

ASIAN DEVELOPMENT BANK

**THE TRANSFER OF LIABILITIES AND GENERATION ASSETS
FROM THE NATIONAL POWER CORPORATION
TO THE POWER SECTOR ASSETS AND LIABILITIES MANAGEMENT
CORPORATION**

AND

**THE TRANSFER OF TRANSMISSION ASSETS
FROM THE NATIONAL POWER CORPORATION
TO THE NATIONAL TRANSMISSION CORPORATION**

IN THE

REPUBLIC OF THE PHILIPPINES

June 2005

CURRENCY EQUIVALENTS

(as of 9 May 2005)

Currency Unit	–	peso (₱)
Currency Unit	–	Japanese yen (¥)
₱1.00	=	\$0.0185
\$1.00	=	₱ 54.10
¥1.00	=	₱ 0.5136

ABBREVIATIONS

ADB	–	Asian Development Bank
EPIRA	–	Electric Power Industry Reform Act
IPP	–	independent power producer
NPC	–	National Power Corporation
PCG	–	partial credit guarantee
PSALM	–	Power Sector Assets and Liabilities Management Corporation
PSRP	–	Power Sector Restructuring Program
TRANSCO	–	National Transmission Corporation

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. Pursuant to Section 49 of Republic Act No. 9136, or the Electric Power Industry Reform Act (EPIRA) of 2001, the Government of the Republic of the Philippines (the Government) and the National Power Corporation (NPC) requested ADB's consent to transfer all liabilities and generation assets of NPC to the Power Sector Assets and Liabilities Management Corporation (PSALM),¹ and to transfer all the transmission and sub-transmission assets to National Transmission Corporation (TRANSCO) (footnote 1). Since the Government's request would affect all ADB loans to NPC, the Board's approval is considered required.

II. BACKGROUND

A. The Sector

2. In the early 1990s, the Philippines experienced severe power shortages, leading to prolonged blackouts and adverse economic impacts. As an emergency action and with the support of Government, NPC contracted to purchase power from independent producers (IPPs) on a take or pay basis. Most of the contracts were denominated in foreign currency. Although this action eased the power shortage, the subsequent Asian financial crisis suppressed electricity demand and left NPC with an oversupply of generation capacity. The result of this combination of factors was that NPC had to continue paying - in increasingly more expensive foreign currency - for unused power that it could not in turn sell. For a time, NPC's upwardly spiraling debt burden was serviced through commercial borrowings by NPC and the Government. This strategy became unsustainable with the continuous slide of the peso, the prevailing low electricity demand, and the low tariffs charged by NPC.

3. In 2000, Government restructured the power sector to make it more efficient, and to reduce its long term negative impact on the fiscal position of the Government. The centerpiece of the restructuring was the passage of the EPIRA in June 2001. Among other things, EPIRA created TRANSCO to take over NPC transmission assets, and created PSALM to be responsible for repaying all of NPC's existing debt obligations, privatizing all of its generation assets, and privatizing the transmission operations through a concession.² The adjustment costs of the reform were supported in part by ADB's \$300 million Power Sector Reform Program (PSRP).³

B. ADB's Assistance to the Sector

4. ADB has provided 20 loans to NPC (the "Loans"), all of which are guaranteed by the Republic of the Philippines (the "Guarantees").⁴ The loans had a combined value of \$1,597 million (or \$1,224 million, net of cancellations).⁵ In addition to its lending, ADB has provided 34 technical assistance grants to the energy sector totaling about \$15 million. These cover the

¹ Created under EPIRA in 2001.

² EPIRA also mandated the establishment of an independent electricity regulator, and an open and competitive electricity market.

³ ADB. 1998. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grants to the Republic of the Philippines for the Power Sector Restructuring Program*. Manila.

⁴ Under NPC's Charter, all obligations of NPC are automatically guaranteed by the Republic of the Philippines and are excluded from the national borrowing and guarantee ceilings set in the Foreign Borrowings Act.

