

POWER SECTOR ASSETS AND LIABILITIES MANAGEMENT CORPORATION NOTES TO FINANCIAL STATEMENTS

1. CORPORATE INFORMATION

To avert the crippling power crisis in the 1990s and continue to 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. has started in 2007 the initial asset transfer from NPC to PSALM with the transfer of 360 MW Magat Hydro Electric Power Plant (HEPP). Apart from the EPIRA, the transfer was backed by the plant's Deed of Transfer, specific creditors' consent and the Transfer Certificate of Title. PSALM will continue with the asset-debt transfer as it obtains similar documentary supports. Upon issuance of the creditors' universal consent, full implementation of the asset-debt transfer will commence and all privatization-related transactions will be recognized in the PSALM books.

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.

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 using the accrual basis of accounting in accordance with paragraphs 25 and 26 of Philippine Accounting Standards (PAS) I and 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 and consist only of office supplies.

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 in accordance with paragraph 23 of PAS 21, which requires foreign currency monetary items to be translated using the closing rate.

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 National Electrification Administration (NEA) which was assumed by PSALM Corp. was charged to a deferred asset account and subject to amortization. This deferred asset account increases as PSALM assumes additional ECs loans from other government agencies (OGA) and local government units (LGUs). In 2007, the deferred asset account *Assumed REP Loans* was restated to effect the change in amortization policy. The amortization expense for CY 2007 was computed based on a straight-line 10-year amortization of the total assumed NEA loans and a straight-line amortization of the OGA and LGU loans over the remaining balance of the 10-year period, beginning from the year the OGA and LGU loans were assumed. The change in policy was based on IAS/PAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors, paragraphs 14, 19 and 22. Accordingly, the understatement of prior years' amortization expense was treated as an adjustment to the *Equity* account.

Electricity Trading

As owner of NPC-IPP contracts, PSALM trades the output of these IPPs in the Wholesale Electricity Spot Market (WESM). All transactions for electricity trading pass through the books of PSALM and are recorded in a separate set of books. Only the net receivables from Philippine Electricity Market Corporation (PEMC) (billings less payments and adjustments) are reflected in PSALM's balance sheet under the *Other Assets - Electricity Trading* account with the same amount presented in the contra account *Other Liabilities - Electricity Trading*.

In the 2007 balance sheet, the Electricity Trading accounts are derecognized due to the observation that their inclusion overstates PSALM's assets and liabilities. The accrual of receivables from PEMC is made by PSALM in behalf of NPC and PSALM has no obligation to remit to NPC more than what it received as payments from PEMC. The derecognition of these accounts are in accordance

with the guidelines set under IAS/PAS 39 - Financial Instruments: Recognition and Measurement, paragraphs 17 to 20.

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 in accordance with paragraph 23 of PAS 21, which requires foreign currency monetary items to be translated at balance sheet date using the closing rate.

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 in accordance with paragraph 21 of PAS 21. Under paragraph 21, foreign currency transactions shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of transaction.

The Corporation translates its foreign currency-denominated deposits and loans at year-end rates in accordance with paragraph 23 of PAS 21, which requires foreign currency monetary items to be translated at balance sheet date using the closing rate. 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:

	2007	2006
Philippine Peso (₱) : US Dollar (\$)	41.4010	49.1320
Philippine Peso (₱) : Japanese Yen (¥)	0.3642	0.4131

3. CASH AND CASH EQUIVALENTS

This account consists of the following:

	2007	2006
Cash on Hand and Cash in Banks	₱ 39,112,204	₱ 744,957,148
Cash Equivalents - Priva proceeds	21,926,498,398	2,806,576,845
- Others	7,475,385,012	8,294,809,040
	₱ 29,440,995,614	₱ 11,846,343,033

Cash Equivalents include the short-term placement of the proceeds from the sale of generation plants with the Bangko Sentral ng Pilipinas (BSP), Land Bank of the Philippines (LBP) and Development Bank of the Philippines (DBP) as follows:

	2007		2006	
	US\$	Peso	US\$	Peso
BSP	501,434,609	20,759,894,274		
LBP	27,731,018	1,148,091,875	25,800,000	1,267,605,600
DBP	447,145	18,512,249	31,323,196	1,538,971,245
	529,612,772	21,926,498,398	57,123,196	2,806,576,845

The ₱17.595 billion increase in the *Cash and Cash Equivalents* account compared to last year's level was brought about by the receipt of full payment for the sale of Magat plant and land (₱25.104 billion), deferred payment for Pantabangan-Masiway (₱0.347 billion), and interest on deferred payments for sold plants (₱0.845 billion). These were offset by the funds released to NPC for its debt service requirements (₱3.896 billion net), payments made to NEA for PSALM-assumed loans (₱1.800 billion), and the net amount used for corporate operations (₱3.005 billion).

