Power Paradox: Breaking institutionalized populism to enhance economic choices

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Executive Summary

The Philippine paradox—high power prices, near bankrupt companies—continues to bewilder investors who are accustomed to operating under a system of fair returns for honest labor and capital.

The Philippine power conundrum, where the country has a penchant for lurching from one crisis to another, is brought about by a combination of institutionalized populism in the approach to regulation, engendered by a flawed legislative process and poor legal and economic framework for the power industry. Combined, these factors stifle socio-economic choices that are essential to the proper functioning of a market economy.

This paper seeks to address the systemic factors that led to institutionalizing populism in power regulation, assess how economic choices were impaired as a consequence, and offers ways by which the Philippine power industry could emerge successfully from its continual crises.

Specifically, the following are posited:

- Constitutional restrictions on ownership, protectionist tendencies in economic policies, and a state bestowed with an obligation to promote distributive justice by intervening when the common good so demands shape legislative and political processes. The attempt to reconcile the Philippines' need to access global capital with limited Filipino counterpart funding often leads to sub-optimal approaches to power restructuring and privatization.

- As a result, legislation has to craft creative means to provide foreign capital access to power projects through concessions or long-term contracts that only fall short of ceding ownership, with the government virtually guaranteeing returns on risks. On such a rigid legal construct, competition in power markets is unlikely to flourish, with consumers ultimately absorbing the inefficiencies via a tariff set-up to recover power costs.

- Corruption erodes trust in public office and engenders a type of checks and balances which, aimed to protect Filipino interests, only end up institutionalizing populist measures in power regulation to the detriment of the economy.

Underpinning this assessment is this basic proposition: economic freedom lies at the heart of successful economies. By adopting a strategic view to power restructuring, privatization and deregulation, the Philippines can stop charging among the highest power prices in the world and remain financially viable.

A change in mindset is essential—from a paternalistic protectionist viewpoint to a trust in a market economy that allocates scarce resources and expands opportunities. Therefore, regulation should aim to promote the capabilities of Filipino enterprise to compete globally, and not to coddle uncompetitive industries.

To avoid continual crises in the future, the country's economic managers should consider the following three-point agenda:

a) open all sectors to all investors through constitutional reform;

b) bundle power assets into corporate entities for privatization;

c) simplify power legislation to foster market forces for pricing and allocating investments.

In the context of repeated failures to privatize the power industry, the first steps towards recovery is to learn from failed approaches, to revise strategies, and to move forward.

Why Does Political Populism Cause Economies to Flounder?

Populist politics in the Philippines comes in the guise of "power to the people" and a "pro-poor" agenda. In reality, it seeks distributive justice while maintaining a paternalistic elite which dispenses money, protection, and political favor. As a consequence, what started as a well-intentioned pro-poor agenda quickly degenerates into income transfers from the "rich" corporations to the "poor" ones through subsidies, a process that not only distorts economic efficiency and market incentives, but also perpetuates a culture of dependency that impedes the emergence of a self-reliant people with vibrant enterprises.

This populism projected to national politics, the quest for public office becomes a struggle for control of resources. Hence, popular perceptions of where the balance of power is shifting often dictates the ebb and flow of political support. In concrete terms, a political leader who demonstrates command over significant resources often wins popular support. Given that delivery of short-term gains is a barometer of influence, the grand gestures to project control and omnipotence often leads to substituting policy-making with political expediency.

Two ideas about the corporate world in the work of Jeffrey Pfeffer and Robert I. Sutton (2006, pp. 206–207) can provide wise insights into the Philippine political process because of certain similarities:

- One of the major challenges faced by leaders who want to convince others that they are in control, and want to gain control, is the onslaught of conflicting and small details that demand attention on what are urgent but not important, and this is one of the reasons that leaders can't lead effectively.

- One of the paradoxes of effective leadership is the need to instill confidence in others, to motivate and convince them that the future will be bright if they act in a cooperative, coordinated fashion—without succumbing to their own hype and believing their own press.

These lessons are closely linked to the view that political leaders, even the benevolent types, are hard pressed to deliver results on the interventionist agenda that political populism encourages. By repeatedly intervening in the workings of a functioning market economy, political leaders can only hope to deliver limited good. They can even inflict unlimited damage by pursuing ill-advised populist policies for short-term gains.

Populist political measures such as power price cuts may project control and omnipotence for a short time until people realize that they themselves have to pay for the dole-outs in the form of taxes and economic misery.

There are historical precedents to support this contention. A number of academic studies has established the link between economic freedom and the prosperity achieved by free societies around the world.

Economic Freedom and Prosperity: The Evidence To-Date

Milton Friedman, the 1976 Nobel Prize winner for economics, pointed to the "historical evidence that speaks with a single voice on the relation between political freedom and a free market" (1962). He "knows 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."

In a study on economic freedom, a group of renowned academics examined the objective data comprising 38 indicators on 99 countries from 1980 to 2000 (Gwartney & Lawson, 2003). A number of their findings support Friedman's contention:

- 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;

- Various measures of investment flows and levels are positively influenced by variations in each country's economic freedom index measure. A 1% point increase in economic freedom measures resulted in 1.25% points rise in long term growth;

- 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;

- Soundness and predictability of legal protection of property rights are seen as essential for prosperity.

In that same conference, Gwartney and Lawson contended that without the legal protection of private property, the incentive to

develop productive resources and engage in entrepreneurial activities is eroded. Correspondingly, without the enforcement of contracts, trade and the accompanying gains from division of labor and specialization are stifled.