⁵ The Loans are governed by Loan Agreements (the "Loan Agreements"), and the Guarantees by Guarantee Agreements (the "Guarantee Agreements"). These are listed in Appendix 2.

areas of power generation and transmission; power development planning; rural electrification; tariff and pricing studies; regulation; consumer impact assessments; feasibility studies; and environmental assessments, as well as energy conservation; coal industry development; and geothermal steam and natural gas pricing studies. The list of the loans and TAs is included in Appendix 1. As of 31 March 2005, 11 loans had been fully repaid. Nine loans with a total current principal amount of \$562.2 million equivalent, remain outstanding and unpaid (Appendix 2). Among these nine loans, eight loans have been completed and one loan is being implemented. In addition, in November 1995, ADB provided a partial credit guarantee (PCG) in the form of a put-option deed (the "Put-Option Deed") for credit enhancement of NPC's ¥12 billion bond issue, due in 2015, with a Government counter-guarantee in the form of a counter-put option. In December 2002, ADB provided a PCG to support the ¥24.75 billion (\$200 million equivalent) 18-year PSALM bond, and the ¥37 billion (\$300 million equivalent) 20-year PSALM bond. The PCG was counter-guaranteed by the Government. The PSALM bonds were issued to cover the funding gap resulting from a timing mismatch between the receipt of expected revenues and cash outflows, particularly in the initial stages of the privatization process.

III. REQUEST FOR CONSENT

5. Four years after the passage of the EPIRA, the Philippine power sector is now at a cross road. With continued support from ADB, the basic ground work has been laid for an open and competitive electricity market with opportunities for improved efficiencies, and greater private sector participation. On the other hand, prospects for large scale expansion of generation capacity and sustained improvements in transmission would be viable only in the context of privatized sector operations.⁶ In line with the ongoing policy dialogue on the power sector, there have been initial steps at privatizing the NPC assets. PSALM has successfully sold to private investors five mini-hydro power plants.⁷ The Government has also tendered and awarded the 600 megawatt Masinloc coal-fired power plant. The transaction is expected to be completed in December 2005, upon completion of conditions precedent to financial close including the provision of creditors' consent. Another medium sized plant, the 600 megawatt coal-fired Calaca power plant, is scheduled to be tendered late in July this year. There have also been initial attempts to privatize the transmission operations through a concession agreement, but actions in this area still need to progress further. With advice from international and domestic experts, and in consultation with the national oversight agencies and Congress, PSALM continues to develop strategies and transaction documents that would best serve the purpose of privatization. But in order for PSALM to pursue privatization at a faster and sustained pace, it needs to assure the potential bidders that NPC's creditors have consented to the sale of NPC's assets.

6. Since the Loan Agreements provide that NPC cannot sell its assets, except in the normal course of business or with the consent of ADB, the Government and NPC are now requesting ADB to (i) provide NPC with the necessary consents to transfer certain of its generation assets to PSALM and all of its transmission and sub-transmission assets to TRANSCO (paragraph 9); (ii) permit PSALM to subsequently sell to private investors the generation assets financed under the Loan Agreements, the Guarantee Agreements, and the Put Option Deed, and to lease TRANSCO's assets through the grant of a transmission concession to the private sector (paragraph 11); (iii) allow for PSALM's accession to the Loan Agreements as co-obligor of NPC (paragraph 9); and (iv) make certain changes to the Loan

⁶ Only if there is, in the determination by the President of the Philippines, an imminent shortage of power supply, may Congress authorize additional generating capacity.

⁷ To facilitate completion of the mini-hydro sales, and considering the restricted impact of these plants on the NPC asset base, ADB consented to the sales.

Agreements to address the fact that (a) PSALM, and subsequently a third party investor, and not NPC, will be the legal and beneficial owner of the relevant generation assets; and (b) TRANSCO, not NPC, will be the legal and beneficial owner of the transmission and sub-transmission assets financed by the Loans (paragraph 14).

