Republic of the Philippines
Supreme Court
Manila

EN BANC

NATIONAL ASSOCIATION OF ELECTRICITY CONSUMERS FOR REFORMS, INC.,
Petitioner,

- versus -

ENERGY REGULATORY COMMISSION, MANILA ELECTRIC COMPANY, and COMMISSION ON AUDIT,
Respondents.

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CLARK ELECTRIC DISTRIBUTION CORPORATION, DAGUPAN ELECTRIC CORPORATION, ANGELES ELECTRIC CORPORATION, CAGAYAN ELECTRIC POWER & LIGHT COMPANY, INC., SAN FERNANDO ELECTRIC LIGHT & POWER COMPANY, INC., CABANATUAN ELECTRIC CORPORATION, TARLAC ELECTRIC, INC., and OLONGAPO ELECTRICITY DISTRIBUTION COMPANY, INC.,
Movant-Intervenors.

G.R. No. 226443

Present:

BERSAMIN, *C.J.*,
CARPIO,
PERALTA,
PERLAS-BERNABE,
LEONEN,
CAGUIOA,
REYES, A., JR.,
GESMUNDO,
REYES, J., JR.,
HERNANDO,
CARANDANG,
LAZARO-JAVIER,
INTING* and
ZALAMEDA, *JJ.*

Promulgated:

October 8, 2019

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D E C I S I O N

CARPIO, *J.*:

The Case

The present petition for review on certiorari[1] filed by petitioner National Association of Electricity Consumers for Reforms, Inc.

* On official leave.
[1] Under Rule 45 of the Rules of Court. *Rollo* (G.R. No. 226443), Vol. I, pp. 18-42.

(NASECORE) assails the Decision[2] dated 29 February 2016 and the Resolution[3] dated 18 August 2016 of the Court of Appeals (CA) in CA-G.R. SP No. 129052. The CA affirmed the Orders[4] dated 21 June 2011 and 4 February 2013 of the Energy Regulatory Commission (ERC) in ERC Case Nos. 2001-646 and 2001-900.

The Facts

The facts, as culled from the records, are as follows:

In *MERALCO v. Genaro Lualhati (Lualhati)*,[5] the Court directed the ERC to request the Commission on Audit (COA) to undertake a complete audit on the books, records, and accounts of Manila Electric Company, Inc. (MERALCO) relative to its provisionally-approved rate increases and unbundled rates. The dispositive portion of this Court's Decision dated 6 December 2006 states:

> WHEREFORE, the petition is *GRANTED*. The 22 July 2004 Decision and 24 January 2005 Resolution of the Court of Appeals in CA-G.R. SP No. 77559 are hereby *SET ASIDE*. The ERC Decision dated 20 March 2003 and its Order dated 30 May 2003 in ERC Case Nos. 2001-646 and 2001-900 are REINSTATED subject to the above disquisitions.
>
> The Energy Regulatory Commission is, thus, directed to request the COA to undertake a complete audit on the books, records and accounts of MERALCO relative to its provisionally-approved rate increases and unbundled rates.
>
> SO ORDERED.[6]

In its Order dated 12 January 2007, the ERC requested COA to conduct an audit of MERALCO's books, accounts and records to determine: (a) whether the implementation of the approved distribution rates resulted in a fair return; and (b) whether the recovery of generation costs had been revenue-neutral to MERALCO. The COA conducted the audit pursuant to MS/TS Office Order No. 2008-015 dated 8 September 2008.

On 12 November 2009, the COA transmitted to the ERC its Special Audits Office Report No. 2009-01 Rate Audit of Unbundled Charges of MERALCO (COA Report).[7]

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2 Id. at 358-373. Penned by Associate Justice Victoria Isabel A. Paredes, with Associate Justices Magdangal M. De Leon and Elihu A. Ybañez concurring.
3 Id. at 384-385.
4 Id. at 189-217.
5 539 Phil. 509 (2006).
6 Id. at 531.
7 *Rollo*, (G.R. No. 226443), Vol. I, pp. 74-184.

The COA Report states that: (1) the audit covered the test years 2004 and 2007, as the unbundled rates were implemented in June 2003; (2) the team performed the following: a) accounted for revenues generated from approved rates and those earned from related activities; b) reviewed property and equipment accounts to ascertain propriety and values to be considered in rate base; c) conducted ocular inspection of selected transmission substations and branches to determine existence, condition and usage; d) reviewed operating expense accounts to determine expenses recoverable from consumers; and e) accounted for generation costs and related revenues;[8] and (3) the rate-setting methodology used is a cost based method known as Return on Rate Base (RORB).[9]

The audit disclosed the impact on MERALCO's revenue structure upon implementation of the approved distribution rates computed at three different rates of return: (1) the ERC-approved rate of return of 15.50% based on MERALCO's Weighted Average Cost of Capital (WACC) for 2000; (2) the actual WACC of 12.80% and 11.70% for CYs 2004 and 2007, respectively; and (3) the reasonable rate of return of 12% established in jurisprudence using both historical costs and appraised values, tabulated as follows:

Rate of Return	Excess (Deficiency) Revenue Computed Based on			
	2004		2007	
	Historical Cost	Appraised Value	Historical Cost	Appraised Value
Approved Rate of 15.50% based on WACC	₱6,756,940,879	₱2,590,667,993	₱2,207,598,653	₱(1,272,322,123)
Actual WACC: CY 2004 (12.80%) CY 2007 (11.70%)				
	8,142,009,602	4,701,474,573		
			4,561,646,651	1,934,867,743
Reasonable rate of return of 12% established in jurisprudence	₱8,552,400,334	₱5,326,898,745	₱4,375,800,757	₱1,681,668,543

The COA Report further states that the excess or deficiency in distribution revenues was determined after considering the following factors in establishing MERALCO's revenue requirements: a) certain operating expenses, which include employee pension and other benefits, amounting to ₱3.479 billion and ₱2.916 billion for 2004 and 2007, respectively, were not considered recoverable from the consumers as these were not reasonable and necessary in the delivery of distribution services; and b) certain property and equipment amounting to ₱3.701 billion and ₱3.586 billion for 2004 and

8 Id. at 78.
9 Id. at 83.

2007, respectively, were not considered by the team as part of the rate base as these were not used and useful in the distribution operation during the test period.[10]

In an Order dated 15 February 2010, the ERC directed the intervenors to comment on the COA Report. On 2 March 2010, Genaro Lualhati filed his Comment, while NASECORE filed its Comment on 5 April 2010.

