

POWER SECTOR ASSETS AND LIABILITIES MANAGEMENT CORPORATION
Notes to Financial Statements

1. CORPORATE INFORMATION

Power Sector Assets and Liabilities Management Corporation is a wholly-owned and controlled government corporation created on June 26, 2001, by virtue of Section 49, Chapter VI of Republic Act No. 9136, known as “Electric Power Industry Reform Act of 2001” or “EPIRA”.

PSALM Corp. is mandated to take ownership of all the existing generation assets, Independent Power Producer (IPP) contracts, real estate and all other disposable assets, and to assume all liabilities and obligations of the National Power Corporation (NPC). Its principal purpose is to manage the orderly sale, disposition and privatization of NPC’s assets with the objective of liquidating in an optimal manner all of NPC’s financial obligations and stranded contract costs. PSALM Corp. fully owns the National Transmission Corporation (TRANSCO) which assumes the transmission, sub-transmission and related assets of NPC.

PSALM Corp. shall, in the performance of its function and for the attainment of its objective, have the following powers under Section 51 of the EPIRA:

1. To formulate and implement a program for the sale and privatization of the NPC assets and IPP contracts and the liquidation of NPC debts and stranded contract costs, such liquidation to be completed within the terms of existence of the PSALM Corp.;
2. To take title to and possession of, administer and conserve the assets transferred to it; to sell or dispose of the same at such price and under such terms and conditions as it may deem necessary or proper, subject to applicable laws, rules and regulations;
3. To take title to and possession of the NPC IPP contracts and to appoint, after public bidding in transparent and open manner, qualified independent entities who shall act as the IPP Administrators in accordance with the EPIRA;
4. To calculate the amount of the stranded debts and stranded contract costs of NPC which shall form the basis for ERC in the determination of the universal charge;
5. To liquidate the NPC stranded contract costs, utilizing the proceeds from the sale and other property contributed to it, including the proceeds from the universal charge;
6. To adopt rules and regulations as may be necessary or proper for the orderly conduct of its business operations;

7. To sue and be sued in its name;
8. To appoint or hire, transfer, remove and fix the compensation of its personnel: Provided, however, that the Corporation shall hire its own personnel only if absolutely necessary, and as far as practicable, shall avail itself of the services of personnel detailed from other government agencies;
9. To own, hold, acquire, or lease real and personal properties as may be necessary or required in the discharge of its functions;
10. To borrow money and incur such liabilities, including the issuance of bonds, securities and other evidence of indebtedness utilizing its assets as collateral and/or through the guarantee of the National Government: Provided, however, that all such debts or borrowings shall have been paid off before the end of its corporate life;
11. To restructure existing loans of NPC;
12. To collect, administer, and apply NPC's portion of the universal charge; and
13. To structure the sale, privatization or disposition of NPC assets and IPP contracts and/or their energy output based on such terms and conditions which shall optimize the value and sale prices of said assets.

In line with Section 55 of the EPIRA, the following funds, assets, contributions and other property constitute the property of PSALM:

- a. The generation assets, real estate, contracts with IPPs, other disposable assets of NPC, proceeds from the sale or disposition of such assets and the residual assets from Build-Operate-Transfer (BOT), Rehabilitate-Operate-Transfer (ROT), and other variations thereof;
- b. Transfers from the National Government;
- c. Proceeds from loans incurred to restructure or refinance NPC's transferred liabilities, provided, however, that all borrowings shall be fully paid for by the end of the life of PSALM;
- d. Proceeds from the universal charge allocated for the stranded contract costs and the stranded debts of NPC;
- e. Net profit of NPC;
- f. Net profit of TRANSCO;
- g. Official assistance, grants, and donations from external sources; and

- h. Other sources of funds as may be determined by PSALM Corp. necessary for the above mentioned purposes.

Moreover, Section 56 of the EPIRA provides that the following shall constitute the claims against PSALM:

- a. NPC liabilities transferred to PSALM;
- b. Transfers from the National Government;
- c. New loans; and
- d. Stranded contract costs of NPC.

PSALM Corp. shall exist for a period of twenty-five (25) years from the effectivity of the EPIRA, unless otherwise provided by law, and all assets and liabilities of the Company outstanding upon the expiration of its term of existence shall revert to and be assumed by the National Government.

The Company's principal place of business is in Ayala Avenue, Makati City, Metro Manila.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Preparation of Financial Statements

The financial statements of PSALM Corp. have been prepared in accordance with the Philippine Financial Reporting Standards (PFRS) issued by the Accounting Standards Council of the Philippines.