4. RECEIVABLES

This account is composed of the following:

	2007	2006
Due from GOCCs	₱ 5,197,223,472	₱ 3,619,856,349
Asset Sale Receivable-current portion (Note 6)	395,330,672	372,770,785
Interest Receivable	106,154,283	43,320,152
Due from NGAs	38,945,811	29,216,734
Due from/Advances to Officers & Employees and Others	2,259,339	302,497
	₱ 5,739,913,577	₱ 4,065,466,517

The *Due from Government-Owned and Controlled Corporations (GOCCs)* account pertains to advances to NPC for debt service and 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. Net advances to NPC in 2007 amounted to ₱1.577 billion.

The PGI transaction originated from the 1971 service contract between NPC and PGI for the development of PNC's Tiwi and Makiling-Banahaw geothermal steam fields. The contract was for 25 years with an option to extend for another 25 years. Upon expiry of the contract in 1996, a dispute arose as NPC challenged the constitutionality of the renewability provisions in view of the prohibition in the 1987 Constitution for wholly-owned foreign corporations to explore, exploit and utilize the country's natural resources. The dispute was brought by PGI before the International Court of Arbitration for payment of damages while NPC filed a Petition for Declaratory Relief before the Regional Trial Court of Quezon City which was eventually elevated to the Supreme Court (SC). So as not to jeopardize the operations of Tiwi and Makban steam fields, an Interim Agreement was put in place. A joint motion to suspend the determination of the case was filed by NPC and PGI before the SC as both parties endeavored to negotiate a settlement of the case. In October 2002, the PSALM-NPC-PGI Term Sheet for the Settlement Agreement was completed. The Term Sheet was formalized into the Compromise Agreement and executed by PSALM, NPC and PGI and was concurred in by the Republic of the Philippines through the Department of Energy.

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. The bulk of the increase in *Due from/Advances to Officers & Employees* was due to the advances made by the Corporation in behalf of employees for the payment of their group and life insurance coverage to the Insular Life Assurance Co. Ltd.

5. OTHER CURRENT ASSETS

This account is composed of the following:

	2007	2006
Rent deposit	₱ 2,191,912	₱ 1,786,828
Guaranty deposit related to Nomura bonds	1,348,487	1,529,544
Guaranty deposit related to leased vehicles	402,500	402,500
Others	2,000	9,500
	₱ 3,944,899	3,728,372

The Corporation holds office at the five floors (third to seventh) 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.

6. ASSET SALE RECEIVABLE

The ₱2.933 billion asset sale receivable in 2007 represents the balance of the sale proceeds of 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). 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 starting 17 May 2007. Amounts falling due in May and November 2008 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).

7. INVESTMENT IN BONDS

Breakdown of this account is as follows:

	2007	2006
Beginning balance	₱ 10,299,003,647	₱ 14,737,952,073
Payments by NPC	-	(2,000,000,000)
Amortization of bond discount	1,411,481	74,743,335
Revaluation	(1,217,688,778)	(2,513,691,761)
Change in the number of decimal point of % allocation	(13,559,623)	
	₱ 9,069,166,727	₱ 10,299,003,647