In its Comment, NASECORE alleged that: (1) the rate of return granted to MERALCO in 2003 was 15.50%, which was 3.5% higher than the 12% established and adopted by administrative and judicial bodies; (2) based on its excessive revenue, MERALCO should not be entitled to rate increase in 2003 and the ERC should direct it to refund its excess profits; (3) the ERC should hold in abeyance any further rate increase of MERALCO until after conducting a complete audit of its books, accounts and records for the years 1987 to the present; and (4) the COA report confirmed that MERALCO's provisionally approved unbundled rates were oppressive and exorbitant.

In its Comment, MERALCO alleged that: (1) the ERC has the final decision on matters involving rates; (2) the pension and benefits are reasonable costs of a utility and are recoverable expenses; (3) certain assets disallowed by COA have been consistently upheld by the ERC as used and useful in providing utility service; and (4) the basis whether it exceeded its return should be 15.5% and the ERC is not bound to maintain its rate of return at 12%.

The Ruling of the ERC

In its Order[11] dated 21 June 2011, the ERC affirmed its findings and conclusions in its Decision dated 20 March 2003 and Order dated 20 May 2003, and declared MERALCO's approved unbundled rates final. The ERC held that COA's findings of "excess revenues" or "over-recovery" on the part of the MERALCO were due to the following factors: 1) the application of the disallowances under MERALCO's Performance Based Rate (PBR) application to its RORB application; 2) the calculation of MERALCO's revenues using historical costs of the assets and a 12% RORB; and 3) the calculation of MERALCO's disallowances and revenues without regard to incrementals.

The ERC found that COA's application of the disallowances under MERALCO's PBR application to its RORB application is not supported by established rules on rate-making, and that it is a clear violation of the principle against retroactive rate-making, which prohibits the adjustment of

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10 Id. at 78.

11 Id. at 189-205.

rates previously fixed by the regulatory body following a prescribed procedure. The ERC also found that COA's calculation of MERALCO's revenues using the historical costs of the assets and a 12% rate of return is contrary to existing laws and jurisprudence, which allows the use of present market value in fixing the rates to be applied prospectively and the use of a WACC in determining the reasonable return to which the utility is entitled. The ERC likewise found that COA's calculation cannot be adopted because it failed to take into account the incrementals, and the revenues for 2000 should not be compared to revenues for 2004 and 2007 to determine whether they were reasonable.

In its Order[12] dated 4 February 2013, the ERC denied the motion for reconsideration filed by NASECORE for lack of merit. Thus, NASECORE filed an appeal.

The Ruling of the Court of Appeals

In its Decision[13] dated 29 February 2016, the CA found that the ERC dutifully complied with this Court's Order in *Lualhati.* The CA explained that the conduct of a COA audit is not a requisite for the ERC's exercise of its rate-fixing powers, and the ERC is not bound to accept and adopt any finding that the COA audit may come up with. Furthermore, the CA held that it would be highly unlikely that the COA will come up with a conclusion similar to that of ERC given COA's use of different factors, *i.e.* test year and accounting methodology. The CA found that there was no reason for the COA to use an accounting methodology other than that used by MERALCO when it applied for the rate increase. Thus, the CA concluded that the ERC acted correctly when it did not adopt the COA Report in its entirety, because it cannot determine whether the rate increase granted to MERALCO was justified.

Thus, the dispositive portion of the CA Decision states:

> WHEREFORE, premises considered, the petition is DISMISSED. The Orders dated June 21, 2011 and February 4, 2013, respectively, of the Energy Regulatory Commission in ERC Case Nos. 2001-646 and 2001-900 are AFFIRMED.
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> SO ORDERED.[14]

In a Resolution[15] dated 18 August 2016, the CA denied the motion for reconsideration filed by NASECORE on 22 March 2016. On 3 October 2016, NASECORE filed the present petition before us. Subsequently,

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12 Id. at 206-217.
13 Id. at 358-373.
14 Id. at 372
15 Id. at 384-385.

MERALCO, COA and the ERC, through the Office of the Solicitor General (OSG), filed their Comment.

On 22 June 2017, movant-intervenors Clark Electric Distribution Corporation, Dagupan Electric Corporation, Angeles Electric Corporation, Cagayan Electric Power & Light Company, Inc., San Fernando Electric Light & Power Company, Inc., Cabanatuan Electric Corporation, Tarlac Electric, Inc., and Olongapo Electricity Distribution Company, Inc., (collectively, intervenors) filed a Motion for Leave to Intervene and Admit Attached Comment-In-Intervention (Motion),[16] essentially alleging that (1) the instant case involves a matter of transcendental importance, (2) they have a legal standing to intervene as electric distribution utilities, and they will be directly and substantially affected if a ruling is held that a COA audit is a prerequisite in granting rate applications.

In a Resolution[17] dated 11 July 2017, the Court resolved to require the adverse parties to Comment on the Motion. Thereafter, NASECORE, ERC, through the OSG, MERALCO and the COA filed their respective Comments to the Motion.