Power Industry: Economic Freedom Drives Capital Flow

The institutional framework that supports investment flows is rooted in transparency and predictability of the regulatory and legal systems. Capital flows are influenced by relative returns and risks. In an increasingly uncertain world, risk assessment is gaining prominence in investment decisions. This is made unequivocally clear by the results of analyses by credit-rating agencies of the causes of credit downgrades that lead to defaults and bankruptcies.

At the micro-economic level, economic freedom as a condition applies to the financing of power projects. From 1994 to 2004, Standard and Poor's assessment of the causes of project finance debt downgrades and defaults pointed to similar factors that make countries lag economically (Rigby, 2004). Specifically, these factors are:

- Sovereign-related risks which account for 36.8% of defaults, with a majority located in emerging economies;

- Legal or structural deficiencies that cannot protect projects from downgrades of sponsors and which account for 31.6% of defaults;

- Counter-party risks, which are *de facto* sovereign exposures through state-owned companies, which account for 10.5% of defaults.

Investors in "rated project finance debts will continue to separate better projects from the weaker ones" (Rigby, 2004) so that countries

with sound legal frameworks will continue to attract capital at the expense of higher-risk countries.

The Philippine experience in power financing is a study of contrasts between the period 1992–1997 under President Fidel V. Ramos, and that of 1998 to the present, which is characterized by political instability and an unpredictable regulatory framework. Suffice it to highlight at this stage that while in 1994, investors and bankers saw the Philippines as a tiger cub with a roaring future, the post-1998 scenario showed a complete reversal. By 1999, thanks to the debilitating effects of the Asian crisis, the bright future of the Philippine economy had considerably dimmed.

What a difference the erosion of investor confidence makes!

The Philippine Dilemma: Paternalism vs. Market Forces

The "question we pose to Europe of how far governments can trust the markets' and their country's ability to make creative responses to competitive pressures" (Barcelona & Velamuri, 2006, p. 7) has a wide application for the Philippines where the government's omnipresence in strategic economic endeavors is damaging the country's economic foundations.

The Philippine model of patronage politics faces a dilemma similar to that of protectionist European regimes such as France: Can Philippine political leaders learn to trust the proper functioning of markets so that the government can focus on creating a more supportive institutional framework?

Pfeffer and Sutton's wise observations may help explain why Philippine attempts at transforming the Philippine power industry has been able to show only limited success to date.

Power Legislation: Sowing Seeds of Populism

Populism comes to mind when one examines historical patterns of intervention and political expediency. The following are some of the critical turning points within the Philippine power industry:

- President Ferdinand E Marcos declared Martial Law in 1972. That year saw the NAPOCOR given the monopoly of power generation, transmission and supply to local utilities (Pres. Decree No. 40, 1972). At about the same period, the government sequestered the Manila Electric Company (Meralco), which was distributing half of the country's electricity. The State's right to take over utilities and strategic industries during states of emergency was retained under the 1987 Philippine Constitution.

- The fall of the Marcos regime in 1986 ushered in the first freely elected presidency, that of President Corazon C. Aquino, after 20 years of dictatorship. To attract private investment, the government provided the then-pioneering concept of public-private initiatives to fund the rehabilitation of power infrastructures. The existing institutions could no longer cope with the capital expenditures to meet power demands. This program became known as "build-operate and transfer (BOT)" (Executive Order No. 215, 1987).

- While the government was struggling with the aforementioned funding, the newly adopted 1987 Philippine Constitution, in true paternalistic fashion, made it a constitutional requirement for public utilities, such as power, to be reserved for Philippine nationals or corporations. In the latter case, a corporation is Filipino if Philippine nationals own 60% of it (Constitution of the Republic of the Philippines, Article 12, Section 11, 1987).

- Plagued by a series of coups d' etat, the Aquino presidency

had only limited success with its BOT program. The return of Meralco to its former owners was among the few highlights in the power industry during this era.

- By the time Fidel V. Ramos became president, 12 hours of power outage was a common phenomenon, and sales of private power generating sets had boomed.

- Independent power projects (IPPs) were fast tracked, and the restoration of reliable power supply done in record time. This period coincided with the global push of power companies in Europe which, awash with cash, invested liberally in emerging markets such as the Philippines. American and Asian companies followed in short order, with Asian entrepreneurs taking the lead. Various laws were passed which facilitated investment in the Philippine power infrastructures (Rep. Act No. 6957, 1990), ensuring a predictable and liberal legal framework. With the classification of power generation as a non-utility business, legislative fiat bypassed the constitutional restrictions on foreign ownership and investments.

- Having restored stable power supply, the Ramos government turned its attention to the long term reliability of the Philippine power system. The success of the IPPs demonstrated the country's ability to reverse its fortunes rapidly. This was followed by the successful liberalization of the banking and telecommunications industries, winning for the Philippines the accolade of investors as Asia's new tiger. Today's power generation capacity is a legacy of that era.

- The privatization of NAPOCOR was an achievement of the Ramos presidency. But the power privatization program remained unimplemented after the election of a new president in 1998. While the Asian crisis in 1997 held back the government's progress, the populist agenda of the succeeding

presidency and political inertia held back the successful privatization of the power industry.

It was perhaps by sheer luck and grit that the Philippine economy, after decades of neglect of the power infrastructure, managed to prevent an economic meltdown in 1992. Noted Asian economist Dr. Bernardo M. Villegas once remarked, "This is a good time to invest in the Philippines when everything is down and in disarray. Just make sure you bring your own power generator" (personal communication, 1992). Events afterwards proved Dr. Villegas right.

Events from 1992 to 1998 have proven how a strong-willed president and executive can tide the Philippines through economic ruin and make it recover sufficiently to create an economic boom. Unfortunately, the opposite also came true. With political leadership afterwards in disarray, and the boundaries and jurisdictions of the executive, legislative, and judicial branches entangled, the checks and balances in governance took on a new meaning.