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 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	
COST					
As of Jan. 1, 2007	₱92,857,971	₱24,024,945	₱5,718,182	₱ 3,622,500	₱126,223,598
Additions	10,546,308	7,862,126	3,814,286		22,222,720
Adjustment					
As of Dec. 31, 2007	103,404,279	31,887,071	9,532,468	3,622,500	148,446,318
ACCUMULATED DEPRECIATION					
As of Jan. 1, 2007	47,398,634	6,167,560	2,706,721	1,185,443	57,458,358
Provision	15,555,465	2,767,881	857,727	394,968	19,576,041
As of Dec. 31, 2007	62,954,099	8,935,441	3,564,448	1,580,411	77,034,399
Carrying amount As of Dec. 31, 2007	₱40,450,180	₱22,951,630	₱5,968,020	₱2,042,089	₱71,411,919
Carrying amount As of Dec. 31, 2006	₱45,459,337	₱17,857,385	₱3,011,461	₱2,437,057	₱68,765,240

9. ASSUMED RURAL ELECTRIFICATION PROGRAM (REP) LOANS

Section 60 of the EPIRA provides that all outstanding financial obligations of the electric cooperatives (ECs) to 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 26 June 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 3 October 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 ₱0.096 billion, putting the total loans assumed to-date by PSALM Corp. at ₱18.074 billion.

The condonation was subject to compliance with certain conditions required under Executive Order (EO) No. 119. On 2 September 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.

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.

11. OTHER ASSETS – ELECTRICITY TRADING

This account represents the amount due (plus interest earned) to the National Irrigation Administration (NIA)-Baligatan Hydroelectric Power Plant for the income generated from the trading of their energy output in excess of their station service use and net of the value of energy withdrawn from the market when the plant is not generating power, as follows:

Billing period	April 26 to November 25, 2007
Traded quantity (MWh), net	1,478.96
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Traded amount, net	₱ 8,079,432
Market fees, net of taxes	(17,252)
Interest from fund management, net	94,963
Balance	₱ 8,157,143

NIA-Baligatan used to be an NPC-IPP by virtue of an Electric Interchange Power Agreement (EIPA) between NIA and NPC for the purchase by the latter of the excess power generated by the plant under an off-setting arrangement. When PSALM commenced trading in WESM, NIA-Baligatan was included in the portfolio of its Trading Team 1 as an NPC-IPP.

When the EIPA was terminated between NPC and NIA in 2007, NIA requested PSALM to continue trading its power output. The two corporations are currently involved in negotiations towards this end and a Memorandum of Agreement (MOA) has been drafted for the purpose. Pending its finalization, PSALM is holding the funds under restricted cash.

12. 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 (15th) 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:

	2007		2006
Special Trust Fund (STF)	P 357,755,392	P	317,774,778
Receivables	492,093,627		264,823,623
	P 849,849,019	P	582,598,401

Transactions affecting the UC are as follows:

	2007		2006
Remittances by collecting entities to PSALM			
For missionary electrification	P 7,395,782,644	P	5,640,025,625
For watershed rehabilitation Management	499,157,625		380,693,368
Others ¹	2,811,552		16,987,751
	7,897,751,821		6,037,706,744
Interest earnings, net of bank Charges	103,039,242		93,692,447
	8,000,791,063		6,131,399,191
Disbursements to NPC	(7,643,035,671)	(5,813,624,413)
STF balance	357,755,392		317,774,778
Receivables from ECs	491,595,417		264,483,946
Interest receivable	498,210		339,677
	P 849,849,019	P	582,598,401

¹ 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*.

13. EPIP FUND

Refers to funds earmarked by the Corporation for the employees' productivity improvement programs (EPIP) pursuant to the Collective Negotiation Agreement between the PSALM Association of Corporate Employees (PACE) and PSALM Management and in accordance with Department of Budget and Management Circular No. 2006-1.

14. DUE TO GOVERNMENT AGENCIES

This account consists of amounts due to the following:

	2007	2006
NPC for - sale of assets (Note 6)	₱ 4,080,830,979	₱ 6,594,320,656
- transferred Magat Plant	4,730,855,332	
- Nomura bonds-related items	1,699,440,097	1,207,455,344
- PSALM Corp. initial working fund	716,127,317	716,127,317
- insurance premiums – Pantabangan-Masiway	507,399	
- trading transactions	383,180	
Others	25,025,877	21,460,515
	₱ 11,253,170,181	₱ 8,539,363,832

Transferred Magat Plant refers to the difference between the net carrying value of asset vis-à-vis its outstanding loan. *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. *Others* pertain largely to various withheld taxes for remittance to the BIR in the amount of ₱ 22,925,425 for 2007 and ₱ 19,542,764 for 2006. These withheld taxes are usually remitted to BIR every 10th day of the succeeding month so the amounts reflected are payable in January of the succeeding year.

