



**Draft Final Report on Investment Management
Contracts (IMC) for Electricity Cooperatives**

For

Government of Philippines Department of Energy

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1 Introduction

This report completes the deliverables required for consulting services to the Government of the Philippines through the provision of Transaction Advisory Services for the Electric Cooperative System Loss Reduction Project.

The purpose of this project is to carry out the preparatory work necessary for the successful completion of at least 3 transactions implementing Investment Management Contracts (IMCs) for rural electric cooperatives in the Philippines (ECs).

In addition to undertaking due diligence and preparing draft Offering Memoranda for 3 ECs, we have also submitted three prior policy reports as part of this project.

- Stakeholder and Sales Assessment Report – April 2004
- Marketing Strategy Report – May 2004
- Sales Policy Report – August 2004

The 3 ECs which have gone through the due diligence phase of the IMC are CASURECO 3, PELCO 2, and PELCO 3. PELCO Boards are presently considering our reports, and will shortly make decisions on inviting bids from private sector investors. CASURECO 3, on instructions from the National Electrification Administration (NEA), has to conduct elections for a new Board before finally considering how to proceed with the IMC option.

The Castalia consortium is conducting a fourth due diligence, on CASURECO 1, because of our concerns about the possibility that at least one of the other 3 ECs will decide not to complete an IMC transaction.

This report

- sets out our conclusions on the IMC process to date;
- outlines the remaining steps needed to complete the transactions for the ECs willing to contract a private sector investor to rehabilitate their business;
- identifies key issues for achieving successful IMC transactions for ECs in a timely manner given the imminent implementation of a competitive electricity market in the Philippines; and
- addresses some outstanding issues about the design of the Investment Management Contracts raised by World Bank peer reviews

2 Conclusions on IMC Process

We believe it is important to emphasize again a unique feature of the IMC process: it involves the Government assisting with the implementation of a form of public – private partnership for locally controlled organizations. The Government has, at best, indirect influence over ECs. As a result, this project has been different from the traditional transaction advisory tasks, where consultants are hired to manage a transaction on behalf of a public sector organization, and where the primary job is to design the best contractual arrangement and then find the best investor through a competitive process. In this case, our task has been as much about finding “sellers” as about finding “buyers”. The ECs have been very cautious about entering the IMC process, even though they have no other viable options to improve their operations. In part, this is due to the fact that ECs have sufficient political clout to continue stumbling along even despite being effectively bankrupt, and their elected Boards have mixed incentives with respect to IMC contracts.

The unusual nature of this advisory task also means that many aspects of the transaction will continue evolving even after the completion of this preparatory stage. For example, since candidate EC Boards have been reluctant to make a full and final commitment to proceed with the transaction, we have not been able to engage them as much as we would have liked on the details of the contract design. This engagement is yet to come.

2.1 Finding EC Candidates for IMCs

Considerably greater effort than was anticipated had to be invested in convincing EC Boards to *first*, understand and distinguish the IMC from other management contract options which have been tried; *secondly*, to agree to enter the due diligence phase of the IMC process; and *thirdly*, to agree to enter the final bidding stage of IMC and therefore pass over day-to-day management control of the EC’s business to an investor.

We put significant effort into marketing the IMC concept beyond the panel of ECs identified at the commencement of the contract. The EC community - through representative organizations, NEA and local political organizations - has been closely monitoring the progress of the IMC concept.

There was initial suspicion by ECs, in part because the terminology of IMC was often confused with other forms of management contracts. Some ECs have had unfortunate experiences with the latter, so there was a natural negative reaction to the IMC and the involvement of the private sector. Most of this has been overcome by the extensive presentations Castalia has made over the period of the project to date. We believe we have reached the point where many ECs now have an open mind towards, or positively support, IMCs.

Nevertheless, the IMC process and resulting transactions, as well as the involvement of the private sector in the business of ECs, have yet to be tested in practice. Any lingering suspicion towards IMCs will be removed only when they are seen to succeed to the satisfaction of the EC Boards, customers and the investors.