The 1987 Philippine Constitution: Economic Populism to the Fore!

A cursory examination of the constitution of the United States and those of the more advanced European countries shows that their provisions to ensure state control over the economy are not as pronounced as those enshrined in the 1987 Philippine Constitution. In this constitution, a full article is devoted to the ways by which the state is obliged to protect Filipino interests related to national economy and patrimony (Article 12, 1987).

Besides specifying Philippine ownership of utilities, the article bestows on the state the obligation to protect Filipino enterprises against unfair foreign competition and trade practices (Sec. 1, 1987), the right to undertake the exploitation of natural resources with each contract

entered into by the president (subject to the review of Congress) (Sec. 2), with the duty to promote distributive justice and to intervene when the common good so demanded (Sec 6).

The same constitutional article extends the state's duty to protect its people as regards the use of Philippine labor, talents and material (Sec 12, 14) and, in times of national emergency, empowers the state to take over or direct the operation of any privately owned public utility or business affecting public interest (Sec. 17).

Given this wide constitutional obligation, the scope is almost limitless for a government to use populist interventions when it believes that they are in the best interests of its people.

How then did this constitutional obligation influence the legislation underpinning the restructuring of the Philippine power industry?

The Long Road to the 2001 Power Reform Act

Starting with the BOT Law, legislative effort was spent trying to reconcile constitutional restrictions regarding ownership with scarcity of Philippine capital and the political leadership's retention of political control through regulation, direct ownership, and moral suasion.

For this reason, legislators needed to establish a juridical persona for power generation investors to fund their investments with 100% foreign capital, while complying with the Philippine Constitution. To enable the implementation of the BOT schemes, new rules were drawn up to redefine the power generation business as a non-utility activity. Thus the restriction to Philippine ownership no longer applied, and by extending pioneer status, the 60% Filipino ownership requirement was waived.

The drafting of legislation to restructure the Philippine power industry began in 1995. The dilemma that then Secretary of Energy

Francisco L. Viray faced remains unresolved to this day, and covers such concerns as:

> *The balance in regulatory focus:* Is regulation directed at controlling "collusion in power generation and retail sales, while maintaining a competitive balance among different players in the industry"? Or is regulation concerned with "controlling monopoly power through price and investment regulations and other regulatory intervention and, at worse, in utility management decisions"? (Viray, Conference, 1995.)
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> *Structural model:* Should we go for a vertically integrated system which maintains the monopoly structure, or for an unbundling of power generation, transmission, supply and distribution, which is described as "essentially market based ... playing in a highly competitive environment"(Viray, p. 6)? The government opted for an unbundled structure, while retaining state ownership of transmission.
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> *Corporate vs. asset sales:* Splitting NAPOCOR into subsidiaries for eventual sale was discarded by the then Department of Energy (DOE) to "minimize cost and ensure timely program implementation" (Viray, p. 14).

These sentiments need to be seen in the context of the political and economic environment at the time. The Philippines was riding a wave of popularity after resolving the power outage in record time. At the same time, the wave of global investments by newly privatized foreign power companies was at its height. Companies from Europe, the United States, Asia, and even Argentina, were queuing to get on the Philippine privatization bandwagon.

Underlying the government's discomfort with monopoly were the loud voices of detractors who accused the government of coddling monopolists instead of subjecting the economy to global competition.

Secretary Viray had much to say about his proposed approach to privatizing NAPOCOR:

> "Our proposal seeks to minimize, during the implementation process, the granting of power and clout to a larger number of people. We cannot dismiss the fact that some individuals, if given the opportunity, tend to hold on to their power and clout that could prolong or, at worse, discontinue the whole process. Thus, subsidiarization as part of the privatization process was discounted." (Conference, 1995).

Subsidiarization was a terminology that gained currency during the debates on power industry restructuring to refer to the break up of NAPOCOR, the state-owned power generation and transmission company, into fully-owned subsidiaries as a prelude to privatization.

The approach outlined by Secretary Viray was a pragmatic solution to the constitutional restrictions on ownership. Specifically:

- A substantial power generation subsidiary would require billion-dollar investments, which are beyond the reach of most Philippine investors. By securing the assets through long-term contracts, the government contemplated replicating the model of the successful independent power program through piece-meal sale of assets;

- By retaining state ownership, the approach sidesteps the difficult issues surrounding restrictions of foreign ownership and operations of a utility franchise;

- Transferring a state-owned monopoly to the private sector, in an industry already dominated by a private monopoly in distribution, MERALCO, loomed large in public debates on power industry restructuring.

As subsequent events would demonstrate, delays in getting legislation through Congress lasted until 2001, when a watered-down version of the Electric Power Industry and Restructuring Act (or popularly known as EPIRA or Power Reform Act) was finally passed.

The Good, the Bad, the Ugly ... and the Beautiful of EPIRA

The EPIRA, which was finally passed in its present form, perhaps under duress, is not a total loss to Philippine power restructuring and privatization. (The Asian Development Bank made the passage of EPIRA a condition for its continued funding of the power industry. With President Gloria Macapagal Arroyo assuming the presidency after the ouster of President Joseph Estrada in a People's Power upheaval, EPIRA was rushed through Congress and the Senate for passage.) The relative merits of power restructuring and privatization in Europe and the Philippines were covered extensively in previous papers (Barcelona, 1996 & 2004).This paper focuses on the legislative process and its economic impact.

The EPIRA was drafted with the presumption that constitutional constraints to ownership and state interventions can be overcome by applying the lessons of BOT. However, the challenges in 2006 were institutional rather than financial. Power restructuring had the added task of creating institutions to support competition and make market forces flourish. While the imperative for privatization had changed since 1998, the need was still to address the funding requirements that had worsened by piecemeal sale of power assets. Creating a power market and regulation to allow the industry to move successfully to a competitive market came only as an afterthought.

