

**ASIAN DEVELOPMENT BANK**

**PHILIPPINES**

**COUNTRY PROGRAM UPDATE FOR 2002**

**July 2002**

## I. BACKGROUND

1. The 2002-2004 Country Strategy and Program Update (CSPU) for Philippines was considered by the Board on 18 September 2001. Subsequently, the Government requested ADB to provide support for urgent activities to sustain the progress achieved under the ADB supported Power Sector Restructuring Program (PSRP).<sup>1</sup> In response, ADB proposes to include two new operations in its 2002 program: an investment loan for \$40 million and a partial credit guarantee of up to about \$400 million (in net present value terms).

## II. NEW SUPPORT FOR THE POWER SECTOR

2. ADB has had long involvement in supporting investment, policy development, and institution building for the Philippines power sector, having provided 25 loans for a total of \$2.2 billion and 22 TA grants for \$8.4 million. Our priority now, in close collaboration with the Government and other development partners, is to provide well focused support for comprehensive restructuring of the power industry, including unbundling functional activities, privatization, and introducing competitive markets. The Government's request for support for the two new activities is both a concrete expression of its strengthened commitment in these important areas, as well as with the long-term strategic objectives we have previously articulated.

### A. Electricity Market and Transmission Development Project

3. The project is being prepared on the basis of preparatory work of the earlier proposed Transmission Interconnection and Reinforcement Project (TIRP). TIRP was included in ADB's earlier lending pipelines, but processing was suspended due to the Government's decision to implement the major submarine transmission component with private sector financing. The new project comprises three other components of TIRP: (i) establishing an wholesale electricity spot market, (ii) Luzon transmission upgrading, and (iii) Mindanao substation expansion. The components are prerequisite for maintaining the momentum of the reform agenda for restructuring and privatizing the power industry.

4. The proposed financing plan is for an ADB loan of \$40 million (40% of total project cost), cofinancing of \$40 million from Japan Bank for International Cooperation, and \$20 million from the Government. The concept paper for the project is attached.

### B. Partial Credit Guarantee

5. ADB has been requested by the Government to provide a partial credit guarantee (PCG) to assist it to mobilize resources to meet the adjustment costs for the ongoing comprehensive restructuring of the power sector. The Electric Power Industry Reform Act (EPIRA), effective since June 2001, provides the legal framework for the restructuring, including privatization of National Power Corporation (NPC). The EPIRA creates two new agencies: Power Sector Assets and Liabilities Management Corporation (PSALM) and National Transmission Corporation (TRANSCO). PSALM, with the principal role of liquidator, will take possession of NPC's assets and liabilities. PSALM will arrange for the sale of the generation assets. NPC's transmission assets will be transferred to TRANSCO (wholly owned by PSALM), whose operation will be bid out to a private concessionaire. Operating revenues, privatization proceeds, and debt

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<sup>1</sup> Loan 1662 PHI: *Power Sector Restructuring Program*, approved on 16 December 1998 for \$300 million.

assumption by the Government will be adequate over time to cover the public sector restructuring costs. However, the cash flow deficit in the initial years, especially in 2002, is greater than earlier envisioned. Half of the \$1.5 billion financing gap projected for 2002 has been funded through an international sovereign bond issue. As the privatization plan is implemented, commencing with asset sales in 2003, the annual cash deficits are expected to decline significantly, and to disappear after 2005.

6. The PCG will support issuance of new debt either by the Government or one of the power sector agencies. In the latter case, the Government will provide ADB with a counter guarantee. The PCG will be anchored in ADB's PSRP loan.<sup>2</sup> Reforms supported by the PSRP are proceeding well, and the third (final) tranche is expected to be released during 2002. Finalization of the PCG proposal for Board consideration will depend on satisfactory compliance with the third tranche conditions for the PSRP.

7. Based on initial market soundings by the Government and ADB, there is strong interest from financial firms to participate in the transaction, including with PSALM as the possible borrower. The PCG will reduce the costs to the Government of meeting incremental restructuring costs of up to \$750 million, and will be structured to minimize ADB's exposure. Based on the net present value (NPV) of the portion of the debt to be guaranteed, this could be up to about \$400 million.