The financial statements have been prepared on a historical cost basis and transactions are recorded on a modified accrual basis of accounting which is in accord with the New Government Accounting System (NGAS) of the Commission on Audit.

Use of Estimates

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the statements and related notes. We estimate the useful lives of our property, plant and equipment based on the period over which these assets are expected to be available for use. The estimated useful lives of these assets are reviewed and updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limits on their use. Changes in these factors could result in changes to the estimates and to the amounts and timing of the recorded expenses for any period.

Adoption of new PFRS/Changes in Accounting Policies

In recent years, the Accounting Standards Council (ASC), the accounting standards-setting body in the Philippines, has been adopting the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC).

The responsibility for setting the IAS was later assumed by the International Accounting Standards Board (IASB). The standards issued by the IASB are designated as International Financial Reporting Standards, or IFRS. The IASB also adopted the IAS issued by the IASC. The IASB made improvements in certain IAS in preparation for the full adoption of IFRS effective January 1, 2005.

To correspond better with the adopted IAS and IFRS of the IASB, the ASC re-named the standards it issues as Philippine Financial Reporting Standards or PFRS (previously designated as Statements of Financial Accounting Standards, or SFAS). The PFRS consist of (1) PFRS – corresponding to IFRS; (2) the Philippine Accounting Standards, or PAS – corresponding to IAS and (3) Interpretations. PFRS are assigned the same number as those of the related IFRS, IAS and Interpretation.

We have adopted the following new accounting standards intended to be mandatory beginning on or after January 1, 2005. Adoption of these standards did not have a material financial impact to the Company. Previous year's financial statements have been restated, where necessary, to give effect to the provisions of the new standards adopted.

- **PAS 1, “Presentation of Financial Statements”**, prescribes the overall requirements for the presentation of general purpose financial statements in terms of structure and content.
- **PAS 2, “Inventories”**, limits the alternatives for measurement of inventories. The Company changed in 2005 its inventory costing from FIFO to moving average method in accordance with the policies and basic concepts set in the New Government Accounting System (NGAS). The change did not have a material financial impact to the Company.
- **PAS 8, “Accounting Policies, Changes in Accounting Estimates and Errors”**, sets the criteria for selecting and applying accounting policies, including accounting treatment and disclosure requirements of changes in accounting policies and estimates and corrections of errors.
- **PAS 16, “Property, Plant and Equipment”**, provides guidance and clarification on the principal issues in accounting for property, plant and equipment - recognition and measurement of the assets, determination of their carrying amounts and the depreciation charges and recognition of impairment losses.

This Standard prescribes the following: conditions when the cost of an item of property, plant and equipment shall be recognized as an asset; that an item of property, plant and equipment that qualifies for recognition as an asset shall be

measured at its cost; composition of the elements and measurement of cost; that in measuring the asset after its recognition, an entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

The cost model maintains that an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses. The revaluation model states that after recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

PAS 16 provides guidance on depreciation (amount, period and methods), impairment (in conjunction with PAS 36), de-recognition and disclosure requirements.

- **PAS 17, “Leases”**, prescribes the appropriate accounting policies and disclosure to apply to finance and operating leases. Finance leases are those that transfer substantially all the risks and benefits of ownership to the lessee. The standard requires that the lessee, at the commencement of the lease term, shall recognize finance lease as asset and liability in the lessee’s balance sheet at amounts equal to the fair value of leased property or, if lower, at the present value of the minimum lease payments. The subsequent minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the obligation.

Our adoption of this standard has no financial impact as the lease entered into in December 2004 was recorded as capital lease equivalent to the present value of the lease payments. The depreciation policy adopted for the assets under lease is consistent with that for depreciable assets that are owned and are calculated in accordance with COA Circular No. 2003-007 dated December 11, 2003.

- **PAS 19, “Employee Benefits”**, prescribes the accounting and disclosure requirements for employee benefits. It establishes separate requirements for the different categories of benefits it identified. PSALM runs on a state plan which is described by the Standard as one established by legislation to cover all entities and are operated by national or local government or by another body which is not subject to control or influence by the reporting entity. State plans are characterized as defined benefit or defined contribution in nature based on the entity’s obligation under the plan. Defined contribution plans are post-employment plans under which an entity pays fixed contributions into a separate entity (fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods, while defined benefit plans are those other than defined contribution plans.