2.2 Political Management

Managing the political problems of the panel of ECs chosen to enter into the IMC process has, for the most part, been challenging. ECs are essentially political creatures, where local political control and interference is a feature of governance and management. Too often the business of ECs has been determined by local political agendas rather than good business principles. Consequently customer service, technical reliability and the long term viability of the organisation have often suffered.

Local political control and interference is not the only issue. There has been a strong theme running through all levels of political and regulatory system that customers should receive electricity at the least possible price, even if it undermines the long-term financial viability of service providers and depresses investment. For example, the cash needs regulatory approach adopted by the ERC emphasizes short-term gains to consumers in the form of lower tariffs, while making it difficult for ECs to attract capital. The general community appears to be equally focused on short-term gains. There are no well-organized interest groups with an interest in educating the community about the costs which arise from under-investment in distribution due to artificially low tariffs.

Hence, the greatest opposition to the IMC concept comes from the perception that it must be bad for consumers because investors will want to earn a profit as opposed to the non-profit EC.

A real challenge for the Castalia consortium has been to harness local political interests to play a positive role in implementing IMCs. We have briefed local politicians, Congressmen, Governors and various political interest groups on how IMCs can help their communities. Most now seem to have a positive view of the IMC process. These views will continue to be shaped by the backdrop of the candidate ECs' poor financial positions and the knowledge that the IMC is the only realistic alternative to bankruptcy.

In spite of official endorsement by the Department of Energy (DoE) and NEA, and full support from Cabinet members, there is still resistance at this stage by some EC Boards to fully commit to IMCs in a timely manner.

We have been very pleased with the support of DoE and NEA as the project has proceeded, but we believe much more rapid progress in rehabilitating cooperative distribution utilities can be made if the NEA was to exercise greater proactive leadership in promoting the IMC transaction process. EC Boards look to NEA for advice and approval, and early engagement by NEA in the IMC process will make considerable difference to achieving the Government's electricity reform objectives in accordance with the timetable set by the President and in EPIRA.

2.3 Management and Union Attitudes

There is resistance to IMCs from the unions in some ECs, although it is not a universal problem. In the most financially distressed EC (CASURECO 3), the union has engaged in public demonstrations to resist the implementation of an IMC transaction. The union's attitudes have hardened since we last reported on this issue in April. Ironically, the greatest

resistance comes from those ECs with the weakest governance structures and which are in the most parlous of financial circumstances.

We have been careful to involve staff and their union representatives in the IMC process. The steps involved in preparing the Board for key decisions on IMCs (e.g. due diligence, consideration of potential investors) have been open and in public. In some cases we have briefed public meetings and the local press as a way of reaching beyond the staff or union influences, which for the most part are narrowly focused on their employment position.

The concerns of staff and unions are understandable. We have made no secret of the possibility that staff redundancies will be involved, but the IMC process does involve the protection of pension and redundancy rights in the event the EC Board decides to invite a private investor to manage the business.

However, it is equally true – as we have made clear to the union movement – that the choice facing ECs which are candidates for IMCs is clear. Financial rehabilitation through IMCs is the way forward for staff, management and customers, and their jobs are better protected with a strong and viable EC than continuing with present arrangements where customer service is poor and declining, and the EC is neither bankable nor capable of rehabilitating itself without outside capital and management.

We believe that consistent communication by the elected Boards will help change entrenched attitudes.

2.4 Investor Attitudes

There is considerable positive interest by investors in the IMC transactions. Like the Boards of many ECs, there was an initial confusion between other forms of management contract and the IMC. Some forms (e.g. ALECO) produced real conflict between the EC and the “investor”. In part the problems created were a result of poor transparency of process and of contract. In other cases, the main driver for the investor was to secure a monopoly power supply contract from a distribution utility, and the management contract was less about rehabilitating the EC and more about securing a guaranteed outlet for generator production.