8. To date ADB has provided 11 PCGs, including one for the Philippines in 1995 for \$21 million (in NPV terms), supporting a \$142 million bond issue in the power sector. The largest PCG has been for \$620 million (in NPV terms) in 1998 for a \$1 billion syndicated loan for an export financing facility to support Thailand's re-entry to international capital markets after the East Asian financial crisis.<sup>3</sup>

9. The PCG will have high development impact in a key infrastructure sector in terms of maintaining reform momentum, profiling a new power sector agency in the international capital market, and crowding in private sector financing and investment.

### III. FURTHER PROCESSING

10. Both new operations will be processed in accordance with standard ADB procedures, including submission to the Board for consideration.

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<sup>2</sup> In conformity with ADB's Charter, the policy for guarantee operations requires ADB's direct exposure to projects and programs for which a guarantee is provided. (*Review of the Bank's Guarantee Operations*, 31 August 1999, Doc. R135-99, para 26).

<sup>3</sup> *Review of the Bank's Guarantee Operations*, 31 August 1999, Doc. R135-99, Appendix 1. These NPVs use a discount rate of 8%. The discount rate was changed to a 10-year moving average of ADB's return on equity from April 2000 (*Partial Credit Guarantee Charges*, 22 March 2000, Doc. R88-00).

## CONCEPT PAPER

**Title:** Philippines – The Electricity Market and Transmission Development Project

**Date:** 18 June 2002

<p><b>1. Type/modality of assistance</b></p> <ul style="list-style-type: none"> <li><input checked="" type="checkbox"/> Lending           <ul style="list-style-type: none"> <li><input checked="" type="checkbox"/> Project loan</li> <li><input type="checkbox"/> Program loan</li> <li><input type="checkbox"/> Sector loan</li> <li><input type="checkbox"/> Sector development program loan</li> <li><input type="checkbox"/> Other</li> </ul> </li> <li><input checked="" type="checkbox"/> Nonlending           <ul style="list-style-type: none"> <li><input type="checkbox"/> Project preparatory</li> <li><input type="checkbox"/> Other than project preparatory               <ul style="list-style-type: none"> <li><input type="checkbox"/> Economic, thematic, and sector work</li> <li><input checked="" type="checkbox"/> Institutional development</li> <li><input type="checkbox"/> Other:</li> </ul> </li> </ul> </li> <li><input type="checkbox"/> Activities financed by JFICT or JFPR</li> </ul>		
<p><b>2. Assistance Focus</b></p> <p>a. If assistance focuses on a particular sector or subsector, specify the Sector: Energy Subsector: Power</p> <p>b. For project preparatory and lending, classification</p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Core poverty intervention</li> <li><input type="checkbox"/> Poverty intervention</li> </ul> <p>c. Key thematic area</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"> <ul style="list-style-type: none"> <li><input checked="" type="checkbox"/> Economic growth</li> <li><input type="checkbox"/> Gender and development</li> <li><input type="checkbox"/> Environmental protection</li> <li><input type="checkbox"/> Regional cooperation</li> <li><input type="checkbox"/> Other:</li> </ul> </td> <td style="width: 50%; vertical-align: top;"> <ul style="list-style-type: none"> <li><input type="checkbox"/> Human development</li> <li><input type="checkbox"/> Good governance</li> <li><input checked="" type="checkbox"/> Private sector development</li> <li><input type="checkbox"/> Social protection</li> </ul> </td> </tr> </table>	<ul style="list-style-type: none"> <li><input checked="" type="checkbox"/> Economic growth</li> <li><input type="checkbox"/> Gender and development</li> <li><input type="checkbox"/> Environmental protection</li> <li><input type="checkbox"/> Regional cooperation</li> <li><input type="checkbox"/> Other:</li> </ul>	<ul style="list-style-type: none"> <li><input type="checkbox"/> Human development</li> <li><input type="checkbox"/> Good governance</li> <li><input checked="" type="checkbox"/> Private sector development</li> <li><input type="checkbox"/> Social protection</li> </ul>
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<p><b>3. Coverage</b></p> <ul style="list-style-type: none"> <li><input checked="" type="checkbox"/> Country                      <input type="checkbox"/> Subregional                      <input type="checkbox"/> Interregional</li> <li><input type="checkbox"/> Internal policy development</li> </ul>		
<p><b>4. Responsible division/department:</b> SEID/SERD</p>		
<p><b>5. Responsible ADB officer:</b> Yongping Zhai</p>		
<p><b>6. Description of assistance</b></p> <p><b>a. Background/linkage to country/regional strategy:</b></p> <p>The Government's policy in the sector is to ensure and accelerate the total electrification of the country with transparent and reasonable prices of electricity to enhance the competitiveness of Philippine products in the global market. The enactment of the Electric Power Industry Reform Act paves way for the power sector's major restructuring towards a market with retail competition and open access in 2004. Such a market requires, as a prerequisite, a power trading and pooling system and adequate transmission networks.</p>		