15. OTHER CURRENT LIABILITIES

This account consists of the following:

	2007	2006
Accrued interest and guaranty fee on Nomura bonds	₱ 41,378,279	₱ 51,588,335
Accrued professional fees & out-of-pocket expenses	57,658,328	41,281,133
Other current liabilities	110,730,721	29,936,197
	₱ 209,767,328	₱ 122,805,665

Other current liabilities refer mostly to the provision for salary differential and 1-month incentive for employees claim for various payments and performance bonds and guaranty deposits payable.

16. LONG -TERM LIABILITIES

This account consists of:

	2007		2006	
Bonds payable	P	22,489,350,000	P	25,508,925,000
Less bond discount		76,922,642		92,064,335
		22,412,427,358		25,416,860,665
Assumed electric cooperative loans		10,767,687,680		12,553,610,261
Assumed loans – Magat		246,679,747		
Lease obligation				1,435,042
		33,426,794,785		37,971,905,968
Less current portion				
Assumed electric cooperative loans		2,614,180,578		2,602,308,023
Lease obligation				1,412,578
		2,614,180,578		2,603,720,601
	P	30,812,614,207	P	35,368,185,367

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 Currency (¥)	2007		2006	
		US\$	Peso	US\$	Peso
A	24,750,000,000	217,723,002	9,013,950,000	208,097,065	10,224,225,000
B	37,000,000,000	325,484,892	13,475,400,000	311,094,602	15,284,700,000
	61,750,000,000	543,207,894	22,489,350,000	519,191,667	25,508,925,000

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 ₱18.074 billion loans assumed by the Corporation from NEA and other government agencies (see Note 9), a total of ₱7.306 billion has been paid as of December 31, 2007.

17. EQUITY

Equity represents accumulated retained earnings of ₱11,119,678.157. PSALM Corp. is a government-owned and-controlled corporation 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 ₱0.716 billion was advanced by NPC and was recognized as an obligation of PSALM Corp. to said agency (see Note 14).

18. INCOME

The bulk of the income generated in 2007 came from the ₱20,534,301,372 gain recognized from the sale of Magat HEPP. Other sources of income are the participation fees paid by prospective bidders, sales of compact discs containing data about power plants and fees derived from the Investors' Preliminary Asset Review Program. Below are the details of the income account:

Source	2007	2006
Privatization participation fees	₱ 8,532,279.10	₱ 2,636,905.00
IPARP data room access and site visit/ sale of CDs	594,905.00	322,967.20
Magat purchase price option and accrued rental	315,445.51	
Gain on sale of disposed assets	20,534,301,372.21	
Forfeited performance bond of YNN for Masinloc		757,720,181.07
Total	₱ 20,543,744,001.82	₱ 760,680,053.27

19. MAINTENANCE AND OTHER OPERATING EXPENSES (MOOE)

Compared against last year's, notable increases were posted in Other MOOE (₱28.3 million), Taxes, Insurance Premiums & Other Fees (₱11.3 million) and Traveling Expenses (₱5.2 million). A considerable decrease of ₱40.8 million was recorded in Professional Services.

20. GAIN (LOSS) ON FOREIGN EXCHANGE

This account is composed of:

	2007		2006
Unrealized net gain on revaluation of Nomura bonds-related transactions	P 1,791,558,058	P	1,170,131,037
Unrealized gain on revaluation of privatization proceeds payable to NPC and Asset Sale Receivable for Pantabangan	2,860,532,758		
Unrealized gain (loss) on revaluation of advances to NPC for debt service	(88,635,320)		
Unrealized net gain on revaluation of other payables	411,174		56,438,221
Net realized foreign exchange gain(loss) on operating expenses and revaluation of foreign currency deposits	(6,102,942,832)	(121,367,905)
	P (1,539,076,162)	P(1,105,201,353)

21. OTHER SIGNIFICANT EVENTS FOR 2007

Privatization

Generation Assets

In 2007 PSALM successfully bid out two (2) 600 MW coal-fired power plants – Masinloc and Calaca, and the 175 MW Ambuklao/Binga Hydroelectric Power Complex. The Masinloc-Power Partners Co. Ltd. won the bidding for Masinloc (US\$930 million) while Calaca was won by the Calaca Holdco Inc. (US\$786.5 million) and the Ambuklao/Binga was won by SN Aboitiz Power Hydro, Inc. (US\$325 million)

The privatization of the four plants generated US\$2.04 billion in expected proceeds. As of 31 December 2007, a total of twelve (12) generation plants have been sold with a total bid price of US\$2,705,618,221.

