

# POWER SECTOR ASSETS AND LIABILITIES MANAGEMENT CORPORATION

## NOTES TO FINANCIAL STATEMENTS

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### 1. CORPORATE INFORMATION

To avert the crippling power crisis in the 1990s and continue energize the developing economy, the Philippine government embarked on the electric power industry privatization and restructuring program. This program is outlined in Republic Act No. 9136, known as the Electric Power Industry Reform Act of 2001 or "EPIRA", enacted on June 8, 2001.

EPIRA seeks, among others, to ensure quality, reliable, secure and affordable electric power supply; to promote a regime of free and fair competition; to enhance the inflow of private capital and broaden the ownership base of the power generation, transmission and distribution sectors; and to provide for an orderly and transparent privatization of the assets and liabilities of the National Power Corporation (NPC).

Thus, Power Sector Assets and Liabilities Management Corporation (PSALM Corp. or the "Corporation") was created on June 26, 2001 as a government-owned and controlled corporation by virtue of Section 49, Chapter VI of EPIRA. It 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 NPC. The principal purpose of PSALM Corp. 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. shall, in the performance of its function and for the attainment of its objective, have, among others, the following powers under Section 51 of the EPIRA:

- a. 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.;
- b. 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;
- c. 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;
- d. To calculate the amount of the stranded debts and stranded contract costs of NPC which shall form the basis for Energy Regulatory Commission (ERC) in the determination of the universal charge;

- e. 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;
- f. 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 that all such debts or borrowings shall have been paid off before the end of its corporate life;
- g. To restructure existing loans of NPC;
- h. To collect, administer, and apply NPC's portion of the universal charge; and
- i. 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.

The following funds, assets, contributions and other property constitute the property of PSALM Corp., as enumerated in Section 55 of the EPIRA:

- 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 Corp.;
- 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 Corp.:

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

To carry out the mandate of ownership of assets and assumption of obligations of NPC by PSALM Corp., a Deed of Transfer was executed by and between PSALM Corp. and NPC in December 2001. This Deed enumerated, among others, the assets to be transferred and retained, liabilities to be assumed, representations and warranties and conditions precedent to transfer.

Notwithstanding the above, NPC assets and liabilities still remain in the books of NPC pending receipt of creditors' consent. Without creditors' consent, transfers cannot be effectively made without violating the provisions of the loan agreements (between NPC and its creditors) prohibiting the conveyance of the assets. In the meantime, PSALM Corp. sought specific consents from creditors for each plant that is being privatized. Pending the transfer, PSALM Corp. recognizes an obligation to NPC (Due to Government Agencies) corresponding to the proceeds of the various assets sold.

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 Corporation outstanding upon the expiration of its term of existence shall revert to and be assumed by the National Government.

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

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## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### **Basis of Preparation of Financial Statements**

The financial statements of PSALM Corp. have been prepared on a historical cost basis and transactions are recorded in accordance with the New Government Accounting System (NGAS) prescribed by the Commission on Audit.

### **Cash Equivalents**

Cash equivalents consist of short-term placements/time deposits which are highly liquid investments with a maturity of three months or less from the date of acquisition and which are subject to insignificant risk of changes in value.

### **Inventories**

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 using the effective interest method with other costs treated as outright expenses. Balance is revalued at year-end to reflect Philippine peso to Japanese yen exchange rate prevailing as of the balance sheet date.

### **Property and Equipment and Depreciation**

Property and equipment, which consists mainly of computers, office furniture and fixtures, 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. Generally, tangible assets that are expected to be used for more than one year are considered as capital assets. 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 lives of the assets as follows:

Furniture, Fixtures and Equipment	5 - 10 years
Transportation Equipment	7 years
Computers and Accessories	5 years

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

The carrying values of property 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 and expenses.

### **Accounting for Lease and Amortization**

Service vehicles acquired through finance lease are recorded under property and equipment at the amount equal to the present value of the lease payments. The obligation is amortized over the term of the lease of three (3) years.

### **Assumed Loans**

The total amount of electric cooperatives (ECs) loans from NEA which were assumed by PSALM Corp. was charged to a deferred asset account. Amounts actually paid by the Corporation to NEA and other government agencies for these assumed loans are amortized and charged to expense. The initial amount was amortized using straight-line method over a period of ten years. The succeeding payments (grouped on a yearly basis) were amortized over what is remaining of the 10-year period.