The Issues

In the present petition, NASECORE raises the following issues for resolution:

I. WHETHER OR NOT RESPONDENT ENERGY REGULATORY COMMISSION (ERC) GAVE PROPER WEIGHT AND CREDENCE TO THE FINDINGS OF THE COMMISSION ON AUDIT;

II. WHETHER OR NOT MERALCO'S OPERATING EXPENSES (OPEX) SUCH AS EMPLOYEES' PENSION AND OTHER BENEFITS AMOUNTING TO PHP3.148 BILLION IN 2004 AND PHP3.228 BILLION IN 2007 ARE RECOVERABLE FROM THE CONSUMERS;

III. WHETHER OR NOT CERTAIN PROPERTIES AND FACILITIES AMOUNTING TO PHP3.848 BILLION IN 2004 AND PHP3.069 BILLION IN 2007 SHOULD BE CONSIDERED AS PART OF THE RATE BASE – E.G. THE MERALCO THEATER, MERALCO MUSEUM, MERALCO WELLNESS CENTER, MERALCO SHOOTING RANGE, MERALCO TENNIS COURT/FITNESS CENTER/OVAL/OPEN SPACE[;]

16 *Rollo*, (G.R. No. 226443), Vol. IV, pp. 1483-1503, 1706-1794.
17 Id. at 2021-2022.

IV. WHETHER OR NOT ALL COSTS RECOVERED BY MERALCO FROM THE CONSUMERS IN EXCESS OF LIMITS ALLOWED BY LAW SHOULD BE TREATED AS "OVER-RECOVERY" AND REFUNDED TO THE CONSUMERS ACCORDINGLY.[18]

The Ruling of the Court

We partly grant the petition.

Section 38 of the Government Auditing Code of the Philippines and Book V, Title I, Subtitle B, Chapter 4, Section 22[19] of the Administrative Code of 1987 specifically authorize the COA to examine accounts of public utilities in connection with the fixing of rates of every nature. Section 38 of the Government Auditing Code of the Philippines provides:

> Section 38. *Authority to examine accounts of public utilities*:
>
> 1. **The Commission shall examine and audit the books, records, and accounts of *public utilities in connection with the fixing of rates of every nature***, or in relation to the proceedings of the proper regulatory agencies, for purposes of determining franchise taxes.
>
> 2. During the examination and audit, the public utility concerned shall produce all the reports, records, books of accounts and such other papers as may be required. The Commission shall have the power to examine under oath any official or employee of the said public utility.
>
> 3. Any public utility refusing to allow an examination and audit of its books of accounts and pertinent records, or offering unnecessary obstruction to the examination and audit, or found guilty of concealing any material information concerning its financial status shall be subject to the penalties provided by law. (Boldfacing and italicization supplied)

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18 *Rollo,* (G.R. No. 226443), Vol. I, pp. 25-26.

19 Administrative Code of 1987, Section 22. *Authority to Examine Accounts of Public Utilities.*-
(1) The Commission shall examine and audit the books, records and accounts of public utilities in connection with the fixing of rates of every nature, or in relation to the proceedings of the proper regulatory agencies, for purposes of determining franchise taxes;
(2) Any public utility refusing to allow an examination and audit of its books of accounts and pertinent records, or offering unnecessary obstruction to the examination and audit, or found guilty of concealing any material information concerning its financial status shall be subject to the penalties provided by law; and
(3) During the examination and audit, the public utility concerned shall produce all the reports, records, books of accounts and such other papers as may be required. The Commission shall have the power to examine under oath any official or employee of the said public utility.

Thus, in *MERALCO v. Lualhati*[20] *(Lualhati),* we directed the ERC to seek the assistance of the COA in conducting a complete audit on the books, records and accounts of MERALCO to see to it that the rate increases that MERALCO has asked for are reasonable and justified, to wit:

> Contrary to the Court of Appeals' insinuation that the ERC did not perform its legal mandate to protect the public, the foregoing disquisitions of the ERC speak otherwise. MERALCO's proposed revenue requirement and rate base for purposes of fixing its rates were, after having been assumed to be carefully considered, adjusted downwards. MERALCO did not get what it prayed for, which was a rate higher than that approved by the ERC.
>
> The established rule in this jurisdiction is that findings of administrative or regulatory agencies on matters within their technical area of expertise are generally accorded not only respect but finality if such findings are supported by substantial evidence. Rate-fixing calls for a technical examination and a specialized review of specific details which the courts are ill-equipped to enter; hence, such matters are primarily entrusted to the administrative or regulating authority. Thus, this Court finds no reversible error on the part of ERC in rendering its assailed decision and order.
>
> However, while ruling in said manner, this Court is cognizant that such ruling has far-reaching effects and is of utmost significance to the public, especially to the poor, who face the threat of deeper wallowing in the quagmire of financial distress once the burden of electricity rate increases is passed on to them. Better judgment, therefore, calls for this Court to temper the rigidity of its decision.
>
> Although affirming the decision and the order of the ERC approving the rate increases for electricity, this Court is not closing its eyes to the fundamental principle of social justice so emphatically expressed by the late President Magsaysay in his statement: "He who has less in life should have more in law."
>
> The concern for the poor is recognized as a public duty, and the protection of the rights of those marginalized members of society have always dutifully been pursued by the Court as a sacred mission. Consistent with this duty and mission, the Court deems it proper to approve the rate increases applied for by MERALCO provisionally, *i.e.*, MERALCO to impose provisional rate increases while directing **the ERC, at the same time, to seek the assistance of COA in conducting a complete audit on the books, records and accounts of MERALCO to see to it that the rate increases that MERALCO has asked for are reasonable and justified. Stated otherwise, the provisional rate increases will continue to be subject to its being reasonable and just until after the ERC has taken the appropriate action on the COA Report.**[21] (Emphasis supplied)

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20 Supra note 5.