The successful bidding of the four generation plants brings the privatization level from 13% in 2006 to 49% in 2007, vis-à-vis the 70% requirement for Open Access and Retail Competition.

Decommissioned Plants

PSALM conducted a bidding for the decommissioned 200 MW Manila Thermal Power Plant (MTPP) in the first quarter of 2007. This was the second held for the MTPP but, like the first bidding, was declared a failure due primarily to lack of investor interest.

On 03 October 2007, another Invitation to Bid for the said plant was issued, with the bidding date set for 19 December 2007. The bidding date was subsequently moved to 06 February 2008 to provide leeway for internal submissions such as the receipt of documentary deliverables from interested parties and to enable PSALM to cope with the successive biddings scheduled last December. However, this February 6 bidding for the MTPP was declared a failure.

Transmission Assets

On 05 February 2007, the 3rd round of bidding was conducted by PSALM for the transmission business of the National Transmission Corporation (TRANSCO) via a 25-year concession. This bidding was, however, declared a failure after only one (1) investor group submitted its bid out of the three (3) pre-qualified bidders.

On 04 June 2007, the PSALM Board approved the formal launch of the process for the 4th round of bidding for the privatization of TRANSCO, retaining the key bidding principles and basic deal structure and parameters under the previous privatization exercise while addressing the outstanding issues identified by the previous bidders.

In July, a TRANSCO roadshow was undertaken by PSALM/TRANSCO locally and in Singapore, London, Dubai and Hongkong. In the same month, the Invitation to Express Interest, Pre-Qualify and Bid was published. Twenty one (21) Expressions of Interest were received but only seventeen (17) interested parties actually purchased bidding packages. Five (5) prospective bidders submitted Pre- Qualification Proposals, of which four (4) passed the pre-qualification process.

PSALM management conducted the bidding on 12 December 2007, which was participated in by two (2) of the pre-qualified bidders. The consortium of Monte Oro Grid Resources Corporation/State Grid Corporation of China /Calaca High Power Corporation won with a bid of US\$3.95 billion. Post-qualification evaluation was conducted 14 - 23 December 2007 and results presented to the Board in January 2008, after which the Notice of Selection was delivered to the consortium.

Management of Privatization Proceeds

With the winning bid price of US\$3.95 billion for the TRANSCO concession, privatization efforts are expected to yield US\$6,655,618,221. As of 31 December 2007, actual cash received amounted to US\$613,635,982, representing full

payment of Talomo, Barit, Agusan, Loboc, Cawayan, Magat, interest payment of Magat and 40% upfront plus two (2) deferred payments (principal and interest) of Pantabangan-Masiway.

On 20 June 2007, the joint Boards of PSALM and NPC under Board Resolution No. 07-29, approved the utilization of the privatization proceeds to liquidate principal and interest obligations of NPC as they fall due. This was amended last 4 October 2007 by Board Resolution No. 07-61, which granted authority to PSALM Management to utilize the privatization proceeds to:

- Prepay NPC's principal obligations,
- Settle NPC's principal and interest obligations as they become due only after NPC shows deficit in its cash flow after utilization of its own internally generated cash,
- Manage NPC's liabilities with the objectives of reducing interest cost and liquidity risk in 2009-2011 and hedging foreign exchange risks at terms and conditions advantageous to the government, and
- Pay other financial obligations of NPC.

From 22 August 2007 to 31 December 2007, a total of US\$111,754,227 was disbursed from the privatization proceeds to service the debt of NPC for 2007 leaving a balance of US\$501,881,755 and ₱1,148,091,875 (representing the amount returned by NPC for the debt service).