### **Bonds Payable**

Bonds payable are presented net of unamortized discount and are revalued at year-end to reflect Philippine peso to Japanese yen exchange rate prevailing as of the balance sheet date.

### **Foreign Currency Transactions**

The accounting records of the Corporation are maintained in Philippine pesos. Expenses incurred which are denominated in foreign currencies are translated into Philippine pesos at exchange rates prevailing on the transaction dates.

The Corporation translates its foreign currency-denominated deposits and loans at year-end rates. The resulting gains and losses from the exchange differences are recognized in the statement of income and expenses.

Year-end foreign currency exchange rates follow:

	2006	2005
Philippine Peso (₱) : US Dollar (\$)	49.1320	53.0670
Philippine Peso (₱) : Japanese Yen (¥)	0.4131	0.4503

## **3. CASH AND CASH EQUIVALENTS**

This account consists of the following:

	2006	2005
Cash on Hand and Cash in Banks	₱ 744,957,148	₱ 57,583,091
Cash Equivalents	11,101,385,885	6,727,832,428
	₱ 11,846,343,033	₱ 6,785,415,519

*Cash Equivalents* include the short-term placement with the Development Bank of the Philippines (DBP) and Land Bank of the Philippines (LBP) of the proceeds from the sale of NPC's six hydro-electric plants (Talomo, Agusan, Barit, Cauayan and Loboc in 2005 and Pantabangan-Masiway in 2006) and amounts received for lease rental, as follows:

	2006		2005	
	US\$	Peso	US\$	Peso
DBP	31,323,196	1,538,971,245	5,341,758	283,471,096
LBP	25,800,000	1,267,605,600	-	-
	57,123,196	2,806,576,845	5,341,758	283,471,096

The ₱5.061 billion increase in the account compared to last year's level was brought about by the receipt of the 40% upfront payment for the sale of Pantabangan-Masiway (₱2.57 billion), NPC's partial payment of Tranche B of Nomura bond and the amount advanced by PSALM to settle NPC's obligation (₱3.642 billion) and proceeds from forfeiture of performance bond for bid of Masinloc (₱0.758 billion). These were partly offset by the ₱1.762 billion payment of PSALM-assumed loans and the amount used for corporate operations.

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#### 4. RECEIVABLES

This account is composed of the following:

	<b>2006</b>	2005
Due from GOCCs	<b>₱ 3,619,856,349</b>	₱ 5,265,180,622
Asset Sale Receivable-current portion (Note 6)	<b>372,770,785</b>	-
Interest Receivable	<b>43,320,152</b>	24,518,555
Due from NGAs	<b>29,216,734</b>	19,485,368
Due from Officers & Employees and Others	<b>302,497</b>	221,755
	<b>₱ 4,065,466,517</b>	₱ 5,309,406,300

The *Due from Government-Owned and Controlled Corporations (GOCCs)* account pertains to advances to NPC for the settlement agreements with independent power producers (IPPs) and the Philippine Geothermal Inc. (PGI). This is in line with PSALM Corp.'s mandate to renegotiate with certain IPPs for the reduction of stranded contract costs (the excess of the contracted cost of electricity under eligible contracts over the actual selling price of the contracted energy output of such contracts in the market). NPC Board Resolution Nos. 2005-03 and 2005-04, both dated January 11, 2005, provide, among others, that these advances shall be repaid by NPC on terms and conditions to be agreed upon by the parties. In 2006, a total of ₱1.642 billion of these advances were repaid by NPC.

*Interest Receivable* is interest income accruing on short-term placements/time deposits. *Due from National Government Agencies (NGAs)* is mostly due from the Bureau of Internal Revenue (BIR) for input tax.

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#### 5. OTHER CURRENT ASSETS

This account is composed of the following:

	<b>2006</b>	2005
Rent deposit	<b>₱ 1,786,828</b>	₱ 1,213,725
Guaranty deposit related to Nomura bonds	<b>1,529,544</b>	1,667,281
Guaranty deposit related to leased vehicles	<b>402,500</b>	402,500
Others	<b>9,500</b>	9,500
	<b>₱ 3,728,372</b>	₱ 3,293,006

The Corporation holds its office at the four floors (third to sixth) of Bankmer Building which it leases from the Bankmer Realty Corporation. Section 2.2 of the Contract of Lease provides that the lessee shall deposit an amount equivalent to three (3) months rental which shall answer for damages and any other monetary obligation under or resulting from the lessee's violation of any of the provisions of this Contract.