PSALM pays its employer share to Government Service Insurance System (GSIS) and it has no further payment obligations once the contributions have been paid. The contributions are recognized as employee benefit expense when they are due.

- **PAS 21, “The Effects of Changes in Foreign Exchange Rates”**, prescribes how to include foreign currency transactions in the financial statements of an entity and how to determine which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements. It requires that a foreign currency transaction be recorded, on initial recognition in the functional currency, at the spot exchange rate at the transaction date. At subsequent balance sheet dates, foreign currency monetary items shall be translated using the closing rate. Exchange differences arising from the translation shall be recognized as gains and losses in the period in which they arise.

The Company translated its foreign currency-denominated deposits and loans at year-end rates of ₱53.067 in 2005 and ₱56.267 in 2004. The resulting gains and losses from the exchange differences were recognized in the statement of income.

- **PAS 23, “Borrowing Costs”**, prescribes the accounting treatment for borrowing costs. The Standard generally requires the immediate expensing of borrowing costs, but allows, as an alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. It may include (a) interest on short- and long-term borrowings; (b) amortization of discounts or premiums relating to borrowings; (c) amortization of ancillary costs incurred in connection with the arrangement of borrowings; (d) finance charges in respect of finance leases; and (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Cash and Cash Equivalents

Cash and cash equivalents are defined as cash on hand, demand deposits and short-term, highly liquid investments readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value.

Inventory

Inventories are valued at cost using the moving average method.

Investment in Bonds

Investment in bonds are recorded at cost and adjusted for amortization of discount and other costs. Discount is amortized on straight line method over the life of the bonds with other costs treated as outright expenses.

Property, Equipment and Depreciation

Property and equipment which consists mainly of computers, office furniture, vehicles and communication equipment are stated at cost less accumulated depreciation and any impairment in value. The stated cost comprises its purchase price and directly attributable costs of bringing the asset to working condition for its intended use. Assets worth ₱10 thousand and up, purchased on a per item basis or same item - per lot basis, are capitalized. Expenditures for additions, improvements and renewals are capitalized; expenditures for repairs and maintenance are charged to expense as incurred.

Depreciation is computed on a straight line basis over the useful life of the assets as prescribed under COA Circular No. 2003-007 dated December 11, 2003 which takes effect January 1, 2004. Furniture and fixtures and communication equipment have an estimated useful life of 10 years, transportation equipment has 7 years and computers, office equipment and library books have 5 years.

Residual value equivalent to ten percent (10%) of the acquisition cost/appraised value is deducted before dividing the same by the estimated useful life.

The carrying values of property, plant and equipment are reviewed for impairment when changes in circumstances indicate that the carrying value may not be recoverable or may have diminished. If any such indication exists and where the carrying values exceed the estimated recoverable amount, the assets are written down to their recoverable amount and impairment losses are recognized in the statement of income.

Accounting for Lease and Amortization

Service vehicles acquired through lease agreement are recorded as leased equipment under property, plant and equipment. Like any ordinary property and equipment, the service vehicles are depreciated in adherence to COA Circular Nos. 2003-007 dated December 11, 2003.

Bonds Payable

Bonds payable are recorded at par and revalued at year-end to reflect Japanese yen to Philippine pesos exchange rate prevailing as of the balance sheet date.

Foreign Currency Transactions

The accounting records of the Company are maintained in Philippine pesos. Expenses denominated in foreign currencies during the year are translated into Philippine pesos at exchange rates prevailing on the transaction date.

3. CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

	<u>2005</u>	<u>2004</u>
Cash on hand and in banks	₱ 57,583,091	₱ 173,491,962
Short-term placements	6,444,361,332	6,061,276,503
Restricted cash	<u>283,471,096</u>	<u>-</u>
	<u>₱ 6,785,415,519</u>	<u>₱ 6,234,768,465</u>

Cash in banks earn interest at the prevailing bank deposit rates. Short-term placements are all highly liquid instruments purchased with original maturities of three months or less from dates of acquisition. Restricted cash pertains to proceeds from the sale of NPC's five hydroelectric plants – Talomo, Agusan, Barit, Cauayan and Loboc.