21 Supra note 5, at 530-531.

Consistent with its mandate and our ruling in *Lualhati* that a prior COA audit is not mandatory in rate-fixing, the COA conducted a **post-audit** on the books, records and accounts of MERALCO to see if the rates asked for are reasonable and just, and "**recommend[ed]** that the results of the audit be considered by the ERC in deciding the MERALCO cases."[22]

The regulation of rates to be charged by public utilities is founded upon the police powers of the State and statutes prescribing rules for the control and regulation of public utilities are a valid exercise thereof.[23] In regulating rates charged by public utilities, the State protects the public against arbitrary and excessive rates while maintaining the efficiency and quality of services rendered.[24] The fixing of just and reasonable rates involves a balancing of the investor and the consumer interests.[25] While the power to fix rates is a legislative function, whether exercised by the legislature itself or delegated through an administrative agency, such as the ERC, a determination of whether the rates so fixed are reasonable and just is a purely judicial question and is subject to the review of the courts.[26]

Thus, in determining the just and reasonable rates to be charged by a public utility, three major factors are considered by the regulating agency: a) *rate of return*, that is a judgment percentage which, if multiplied with the rate base, provides a fair return on the public utility for the use of its property for service to the public; b) *rate base*, that is an evaluation of the property devoted by the utility to the public service or the value of invested capital or property which the utility is entitled to a return; and c) the *return* itself or the computed revenue to be earned by the public utility based on the rate of return and rate base.[27] In the most simple terms, the traditional rate formula, designed to produce the utility's revenue requirement, is **R = O + (V-D) r**, where: **R** is the public utility's total revenue requirement; **O** is the public utility's operating expenses; **V** is the gross value of the public utility's tangible and intangible property; **D** is the utility's accrued depreciation; combined **(V-D)** constitute the utility's *rate base,* also known as its capital investment; and **r** is the *rate of return* a utility is allowed to earn on its capital investment.[28]

At issue here is whether the ERC erred in not adopting the recommendation of the COA, particularly as to: (1) the determination of the kind and the amount of operating expenses that should be allowed to MERALCO and (2) the proper valuation of the rate base or the value of the property entitled to a return.

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22 *Rollo,* (G.R. No. 226443), Vol. I, p. 79.

23 *Republic of the Philippines v. Manila Electric Company,* 440 Phil. 389 (2002).

24 Id.

25 Id.

26 Id.

27 *Republic of the Philippines v. Medina,* 148-B Phil. 1127 (1971).

28 Jan G. Laitos and Joseph P. Tomain, *Energy and Natural Resources Law in a Nutshell* (1992), p. 529.

In its Order[29] dated 21 June 2011, the ERC stated that:

Operating Expenditures (OPEX)

MERALCO's OPEX, per its books for CYs 2004 and 2007, were at Php14,851,187,785.00 and Php17,744,879,185.00, respectively. **The COA made some disallowances on the OPEX based on the principles laid down under the PBR Methodology. Since the approved OPEX was determined under the RORB Methodology for the test year 2000, there was no mechanism to account for any incremental cost.**

In the unbundling of MERALCO's rates, the items "pensions and other benefits" amounting to Php1.381 Billion was allowed to be recovered based on test year 2000. The COA disallowed pensions and other benefits which increased to Php3.148 Billion in 2004 and Php 3.228 Billion in 2007. These amounts are already considered as incremental costs.

Asset Base

The Commission approved MERALCO's rate base after review and evaluation of its books as of year-end 1998, asset appraisal performed on September 19, 1999 and at cost for year ending December 31, 2000.

The COA determined MERALCO's assets in service based on historical and appraised book values for the years 2004 and 2007. The Commission believes that the audit conducted disregarded the fact that for purposes of determining the utility's rate base, the present or market value of its properties should be determined. The assessment of the assets changes over time such that some of these assets may have depreciated while the others may have appreciated. Either way, the value of the properties will no longer be the same. It is worth mentioning that **MERALCO's assets increased by 10% and 15.54% for CYs 2004 and 2007, respectively. MERALCO's rates had been approved by the Commission but had not been adjusted for any incremental cost/asset after the year 2000 despite the approval of its Capital Expenditure (CAPEX) Projects.**

Kilowatt Hour (kWh) Sales

The Commission's approved distribution rate for MERALCO made use of an annualized kWh sales of 21,880,741,235 for CY 2000 as billing determinant.

Based on the Audit Report, MERALCO sold a total of 24,660,000,000 kWh and 26,219,000,000 kWh of electricity for CYs 2004 and 2007, respectively, which translate to an increase in sales of 12.70% and 19.83% for CYs 2004 and 2007, respectively. The yearly increase in kWh sales posted an average of 6.32%. The COA determined MERALCO's distribution revenue based on the approved revenues of

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29 *Rollo,* (G.R. No. 226443), Vol. I, pp. 189-205.

> PhP25,620,683,446.00 and Php25,886,216,689.00 for CYs 2004 and 2007, respectively. Compared to the approved revenue of Php22,563,244,745.00 for CY 2000, there was an increase of 13.55% and 14.73% for the CYs 2004 and 2007, respectively. **Hence, MERALCO's distribution revenue increased by an average of 1.04%. This, however, should not be treated as "over-recovery", as claimed by the COA, being merely a consequence of increased kWh sales.**[30](Emphasis supplied)

We find that the ERC failed to properly consider the findings of the COA as well as to comply with its statutory mandate to approve a rate that provides electricity to consumers "in the least cost manner" as expressly provided in ERC's charter.

On the issue raised by NASECORE as to the operating expenses, the COA found that pension costs and benefits as a necessary expense are not in issue, but the ERC merely disallowed the amount that MERALCO failed to prove, to wit:

> The pension costs as a necessary expenses is not an issue. MERALCO, however, is expected to justify the requirements of the regulator and the public as the distribution sector is a regulated business and any related expenses are recoverable from the consumers.
>
> ERC discussed under its Order dated September 4, 2006 that the information submitted by MERALCO is limited to a description of overall totals and do not contain broken-down details of the actual salary scales and benefits applying to MERALCO employees that would allow ERC to conduct a comparative analysis of these benefits with the norm of other utilities and businesses countrywide and in the Manila Region. In the absence of such analysis, ERC cannot make a ruling on whether the compensation offered by MERALCO to its employees is reasonable and will therefore not allow the additional funding requested by MERALCO.
>
> The team cannot exclude any disallowance on other employee benefits in the absence of sufficient documentation to prove that the same is reasonable.[31]

As to whether the properties, such as Meralco Theater, Meralco Museum, Meralco Wellness Center, Meralco Shooting Range, Meralco Tennis Court/Fitness Center/Oval/Open Space shall form part of the rate base, the COA Report stated:

> *MERALCO Museum*
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> MERALCO is not prohibited from maintaining a Museum to preserve its history. However, this should not be charged to the customers as this cannot be considered as a property incidental to electric operation and could be dispensed with. MERALCO could still render adequate, reliable

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30 Id. at 201-203.