Potential investors in ECs have expressed their confidence in the IMC process for the following reasons:

- the official endorsement of the process and the IMC concept by DoE and NEA, gives comfort to investors that the contractual arrangements are likely to be durable;
- the openness and transparency of the process
- many of the potential problems they would have had to manage, are being managed by the Transaction Adviser before a contract is signed, including:
 - union/staff issues (especially with respect to retirement and redundancy)
 - the regulatory regime for IMC ECs

- the political issues that might affect the form of private sector involvement in ECs
- the role of the Board of ECs, which will be established in the IM contract
- the responsibilities of the contractual parties – the EC and the investor
- the independence of the IMC Transaction Adviser (Castalia)
- the independence and objectivity of the due diligence on candidate ECs
- the absence of “back door deals” by competitors with local political interests or the management/Board of the EC, because of the open bidding process

These are regarded as powerful positive factors in the Philippines context by potential investors, to the point where a number have advised us they are not prepared to rehabilitate financially distressed ECs, which would otherwise involve considerable financial, regulatory and reputational risk, without the open IMC process mandated by the Government.

However, unless rapid progress is made in completing transactions with ECs, this investor interest could easily be diverted to other – potentially lower risk – investment opportunities in the generation or private distribution sectors of the electricity market as the EPIRA privatisation process accelerates.

Our overall conclusion is that there is a large enough pool of potential investors prepared to participate in financial rehabilitation of ECs providing rapid progress is made over the next few months by the candidate EC Boards. We have strongly advised the Boards involved to this effect.

3 Completing the IMC Transactions

Three ECs have completed due diligence – CASURECO 3, PELCO 2 and PELCO 3. A fourth, CASURECO 1 is expected to complete due diligence within the next 2 weeks. We have submitted our due diligence reports to the EC Boards and the DoE on the first three.

PELCO 3 and CASURECO 3 conclusively show an IMC can achieve financial turnaround with adequate rates of return for an investor. PELCO 2 can achieve turnaround only with a reversal of the recent, as yet unimplemented, tariff reduction.

Although the present Advisory Board of CASURECO 3 has indicated it would like to proceed to bidding, there was concern that this NEA-appointed Board lacked the legitimacy needed to make such a complex decision. Hence, NEA has used its authority to initiate a new Board election to ensure the cooperative owners of the EC install a properly elected Board. We anticipate that the IMC will be a key election issue. Unfortunately, the time needed to organize elections will delay the process somewhat.

CASURECO 1 is very keen to proceed with an IMC, and the Board is in a position to make the decision after due diligence quickly.

The most likely sequence of moving to the bidding stage of these IMC transactions is as follows (from end November 2004):

▪ **PELCO 3**

- Decision by EC Board to approve IMC – 1 month, then
- Bidding Process – 2.5 months (including Castalia assessment of Technical Proposal), then
- Decision on Successful Bid by EC Board – 1 month
- In PELCO 3's case this could mean a completed transaction by **mid-April 2005**

▪ **CASURECO 1**

- Due Diligence Report to EC Board – 2 weeks, then
- Decision by EC Board to approve IMC – 1.5 months, then
- Bidding Process – 2 months (including Castalia assessment of Technical Proposal), then
- Decision on Successful Bid by EC Board – 1 month
- In CASURECO 1's case this could mean a completed transaction by **end-April 2005**

▪ **PELCO 2**

- Decision by EC Board to Approve IMC – 1 month (this assumes a board meeting before Christmas and a resolution of the ERC tariff reduction), then
- Bidding Process – 2.5 months (including Castalia assessment of Technical Proposal), then
- Decision on Successful Bid by EC Board – 1 to 2 months to allow for resolution of local political issues
- In PELCO 2's case this could mean a completed transaction by **mid May 2005**

▪ **CASURECO 3 (this assumes local politics does not intrude into or destroy the IMC process)**

- Election for new Board (expected by February 2005), say 3 months, then
- Decision by EC Board to Approve IMC – 1 month, then
- Bidding Process – 2 months (including Castalia assessment of Technical Proposal), then
- Decision on Successful Bid by EC Board – 1 month
- In CASURECO 3's case this could mean a completed transaction by **late May or early June 2005**

This is an estimated timetable only, and depends on the Board of each EC making the necessary decisions in a timely fashion. We understand from our discussions with potential investors that this timetable would just be acceptable in view of emerging investment opportunities from the SPUG privatizations, the programme of privatizing PSALM assets, and new generation investment opportunities as the Philippines electricity sector copes with demand growth.