4. RECEIVABLES

This account is composed of the following:

	<u>2005</u>	<u>2004</u>
Due from GOCCs	₱ 5,265,180,623	₱ 5,867,585,142
Accrued interest	24,518,555	6,466,622
Input tax	19,485,368	13,455,591
Others	<u>221,754</u>	<u>562,192</u>
	<u>₱ 5,309,406,300</u>	<u>₱ 5,888,069,547</u>

The Due from GOCCs account pertains to advances to NPC for the settlement agreements with Independent Power Producers (IPPs) and Philippine Geothermal Inc. (PGI). This is in line with PSALM's mandate to continuously renegotiate with certain IPPs for the reduction of stranded contract costs. NPC Board Resolution Nos. 2005-03 and 2005-04 dated January 11, 2005 provide, among others, that these advances by PSALM Corp. shall be repaid by NPC on terms and conditions to be agreed upon by PSALM and NPC.

5. INVENTORIES

This account pertains to office supplies inventory. The 2005 book balance of ₱2,294,960 is more than the ₱807,425 actual physical count that was conducted at year-end. The ₱1,487,535 variance was lodged in a separate subsidiary ledger for inventory. The segregation was made to immediately identify the amount subject to reconciliation by and

accountability of the Property Officer and to segregate the transactions starting year 2006 which are now being handled by a different personnel.

6. PREPAID CHARGES

This account is composed of the following:

	<u>2005</u>	<u>2004</u>
Rent deposit	₱ 1,213,725	₱ 1,213,725
Others	<u>9,500</u>	<u>-</u>
	₱ <u>1,223,225</u>	₱ <u>1,213,725</u>

Rent deposit is equivalent to three months rent with Bankmer Realty Corporation.

7. OTHER CURRENT ASSETS

This account is composed of:

	<u>2005</u>	<u>2004</u>
Guaranty deposit related to Nomura bonds	₱ 1,667,281	₱ 2,021,620
Guaranty deposit related to leased vehicles	<u>402,500</u>	<u>402,500</u>
	₱ <u>2,069,781</u>	₱ <u>2,424,120</u>

8. INVESTMENT IN BONDS

Breakdown of this account is as follows:

	<u>2005</u>	<u>2004</u>
Cash proceeds	₱ 26,719,449,160	₱ 26,719,449,160
Imputed discount	12,732,229	10,102,540
Partial payment of principal	(14,908,342,675)	(12,346,472,936)
Revaluation	<u>2,914,113,359</u>	<u>5,766,081,628</u>
	₱ <u>14,737,952,073</u>	₱ <u>20,149,160,392</u>

Under an On-Lending Agreement dated December 12, 2002, PSALM Corp. subscribed to bonds issued by NPC, specifically Tranche A bonds and Tranche B bonds with principal amounts of ¥24.75 billion or ₱10.77 billion and ¥37.0 billion or ₱16.08 billion. Tranche

A and B bonds were purchased at the price of 99.457% and 99.645% and will fall due in 2020 and 2022, respectively. Tranche A bears annual interest of 3.2% and Tranche B of 3.55%. The On-Lending Agreement was entered into between PSALM Corp. and NPC in order to cover partly the funding requirements of NPC for fiscal years 2002 and 2003. (See Notes 7, 10 and 14.)

In 2003, PSALM required NPC to prepay a portion of the above investment. By 2004, the full amount of Tranche A was already paid in full by NPC. The additional prepayment of ¥4.692 billion or ₱2.118 billion in 2005 and ¥2.506 billion or ₱1.368 billion in 2004 was applied against Tranche B.

9. PROPERTY, PLANT AND EQUIPMENT

Following is the breakdown of this account:

	2005	2004
Computers and accessories	₱ 80,617,214	₱ 79,745,486
Furniture and fixtures	15,104,630	14,591,073
Transportation equipment	9,340,682	9,696,182
Communication equipment	1,642,072	1,214,799
Office equipment	1,035,852	634,289
Library books	525,410	170,170
	<u>108,265,860</u>	<u>106,051,999</u>
Accumulated depreciation	39,495,232	23,086,153
	<u>₱ 68,770,628</u>	<u>₱ 82,965,846</u>

10. OTHER NON-CURRENT ASSETS

This account is composed of:

	2005	2004
Assumed REC loans:		
NEA	₱ 17,977,951,554	₱ 17,977,951,554
Other financ'l institutions/gov't agencies	49,443,695	49,443,695
Local gov't units	32,038,835	-
	<u>18,059,434,084</u>	<u>18,027,395,249</u>
Amortization	477,377,410	239,873,078
Subtotal	<u>17,582,056,674</u>	<u>17,787,522,171</u>
Unamortized balances:		
Debt transfer-related expenses	123,539,752	145,178,966
Discount on Nomura bonds	96,882,976	102,982,043
	<u>₱ 17,802,479,402</u>	<u>₱ 18,035,683,180</u>