31 Id. at 117.

and efficient service without maintaining said property. This is more of a concern of the investors than the customers.

MERALCO Theater

This asset was already 100% disallowed by COA as early as 1993. Under ERC Case No. 93-118, it was disallowed by COA as this is not necessary in the distribution of power to the customers.

The said theater cannot also be considered as a property incidental to electric operation and therefore could be dispensed with as MERALCO could still render adequate, reliable and efficient service without maintaining said property. This property was eventually 100% disallowed by ERC.

Corporate Wellness Center formerly JFC Hospital

The team applied the 8.7% disallowance for test year 2004. However, for the test year 2007, the team adopted the ERC's position in ERC Case No. 2006-045 that the amount equivalent to 36.43% associated with the use of the facility by affiliates, relatives and the public should be executed in the allowable OPEX.

MERALCO Fitness Center/Tennis Court/ Oval/Open Space at the North and East of MERALCO Fitness Center

Sports and recreational facilities were already considered by the ERC as unnecessary under ERC Case No. 2006-045 which was duly accepted by MERALCO. Thus, for CY 2007, these facilities were fully disallowed in audit. For CY 2004, the team applied the proportionate value of 9.4% of the total assets.

Shooting Range

The team disallowed the area of 3,600 sq.m. reflected in the survey forwarded to the team by MERALCO.[32]

We agree with COA that consumers should not be charged for expenses that are not necessary, proper or even incidental to the operation of a distribution utility. ERC should formulate the parameters whether expenses that are not directly and entirely related to the operations of a distribution utility should be wholly or partially passed on to consumers of MERALCO's electricity.

More importantly, in its assailed Order, the ERC stated that "[t]he COA determined MERALCO's assets in service based on historical and appraised book values for the years 2004 and 2007. The COA believes that the audit conducted disregarded the fact that for purposes of determining the

32 Id. at 103.

utility's rate base, **the *present or market value* of its properties should be determined.**"[33]

The determination of what constitutes the rate base forms the basis for judging whether or not rates are confiscatory,[34] reasonable or just. Various theories have been proposed to appraise the assets and determine what are fair rates for public utilities:

> Valuation methods vary. In a period of static costs, an original cost valuation may be sufficient. With a period of high inflation, a rate base which values plant and equipment at original cost substantially shrinks the purchasing power of dollar. In these circumstances, utilities argue in favor of reproduction cost valuations. In either case, depreciation on plant and equipment is subtracted from the rate base and carried as an operating expense. The theory behind including depreciation as an expense is that capital may be accumulated for further expansion and growth. With inflationary trends, utilities are seeking to use accelerated depreciation techniques to accumulate capital more quickly in the hope of beating inflation. Accelerated depreciation is the exception rather than the rule, but the trend persists.[35]

Thus, of the various valuation methods, three appear to have gained favor at various times: (1) the historical cost or prudent investment formula; (2) that of present cost or market value; and (3) the cost to reproduce theory.[36]

Under Section 23 of Republic Act No. 9136, or the *Electric Power Industry Reform Act of 2001* (EPIRA), **"[a] distribution utility shall have the obligation to supply electricity *in the least cost manner* to its captive market, subject to the collection of retail rate duly approved by the ERC."** The 2001 EPIRA law is now the governing law on the rate setting of electricity, and the standards for rate setting prescribed in the EPIRA law have superseded all prior standards inconsistent with the EPIRA law. **In this present case, the governing statutory standard on rate setting is the "*least cost manner*" standard.**

The retail rates charged by distribution utilities for the supply of electricity in their captive market are subject to regulation by the ERC based on the **principle of full recovery of *prudent and reasonable economic costs* incurred**, or such other principles that will **promote efficiency** as may be determined by the ERC.[37] MERALCO, presently operating by virtue of a

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33 Id. at 202.
34 Supra note 28.
35 Supra note 28, at 531.
36 *Republic of the Philippines v. Medina*, supra note 27.
37 REPUBLIC ACT NO. 9136, Section 25.

franchise granted under RA 9209,[38] is one of the distribution utilities operating in the country, and the costs it incurs in delivering electricity to its customers are being recovered through charging of rates duly approved by the ERC.[39]

In the conduct of its audit, the COA used a Cost Based Method known as Return on Rate Base (RORB) methodology, which simply means that a regulated utility is allowed to set rates that will cover operating costs and provide an opportunity to earn a reasonable return on the rate base or the assets utilized in the business.[40] Acting in accordance with its rate-setting authority under RA 9136,[41] the ERC signaled its shift from the RORB methodology to the Performance-Based Regulation (PBR) methodology in fixing the wheeling rates of regulated entities.[42] MERALCO was among the first entrants to the PBR methodology.[43] The PBR methodology uses projections of operating and capital expenditures to meet projected demand, thereby enabling the regulated entities to invest in facilities to meet customer requirements and prescribed service levels.[44] This methodology also features a performance incentive scheme which provides incentives and penalties to the utility to compel it to be more efficient and reliable, while maintaining reasonable rates and improving the quality of service to achieve pre-determined target levels.[45] In simpler terms, PBR is the setting of rates based on forecast of cost and expenses.[46]

In ERC Case No. 2005-041 RC dated 12 July 2010, the ERC distinguished the RORB and the PBR methodologies as follows:

Points of Distinction	RORB	PBR
1. Corporate Income Tax	Not allowed as an operating expense	Incorporated in the revenue building blocks Allowed as a reasonable cost (not a straight pass-through).