Unfortunately, in the absence of a liquid power market, investors have to resort to long-term power contracts to secure their returns. By locking in long-term commitments with a state-owned power company,

privatization becomes no more than a transfer of the obligation for capital expenditures to the private investor. In exchange for this, the government underwrites the power assets by assuming a long-term liability under the power off-take contracts.

In plain language, the sum paid by the investor is a quasi-borrowing from the government that the state-owned company pays back in secure cash payments. Therefore, the ability to create a traded power market is impaired by the absence of a need for merchant power capacity, since the bulk of production is contracted under fixed long-term commitments. Merchant capacity is sold to a variety of utilities and industrial customers, either on short-term contracts or through traded power market, where prices and volumes are sold in a wholesale market. The latter hardly exists in the Philippines although the law provides for its creation.

Under normal conditions, the guarantee of a state-supported contract should attract investments in the power industry. However, these are not normal times, and the credibility of the government as counterparty is now in question. The political expediency that reversed the contractual commitments of previous regimes reinforces the perception that the Philippine government is not ready for business—at least not in 2006.

Good and Bad Times

When the Philippine economy was buoyant (1992–1997) and government credibility was high, the constitutional constraints on ownership and the ways that investors managed to work around these restrictions were readily regarded as manageable business risks. The outlook was good, and any concern about capricious government interventions was outweighed by optimistic expectations on investment returns.

The bad times came with the Asian financial crisis in 1997. The Philippines felt its impact in 1999. Previous to this, the Philippines was faring better than its neighbors in economic performance as remittances from Philippine overseas workers shored up the weak economy. Legislators believed their own propaganda that the Philippine economic resilience was of a superior nature, and that it could be attributed to sound government policies.

Power privatization in the Philippines faced even greater challenges in 2006. The factors were:

- *Loss of confidence:* Populist actions, such as the reversal of the bid award on the Manila Hotel on grounds of Philippine patrimony (Philippine Constitution, Sec. 10, 1987); the rescinding of the Manila International Airport's new terminal contract (PIATCO); and the power tariff cuts in 2003 only to see the cuts reversed by sharp price increases—all these raised questions on the stability of country's regulatory framework;

- *Pull back of power investors:* Financial difficulties and consolidation at home reduced the number of credit-worthy global power investors. The few power investors that remained were largely bypassing the Philippines for other markets;

- *Perception of political instability and corruption:* The Philippines ranks among the countries that face significant challenges with regard to economic freedom, corruption, and transparency.

The Philippines may believe its own press that its economic strength is creditable, citing statistics such as a significant increase in direct foreign investment inflows, strong remittances from overseas workers, and strong earnings from the corporate sector. But none of these indicators matter as global capital flows are pushing other countries ahead, leaving the Philippines in its wake. Ultimately, investors allocate their investment dollars to more attractive markets.

This is why the Philippines needs to assess its competitiveness and to firm up an investment framework that enhances, rather than stifles, economic choices.

And Now, the Ugly Part …

EPIRA perpetuates political populism by institutionalizing state influence through a range of regulations, powers to Congress, and a type of checks and balances that renders executive decisions subject to congressional review.

The following conditions perpetuate existing regulations and controls that only serve to diminish investor interest:

- Mega-control and micro-management by the government provide its three branches license to intervene in the public interests across the full spectrum of the energy industry;
- Economic choices created by competition in power generation and supply are curbed if the government interposes its protective power beyond the regulated public utilities;
- Weak governance and financial dependence of power companies perpetuate reliance on political patronage for survival.

The experiment with deregulation had thus become fraught with difficulties due to regulatory practices, hazy boundaries between the executive, legislative, and judicial branches, and the inability of jurisprudence to adapt to the requirements of a competitive power market.

In October 2005, EPIRA's status report (Department of Energy, 2005) suggested that much work needed to be done in view of the challenging political backdrop—and this was more than five years after the law was enacted.

Mega Control and Micro-Management

On paper, EPIRA recognizes the power generation sector (Electric Power Industry and Restructuring Act [EPIRA], Sec. 6, 2001) and the supply sector (Sec. 29) as competitive businesses although "affected with public interest." In principle, market forces are relied upon to set price levels to consumers, with the regulator promoting a legal framework that can support the rapid evolution of a competitive market.

In practice, the transition to a competitive power generation and supply market is impeded by government control over pricing. For instance:

- The president ordered cuts in purchased power adjustments (PPAs) in 2003, and the "independent" regulator readily complied. However, the relief to consumers was short-lived as power prices for generation were increased sharply in 2004 to cover the losses of NAPOCOR;
- Under EPIRA, the Department of Energy, the Power Commission at Congress, and the Executive branch continue to exert their political influence on the "independent" regulator;
- The Energy Regulatory Commission still has to demonstrate where its independent status can withstand political pressures. As tariff setter, adjudicator of disputes, promoter of competition, with police powers against anti-trust behavior, it is endowed with too much clout, so that it perpetuates the politicized approach to energy regulation (Barcelona, 2002, Staff Memos no. 21);
- The Board of Directors of the various legal entities under EPIRA and the manner they are constituted and operated only lead to one conclusion. The government, by legislating the staffing and operation of the legal entities, instead of leaving

such stipulations to the corporation's articles of association, 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 regulated public utility to power generation and supply without the benefits of protected returns (Rules & Regulations Implementing the Power Reform Law, 2f). It is one example of how public interest obligations, in a public utility sense, may be extended to power generation and supply, activities that are recognized by EPIRA as competitive and open. Before long and not surprisingly, competition becomes a burden because any achievement from superior competitive positioning is eroded by regulatory actions, while extra burdens to meet "public interest" can hardly be supported. The PPA cut in 2003 is a case in point—NAPOCOR is still reeling from the president's decision, with losses amounting to over P113B ($2B), with debt spiraling to more than P500B ($9.0B).