Section 60 of the EPIRA provides: “Upon the effectivity of this Act, all outstanding financial obligations of electric cooperatives to NEA and other government agencies incurred for the purpose of financing the rural electrification program shall be assumed by the PSALM Corporation in accordance with the program approved by the President of the Philippines within one (1) year from the effectivity of this Act which shall be implemented and completed within three (3) years from the effectivity of this Act. The ERC shall ensure a reduction in the rates of electric cooperatives commensurate with the resulting savings due to the removal of the amortization payments of their loans. Within five (5) years from the condonation of debt, any electric cooperative which shall transfer ownership or control of its assets, franchise or operations shall repay PSALM Corp. the total debts including accrued interests thereon.”

The total estimated amount of Rural Electric Cooperatives (RECs) loans to National Electrification Administration (NEA) for assumption and condonation by PSALM Corp. amounted to ₱18.014 billion. Based on the results of audit made by PSALM Corp., it was adjusted to ₱17.978 billion. The condonation was subject to compliance with certain conditions required under Executive Order No. 119.

The PSALM Board approved on 28 July 2004 the condonation of loans of Batangas Electric Cooperative II, Inc. (BATELEC II) with the Development Bank of the Philippines amounting to ₱49.444 million.

The initial amount of RECs loans actually condoned and paid (which started in 2003) is being amortized over a period of ten years. The succeeding condonation/payments (grouped on a yearly basis) are amortized over what is remaining of the 10-year period. (See Notes 8 and 14.)

11. OTHER ASSETS – UNIVERSAL CHARGE

This account consists of:

	<u>2005</u>	<u>2004</u>
Restricted cash - Special Trust Fund	₱ 1,582,155,296	₱ 398,753,301
Receivables	<u>136,720,807</u>	<u>49,646,234</u>
	<u>₱ 1,718,876,103</u>	<u>₱ 448,399,535</u>

PSALM Corp. administers the Special Trust Funds created in accordance with the Guidelines on the Remittance and Disbursements duly promulgated by PSALM Corp., concurred by the Department of Finance (DOF) and approved by the Energy Regulatory Commission as provided for in the EPIRA.

PSALM Corp. maintains separate books of accounts for these Special Trust Funds and records all receipts and disbursements on accrual basis and in accordance with existing government accounting and auditing rules and regulations on the proper handling and administration of trust funds

12. CURRENT PORTION OF LONG-TERM LIABILITIES

This account pertains to the portion of assumed loans from RECs which are scheduled for payment in the year 2006. (See Notes 10 and 14.)

13. DUE TO GOCC

This account consists of:

	<u>2005</u>	<u>2004</u>
PSALM's initial working capital req'mnts	₱ 716,127,317	₱ 716,127,317
Nomura-related transactions	746,369,441	297,262,020
Proceeds from privatization	287,662,817	-
Effect of foreign currency translation of privatization proceeds at yearend rate	(<u>10,843,588</u>)	-
	<u>₱ 1,739,315,987</u>	<u>₱ 1,013,389,337</u>

14. LONG -TERM LIABILITIES

This account consists of:

	<u>2005</u>	<u>2004</u>
Nomura bonds	₱ 27,806,025,000	₱ 33,715,500,000
Assumed REC loans	11,749,097,375	14,039,103,608
Lease obligation	<u>1,435,041</u>	<u>2,967,678</u>
	<u>₱ 39,556,557,416</u>	<u>₱ 47,757,571,286</u>

On December 10, 2002, PSALM Corp. issued two tranches of Japanese Yen-denominated bonds in the total amount of ¥61.75 billion or ₱26.85 billion jointly guaranteed by the Republic of the Philippines and by the Asian Development Bank. Tranche A consisted of ¥24.75 billion or ₱10.77 billion with a maturity of 18 years at 3.2% annual interest. Tranche B consisted of ¥37.0 billion or ₱16.08 billion with a maturity of 20 years at 3.55% annual interest. As of December 31, 2005, Tranche A & B was revalued at ₱11.145 billion and ₱16.661 billion, respectively.

As provided under the On-Lending Agreement between PSALM Corp. and NPC, the proceeds from the issuance of Tranche A and B were used to subscribe to certain bonds issued by NPC on December 12, 2002. (See Notes 7, 8 and 10.)