**b. Goal and purpose:**

The objective of the Project is to develop the necessary system and infrastructure to support the power sector restructuring, i.e. (i) to establish the Wholesale Electricity Spot Market (WESM), which will allow electricity generation to be dispatched on a competitive basis to meet the power demand at a lower cost; and (ii) to reinforce and upgrade the critical transmission lines and substations in Luzon and Mindanao, which will improve the reliability of the power supply, and help expand rural electrification.

**c. Components, outputs, specific deliverables:**

The Project consists of Part A - the Wholesale Electricity Spot Market (WESM) and Part B-Transmission Reinforcement. Part A includes procurement and installation the WESM hardware, software and system integration. Part B includes (i) Luzon transmission line upgrading; and (ii) Mindanao substation expansion.

**Part A. WESM**

This subproject will develop the power trading and pooling system software and provide the required computer hardware to control and process transactions and functions associated with the competitive electricity market. TRANSCO envisions a turnkey contract, which will cover system development; hardware and software specification, acquisition and installation; system installation, implementation and testing; and the training of operators in the use of the new system. Consulting services are required to (i) supervise the performance of the turnkey contractor with regard to software design and hardware acquisition, and subproject implementation; (ii) perform quality control functions; and (iii) supervise and assist in the installation and commissioning phases of the subproject. The implementation of such an operational system is on the critical path for release of the third tranche of the PSRP loan.

**Part B – Transmission Reinforcement****(i) Luzon Transmission Upgrading**

This component consists of procurement and erection of lines and substation equipment to reinforce and upgrade the existing 230 kilovolt (kV) overhead transmission network in Luzon to increase the transfer capacities to accommodate planned generation additions and the load growth in the concerned provinces. The San Miguel-Conception (80 km) and Conception-Mexico (37 km) lines will be upgraded from single circuit-single conductor to double circuit-bundle of two conductors. The associated substations will also be upgraded as necessary.

**(ii) Mindanao Substation Expansion**

This component consists of procurement and installation of 6 nos of 138/69 kV power transformers with total capacity of 475 megavolt-ampere (MVA), 9 nos of 138 kV and 18 nos of 69 kV power circuit breakers (PCB) in Davao, Bislig, Butuan, Kibawe, Sta. Clara and Tindalo.

**d. Expected results and deliverables:**

Part A: The Wholesale Electricity Spot Market will be established and become operational by June 2004.

Part B: The transmission networks in Luzon and Mindanao will be reinforced to improve the reliability of the power supply.

**e. Social or environmental issues or concerns:**

The equipment procured under Part A of the Project will be installed inside the TRANSCO's existing compound in Diliman, Quezon City. Therefore, Part A will not have adverse environmental impacts. Transmission components under Part B are classified as Environment Category B.