The seeds for such a misalignment between a competitive structure and the government's political control may have been planted in the Supreme Court ruling on Meralco. In the opinion penned by Justice Reynato S. Puno, "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 for public utilities without being unreasonable to the consuming public" (Energy Regulatory Board v. Meralco, 2003). Up to this point, it is hard to disagree with Justice Puno. However, his qualification of what is reasonable suggests that a deep-seated *ad hoc* approach to energy policy has crept into jurisprudence as well. To quote from the decision: "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." For investors seeking predictability in the legal framework, such a flexible legal doctrine does not provide much comfort.

Weak Governance and Dependence On Political Patronage

Governance is another weakness that manifests itself in the rigid specifications for membership in the board of the various entities under EPIRA. Cabinet members appear to be given the right to sit on the boards of companies whose assets are being prepared for privatization.

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

- Unlike in the Philippines, companies up for privatization were organized under a corporate structure that resembled a private enterprise;
- Chief Executives, board members and senior management were drawn from the best-qualified pool of private sector executives;
- Corporate charters or articles of associations were drafted to fit the specific circumstances of the companies that would enter a future life in the private sector.

In the context of this paper, the power restructuring and privatization in Europe refer to the successful experiences of the United Kingdom, Spain, Sweden; and for restructuring and deregulation, in addition to the above countries, Portugal, Italy, Belgium and Germany. Portugal could arguably be said to have regressed to a more protectionist model of creating national champions.

By providing a private-sector framework, the entities were insulated from government control. Such insulation is important for smoother transition from state to private ownership.

The Philippine approach, as pointed out earlier, solidifies political control which specifies the corporate structure and governance. Therefore, instead of greater commercial freedom, legislation has made sure that management conforms to the strictures of government-owned and -controlled corporations (GOCCs).

The problem does not end with the rigid governance and corporate structures.. The financial viability of the power entities to be privatized appears to be a *priori* set for failure under the privatization plan. For example:

- TRANSCO was created with neither a license nor a concession that would secure its returns on infrastructure investments. For this reason, its ability to attract funding either as a state-owned or privatized entity relied on government support in one form or another;

- Power generation assets were sold as individual plants. Unlike a corporate entity with a portfolio of assets, the "new" power generators ended up without the scale or the diversity of fuel that would ensure its financial viability (Barcelona, 2002, Staff Memos no. 23).

Interestingly, the blurring of the boundaries of obligations and rights may have been extended to the TRANSCO bidding process. In its press release, the government through its privatization agency, required "the winning bidder for the 25-year concession . . . to obtain a congressional franchise to operate the transmission company which is considered a public utility" (Power Sector Assets and Liabilities Management Corporation Press Office [PSALM], 2006). This approach raises the question—"If the government cannot obtain a concession from its Congress, will a private investor have a better chance?"

Energy Regulatory Commission: Compromised Independence and Conflicting Roles?

The failure to recognize the basic law on economic choices, political control, and shifts in influence that competition brings about may explain the ambivalence of the Philippine approach to power regulation, an ambivalence that swings from distrust of market forces to set power prices, attract investments, and recognize the regulator's role as the arbiter of rules of engagement, to the other extreme of pandering to the political leadership's continued need to project an image of omnipotence. Such a formula can only generate constant tension and regulatory instability. Unfortunately, this is just the kind of instability that is most certainly guaranteed under EPIRA.

The Energy Regulatory Commission is in an unenviable position, saddled with the responsibilities of being the (a) consumers' champion (EPIRA, Sec. 41); (b) promoter of competition and builder of market institutions (Sec. 43); (c) tariff setter and enforcer as judge and jury (Rules and Regulations of EPIRA, Rule 3, Sec. 4); and (d) police force to counter the anti-competitive behavior of power generators (clauses A & I).

The independence of the regulator is already compromised under the compensation system (EPIRA, Sec. 39) where Congress and the President of the Philippines often determine the Commission's appointments and pay scales. The question therefore arises: While independence is well-recognized as a condition for success, are there incentives for the regulator to exert his independence, notwithstanding his security of tenure? (EPIRA, Sec. 38)

The implications of regulatory independence from political control must be recognized. In a fully functioning competitive power generation and supply market, the exercise of economic choices resides in the economic agents, with the regulator and the government providing a framework that makes choices possible. A government that is not prepared to relinquish traditional controls over industry is

bound to fail in its experiment on market liberalization.

Under EPIRA, this transfer of control points and influences has been inadvertently concentrated on the Energy Regulatory Commission, forcing roles and responsibilities that put the regulatory body in conflict with itself. For instance:

- The ability to set rules and to adjudicate endows the regulator with powers that are legislative and judicial in nature.
- Policing power is given to the same entity that sets the rules, balances both the consumer and power generator's interests, and renders a judgment on the actions of the police and the respondents on anti-competitive behavior.

The prescriptive manner in which EPIRA defined the roles of the Energy Regulatory Commissioners (EPIRA, Section 38) betrays a misconception of the role of a regulator. In a successful transition from a highly regulated to a competitive power market, the primordial contribution of an effective regulator lies in building the institutions and market framework that will sustain competition. In EPIRA's perspective, the regulator is a quasi-judicial authority that adjudicates on tariff applications and lawsuits within the power industry.

Thus, by having a very legalistic approach to power regulation, EPIRA has set up the Commissioners of the Energy Regulatory Commission to adjudicate tariff applications and render judgments on power companies and consumers. The emergence of a competitive power market could happen only by luck.