IV. AMENDMENTS TO RELEVANT AGREEMENTS

A. Omnibus Amendment Agreement

7. It is critical for the success of the restructuring that ADB provide the requested consent. However, in order for ADB to provide this consent, appropriate amendments need to be made to the Loan and Guarantee Agreements and Put-Option Deed. ADB staff together with Government, NPC, PSALM and TRANSCO officials have negotiated and drafted such an amendment agreement (the “Omnibus Amendment Agreement”).⁸

8. The parties to the Omnibus Amendment Agreement will be NPC as the Borrower and transferor of assets, PSALM as the Co-obligor and transferee of generation assets, TRANSCO as the Transferee of the transmission assets, the Republic of the Philippines as the Guarantor, and ADB as the Lender. The Omnibus Amendment Agreement provides for two phases.

B. Phase I: Co-Obligor Structure on Liabilities; Maintenance of Guarantees

9. Under Phase I, ADB agrees that (i) NPC will transfer its generation assets to PSALM and its transmission assets to TRANSCO; (ii) PSALM may then proceed to privatize the generation assets and the transmission concession; and (iii) in consideration of the asset transfer, PSALM will accede to the Loan Agreements and become a co-obligor of NPC for all of NPC’s liabilities and obligations, including the Loans. Under such arrangement, both NPC and PSALM will be contractually liable to pay ADB the full amount of the outstanding Loans, in accordance with the originally agreed repayment schedule. As a practical matter, scheduled repayments may be serviced by either NPC or PSALM, and ADB will be entitled to receive such service payments. By the same token, ADB may seek full or partial payment from NPC, PSALM, or both, of all Loans that are due and payable. It is noted that this phase occurs after execution of the Omnibus Amendment Agreement and the completion of certain conditions precedent, including the formal delivery of legal opinions and corporate clearances.

10. During Phase I, although PSALM accedes as a co-obligor of NPC, ADB will continue to enjoy the full benefits of the Guarantees. The Republic of the Philippines will continue to unconditionally guarantee, as primary obligor and not merely as surety, the due and punctual repayment of all the Loans. The Republic of the Philippines will also waive any new contractual or statutory defenses that may arise as a result of the Omnibus Amendment Agreement or the accession of PSALM as a co-obligor of NPC.

11. ADB will confirm it has no objections to the transfer of assets from NPC to PSALM and TRANSCO, and the eventual sale or lease of those assets to the private sector in order to privatize the assets and operations of NPC.

12. The Omnibus Amendment Agreement provides that when generation assets and the transmission operations are privatized, the controlling entity at various points will be obligated to comply with relevant project implementation covenants and ADB safeguard policies that NPC,

⁸ Copies will be available upon request.

as original executing agency, had committed to undertake or accomplish. There will, however, be no impact on the actual scope of the projects financed by the Loans.

C. Phase II: PSALM as Sole Obligor

13. Phase II will occur if the Republic of the Philippines unconditionally guarantees the due and punctual repayment of all the Loans it proposes to completely and finally transfer to PSALM (pursuant to which transfer PSALM becomes the Borrower and not merely a co-obligor of NPC). The Omnibus Amendment Agreement provides that in such event, ADB will agree to the full and complete transfer to PSALM of all then outstanding Loans. Upon the commencement of Phase II, NPC will cease to be a Borrower and will no longer be liable to repay any Loan. PSALM will become the Borrower and will be solely liable to repay all the outstanding Loans. Although the occurrence of this phase is not necessary, it provides the legal framework for any future decision by the Government to remove the Loans from NPC's financial books and to transfer them completely to the financial books of PSALM.

D. Special Consent for the Masinloc Power Plant

14. Considering the size of the Masinloc plant, its strategic impact on the privatization of NPC and the restructuring of the power sector, and the advanced stage of its privatization process, it is recommended that ADB waive NPC's covenant not to sell Masinloc, and allow the sale of Masinloc to be completed prior to the effectiveness of Phase I. Considering Phase I is expected to have occurred in time for all other privatization transactions, no further special consents are expected to be required.

E. Other Lenders

15. The Japan Bank for International Cooperation (JBIC), and the Organization of the Petroleum Exporting Countries (OPEC) Fund for International Development, as co-financiers of ADB-financed projects, did not object to ADB's agreement to the requested transfers. In fact, JBIC is processing the Government's request and the OPEC Fund has provided its consent. The World Bank was also consulted. It is currently completing the process of considering the Government's request.