4 Achieving More IMC Transactions after Pilot Project

With the investment we have put into the stakeholder phase of the IMC process, as well as the demonstration effect of three to four successful transactions for ECs and investors from the pilot project, we expect that other ECs will want to rapidly take up IMCs.

IMCs are likely to be the only realistic rehabilitation option for about one third to one half of ECs across the Philippines. World Bank and NEA analyses show at least another 50 ECs are in critical financial shape and do not have recourse to commercial lending resources to obtain long overdue investment to enable turn round. For these ECs, IMCs are their best option for financial rehabilitation, while allowing the community to retain a degree of ownership of their franchise and their assets in the long run.

As the country's financial situation begins to bite, access to commercial funding for ECs other than those in the best of financial shape will be difficult to obtain. NEA funding has been cut off. Partial credit guarantee provided by the LGU-GC with World Bank support will only be available with a clear sign of adequate governance and management in ECs seeking funding. Private sector investors will be prepared to provide risk capital only with management control, and a clear understanding of the respective roles of EC Boards and private sector management, where the franchise remains in EC ownership.

The choices available to those cooperative distribution utilities in poor financial shape have sharply diminished in the last 12 months. They cannot avoid rehabilitation and change as the environment within which they presently work is about to alter.

The impending implementation of the EPIRA reform will radically change the environment for ECs. ECs will be required to open up their networks to retail electricity suppliers, so ECs are likely to face competition for their customers, and especially their better paying

customers. The cost of their electricity supply arrangements will change, as competing generators can supply electricity at lower cost to distributors. The wholesale electricity market (WESM) will mandate competition amongst generators, and require ECs to purchase part of their supply through the market. Distributors, including ECs, will have to pay their electricity bills to the market, and to generators with certainty and with a much shorter time frame, than they are now: otherwise power supply will be cut, under the EPIRA Rules.

The implications of these significant changes are not well understood by the Boards and managements of most cooperatives. Until now, the quality of their decision making has been shielded by a number of factors, including:

- the natural monopoly of the franchises held by ECs, which protects them from competition
- previous NEA financial rescue funding often protected from the normal disciplines of repayment and penalties for non-payment
- “understanding” state owned generators not prepared to switch off power supply to ECs who do not pay their bills because of the political ramifications
- government institutions which were prepared to acquiesce in declining service and power quality standards

Consequently, the 50 or so ECs that are not in this position now will need to implement programmes of rehabilitation and management reform very quickly. The IMC Transaction process is one effective way of achieving this.

As we approach the end of the pilot phase of the IMC project, one conclusion is inescapable: unless rapid progress is made to rehabilitate these ECs, there is a very real risk in our view that the EPIRA reforms could founder on the inability of a major section of the distribution utility sector to manage in the emerging competitive electricity market.

Accordingly, for the EC sector we conclude that:

- those ECs at financial risk need to be put through urgent financial rehabilitation programmes such as IMC
- the capacity of EC Boards and management to understand and operate in the EPIRA mandated competitive electricity market needs to be urgently addressed
- staff and customers of ECs need to be “educated” on the implications of EPIRA and the electricity market well ahead of introduction
- private sector investors need to be encouraged to invest in the EC sector (especially if the Government moves to extend IMC transactions to 50 or so ECs), with certainty of action by the Government at political and official level, and certainty of action by the ERC

The key conclusion is that the official agencies in the electricity sector – principally NEA – need to be far more proactive in supporting and promoting policy initiatives such as IMC. We would like to see more active participation by NEA in explaining the IMC concept, in giving EC Boards comfort and guidance on proceeding with IMC transactions, in ensuring that transparent and competitive process is used to implement such transactions and, finally, in educating EC Boards and managers on the consequences of market changes for them.