38 AN ACT GRANTING THE MANILA ELECTRIC COMPANY A FRANCHISE TO CONSTRUCT, OPERATE AND MAINTAIN A DISTRIBUTION SYSTEM FOR THE CONVEYANCE OF ELECTRIC POWER TO THE END-USERS IN THE CITIES/MUNICIPALITIES OF METRO MANILA, BULACAN, CAVITE AND RIZAL, AND CERTAIN CITIES/MUNICIPALITIES/BARANGAYS IN BATANGAS, LAGUNA, QUEZON AND PAMPANGA.

39 *Rollo,* (G.R. No. 226443), Vol. I, p. 82.

40 Id. at 83.

41 Republic Act No. 9136, Section 43 (f).

42 Resolution No. 4, Series of 2003, dated 29 May 2003.

43 *National Association of Electricity Consumers for Reforms v. Manila Electric Company,* 797 Phil. 12 (2016).

44 Id.

45 Id.

46 Juan Arturo Iluminado De Castro, *Philippine Energy Law* (2012), p. 341.

2. Cost Base	Historical cost base (reference year)	Forward forecast of costs (regulatory period)
3. Rate Base	**Present market or replacement value of the properties devoted to service less depreciation plus operating capital equivalent to two (2) months operating income (PSC vs. Mutuc)**	**Uses a reappraised asset base but which is optimized to appraise assets at the lower of replacement cost or modern equivalent asset (MEA) value and excludes the value of assets which are not utilized in provision of public service or are installed at a capacity which is in excess of that required by consumers over a reasonable planning horizon**
4. Level of Return	12% per annum used as a benchmark of reasonable return but other values have been approved in the past	WACC derived from market data
5. Method of Regulating Public Utility Prices	Rate-of-return regulation	Price-cap regulation or revenue-cap regulation

Under both regimes, the rate base was allowed to be remeasured or revalued based on **current or replacement costs** at the time of the rate application, although under the PBR methodology, optimization over a specified planning horizon is explicit and the reappraised asset base is based on the "lower of replacement cost or modern equivalent asset (MEA) value."[47] For commonly used distribution fixed asset, utilities are referred to a list of MEA values for many assets as of 31 December 2009 which amounts are supposed to be adjusted via an index for use in succeeding years.[48] **And, unless replacement costs of the existing assets are to fall,**

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47 Dr. Helena S.Valderrama, *The Rationale For Asset Revaluation In The Philippine Electricity Sector* (2013) <http://www.bsp.gov.ph/events/pcls/downloads/2013s1/BSP_1a_valderrama_paper.pdf >; Dr. Valderrama worked as a consultant for the Energy Regulatory Commission (2007-2008 and 2013); Philippine Power Sector Development Program, Asian Development Bank (2004-2006); Development of Financial Standards for the Philippine Generation and Supplier Sectors, USDOE Sustainable Energy Development Program (2004); Rate Rebasing Project: East and West Concessionaire Zones, MWSS Regulatory office (2002); Rate-setting, Financial Standards, and Competition Policy Issues in the Power Sector, USAID Philippines Climate Change Mitigation Program (2002); Briefing on RORB Issues in the Regulation of the Power Sector and Review of PNOC-EDC and NPC Power Supply Contracts, USAID Philippines Climate Change Mitigation Program (2001); Analysis of Financial Statements and Disclosures of Philippine Firms, Securities and Exchange Commission (2006, 2008, 2009, 2010). See http://mwss.gov.ph/trustee-helena-agnes-s-valderrama/.

48 Id.

the gross valuation of the rate base will be increasing throughout the regulatory period in both the PBR and RORB regimes.[49]

Public utilities regulation in the Philippines has departed from the use of historical or acquisition costs in the valuation of the rate base even before EPIRA was passed. In the 1971 case of *Republic of the Philippines v. Medina*,[50] we held that:

> x x x. The historical cost formula had been proposed by oppositors in the 1965 MERALCO case, and in our 1966 decision (18 SCRA, 668), We noted that -
>
> > x x x. Upon the other hand, Ricardo Rosal urges that the rates should be founded upon the amount of the investment made by MERALCO's stockholders or the "historical cost" formula. The PSC has adopted the present or market value theory, as the basis for the computation of the earnings allowable to and the rate schedule chargeable by the MERALCO, as well as the method of valuation used and the appraisal made by the same, after making therefrom some deductions recommended by GAO.
> >
> > **With respect to the "historical cost" formula urged by Rosal, it should be noted that the present or market value theory adopted by the PSC is in consonance with the practice consistently adhered to in this jurisdiction and upheld in an uninterrupted line of decisions of this Court. And said decisions are borne out by the weight of authority in other jurisdictions.**
>
> Oppositors then, as they do now in the case at bar, argued that the Hope Natural Gas decision of the United States Supreme Court had rejected the present value theory as obsolete. This contention was examined in our previous decision and found incorrect.
>
> > **It is urged that the present value theory is now an obsolete doctrine, it having been rejected by the Supreme Court of the United States in Federal Power Commission *vs.* Hope Natural Gas Co. (320 U.S. 591, 88 L. ed. 333), in which the prudent investment or modified original cost theory was allegedly adopted. This assertion is inaccurate. In said case the Court did *not* reject the present or fair market value theory. It merely *refused to interfere* with the action taken by the Federal Power Commission in applying said prudent investment or modified original cost theory.**[51] (Boldfacing supplied, italicization in the original)

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49 Id.