V. THE PRESIDENT'S RECOMMENDATION

16. In view of the foregoing, the President recommends that the Board (i) agree to provide the requested consents, subject to the Omnibus Amendment Agreement, (ii) authorize the execution and performance of Omnibus Amendment Agreement and related agreements, as described in paragraphs 7–14, and (iii) agree to the immediate sale of NPC's 600 megawatt Masinloc coal-fired power plant.

ADB ASSISTANCE TO THE ENERGY SECTOR

Table A1.1: Asian Development Bank Lending to the Public and Private Sector

Loan No.	Date	Borrower	Project/Main Component	\$ million	Cofinanced by	
					JBIC	OPEC
77	02/11/71	NPC	Agus VI Expansion and Associated Transmission	23.4		
96	13/07/72	NPC	Agus III (Mindanao) Hydroelectric Station Engineering	21.0		
196	07/11/74	NPC	Agus III (Mindanao) Hydroelectric Station Engineering	1.0		
223	27/05/75	NPC	Supplementary Loan - Agus II and Agus VI	22.7		
291	21/12/76	NPC	Agus IV (Mindanao) Hydroelectric Station	52.0		
326	09/12/77	NPC	Agus V (Mindanao) Hydroelectric Station	29.0		
421	19/11/79	PNOC	Malangas Coal Development	14.0		
427	27/11/79	NPC	Pulangi IV (Mindanao) Hydroelectric Station	60.7		
482	18/11/80	NPC	Negros & Mindanao Transmission	60.5		
542	17/11/81	NEA	Rural Electrification	87.5		20.0
607	07/12/82	NPC	Power Systems Development	32.8		
666	12/12/83	NPC	Negros-Panay Interconnection	43.8		
726	20/12/84	PNOC	Philippine National Oil Company Energy Loan	85.0		
728	10/12/84	NPC	Second Power System Development	33.0		
823	18/12/86	NPC	Third Power System Development	92.0		
914	27/10/88	NPC	Fourteenth Power (Sector)	120.0		
985	14/11/89	NPC	Fifteenth Power (Sector)	160.0		
991	23/11/89	Hopewell	Navotas 200 MW Gas Turbine ^a	10.0		
1042	13/10/90	NPC	Masinloc Thermal Power Station (Stage I)	200.0	150.0	
1207	10/12/92	Meralco	Meralco Distribution	138.0		
1230	18/05/93	Hopewell	Pagbilao 700 MW Coal-fired Power Station ^a	40.0		
1231	18/05/93	Batangas Power Corp.	Pinamucan 123 MW Oil-fired Power Station ^a	26.5		
1288	14/12/93	NPC	Power Transmission on Luzon & Mindanao	164.0		
1398	02/11/95	NPC	Northern Luzon Transmission & Generation	244.0	244.0	
1474	30/09/96	NPC	Leyte-Mindanao Interconnection Engineering	5.3		
1590	16/12/97	NPC	Power Transmission Reinforcement	191.4		
1662	16/12/98	DOF	Power Sector Restructuring Program	300.0	300.0	
1984	19/12/02	NPC	Electricity Market and Transmission Development	40.0	45.5	
Total				2,297.6	739.50	20.0

DOF = Department of Finance, JBIC = Japan Bank for International Cooperation, MERALCO = Manila Electric Company, NEA = National Electrification Administration, NPC = National Power Corporation, OPEC = Organization of the Petroleum Exporting Countries, PNOC = Philippine National Oil Company.

^a Private Sector Loan

Source: Asian Development Bank.

