomination schedule starting from 85 MW, instead of designating 115 MW immediately as its right under the agreement. The Caliraya-Botocan-Kalayaan sponsors agreed to limit its nomination for a period of 30 months, even as it allowed Napocor free use of any energy generated above the nominated capacity.

The second point worth noting with the renegotiated terms is that the largest total savings came from projects that have not reached operational status. The limitation on capacity nomination, the use of local coal and other provisions yield substantial savings on the proposed Mindanao Coal Plant. With respect to the proposed San Pascual cogeneration project, the sponsors agreed to terminate or assign its rights over the contract in exchange for a payment from PSALM, avoiding for PSALM stranded costs of over US\$1 billion in nominal terms and about US\$380 million in present value. The San Roque and the Ilijan sponsors also agreed to postpone the commercial commencement of operations, thus giving Napocor additional savings in present value.

In renegotiations that require lenders' consent, the Department of Energy and PSALM communicated with project lenders, and frequently explained the renegotiation process to project finance communities in Hong Kong, Singapore and Tokyo. Numerous dialogues were undertaken with representatives of embassies, ADB, JBIC, OPIC, and U.S. Eximbank, among others.

While there were public pressures from certain quarters to allow civil society representatives to participate in the negotiation process, or to publicize the negotiation process, the Department of Energy and PSALM resisted such pressures and all renegotiations were held in private bilateral sessions. Only upon approval by the boards of Napocor and PSALM and the settlement

agreements were executed by the IPP sponsors, were the results of the settlement and the corresponding savings in stranded costs announced publicly.

The Department of Energy rewarded IPPs who were cooperative in the renegotiation process and who settled earliest with the government panel. I would publicly visit a cooperating IPP's power plant, and publicly encourage other recalcitrant IPP sponsors to follow the lead of those IPPs who settled early. On a few occasions, I would recommend to the President not to entertain any courtesy call request by senior executives of IPPs until they have settled outstanding issues with PSALM. For instance, at the inauguration of the San Roque Multi-purpose Power project on May 29, 2003, President Arroyo revealed:

“The inauguration was supposed to have taken place...a long time ago. But [Sec.] Vince [Perez] was still renegotiating the IPP [contract] with San Roque. And so, we said, let Vince have the leverage by saying, “we’ll inaugurate it when it’s done.”

Recalcitrant IPPs were also prevented from participating in the ongoing privatization of Napocor generating assets.

A total of 20 IPP contracts were resolved in a period of 18 months, from July 2002 to December 2003. The government panel was keen to conclude the renegotiation process as quickly as possible, in order to remove the atmosphere of uncertainty within the power sector community so that new investments would resume. In addition, the government was keen to show concrete results from its renegotiation process by announcing consecutive settlements with various IPP sponsors during the 18 month period.

The government came up with an internal approval process such that any negotiated settlement would be submitted for final government approval only under a pass/fail basis. This “go”/“no go” approval prevented any “second guessing” by any government official that was not involved in the negotiations, from raising issues on specific provisions of any settlement. Instead, the entire negotiated settlement was evaluated as a whole, and not on a provision by provision basis. Thus, the government approval process was expedited, and PSALM was therefore able to conclude 20 renegotiations in 18 months. Only one proposed settlement was disapproved, which was subsequently re-negotiated and eventually approved after December 2003.

As a matter of negotiation policy, our government panel did not rush to international arbitration unless the IPP sponsor brought a case to arbitration first. It was considered a lengthy process, expensive from a legal cost point of view, with no guarantee on the outcome of the arbitration. However, in the two instances where our government panel was taken to arbitration by Mid-American Energy, the government assigned a seasoned arbitration panel which took a very aggressive stance in the arbitration tribunals. Eventually, both arbitration proceedings were suspended and satisfactory settlements were negotiated instead by both parties.

The negotiation process were concluded with expected savings of up to US\$ 2,949 million in nominal terms, or US\$1,036 million in discounted present value. These translate into an equivalent of three years' worth of fixed payments to IPPs that the government was able to save.

The parties in the renegotiation process have reason to feel gratified by the outcome.

For the IPP sponsors, it serves to put closure to unresolved issues with the government and to public criticisms that had placed a cloud of doubt over the legality and enforceability of their contracts. For Napocor, it provided tangible savings that can be passed on to end-consumers or retained for its benefit to reduce future funding needs. For the Arroyo Administration, it manifested the government's adherence to the rule of law and the primacy of valid contracts.