Levers for Political Control

The leadership's desire to retain tight political control is manifested in the Power Crisis provision that authorizes Congress to establish

additional power "generation capacity under such terms and conditions as it may approve" (Rules and Regulations of EPIRA, 24). Given the real prospects of a looming power crisis, the specter of politics interfering in economic allocation of risks and returns could readily turn this exercise into another rent accumulation opportunity where political controls stymie economic choices.

The Joint Power Committee of Congress is empowered to oversee the actions of the Executive branch in implementing the restructuring and privatization of the power industry. In the experiences of Masinloc (PSALM, 2006), and the repeated failed bids for TRANSCO, the committee's penchant for revisiting decisions portends a protracted process for any sale. Faced with this prospect, private investors would either shy away or bid low to make allowances for excessive costs—in legal and lobbying fees, among others—to complete a transaction. This is an instance where the blurring of the boundaries becomes detrimental—Congress both legislates and executes , while the Executive is rendered ineffectual through repeated hearings to justify actions that are well within its mandate under existing legislation.

The question that needs to be asked is: If EPIRA had been the basis for resolving the Philippine power crisis in 1992, would the Philippines still be enjoying candle-lit evenings, with the era of electricity turned into a distant memory?

Secretary Viray's vision in 1995, of promoting low power cost through competition, rationalizing power rates to provide correct economic signals to investments, reducing government financial obligation through privatization, and achieving transparency in subsidies, is far from being realized in 2006.

Now for the Beautiful Part

The creation of a wholesale market and the unbundling of power

generation, supply, and distribution are at the core of a competitive power market. With the implementing rules and regulations in place, work to make the wholesale power market a reality is well at hand.

What is unique to the Philippines is the existence of a financially weak power distribution sector and the missionary work involving the rural electrification program. The framework under EPIRA addresses these realities:

- Consolidation of the power distribution is a necessity if the sector is to survive;

- The government is presumed to do better at allocating the social costs and benefits of rural electrification that a competitive power market is ill-equipped to handle.

With the essential elements on legislation already in place, the work for power restructuring essentially covers two aspects:

- Creating mechanisms and structures to allow competition in power generation and supply to flourish; and

- Simplifying EPIRA by amending less relevant provisions and so reduce government interventions.

A more streamlined version of EPIRA would be better for the Philippine economy. This can be achieved by amending parts of the existing legislation, following a number of simple principles. To wit:

- A clear delineation of roles, with legislators passing on the responsibilities for implementing the law to the Executive branch;

- Freedom to organize the power companies. The mode of privatization is essential for the government to respond to

changing circumstances, without continually amending the law or seeking congressional support to accommodate the changes;

- Transparency in regulation, and elimination of conflicts of interest within the regulatory function;

- The Judiciary as the arbiter of last resort rather than the first port of call for rendering judgment on opposing views bred by legislative ambiguities.

Translating these principles into legislative action, the EPIRA could take on the following proposed form, amending certain unworkable aspects as a framework for restructuring and privatizing the Philippine power industry:

- The Energy Regulatory Commission to focus on power rate-setting in transmission and distribution, and establishing rules on competition in power generation and supply;

- Anti-competitive behavior and market abuse—as regards both the investigative and enforcement functions—to be concerns of the anti-trust body that EPIRA should but did not create. This role is bestowed with an anti-trust authority that still needs to be legislated and created, independently of the energy regulator and the government;

- Litigations involving contractual disputes, challenges to regulatory actions and similar cases, to be handled by the judiciary, precisely to minimize the scope for the regulator to be both judge and jury on cases concerning its competence;

- Building institutions and mechanisms supportive of a competitive power market to be apportioned to the wholesale power market, comprising under the EPIRA, the Wholesale

Electricity Spot Market (EPIRA, Sec 30) and the market operator;

- Articles related to the composition of the board of directors and the management of power companies to be deleted;

- A tariff-setting mechanism based on incentives to be done on a periodic basis (say, five years) for TRANSCO and distribution companies. Moreover, these incentives are to be based on an inflation-indexed formula (the mechanism in the UK and Spain known as RPI-X), to free the Energy Regulatory Commission from a backlog of tariff adjudications that it has little chance of clearing in a timely fashion.

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

There is a saying that goes, "Who pays the piper calls the tune." The regulator is funded through an appropriation from the Office of the President, with subsequent funding being subject to regular or special appropriations (EPIRA, Sec. 42). Perhaps, independence is best served, and interests between consumers and the power industry better aligned, if funding is derived from a specific levy on tariffs. The amount can be capped. By making the regulator's funding separate from government appropriations, political control on price-setting and regulatory actions will be less subject to the influence of a government's populist agenda.

Constitutional Reforms and Revised Privatization Program

Power prices exert significant impact on competitiveness, productivity, and social well-being. For this reason, the paradox that the Philippines harbors an almost bankrupt power industry and yet suffers from exorbitant power rates remains to be solved. Going back to Philippine populism, why does the ambivalent mixture of resentment of the rich and tolerance of the paternalistic elite persist? How does this influence the allocation of socio-economic burdens and benefits?

This persistence can be explained in the context of a constitutionally-mandated obligation by the state to protect Filipino interests. The state becomes the pre-ordained arbiter of what is the best interest of Filipino people. Therefore, for an individual to exert formal influence on the political process, he must have access to the levers of power either through public office or patronage. The need for access to both public office and money from the paternalistic elite becomes a self-sustaining model for recruitment into and funding of the political process.