Table A1.2: Technical Assistance

No.	Date	Title	\$'000
251	24/10/78	Malangas Coal Mine	114
430	17/11/81	Rural Electrification (Dendro Thermal Study)	150
431	17/11/81	Rural Electrification	120
447	25/02/82	Industrial Energy Audits & Energy Conservation	560
450	25/02/82	Second Coal Development	330
496	07/12/82	Cagayan River Hydropower Study	150
611	05/07/84	Electricity Tariff Study	229
651	19/12/84	Private Sector Coal Development Study	350
652	20/12/84	Refinery Sector Rationalization Study	450
733	24/12/85	Geothermal Steam Pricing Study	212
755	17/06/86	Mindanao Power System Development	350
733	15/10/86	Geothermal Steam Pricing Study (Supplementary)	63
834	18/12/86	Luzon Power System Development	260
1015	22/07/88	Development Study of the Visayas Power System	358
1050	27/10/88	Power Sector Cost Structure & Transfer Pricing Study	230
1158	17/05/89	Mineral Resources Development	75
1169	21/06/89	Power Sector Training	93
1372	11/09/90	Review of NPC's Asset Revaluation	96
1405	30/10/90	Environmental Management of Coal-based Power Generation	636
1966	20/10/93	Long-term Power System Planning Study	600
2365	20/07/95	Natural Gas Sales Negotiations	100
2435	02/11/95	Formation of Power Transmission Subsidiary	500
2623	30/07/96	Evaluation of Environmental Standards of Selected Industries	400
2653	30/09/96	Leyte-Mindanao Interconnection Engineering	575
3126	16/12/98	Electricity Pricing & Regulatory Practice in a Competitive Environment	600
3127	23/03/00	Consumer Impact Assessment	720
3422	23/03/00	Rural Electrification Institutional Strengthening	750
3516	10/10/00	Rural Electrification	600
3820	19/12/01	Competition Policy for the Electricity Sector	990
4073	19/12/02	Transition to Competitive Electricity Markets	800
4151	18/07/03	Promoting Good Governance in the Restructured Power Sector	800
4174	16/09/03	Rehabilitation of Renewable Energy Projects for Rural Electrification and Livelihood Development	800
4198	18/10/03	Institutional Strengthening for the Development of Natural Gas Industry	800
4557	28/12/04	Institutional Strengthening of ERC and Privatization of NPC	1,200
Total			15,061

ERC = Energy Regulatory Commission, NPC = National Power Corporation.

Source: Asian Development Bank.

OUTSTANDING LOAN AND GUARANTEE AGREEMENTS

1. Loan 823-PHI: Third Power System Development Program, Loan Agreement between NPC and ADB dated 23 December 1986 and Guarantee Agreement between the Republic of Philippines and ADB dated 23 December 1986 (\$92.00 million)
2. Loan 914-PHI: Fourteenth Power (Sector Loan), Loan Agreement dated 4 November 1988 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 4 November 1988 (\$120.00 million, of which \$ 8.98 million cancelled)
3. Loan 985-PHI: Fifteenth Power (Sector Loan), Loan Agreement dated 18 December 1989 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 18 December 1989 (\$160.00 million, of which \$0.29 million cancelled)
4. Loan 1042-PHI: Sixteenth Power (Masinloc Thermal Power) Project, Loan Agreement between NPC and ADB dated 19 April 1991 and Guarantee Agreement between the Republic of Philippines and ADB dated 19 April 1991 (\$200.00 million, of which \$3.18 million cancelled)
5. Loan 1288-PHI: Power Transmission Project, Loan Agreement dated 20 December 1993 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 20 December 1993 (\$164.00 million, of which \$43.23 million cancelled)
6. Loan 1398-PHI: Northern Luzon Transmission and Generation Project (Masinloc Power Station), Loan Agreement dated 27 November 1995 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 27 November 1995 (\$244.00 million, of which \$ 82.32 million cancelled)
7. Loan 1474-PHI: Leyte-Mindanao Interconnection Engineering Project, Technical Assistance Loan Agreement dated 18 November 1996 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 18 November 1996 (\$ 5.35 million, of which \$ 0.44 million cancelled)
8. Loan 1590-PHI: Power Transmission Reinforcement Project, Loan Agreement dated 21 January 1998 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 21 January 1998 (\$191.4 million, of which 148.10 million cancelled)
9. Loan 1984-PHI: Electricity Market and Transmission Development Project, Loan Agreement dated 16 December 2003 between NPC and ADB and Guarantee Agreement between the Republic of Philippines and ADB dated 16 December 2003 (\$40.0 million)