50 Supra note 27.

51 Supra note 27, at 1148-1149.

The Supreme Court of the United States held in *Federal Power Commission v. Hope Natural Gas Co. (Hope)* that:[52]

> We held in Federal Power Commission v. Natural Gas Pipeline Co., supra, that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of "pragmatic adjustments." And when the Commission's order is challenged in the courts, the question is whether that order "viewed in its entirety" meets the requirements of the Act. **Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling.** Cf. Los Angeles Gas & Electric Corp. v. Railroad; Commission, 289 U.S. 287, 304-305, 314; West Ohio Gas Co. v. Public Utilities Commission (No. 1), 294 U.S. 63, 70; West v. Chesapeake & Potomac Tel. Co., 295 U.S. 662, 692-693 (dissenting opinion). **It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end.** The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. x x x. (Emphasis supplied)

Although *Hope* did not specify a uniquely valid approach to the asset base, *Hope* left the matter in the hands of regulatory commissions and laid the ground for the **movement to historic cost** since most commissions chose to use historic cost valuation of the asset base.[53] The US experience rejected market-based approaches and focused after 1944 on the historical cost approach:

> A survey of 43 states in 1954 found that 19 had explicitly switched to historic cost as a result of *Hope*; a further 8 had adopted historic cost in practice, though they had not formally disavowed fair value; 4 had used historic cost prior to *Hope* and continued to do so; while 9 were still using fair value, leaving 3 states in the survey as indeterminate. A 1991 study of 53 regulatory commissions revealed that 44 were using historic cost, while 7 still adhered to fair value, and two commissions considered all the evidence, without a predetermined choice of rate base.[54]

In Europe, the most common methodologies employed were historical cost accounting and current (or replacement) cost methodologies:

> **Historical cost accounting was used in most cases (11 countries)** for setting opening asset values, specifically in Bulgaria, Germany, Estonia, Greece, Spain, Italy, Lithuania, Luxembourg, Poland, Sweden and Slovenia. **The next most common methodology was a (current**

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52 320 U.S. 591 (1944).

53 Paul Grout, Andrew Jenkins and Ania Zalewska, *Privatisation of Utilities and the Asset Value Problem,* CMPO Working Paper Series No. 01/4 (Revised December 2001). <http://regulationbodyofknowledge.org/wp-content/uploads/2013/03/Grout_Privatization-of_Utilities.pdf>

54 Id.

cost) accounting or valuation methodology – this was employed in eight cases, namely in Belgium, Finland, France, Croatia, Hungary, Ireland, Latvia and the Netherlands. The current cost methodologies employed vary between these countries: (1) Belgium, Hungary and Latvia used a replacement cost concept; (2) Finland refers to a 'net present value' approach; (3) In France the opening asset value was established by a commission headed by the academic Houri, but the methodology employed is not public; (4) In Croatia, revaluation of the assets was undertaken in 2001 as part of the unbundling of the TSO from VIU (INA Ltd) – this was set based on a 'fair value' revaluation methodology, with the study undertaken by professionally qualified valuers and was confirmed by a statutory auditor; and (5) Ireland and the Netherlands employed historical cost indexation. Of the other methodologies pre-specified in the questionnaire: (1) In Romania, the value rolled forward from the value implicitly used in previous tariff/revenue decisions (i.e. the value 'backed out' from the tariff levels prevailing at the time); (2) In Northern Ireland, the value rolled forward from the value explicitly used in previous tariff/revenue decisions.

x x x x

Several [National Regulatory Authority (NRAs)] (five) indicated that 'other' approaches were used and characterised or described their circumstances as follows: (1) Austria – the debt-financed component was valued at historical cost and the equity component using replacement values; (2) Czech Republic – the Regulatory Asset Base (RAB) was set at a level that ensured the prevailing level of profitability; (3) Denmark – although a valuation was conducted, this is not treated as an RAB; it appears that an equity value was established that was equivalent to the net assets at the time and this value has been preserved over time in real terms through inflation indexation; (4) Portugal – the opening asset value was established by the Government, based on revaluation rates defined by the Government itself; and (5) Great Britain – an independent valuation was undertaken at the time of privatising the vertically-integrated British Gas (which included the transportation component as only one element of the whole).

x x x x

Irrespective of how the opening value of the RAB was established, there is a separate question regarding the updating of the RAB over time. In general terms, the valuation options are either to roll in investments (and deduct depreciation) without any further adjustments or revaluation, or to periodically revalue using a current cost methodology. The vast majority of NRAs (20 out of 27) adopt the former approach, i.e. there is no further revaluation of the RAB (see Figure 44), irrespective of whether a current cost methodology was used to establish the opening value.[55]

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55 Final Report, *Methodologies and parameters used to determine the allowed or target revenue of gas transmission system operators (TSOs) Final report,* Economic Consulting Associates (September 2018) <https://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/Consultant>%20Report.pdf>

In the distribution wheeling rate guidelines, the ERC requires the use of the Optimized Depreciated Replacement Cost (ODRC) approach in the valuation of the rate base.[56] The ODRC revaluation methodology would have the effect of setting prices for the use of assets at the commencement of each regulatory period at a level that is (approximately) consistent with the cost structure of a hypothetical (efficient) new entrant: That is, regulated charges would be independent of the costs actually incurred (that is, capital costs and operating costs) in providing services.[57]

According to the ERC and based on similar statements made by Australian and New Zealand regulators, which adopt the ODRC method, it is justified as producing tariffs that are more consistent with rates determined under competitive conditions; i.e., rates where monopoly rents are zero and at a level just sufficient to make a new entrant economically viable.[58] However, a study by the Allen Consulting Group commissioned by the Australian Competition and Consumer Commission has recommended against the continued adoption of the ORDC revaluation methodology. The study stated:

> Moreover, we do not consider that the application of such a methodology is desirable in the longer term. Whether a transmission business would expect to recover the cost of continuing to provide the service – or expected to earn returns much larger than that required to justify its continued financing of the business – would depend upon the accuracy of the estimated ODRC value, for which substantial statistical uncertainty will be inevitable. Given the risks associated with estimation errors, it is difficult to see how the Commission could commit credibly to adhere to such a regulatory regime over the long term. **As a consequence, we do not consider the ODRC revaluation methodology to be appropriate.**[59] (Emphasis supplied)

The use of a revalued Regulatory Asset Base (RAB) can be justified during a period of hyper-inflation, a condition that obviously does not exist in this country. In the Philippines, the revalued RAB was deemed rational when the entire electricity infrastructure was publicly owned, was financed mostly by foreign debt, and the country was struggling with a ballooning public sector deficit and a continuously devaluing currency.[60] Today, there is no justification for using the revalued RAB, thus:

> Clearly, the continued use of the ODRC method in the RAB valuation of transmission and distribution utilities is difficult to justify – **almost *irrational***. As discussed in this paper, the method suffers from the following material defects:

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56 Valderrama, supra note 47.