5 Some Questions on IMC Concept

As we mentioned before, the detailed design of the Investment Management Contract will continue to evolve beyond the preparatory stage. As we proceed through pre-qualification of investors and approach the bidding stage, the transaction will become more “real” to the Boards, and we expect them to become more engaged. We have advised the Boards of all candidate ECs that we will need to hold 3 to 4 day workshops with each of them to finalize the detail of the contract.

In this section we would like to address some questions that we have received from World Bank peer reviewers.

How does the penalty (for non performance by the IMC investor) work? What is the process, and what are the penalties expected to apply to?

The penalty regime is intended to address compliance by investors with customer service standards. We will work with the Boards and management of each EC to develop EC-specific performance milestones required to achieve compliance with the Distribution Code over a 3 to 5 year period. We will then develop a schedule of penalties for missing milestones, which over time escalate to a termination event. The financial value of the proposed penalties will depend on each EC’s particular conditions. Penalties will be structured in the form of specific investment and rectification requirements, which will reduce the profit available to the investor.

Failure to comply with the financial requirements – the obligation on the investor to make the EC current on all payments and to maintain that currency – is a termination event.

What are the security features for protecting the main bank accounts of the EC, to prevent the investor from leveraging the cash flow of the business?

The draft contract includes a number of requirements designed to protect the EC. First, the investor is required to make and remain current on all payment obligations by the EC. Second, the investor is only allowed to pay itself dividend if there is sufficient cash flow to cover such payment.

We do not wish to restrict the investor from maximizing leverage within these constraints. For example, if the investor makes the EC bankable but does not have sufficient cash flow to pay itself the full dividend it is entitled to, we believe it is appropriate to allow the investor to increase debt to cover the full dividend payment, as long as the EC remains current on all its current obligations.

Can the EC revenue sharing be part fixed/part proportion of revenue stream?

The draft contract allows for this. However, following consultations with investors, we recommend against this option. Investors have expressed a clear and strong preference for a straight-forward lease option, which does not involve any sharing of the revenue stream. The reason for this is that any arrangement which involves sharing of the revenue stream will require greater on-going involvement and supervision by the EC Boards. Investors prefer much clearer delineation between their roles and the residual role of the Boards.

What insurance arrangements are contemplated and who pays? If there is to be self-insurance (e.g. for typhoon damage) whose balance sheet bears the risk?

At present, there is no typhoon insurance for infrastructure assets available in the Philippines. We have coordinated our investigation of this issue with the LGUGC, who have looked into this with respect to their partial credit guarantee scheme. Both Castalia and LGUGC have reached a conclusion that the ECs should be required to carry income interruption insurance.

The remaining risk will be accommodated on the balance sheet of the EC. However, to the extent that the need to rebuild distribution networks will depress profitability during the life of the contract, the risk will also be partially assumed by investors. We understand that investors are comfortable with this, as this is comparable to the risks carried by investor-owned distribution utilities, whose return on capital is capped at 14 percent before tax.

What arrangements are contemplated for rural electrification or network expansion? Who pays and how?

The IMC will lead to some network extension as many viable customers currently remain unserved due to lack of capital by ECs. However, the IMCs by themselves are not designed to address the issue of access to electricity by poor or remote households. Under a separate project, we had earlier recommended to DOE a subsidy scheme based on output-based aid principles to promote connections by unserved households. Such a scheme would be available to all distribution utilities, regardless of their form of ownership.

6 Conclusion

The conclusion of the preparatory stage of this project represents an important milestone in the rehabilitation of rural electric cooperatives in the Philippines. However, much remains to be done to achieve success of the program. We are now in a position to proceed towards 3 to 4 transactions over the next few months, depending on the decisions of the Boards involved.

We also recommend that additional resources be allocated to the program to provide transaction assistance to the next wave of ECs willing to enter into IMCs.