15. TRUST LIABILITIES – UNIVERSAL CHARGE

The liability for Universal Charge (UC) is established as follows:

Remittances to PSALM			
For missionary electrification	₱	3,738,785,143	
For watershed management		252,296,240	
Unidentified		<u>280,543,829</u>	₱ 4,271,625,212
Add interest earnings, net of bank charges			<u>63,763,418</u>
Fund total			<u>4,335,388,630</u>
Less remittances to NPC			<u>2,753,233,334</u>
Fund balance			<u>1,582,155,296</u>
Add receivables from ECs			<u>136,720,807</u>
Liability for the UC	₱		<u><u>1,718,876,103</u></u>
Unidentified remittances:			
▪ Collecting entity unidentified	₱	38,448,950	
▪ Collecting entity identified, UC element unidentified		242,094,879	
Total unidentified remittances	₱		<u><u>280,543,829</u></u>

16. OTHER RECEIPTS

Other receipts pertain to income derived from the participation fee of prospective bidders, sale of data about power plants in compact discs and fee from Investors' Preliminary Asset Review Program.

17. MAINTENANCE AND OTHER OPERATING EXPENSES

The 2005 maintenance and other operating expenses of ₱199.1 million pertains largely to professional services (₱91.4 million or 46%) and withholding taxes (₱53.3 million or 27%).

18. GAIN ON FOREIGN EXCHANGE

The gain arose from the revaluation of Nomura bonds payable at 2005 year-end rate (from ₱0.5460/¥ in 2004 to ₱0.4503/¥ in 2005).

The above accounting treatment is in accord with PAS 21, “The Effects of Changes in Foreign Exchange Rates” which requires the recognition of gains and losses from exchange differences in the period they are incurred (see Note 2).

19. OTHER SIGNIFICANT EVENTS

Privatization

Generation Assets

Of the 31 plants identified for privatization, PSALM has successfully bid out five hydro-electric plants and a 600-MW coal-fired plant. The first half of 2005 was highlighted by the turnover to the winning bidders of the first five power plants successfully bid out in 2004 namely Talomo, Agusan, Barit, Cawayan and Loboc hydro-electric plants. Prior to turnover, PSALM obtained specific consents from the Asian Development Bank (ADB), World Bank (WB) and Japan Bank for International Cooperation (JBIC) for the transfer and sale of said plants. The closed-out sale translates to US\$5.2 million in proceeds. The proceeds were recorded in PSALM books as an obligation (Due to GOCC) to NPC and the sales were recorded in NPC books. Proceeds of privatization of said assets will be used to liquidate the outstanding debts and other obligations to be assumed by PSALM from NPC pursuant to the EPIRA.

No additional power plant has been privatized in 2005. The GENCO sale schedule is continuously being updated to factor in investment climate and resolution of plant-specific issues, among others. Other significant accomplishments were as follows:

- *Masinloc sale*: Secured all necessary conditions precedent to the closing of the sale of Masinloc, including consent of major creditors (Asian Development Bank, World Bank and Japan Bank for International Cooperation) for the transfer and sale of the asset. Consistent with Asset Purchase Agreement (APA), PSALM has since asked the winning bidder, YNN Pacific Consortium, to pay on or before 31 March 2006 the US\$222 million upfront payment.
- *Calaca bidding*: Consistent with bidding rules and procedures, PSALM will conduct a second round of bidding for this plant in the 1st Semester of 2006, following the cancellation of the bidding for this plant scheduled in June 2005 due to the withdrawal of two of the three bidders. Final Transaction Documents are due for submission to the PSALM Board for approval.

Non-generation Assets

In view of the failed biddings for some of the decommissioned plants, PSALM has adopted a new strategy through the hiring of a third party auctioneer. The PSALM Board

approved the hiring of an auctioneer on 22 December 2005 and preparation for the Terms of Reference is ongoing.

Transmission Assets

Based on consultations held by DOE/PSALM with potential investors, the bidding for the TRANSCO concession ideally should be undertaken when there is already a clear view on the ERC's forthcoming decision on TRANSCO's Maximum Allowable Return (MAR) for the 2nd Regulatory Period (2006-2010). Inasmuch as TRANSCO's MAR is a main driver of the profitability of the transmission business, uncertainty on the level of TRANSCO's MAR may have an adverse effect on the bidding process.