57 Final Report, *Methodology for Updating the Regulatory Value of Electricity Transmission Assets*, Allen Consulting Group (August 2003) <https://www.aer.gov.au/system/files/Attachment%20A.pdf>

58 Valderrama, supra note 47.

59 Supra note 57.

60 Valderrama, supra note 47.

> 1. **ODRC does not achieve the purpose of producing electricity rates that would be obtained under competitive conditions**. It does not represent the price at which bypass by a new entrant will be viable. As pointed out by Johnstone (2003) and Gale and McWha (2000), uncertainty regarding the response of the incumbent combined with the latter's tremendous sunk cost advantage are barriers to entry that are difficult to overcome, regardless of the price of bypass. Regulators prescribing ODRC appear to fail to see the lack of economic logic in prices going up with the entry of a supposed efficient new supplier in a market without unserved demand. If the new supplier is truly efficient and viable, its marginal cost should not be any higher than the marginal cost of the incumbent supplier.
>
> 2. The GAAP-defined measure of fair value, representing as it does the "exit price" of an asset, could be an acceptable basis for determining return on capital and return of capital. Fair value reflects the utility's capital on which an opportunity cost rationally applies. **Depreciated replacement cost, computed using an index-inflated MEA value divided by a subjectively-determined economic life, is an invalid substitute for fair value and is an almost meaningless number in the economic and accounting sense.**
>
> 3. Using the current MEA value for valuing the RAB rather than the value of the prudent MEA at the time the investment was made can potentially and unfairly hurt an incumbent utility if technological progress rapidly lowers the replacement costs of the utility's assets (Gale and McWha (2000)).
>
> 4. **ODRC results in wealth transfers from electricity consumers to the utilities' shareholders. Electricity consumers end up paying more for the infrastructure than it cost the shareholders to provide it, with a WACC to boot. Utility shareholders thus earn a return higher than is prescribed by their regulatory cost of capital.**[61] (Emphasis supplied)

Consequently, the ERC's Order is in violation of the statutory mandate of ERC to approve a rate that will provide electricity to consumers "**in the least cost manner.**" We thus **VOID** the adoption by ERC of the current or replacement cost valuation of MERALCO's regulatory asset base. We remand the case to ERC for determination of a reasonable and fair valuation of the regulatory asset base that will provide electricity to consumers "**in the least cost manner.**" The ERC shall also determine the parameters whether to allow MERALCO to pass on, wholly or partially, to consumers expenses that are not directly and entirely related to the operation of a distribution utility, to the end that consumers shall be charged for electricity "in the least cost manner."

MERALCO and other electricity distribution utilities are monopolies that are regulated by the State, particularly on the rates they charge

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61 Id.

consumers. As this Court recently held in *Alyansa Para Sa Bagong Pilipinas, Inc. v. Energy Regulatory Commission*:[62]

> Section 19, Article XII of the 1987 Constitution provides: "**The State shall regulate or prohibit monopolies when the public interest so requires**. No combinations in restraint of trade or unfair competition shall be allowed."
>
> The State grants electricity distribution utilities, through legislative franchises, a regulated monopoly within their respective franchise areas. Competitors are legally barred within the franchise areas of distribution utilities. Facing no competition, distribution utilities can easily dictate the price of electricity that they charge consumers. To protect the consuming public from exorbitant or unconscionable charges by distribution utilities, the State regulates the acquisition cost of electricity that distribution utilities can pass on to consumers.

The same rationale in regulating power acquisition costs by distribution utilities applies to the allowable depreciation of capital assets by distribution utilities in the present case.

Considering that this case is remanded to the ERC, the movant - intervenors can raise the issues raised before the present petition to the ERC, instead.

WHEREFORE, we **PARTIALLY GRANT** the petition. We **VOID** the adoption by the Energy Regulatory Commission of the current or replacement cost in the valuation of Manila Electric Company's regulatory asset base. We **REMAND** this case to the Energy Regulatory Commission to determine, within ninety (90) days from finality of this Decision, (1) the valuation of the regulatory asset base of Manila Electric Company, and (2) the parameters whether expenses that are not directly and entirely related to the operation of a distribution utility shall be passed on wholly or partially to consumers, **all to the end that electricity shall be provided to consumers "IN THE LEAST COST MANNER,"** in accordance with this Decision.

SO ORDERED.

ANTONIO T. CARPIO
Associate Justice

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62 G.R. No. 227670, 3 May 2019.

WE CONCUR:

LUCAS P. BERSAMIN
Chief Justice

DIOSDADO M. PERALTA
Associate Justice

ESTELA M. PERLAS-BERNABE
Associate Justice

MARVIC M.V.F. LEONEN
Associate Justice

ALFREDO BENJAMIN S. CAGUIOA
Associate Justice

ANDRES B. REYES, JR.
Associate Justice

ALEXANDER G. GESMUNDO
Associate Justice

JOSE C. REYES, JR.
Associate Justice

RAMON PAUL L. HERNANDO
Associate Justice

ROSMARI D. CARANDANG
Associate Justice

AMY C. LAZARO-JAVIER
Associate Justice

(on official leave)
HENRI JEAN PAUL B. INTING
Associate Justice

RODIL V. ZALAMEDA
Associate Justice

CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution, I certify that the conclusions in the above Decision had been reached in consultation before the case was assigned to the writer of the opinion of the Court.

LUCAS P. BERSAMIN
Chief Justice

CERTIFIED TRUE COPY

EDGAR O. ARICHETA
Clerk of Court En Banc
Supreme Court