*Guaranty deposit related to Nomura bonds* pertains to the amount of US\$30,000 or ¥3,702,600 deducted from the proceeds of the Nomura bonds issued by PSALM Corp. in 2002. This was deposited in a special account with JP Morgan Chase Bank (Nomura bond's fiscal agent, paying agent and common depository bank) for the sole purpose of paying for any carrying cost associated with the negative interest rates of yen. Upon maturity of the bonds, any amount in the account will be transferred back to PSALM Corp.

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## 6. ASSET SALE RECEIVABLE

The ₱3.430 billion asset sale receivable in 2006 represents the 60% balance from the sale during the year for US\$ 129 million (₱6.338 billion) of the 112 MW Pantabangan-Masiway hydro-electric power plant complex to the First Generation Hydro Power Corporation (First Gen) (see Note 18). The sales price is payable by First Gen as follows: 40% cash upfront and the 60% balance payable in 14 equal semi-annual payments with an interest of 12% per annum compounded semi-annually. Amounts falling due in May and November 2007 are presented as part of current receivables (see Note 4).

Pending the transfer of the NPC assets and liabilities as discussed in Note 1, PSALM Corp. recognizes an obligation to NPC corresponding to the sale price of the various NPC assets sold (see Note 13).

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## 7. INVESTMENT IN BONDS

Breakdown of this account is as follows:

	<b>2006</b>	<b>2005</b>
Beginning balance	₱ 14,737,952,073	₱ 20,149,160,392
Payments by NPC	( 2,000,000,000 )	( 2,118,000,000 )
Amortization of bond discount	74,743,335	2,629,689
Revaluation	( 2,513,691,761 )	( 3,295,838,008 )
	<b>₱ 10,299,003,647</b>	<b>₱ 14,737,952,073</b>

Under the On-Lending Agreement dated December 12, 2002, PSALM Corp. issued Nomura bonds with the proceeds used to subscribe 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. NPC Tranches A and B bonds were purchased at the price of 99.457% and 99.645%, respectively, 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.

In 2003, PSALM Corp. 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. Thus, the above numbers for both years pertain to Tranche B alone. The additional prepayments of ¥4.844 billion or ₱2.0 billion, ¥4.709 billion or ₱2.118 billion and

¥2.516 billion or ₱1.368 billion were applied against Tranche B in 2006, 2005, and 2004, respectively.

The decrease in the revaluation was due to the payment made by NPC coupled with the appreciation of peso against Japanese yen.

## 8. PROPERTY AND EQUIPMENT

Following is the breakdown of this account:

	Computers and Accessories	Furniture, Fixtures and Equipment	Transportation Equipment		Total
			Regular	Under Lease	
<b>COST</b>					
As of Jan. 1, 2006	₱80,617,214	₱18,307,964	₱5,718,182	₱ 3,622,500	₱108,265,860
Additions	12,344,928	5,716,981			18,061,909
Adjustment	(104,171)				(104,171)
As of Dec. 31, 2006	92,857,971	24,024,945	5,718,182	3,622,500	126,223,598
<b>ACCUMULATED DEPRECIATION</b>					
As of Jan. 1, 2006	32,655,724	4,200,039	1,971,526	667,943	39,495,232
Provision	14,742,910	1,967,521	735,195	517,500	17,963,126
As of Dec. 31, 2006	47,398,634	6,167,560	2,706,721	1,185,443	57,458,358
<b>Carrying amount</b>					
As of Dec. 31, 2006	<b>₱45,459,337</b>	<b>₱17,857,385</b>	<b>₱3,011,461</b>	<b>₱2,437,057</b>	<b>₱68,765,240</b>
<b>Carrying amount</b>					
As of Dec. 31, 2005	₱47,961,490	₱14,107,925	₱3,746,656	₱2,954,557	₱68,770,628

## 9. ASSUMED RURAL ELECTRIFICATION PROGRAM (REP) LOANS

Section 60 of the EPIRA provides that all outstanding financial obligations of the electric cooperatives (ECs) to National Electrification Administration (NEA) and other government agencies incurred for the purpose of financing the rural electrification program shall be assumed by PSALM Corp. in accordance with the program approved by the President of the Philippines within one (1) year from the effectivity of the Act which shall be implemented and completed within three (3) years from the effectivity of the Act. Section 2, Rule 31 of the Implementing Rules and Regulations of EPIRA states that the assumption covers all outstanding REP-related financial obligations of the ECs as of June 26, 2001.