Extrapolated to the power industry, this is manifested in the EPIRA's interventionist approach to regulation, with the government retaining various forms of control over a system that is supposed to rely on market forces to operate. The design of the privatization program—the piecemeal asset sales vs. corporate sales—appears to have taken the limits of Filipino capital. Within this context, is there hope for a successful turnaround of power restructuring and privatization that the Philippine government has so far failed to deliver?

Conditions for a Turn-Around

The first step toward a serious change in strategy is to identify the conditions that are essential to turn around failed attempts. The two conditions are:

- A functioning market-driven regulation and legal framework that truly allows ease of access to the global capital pool; and

- The creation of the building blocks for power companies to become world-class players and not under-capitalized single-asset operators.

There would be a better chance at attracting capital for profitable, competition-tested companies by removing restrictions on foreign capital flows and ownership and revamping the piecemeal approach to asset sales. Given the political process and the bad press the government has been getting, it is reasonable to question the feasibility of amending the constitution and the government's capacity to learn from its failed privatization program.

Cautious Optimism

Change will not come about due to a government which is intent on repeating its mistakes. Rather, history is on the side of the markets forcing change, often in cataclysmic fashion, like bankruptcies that no amount of government aid and subsidies could prevent.

Governments rise and fall not so much because of mass poverty. Discontent and politically expressed upheaval (People Power, for instance) happen largely because of the generalized perception that the government has lost its moral authority to govern.

While failing to privatize the power industry does not constitute such a loss of moral authority, the effects of high power prices contributes to the government's unpopularity. Adam Posen, in assessing the challenges of political leadership in an era of general economic prosperity, observed:

Our current age of ennui is thus a period of repeated turnover

> in elected governments with little turnover in policy. It is an age where economic performance will not be a dependable predictor of election results; but no ideological or spiritual programs will replace it—instead, reports of corruption and the rise and fall of a politician's personal popularity will drive voting. And it is a period where globalization will continue to be a scapegoat for more vague dissatisfactions by those who are globalization's beneficiaries. (2006).

It bears repeating that each government intervention cements the adverse impact of politically expedient government actions. Such measures as reversals of contracts, tinkering with the regulatory framework, and overruling the authority of the regulator conspire to weaken the economic legal framework of the power industry. Economic freedom deteriorates, and with every repeated and unamended policy mistake, the Philippine's ability to do business remains suspect. Each failure makes the next attempt at restructuring and privatization less credible and more difficult to implement.

Will learning the hard lessons and striking at the roots of failure bring the Philippines closer to success after each failed attempt? Even Thomas Edison performed a thousand failed experiments before he finally got the world's first light bulb right!

Constitutional Change

What is the state supposed to protect . . . and what Filipino interest is the government obliged to protect to safeguard distributive justice in economic matters when the common good so demands?

The bad press over the past few years—PIATCO, Meralco, Manila Hotel, renegotiation of independent power contracts, TRANSCO and Masinloc, are just a few stark reminders of the government's ominous powers to wreak havoc in the name of the best interests of the Filipino people.

The Philippines is not alone in this conundrum. It has good company in France where the French Prime Minister Dominique de Villepin embarked on a similar path of economic patriotism that President Francois Mitterand took and failed in 1982. A year after a strong start, reports *The Economist* ("Patriot Games", July 1–7, 2006), French companies went on a buying spree abroad, while keeping a protectionist stance in its home market, but

> France's new protectionism is looking ragged, as one grand design after another has been thwarted. In 'strategic' industries, such as steel, aerospace and energy, the news for the patriots has been bad. Intervention is not dead, of course; but, as the past few weeks have shown, international capital markets are restricting its scope. (p. 14)

The Philippine economic patriots, using similar arguments, contend that Philippine industries need government support to project its muscles internationally. The reality is far from this notion.

The same article from *The Economist* declares:

> The defenders of state intervention argue that without it, France would not have world-beaters in business, such as the two leading luxury goods groups (LVMH and PPR), one of the biggest insurers (AXA), as well as leaders in cosmetics (L'Oreal) and food (Danone).

The French economic patriots may have handed their argument straight to the hands of the much despised (in their perspective at least) proponents of free and fair trade and open access economies.

In the words of the author, all the companies cited by the French patriots tended to be the ones the state had left alone:

> The companies it backed were the ones that eventually needed

rescuing: Alstom, an engineering group; Bull, a computer firm; Air France, the national airline; Credit Lyonnaise, a big bank. A state guarantee allows managers to run companies irresponsibly without fear of being disciplined by shareholders or banks. (*The Economist,* July 1–7, 2006)

The Philippine examples can list companies in the unenviable company of their French counterparts. There is one pattern that is indisputable—government protection is almost a death embrace for companies that could otherwise have thrived after passing the severe tests of competition and market discipline. As in the French experience, successful Philippine companies such as SGV and Ayala are quietly expanding internationally without much government assistance.

The arguments for protectionism are curious ones. For a country that requires significant foreign capital inflows because local capital is insufficient, the Philippines appears to want to have its cake and eat it too. For example:

- Foreign capital is welcome and offered with all kinds of incentives, yet ownership of real estate, utilities, and natural resources are restricted to Filipinos who have neither capital nor technology;

- With the need for foreign capital to partner with a passive Filipino "owner", "creative" structures of governance are needed to bypass these restrictions within legal bounds; and

- As a consequence, the Constitution has brought about a class of rent seekers whose only role is to give a Filipino face to foreign-controlled ventures. It is hardly surprising that foreign investors have minimized capital commitments to ventures they can control, but which may not always assure continued ownership. Such governance structures reduce the pool of capital and encourage short-term focus on the power industry,

when what is required is a long-term, capital-intensive focus.