Although the Luzon transmission line-upgrading subproject will utilize an existing right-of-way, it also involves land acquisition for transmission tower foundation sites. On the basis of the feedback received from the affected communities and the results of the socio-economic surveys, TRANSCO has prepared a Resettlement Plan for Luzon Transmission Upgrading in order to facilitate the payment of relocation and compensation. ADB conducted field inspections, and made appropriate recommendations to TRANSCO concerning implementation of the plan. The Resettlement Plan and the process used to formulate it have

<p>been reviewed and are in compliance with <i>ADB's Policy on Involuntary Resettlement</i>.</p> <p><b>f. Plans for disseminating results/deliverables:</b></p> <p>A web site for the WESM will be made available for the general public.</p>																															
<p><b>7. Proposed executing/implementing agencies:</b></p> <p>National Transmission Corporation (TRANSCO)</p>																															
<p><b>8. Nature/extent of government/beneficiary involvement in identifying or conceptualizing the assistance:</b></p> <p>For Part A, The Electric Power Industry Reform Act (EPIRA), which became effective in June 2001, requires that establishment of a WESM composed of the wholesale electricity spot market participants. This is also a condition for the third tranche release of the ADB Power Sector Restructuring Program. The World Bank is financing an interim market system for WESM to cope with the initial need of a competitive power market. The proposed ADB Project will finance the final market system of WESM.</p> <p>For Part B, all components are included in the Government approved Transmission Development Plan. Project presentations have been made to affected people and communities in the project areas.</p>																															
<p><b>9. Timetable for assistance design, processing, and implementation</b></p> <p>a. Year included in CSP, CSP update, SCSP, SCSP update, or interregional work plan:</p> <p>2002</p> <p>b. Expected date of submission for approval</p> <p>Lending: November 2002</p> <p>Nonlending (project preparatory): none</p> <p>Nonlending (other than project preparatory): Piggy-backed TA, November 2002</p> <p>Activities financed by JFICT or JFPR: none</p> <p>c. Period and duration of assistance</p> <p>Lending:</p> <p style="padding-left: 40px;">The Project will start in January 2003 with June 2004 as the target completion date for Part A (WESM) and 30 June 2006 for Part B (transmission components).</p> <p>Nonlending:</p> <p style="padding-left: 40px;">The piggy-backed TA will start in January 2003 and be implemented over a period of 12 months.</p>																															
<p><b>10. Financing Plan</b></p> <p>a. For lending</p> <p><input checked="" type="checkbox"/> Ordinary capital resources: \$ 40 million</p> <p><input type="checkbox"/> Asian Development Fund:</p> <p><input checked="" type="checkbox"/> Other- JBIC \$40 million</p>																															
<p>Cost Estimates</p> <table border="1"> <thead> <tr> <th></th> <th>Foreign Cost</th> <th>Local Cost</th> <th>Total</th> </tr> </thead> <tbody> <tr> <td>Part A</td> <td>23.0</td> <td>2.0</td> <td>25.0</td> </tr> <tr> <td>Part B</td> <td></td> <td></td> <td></td> </tr> <tr> <td>    Luzon T/L Upgrading</td> <td>26.0</td> <td>12.0</td> <td>38.0</td> </tr> <tr> <td>    Mindanao S/S Expansion</td> <td>12.0</td> <td>2.0</td> <td>14.0</td> </tr> <tr> <td>    Contingencies &amp; IDC</td> <td>19.0</td> <td>4.0</td> <td>23.0</td> </tr> <tr> <td>Total</td> <td>80.0</td> <td>20.0</td> <td>100.0</td> </tr> </tbody> </table>					Foreign Cost	Local Cost	Total	Part A	23.0	2.0	25.0	Part B				Luzon T/L Upgrading	26.0	12.0	38.0	Mindanao S/S Expansion	12.0	2.0	14.0	Contingencies & IDC	19.0	4.0	23.0	Total	80.0	20.0	100.0
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- b. For nonlending
- No resources required, other than ADB staff
  - ADB's administrative budget:
  - Grant TA funds
    - TA Special Fund: \$ 800,000
    - Japan Special Fund:
    - Other

Technical assistance (TA) will be provided by ADB as a grant to assist Government in ensuring the transition from the current regulated market to a competitive electricity market. Specifically, the TA will (i) develop an implementation plan for the selection of an independent market operator (IMO) for WESM; (ii) conduct industry consultation process; (iii) prepare tender documents for the selection of IMO and (iv) conduct public education campaign and setting up a WESM web site for the general public.

CSP = country strategy and program, JFICT = Japan Fund for Information and Communication Technology, JFPR = Japan Fund for Poverty Reduction, SCSP = subregional cooperation strategy and program