The Act also provides that ERC shall ensure a reduction in the rates of ECs commensurate with the resulting savings due to the removal of the amortization payments of their loans. However, any EC which shall transfer ownership or control of its assets, franchise or operations within five years shall repay PSALM Corp. the total debts including accrued interests thereon.

To carry out the aforementioned objective and that of Executive Order (EO) No. 119, Restructuring Program for Electric Cooperatives, PSALM Corp. and NEA entered into a Memorandum of Agreement (MOA) on October 3, 2003 to lay down the operational legal framework upon which the financial obligations of ECs to NEA shall be lawfully assumed by PSALM Corp. Article IV of the MOA provides that

repayment of the assumed loan shall be for the period of 10 years in accordance with the amortization schedule as may be mutually agreed by the parties.

The total amount of ECs loans to NEA for assumption and condonation by PSALM Corp. amounted to ₱17.978 billion. The obligations of ECs to other government agencies amounted to ₱0.081 billion, putting the total loans assumed to-date by PSALM Corp. at ₱18.059 billion.

The condonation was subject to compliance with certain conditions required under Executive Order (EO) No. 119. On September 2, 2006, EO 460 was issued amending EO 119 by giving retroactive effect to the effectivity of the assumption by PSALM Corp. of the rural electrification loan obligations of the ECs to NEA and other government agencies.

While an amendment agreement to the October 3, 2003 MOA between NEA and PSALM Corp. is being worked out in coordination with the Department of Energy, EO 460 was repealed by EO 622 dated May 9, 2007. EO 622 is entitled Repealing EO No. 460 dated September 2, 2005, Entitled "Amending EO No. 119 (S. 2002) and for Other Purposes".

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## **10. OTHER NON-CURRENT ASSETS**

The amount represents legal fees and other costs incurred in securing creditors' consents for the transfer of NPC debts to PSALM Corp. and are being amortized over the remaining life of the related debts.

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## **11. OTHER ASSETS – UNIVERSAL CHARGE**

Section 34 of the EPIRA provides that a Universal Charge (UC) to be determined, fixed and approved by the Energy Regulatory Commission (ERC) shall be imposed on all end-users for the following purposes:

- a. Payment for the stranded debts in excess of the amount assumed by the National Government and stranded contract costs of NPC and as well as qualified stranded contract costs of distribution utilities resulting from the restructuring of the industry;
- b. Missionary electrification;
- c. The equalization of the taxes and royalties applied to indigenous or renewable sources of energy vis-à-vis imported energy fuels;
- d. An environmental charge equivalent to one-fourth of one centavo per kilowatt-hour (₱0.0025/kWh), which shall accrue to an environmental fund to be used solely for watershed rehabilitation and management and shall be managed by NPC under existing arrangements; and

- e. A charge to account for all forms of cross-subsidies for a period not exceeding three (3) years.

The UC shall be a non-by passable charge which shall be passed on and collected from all end-users on a monthly basis by the distribution utilities. The collections by the distribution utilities and the TRANSCO in any given month shall be remitted to the PSALM Corp. on or before the fifteenth (15<sup>th</sup>) of the succeeding month. Any end-user or self-generating entity not connected to a distribution utility shall remit its corresponding UC directly to the TRANSCO.

ERC approved the ₱0.0025/kWh for UC-watershed management effective May 2003. The UC for missionary electrification was first approved at ₱0.0168 effective February 2003 and increased to ₱0.0373/kWh effective July 2003.

The composition of UC fund follows:

	2006		2005	
Special Trust Fund (STF)	₱	<b>317,774,778</b>	₱	1,582,155,296
Receivables		<b>264,823,623</b>		136,720,807
	₱	<b>582,598,401</b>	₱	1,718,876,103

Transactions affecting the UC are as follows:

	2006		2005	
Remittances by collecting entities to PSALM				
For missionary electrification	₱	<b>5,640,025,625</b>	₱	3,738,785,143
For watershed rehabilitation management		<b>380,693,368</b>		252,296,240
Others <sup>1</sup>		<b>16,987,751</b>		280,543,829
		<b>6,037,706,744</b>		4,271,625,212
Interest earnings, net of bank charges		<b>93,692,447</b>		63,763,418
		<b>6,131,399,191</b>		4,335,388,630
Disbursements to NPC	(	<b>5,813,624,413</b>	)(	2,753,233,334
STF balance		<b>317,774,778</b>		1,582,155,296
Receivables from ECs		<b>264,483,946</b>		136,720,807
Interest receivable		<b>339,677</b>		-
	₱	<b>582,598,401</b>	₱	1,718,876,103

<sup>1</sup> Remittances with no identification of specific purpose.