Without the capacity to exploit the opportunities offered by natural resources such as geothermal power, mining and strategic industries like power and oil, there is very little Filipino interest to protect. In contrast, by allowing capital to flow in and be allocated under a secure legal framework of ownership, opportunities to expand economic activities would ultimately benefit the Filipino nation. What, then, is the Philippine Constitution purporting to protect, when its only apparent purpose in a globalized economy is to render the Philippines economically backward? The Constitution needs to focus the state's role in the economy to a number of areas, namely:

- To promulgate sound fiscal policies by laying the principles against capricious taxation by government;
- To ensure freedom of access and flows of capital on what have been identified as national patrimony and strategic industries, with no restrictions to foreign ownership; and
- To apply the law in a transparent and fair manner.

The details and the mechanics of how government can work for the best interests of Filipino enterprise are best left to policy-making. The government should be given the utmost discretion to govern, and not to saddle the state with a constitutionally-mandated obligation that is anachronistic. Inadvertently, the Constitution has made the courts the arbiter of first resort in economic cases when they may not always be best equipped to pass judgment. Given the choice between a state "dictatorship of good intentions" and what economic patriots call the "dictatorship of cash" (economic patriots fear that an overwhelming influx of cash from foreign investors would sideline Filipino economic activity), the vote should be for cash . . . and freedom from state paternalism.

Revise the Privatization Program

The repeated failures of PSALM to complete a major power asset sale since its creation brings up questions regarding the viability of the present approach. The Philippine's ad hoc approach to privatization runs counter to the basic tenets of investment. The perception of risks, exacerbated by past government actions, continues to linger. Specifically:

- Slow progress to fully implement the wholesale electricity market hinders the transition from state-supported long-term contracts to traded market. Without liquidity, investors will rely on the only "credit worthy" party acceptable—the state—because the rest of the industry are either too small or teetering on bankruptcy.

- Power generation and supply are classified by EPIRA as competitive segments, but the judiciary (*Energy Regulatory Board v. Manila Electric Company, 2003; Lawyers Against Monopoly v. Manila Electric Company, 2003*) undermined the operation of market forces by upholding the state's duty to "interpose its protective power whenever too much profits become the priority of public utilities" (The Supreme Court ruled against MERALCO for overcharging consumers by including income taxes as part of its operating expenses). There is always the uncertainty as to when the state will call on its powers of intervention.

- BOT and other financing schemes that circumvent Filipino ownership restrictions are short-term solutions that work well. However, such schemes prolong the government's obligations as guarantor of state-owned companies, and impede the evolution of a traded market in electricity.

The government should be encouraged to create strong competitors that can sustain investments and become global players—corporations with bundled assets and diversified capacity portfolio. Small companies (by international standards) created to acquire piecemeal assets from the present privatization are unlikely to survive the first round of crises.

The good news is that the task of setting legislation right and getting its power restructuring and privatization program back on track is a legacy-in-waiting, a series of bold moves so that future generations may look back to the present government with sympathetic judgment.

To achieve such a legacy, the government should focus on the following immediate steps:

Constitutional reforms. The present debates on constitutional change has been distracted by less essential chatter about the relative merits of a presidential or parliamentary system of government. The form of government has actually no relevance to economic progress or stagnation.

The debate should turn instead to amending or deleting clauses that restrict state ownership, capital access, and constitutional obligations to protect Filipino enterprises and economic interests; likewise to reduce the populist policies institutionalized by Philippine legislation.

Constitutional amendment does not need to be a condition for revising the EPIRA. However, a constitution that is more attuned to the realities of a globalized economy will give a signal to international investors that the Philippines is finally ready for business.

Amend EPIRA. Taking into consideration the recommendations in this paper, a more streamlined EPIRA would make the legal framework more manageable.

A clear mandate to establish a task force with a finite life and is accountable to the Cabinet has a better chance at getting the right focus and authority to execute a privatization program successfully. The task force's sole task would be to get EPIRA amended by Congress to reformulate a viable privatization program.

All the bad press notwithstanding, the present government has a majority command in Congress. Therefore, if there is a chance of passing meaningful amendments, now is a good a time to do so.

An institutional and corporate approach to restructuring and privatization. The institutional aspects should focus on building the wholesale market to operate fully as a competitive market for the trade of electricity. With a liquid market in operation, the need for government to continue to support long-term power contracts will be reduced. Risk management by power generators could take on a more market-oriented approach, making for more flexibility than a long-term contract allows.

A corporate approach to organizing the power generation and supply can breed globally competitive players. Single plant or small players in a capital-intensive industry will find it difficult to survive. Even with long-term supply commitments, a single plant operator would face a crisis for every disruption of its operations.

In contrast, for a corporation with a portfolio of assets, a sound balance sheet, and good management, the options for privatization expand dramatically. While awaiting privatization, the corporation can survive without government support if it is given the mandate of a private corporation. The need to sell under duress, as what is happening with piece-meal sale of assets, can be avoided. By improving the timing of a sale, the government can choose when to privatize rather than be forced to sell, even under adverse conditions, for the sake of raising cash.

Conclusions

The Philippine power paradox—high power prices, near bankrupt companies—is the product of a Constitution that institutionalizes populism. The irony is, the more the State tries to protect Filipino enterprise and interests, the more havoc it wreaks on the people whose best interests it seeks to protect.

EPIRA is a classic piece of legislation that demonstrates that contradiction. Crafted to provide the blueprint for a fully functional competitive power market and to replace the regulated system, the law institutionalizes a new meaning to the term "checks and balances", where the jurisdictions of the various branches of government become blurred. By taking an interventionist approach to regulation, EPIRA allows a wide scope for the political leadership to achieve omnipotence with grand gestures like price cuts, congressional investigations, and outright contract renegotiations. This is the bad news for the Philippine power industry and economy.

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