TRANSCO and PSALM have jointly filed the regulatory reset requirements for the 2nd Regulatory Period on 31 August 2005. ERC issued its Draft Determination dated 16 December 2005 (released on 23 December 2005). PSALM and TRANSCO are currently participating in the public hearings on responses to the Draft Determination. ERC's Final Determination on TRANSCO's regulated revenues for 2006-2010 is expected in April 2006.

Meanwhile, PSALM is finalizing the bidding term sheet and transaction documents which will then be provided to the interested parties for their comments. After PSALM has considered and addressed comments raised by the investors, it will finalize the term sheet and transaction documents. PSALM is scheduled to publish the Invitation to Express Interest, Prequalify and Bid for TRANSCO in the first quarter of 2006.

Management of Other Finance Matters

Consolidated Financial Program of NPC/TRANSCO/PSALM

PSALM's financing efforts in 2005 resulted in securing loan proceeds of US\$596 million that covered the PSALM Board-approved estimated consolidated deficit requirements of NPC/PSALM/TRANSCO of about US\$600 million.

In August 2005, NPC successfully re-entered the international capital markets with the issuance of six-year Floating Rate Notes valued at US\$300 million. The transaction was offered in Asia at the initial price of US\$200 million but based on strong investor response, the final issue was raised to US\$300 million. Due to strong demand, NPC issued another tranche of US\$100 million in September 2005. These issues attracted order books with total size of over US\$500 million from 85 different accounts across Asia, Europe and North America.

Equally significant transactions in 2005 that were selected from the responses to the request for proposals (RFPs) issued to more than 10 banks were the following:

- ₱5.0 billion Fixed-Rate Power Bonds issued and closed in May 2005 (loan proceeds equivalent to ₱5.062 billion or US\$93.81 million); and
- ₱5.5-11.0 billion Zero Coupon Bonds issued in November 2005 (loan proceeds equivalent to ₱5.6 billion or US\$596.745 million).

Asset and Debt Transfer

Crucial to the privatization efforts of the Company is the transfer of assets and debts from NPC to PSALM. Without creditors' consent, PSALM cannot effectively privatize NPC's assets without violating the provisions of the loan agreements prohibiting the conveyance of the assets. Thus, PSALM is seeking a universal consent that would set the date of effectivity of the transfer to a single date. In the meantime, PSALM sought specific consents from creditors for each plant that was privatized in 2004.

To date, discussions are ongoing between and among PSALM, World Bank and Asian Development Bank (with Department of Energy, NPC and TRANSCO) to negotiate and finalize the Amendment Agreement that should pave the way for the universal consent for asset and debt transfer.

Debt Absorption

The ₱200-billion debt absorption was mandated by Congress in 2001 in recognition of the need for government to assume part of the obligations of NPC. Otherwise, NPC's entire debt obligations would have been passed on to consumers in the form of higher rates and would have adversely affected the competitiveness of the Philippine economy as a whole and of the industrial sector in particular.

President Gloria Macapagal-Arroyo signed Executive Order No. 370 on 12 October 2004 to effect the debt assumption of ₱200 Billion. This paved the way for the absorption by the National Government of ₱200 billion of NPC's financial obligations beginning 31 December 2004. The financial obligations assumed by NG were NPC-issued bonds wholly purchased and held by the NG. Documentation of the NG absorption was completed when said bonds were fully cancelled in March 2005.

Universal Charge

Section 32 of the EPIRA imposed a universal charge (UC) which shall be passed on and collected from all electricity end-users for various purposes. Funds generated from the UC shall have to be administered by PSALM.

As of 31 December 2005, the fund stood at ₱1.582 billion accounted for as follows:

	<u>Missionary Electrification</u>	<u>Watershed Management</u>	<u>Unidentified</u>	<u>Total</u>
Remittances to PSALM	3,738,785,143	252,296,240	280,543,829	4,271,625,212
Less disbursements	<u>2,683,312,293</u>	<u>69,921,041</u>	-	<u>2,753,233,334</u>
Fund balance	<u>1,055,472,850</u>	<u>182,375,199</u>	<u>280,543,829</u>	<u>1,518,391,878</u>
Add int. earnings, net of bank charges				<u>63,763,418</u>
Total fund balance				<u><u>1,582,155,296</u></u>

Renegotiation of IPP Contracts

As PNOC-EDC leads in the negotiation and resolution of the outstanding issues of the Leyte A&B and Mt. Apo I & II IPP contracts, PSALM and NPC continued discussions in 2005 with sponsors of four IPP contracts with outstanding issues, namely, Bauang, Limay A&B and the Mindanao Barges. The highlights of the renegotiated agreements were as follows:

- For Bauang, one of the issues raised by the Inter-Agency Committee (IAC) which reviewed the NPC-IPP Contracts in 2002 was the clarification of the F- Factor or the outage factor within which NPC was paying if the outage factor exceeds the maximum allowable level. The same has been discussed between NPC and Bauang Power Philippines Corporation (BPPC) and was clarified as part of the proposed General Framework Agreement.
- With regard to Limay Blocks A and B, PSALM and NPC agreed to a Settlement and Clarification Agreement which provides for the clarification of the Availability Bonus and the formula to be applied on the calculation of the energy fees including low or zero dispatch scenarios.
- Under the proposed Supplemental Agreement for the Power Barges 117 and 118, the specification for the dead band for the Guaranteed Net Plant Heat Rate which was not clear in the original O&M Agreement was clarified. Moreover, BWSC (IPP Company) also agreed to free start ups up to a certain level/number of start ups per year.

The aforesaid agreements generally provided improvement in the technical specifications of the original IPP Agreements. PSALM has already secured the necessary PSALM (and NP) Board approvals for the said agreements and submitted the same to the Investment

Coordination Committee (ICC) of the National Economic and Development Authority (NEDA) Board for its appropriate approval or clearance-on-a-no-objection basis. Estimated net present value of savings that can be realized from the said agreements amount to US\$ 8.82 million (Bauang), US\$ 18.28 million (Limay) and US\$ 1.53 million (Mindanao Barges) or a total of US\$ 28.63 million in net present value terms (at 10% NEDA-ICC recommended discount rate).

Given the developments and current pace of the discussions with the remaining outstanding IPP contracts, the closing conditions as well as the effectivity of the above renegotiated agreements are expected to be obtained within 2006.

Competitive Electricity Market

In April 2005, the WESM's Trial Operations Program (TOP) using the Market Management System specially designed for the Philippine WESM by Asea Brown Boveri (ABB-MMS), was officially launched. To support the DOE's initiative in establishing a wholesale spot market for electricity, PSALM participated and registered its portfolio of generating facilities with four independent trading teams. The TOP, which consists of five phases, aimed to test the ABB-MMS software and the market rules as well as train the trading participants coming from the generation and customer sides of the business. The participation of PSALM has resulted in the critical mass required to test the ABB-MMS and the WESM Market Rules.

For the dry run and subsequent commercial operation of the WESM in 2006, NPC and PSALM have agreed that NPC is to register and trade all the NPC Plants until such time these facilities are privatized and PSALM is to register and trade the NPC-IPP Plants. Both agencies have registered these facilities in January 2006 to provide the critical mass for the supply side of the market in time for the declaration of commercial operation by the DOE.

Systems Development Project

Item (b), Section 5 of Rule 21 of the Implementing Rules and Regulations of the EPIRA empowers PSALM, in the performance of its functions and for the attainment of its objectives, to take title to and possession of, administer and conserve the assets transferred to it, including the execution of bilateral contracts to sell power from undisposed assets and contracts transferred by NPC. PSALM would thus become a major participant in the operation of the Wholesale Electricity Spot Market (WESM). It therefore needs to organize and develop its capability to carry out this function prior to the privatization of these assets.

One aspect of the preparations the Company made for this function is the acquisition of software that will capture the workings and intricacies of electricity trading. The chosen software is the Contango. To supplement the projected load of data that will be coming in

and at the same time complement the other functional needs of the Company, SAP software was likewise obtained. The implementation, however, of the two systems are still pending awaiting solutions of several issues, mostly on the technical side of the user's requirements.

Alongside the development of this project is the Company's implementation of New Government Accounting System (NGAS) from the Commission on Audit (COA). This entailed the restructuring of the Company's chart of accounts and changes in forms and in some procedures. The realignment of these changes with SAP needs more time for reconfiguration and evaluation. To stem the delay in the implementation of the project, three options are under consideration – (1) continue with SAP, (2) enhance the existing General Accounting System (GAS) and, (3) adopt the electronic NGAS of COA. Apart from considering the cost, efficiency and other factors in the evaluation, the system that will be adopted has to be compliant with the NGAS requirements.

20. AUTHORITY FOR ISSUANCE

These financial statements have been approved for issue by the PSALM Board of Directors on 14 February 2006 per Board Resolution No. 06-11, series of 2006.