Special Trust Funds were created in accordance with the Guidelines on the Remittance and Disbursements duly promulgated by PSALM Corp., concurred by the Department of Finance and approved by the ERC.

PSALM Corp. maintains separate books of accounts for these Special Trust Funds and records all receipts and disbursements on modified accrual basis and in

accordance with existing government accounting and auditing rules and regulations on the proper handling and administration of trust funds.

The same amount is presented in the contra account “*Other Liabilities – Universal Charge*”.

## 12. OTHER ASSETS – ELECTRICITY TRADING

Section 30 of the EPIRA established the wholesale electricity spot market or WESM. WESM is a market for electricity, a centralized venue for buyers and sellers to engage in the trading of electricity as a commodity. It facilitates fair competition through an electricity pool wherein all the electricity produced is brought together and matched with customer demand on an hourly basis. Membership in the WESM includes generation companies, distribution utilities, suppliers, IPP administrators, end-users and others who may be authorized by the ERC. PSALM Corp., being the owner of NPC-IPP contracts, is trading the output of these IPPs.

All NPC- IPP transactions for electricity trading pass through the books of PSALM Corp. The account represents billings for the IPP energy traded at the wholesale electricity spot market for the period November 26, 2006 to December 25, 2006 (P5.4 billion). It also includes some P6.4 billion billings (for the period 26 August 2006 to 25 September 2006) subject of reconciliation arising from: (1) recalculations using the ERC-approved time-of-use rate, (2) pricing from nodal energy to administered price and (3) offsetting by Philippine Electricity Market Corporation (PEMC) of its receivable from NPC against its payable to PSALM. The amount is also inclusive of the P1.6 billion VAT portion not yet remitted by PEMC pending collection from its customers. The same amount is presented in the contra account “*Other Liabilities – Electricity Trading*”.

## 13. DUE TO GOVERNMENT AGENCIES

This account consists of amounts due to the following:

	2006	2005
NPC for - sale of assets (Note 6)	P 6,588,317,217	P 270,334,973
- Nomura bonds-related items	1,207,455,344	746,369,441
- PSALM Corp. initial working fund	716,127,317	716,127,317
- land lease rentals	6,003,439	6,484,257
Others	21,460,515	9,035,446
	<b>P 8,539,363,832</b>	<b>P 1,748,351,434</b>

*Nomura bonds-related items* are interests and guaranty fees advanced by NPC for the account of PSALM Corp., while the *initial working fund* consists of the early expenses of the Corporation paid for by NPC. *Land lease rentals* are payments by the winning bidders for the lease of the land where the generation plants are

located. *Others* pertain largely to various withheld taxes for remittance to the BIR in the amount of ₱ 19,542,764 for 2006 and ₱ 7,330,645 for 2005.

#### 14. OTHER CURRENT LIABILITIES

This account consists of the following:

	2006	2005
Accrued interest and guaranty fee on Nomura bonds	₱ 51,588,335	₱ 56,050,100
Accrued professional fees & out-of- Pocket expenses	41,281,133	40,532,402
Other current liabilities	29,936,197	22,243,392
	<b>₱ 122,805,665</b>	<b>₱ 118,825,894</b>

*Other current liabilities* refer mostly to the accrual of a 2-month incentives for employees, claims for various payments and performance bonds and guaranty deposits payable.

#### 15. LONG -TERM LIABILITIES

This account consists of:

	2006	2005
Bonds payable	₱ 25,508,925,000	₱ 27,806,025,000
Less bond discount	92,064,335	96,882,976
	<b>25,416,860,665</b>	27,709,142,024
Assumed electric cooperative loans	12,553,610,261	14,315,993,039
Lease obligation	1,435,042	2,628,206
	<b>37,971,905,968</b>	42,027,763,269
Less current portion		
Assumed electric cooperative loans	2,602,308,023	2,566,895,665
Lease obligation	1,412,578	1,193,164
	<b>2,603,720,601</b>	2,568,088,829
	<b>₱ 35,368,185,367</b>	<b>₱ 39,459,674,440</b>

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.

Tranche	Original	2006		2005	
	Currency (₱)	US\$	Peso	US\$	Peso
A	24,750,000,000	208,097,065	10,224,225,000	210,016,112	11,144,925,000
B	37,000,000,000	311,094,602	15,284,700,000	339,108,931	16,661,100,000
	61,750,000,000	519,191,667	25,508,925,000	549,125,043	27,806,025,000

As provided under the On-Lending Agreement between PSALM Corp. and NPC, the proceeds from Tranches A and B bonds issued by the Corporation were used to subscribe to certain bonds issued by NPC on December 12, 2002 (see Note 7).

Meanwhile, of the total ₱18.059 billion loans assumed by the Corporation from NEA and other government agencies (see Note 9), a total of ₱5.506 billion has been paid as of December 31, 2006.

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## 16. EQUITY

*Equity* represents accumulated retained earnings amounting to ₱86,403,035. PSALM Corp. as a government-owned and-controlled corporation was created without specific provision for any authorized capital stock or equity from the National Government. The initial working capital requirement of the Corporation in the amount of ₱716 million was advanced by NPC and was recognized as an obligation of PSALM Corp. to said agency (see Note 13).

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## 17. INCOME

This account pertains 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. The balance for CY 2006 also includes the forfeited performance bond of YNN Pacific of US\$14 million or ₱757,720,181.

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## 18. MAINTENANCE AND OTHER OPERATING EXPENSES (MOOE)

Notable increases were posted in Training and Scholarship Expenses (by ₱3.915 million, bulk of which originated from the conduct of seminars/workshops on asset valuation, electricity trading and tariff and from handling of planning and team building activities) and Other MOOE (by ₱19.636 million, largely from grant of performance incentives to employees).

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## 19. GAIN ON FOREIGN EXCHANGE

This account is composed of:

	<b>2006</b>	2005
Unrealized net gain on revaluation of Nomura bonds-related transactions	<b>₱ 1,170,131,037</b>	₱ 2,605,090,917
Unrealized gain (loss) on revaluation of payables	<b>56,438,221</b>	( 200,447 )
Net realized foreign exchange gain (loss) on operating expenses and revaluation of foreign currency deposits	<b>( 121,367,905 )</b>	6,182,344
	<b>₱ 1,105,201,353</b>	₱ 2,611,072,814

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## 20. OTHER SIGNIFICANT EVENTS FOR 2006

### Privatization

#### Generation Assets

PSALM Corp. was able to bid out three (3) generation assets in CY 2006 (i.e., Calaca, Pantabangan-Masiway and Magat). The second bidding for the 600 MW Calaca coal-fired power plant was conducted on April 27, 2006. The bidding, however, was declared a failure as the bidders' price offers did not meet the reserve price.

This was followed by the successful bidding of the 112 MW Pantabangan-Masiway hydroelectric power plant on September 8, 2006 where First Generation Holdings Corporation won with a bid price of US\$129 million. PSALM Corp. was able to secure the specific consent of the ADB (September 20, 2006), WB (September 22, 2006) and JBIC (October 4, 2006) for the sale and transfer to the winning bidder. PSALM Corp. turned over the Pantabangan-Masiway plant on November 17, 2006.

PSALM also successfully bid out the 360 MW Magat hydroelectric power plant on December 14, 2006 where the consortium of SN Power and Aboitiz Power won the bidding with a price offer of US\$530 million.

On the other hand, YNN Pacific, the winning bidder in the 2005 bidding for the 600 MW Masinloc coal-fired power plant, failed to deliver the US\$227.54-million upfront payment on June 30, 2006. Notice of the forfeiture of the performance bond was issued on July 7, 2006 which became effective on August 6, 2006.

The successful bidding of Pantabangan-Masiway and Magat plants brings the privatization level from 0.08% in 2005 (without Masinloc) to 11% in 2006, vis-à-vis the 70% requirement for Open Access and Retail Competition. In terms of

privatization proceeds, PSALM Corp. was able to generate US\$659 million from expected proceeds from the sale of the Pantabangan-Masiway (US\$129 million) and Magat (US\$530 million).

### Decommissioned plants

PSALM Corp. conducted a bidders' forum for the decommissioned or retired plants on September 29, 2006. Twenty-two (22) interested investor groups, consisting mainly of construction and steel manufacturing companies, attended the forum, which sought to solicit feedback and recommendations from bidders on the terms and conditions of the sale of the decommissioned plants.

PSALM Corp. also issued on November 27, 2006 an Invitation to Bid for the decommissioned 200 MW Manila thermal power plant. The bidding for said plant is expected to be conducted in 2007.

### Transmission Assets

PSALM Corp. launched the bid for the transmission business of the National Transmission Corporation (TRANSCO) via a 25-year concession on May 28, 2006 with the publication of an Invitation to Bid. Three consortia have since been pre-qualified and a pre-bid conference was held on November 20, 2006. The year ended with PSALM setting a third round of comments to give the pre-qualified bidders an opportunity to clarify the amendments, revisions and modifications in the bidding procedures before the bid transaction documents are finalized.

On February 5, 2007, bidding was conducted by PSALM Corp. This was, however, declared a failure after only one investor group, the consortium of Citadel and Terna SpA, out of the three pre-qualified bidders, participated in the bidding exercise. The other two pre-qualified bidders – the consortium of Triratna, Newbridge Asia IV L.P. and Malaysian power firm Tenaga Nasional Berhad and the consortium of Monte Oro Grid Resources Corporation and State Grid Corporation of China – did not submit their bids.

PSALM management has briefed the Board on the various issues raised by the bidders and the Board will evaluate these issues before announcing the next steps to be taken.

## **Management of Finance Matters**

### Consolidated Financial Program of NPC/TRANSCO/PSALM

PSALM Corp. secured the PSALM Board approval for the US\$700M funding requirement for PSALM, TRANSCO and NPC on January 25, 2006 and the NPC Board approval on April 4, 2006. The financial position of NPC/TRANSCO/PSALM improved in mid 2006, mainly due to the peso appreciation, thereby decreasing the funding requirements.

Two financing transactions were executed in 2006. On November 2, 2006, NPC issued a US\$500 million 10-year Global Bonds fully guaranteed by the Republic of the Philippines (ROP) and jointly arranged by the Deutsche Bank and the Citigroup. This was priced at 6.875%.

On December 15, 2006, NPC issued ₱10 billion Fixed Rate Bonds guaranteed by the ROP and jointly arranged by the Deutsche Bank and the HSBC. The issue consists of five-year bonds with an issue amount of ₱3.68 billion and 10-year bonds with an issue amount of ₱6.32 billion. The five-year bonds were priced at 5.25%, which was 85.6% of the five-year benchmark PHP interest rate of 6.132% as of the date of issue. The 10-year bonds were priced at 5.875%.

PSALM also secured Board approval for an unprecedented US\$300M Principal Only Swap (POS) on March 10, 2006, as a hedge against foreign exchange fluctuations. Request for Proposals was issued for the \$300-million POS in September 2006. However, execution of the transaction was suspended because of market conditions in December 2006, which may result in a higher pricing for the transaction and a number of documentary deliverables that need to be submitted by PSALM to concerned agencies.

### Asset and Debt Transfer

#### *Creditors' Consent*

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 is being privatized.

The year started with the signing of the ADB Omnibus Amendment Agreement (OAA) on March 3, 2006. Twelve out of the fifteen conditions precedent (CP)/documentary deliverables for the execution and effectivity of the OAA were complied with. The remaining three CPs (consent for PSALM from all creditors, consent of NPC from all creditors and final Monetary Board approval) are largely dependent on critical factors but are targeted for completion in 2007.

The WB Amendment Agreement (AA) has been finalized by all parties concerned including the WB and was submitted for clearance to the Inter-Agency Committee on the Review of Foreign Loan Documents (IAC-RFLD) composed of the Department of Finance, the Department of Justice and the Bangko Sentral ng Pilipinas on August 4, 2006. The signing of the WB-AA is expected to take place in 2007 after IAC-RFLD clearance has been secured.

The draft Loan Amendment Agreements relative to the JBIC loan agreements (JBIC-OECF and JBIC-EXIM) and loan agreements with other creditors were, likewise, submitted to the concerned agencies.

### *Separation of NPC and TRANSCO Books*

The implementation of the separation of books of NPC and Transco, which is part of the debt and asset transfer activity, will commence from the completion of the creditors' consent. Meantime, PSALM Corp. undertook the following tasks in preparation for the separation: (1) creation of work groups consisting of members from PSALM, NPC and TRANSCO, namely: (i) Technical Working Groups (TWG) and (ii) Assets and Contracts Team to work out the enumerated schedules that should accompany the Deeds of Transfer between NPC and PSALM and NPC and TRANSCO. The TWG held meetings with COA-NPC/TRANSCO attending both, in addition to some informal discussions with TRANSCO as opportunities arose and (2) analysis, validation and reconciliation by the 3 agencies of its current field of accounts including identification of accounts with issues. Several critical priorities necessitated the adjustment of the corporate target for the separation of books.

### IPP Renegotiations

PSALM and NPC continued discussions and negotiations for the four remaining (4) IPP contracts with outstanding issues, namely, Bauang, Limay A&B and the Mindanao Barges (Power Barges 117 and 118).

The proposed concessions for the agreements provide for potential improvements in the technical specifications of the original IPP Agreements, such as absorption/assumption by the IPPs the tax/insurance and ER 1-94 obligations of NPC and limitations on capacity and excess energy. PSALM has already secured the necessary PSALM and National Power Board approvals for the agreements, and has coordinated with the Investment Coordination Committee (ICC) of the National Economic and Development Authority (NEDA) Board for appropriate approval or clearance-on-a-no-objection basis for the agreements.

On November 9, 2006, the NEDA-ICC Cabinet Committee approved the Settlement and Clarification Agreement (SCA) for the Operation and Maintenance Agreement of the Limay A/B Combined Cycle Power Plant. The potential savings from the implementation of the SCA is estimated at about US\$23.97 million from 2005-2008, equivalent to a net present value of US\$19.51 million discounted at 10%. In the same month, the NEDA-ICC also gave its final clearance on the Term Sheet offered by the Korea Electric Power Corporation (KEPCO) on the Malaya Rehabilitation, Operation, Maintenance and Management (ROMM) Agreement and the Ilijan Build-Operate-Transfer (BOT)/Energy Conversion Agreements (ECA). The Term Sheet provides a US\$5 million amount for the missionary electrification program of the Department of Energy.

The NEDA-ICC has likewise acted on the Bauang General Framework Agreement (GFA) and the Supplemental Agreement No. 1 for the Mindanao Power Barges 117 and 118. The NEDA-ICC is seeking clarifications from NPC and PSALM prior to granting its final clearance.

### **IPP Administrator (IPPA)**

The World Bank is providing a Technical Assistance on IPPA and Energy Trading for PSALM and NPC under TF 055609. An IPPA expert, expected to be on board in April 2007, shall review options for the IPPA structure, develop alternative approaches to the privatization of PSALM/NPC IPP contracts and make recommendations. The target is to have the IPPA appointed by November 2007.

### **Support to Electricity Market Development**

PSALM was able to fully participate in the final market dry run and during the commercial operation of WESM in the second semester of 2006. PSALM has completed and tested its billing and settlement process during the final market dry run and commercial operation. It has formulated the proposed guidelines and procedures for the settlement of traded energy, which will be incorporated in the corporate Treasury Manual.

PSALM also completed the conceptual framework for the allocation of signed Transition Supply Contracts to each generation asset and awaiting concurrence by NPC before implementation. PSALM has secured approval for registration from the Philippine Electricity Market Corporation (PEMC) on May 16, 2006 and has signed the Market Participation Agreement.

PSALM has also developed a Risk Management Policy for Electricity Trading, secured Board approval in March 2006 and issued the same prior to start of commercial operations of WESM.

### **Organizational Development and Efficiency**

PSALM formulated and developed its 2006 Corporate Priorities in the first quarter of 2006. It has conducted a series of planning exercises and workshops which culminated in a Commitment Setting Activity in March 2006 and Corporate Strengthening Week in June 2006. PSALM was able to launch its Corporate Philosophy (Vision and Mission Statements), which was approved together with the 2006 Corporate Priorities by the Board on June 9, 2006. It was also able to publish/release the PSALM Milestone Report (2001-2005) and the 2005 Annual Report.

Other significant accomplishments were the reconfiguration of office spaces (i.e., refurbishment of a new office at 6th floor of Bankmer building, negotiation for the lease of the 7th floor of Bankmer building), improvement in IS/IT system (i.e., preparation of 2006-2008 Information Systems and Strategic Plan), budget preparation activities, preparation and submission of status reports and position papers to concerned/relevant agencies, the conduct of Annual Physical Examinations and filling in of vacant positions.

### **Change in Leadership**

Ms. Nieves L. Osorio resigned from her post as PSALM President effective close of office hours on February 28, 2007. Appointed as replacement is Mr. Jose C. Ibazeta, who will assume office on March 1, 2007.

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### **21. AUTHORITY FOR ISSUANCE**

These financial statements have been approved for issue by the PSALM Board of Directors on February 14, 2007.