PSALM and NPC are currently working on the approvals/concurrence of the Department of Finance (DOF) and BSP on the prepayments of various NPC loans to maximize the utilization of the privatization proceeds through the savings that can be derived from prepaying high interest bearing loans and as a hedge from foreign exchange fluctuations.

On 14 November 2007, under Resolution No. 2007-65, the NPC Board approved the voluntary prepayment of various JBIC-OECF loans amounting to JP¥17.3 billion and Miyazawa Tranche B of JP¥22.7 billion using the privatization proceeds subject to the approval of DOF and BSP-Monetary Board. As of 31 December 2007, the said prepayment is still in process awaiting concurrence from the two agencies.

Management of Finance Matters

Consolidated Financial Program of NPC/TRANSCO/PSALM

The consolidated NPC/TRANSCO/PSALM financial condition has significantly improved in 2007 to the point that the three corporations did not tap the international and local capital markets for any funding requirements. This complete financial turn around of NPC/TRANSCO/PSALM was brought about by: (i) the recent success of PSALM in the privatization of major assets; (ii) the strong appreciation of the peso against the US Dollar; and (iii) the efficiencies of NPC and TRANSCO operations.

In 20 June 2007, PSALM secured Board approval of the Liability Management Program Phase-1(LMP-1). The LMP-1 aims to prepay US\$ 2.4 billion of NPC debt utilizing the privatization proceeds and the refinancing proceeds to achieve the following objectives: (i) liquidate debt from the privatization proceeds; (ii) manage liquidity risks and improve the debt service coverage ratio (DSCR) for the years 2009-2011; (iii) reduce foreign currency exposure of NPC debt from 90.75% to at least 50%; and, (iv) realize foreign exchange mark-to-market gains from 2004 to 2007.

Since NPC's revenues are in peso and almost 88% of its debts are in foreign currency, forex losses incurred during the years after the Asian financial crisis significantly accounted for the increase in the cost of debt. Re-denominating NPC's foreign denominated debts through this prepayment program effectively reduces the volatility of NPC/PSALM's cash flows brought about by forex rate fluctuations.

PSALM is currently processing government approvals for this prepayment program for full implementation within the years 2008-2009. With the current peso appreciation and the nine-year low local interest rate, PSALM will take this extraordinary opportunity to reduce its foreign debt and re-denominate its obligation into peso through this prepayment program to improve the company's debt currency-mix and subsequently lower costs of debt.

In 18 July 2007, PSALM and NPC successfully executed the unprecedented US\$ 300 million Principal Only Swap (POS) transaction with three international banks. This transaction is the first currency swap undertaken by a Government Owned and Controlled Corporation (GOCC) in the Philippines and the longest currency swap transaction ever in Southeast Asia. The POS fixes US\$ 300 million of NPC obligations at a dollar to peso rate of US\$1 to ₱ 44.788 until the maturity year in 2028 for a competitive interest premium per annum. The transaction serves as "liability insurance" as it synthetically transforms 4% of the foreign-denominated debt into peso, an objective PSALM/NPC has set under LMP-1.

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.

PSALM already obtained the specific consents of the Asian Development Bank (ADB), World Bank (WB) and Japan Bank for International Cooperation-JEXIM (JBIC-JEXIM) for the recently sold assets. Furthermore, PSALM in coordination

with NPC and DOF, is preparing requests for universal consents from ADB, WB and JBIC-JEXIM for the sale of the remaining generation assets and for the privatization of TRANSCO via concession.

Most of the commercial creditors of NPC have already given their consent thru signed amendment agreements for the transfer of NPC liabilities to PSALM, except for JBIC-OECF, Erste Bank and Bank of Tokyo-Mitsubishi. Amendment agreements with WB and JBIC-JEXIM were signed this year. PSALM is now compiling the condition precedents such as Monetary Board (MB) final approvals for the effectivity of these signed agreements. Negotiations to finalize the amendment agreements with JBIC-OECF and the commercial banks are now in advanced stages.

Debt Transfer Documentation

As of 31 December 2007, PSALM/NPC has already secured approval-in-principle from the MB for seven (7) batches of NPC liabilities (bonds and loans from bilateral and commercial banks), of which four (4) batches were subsequently given MB final approval. PSALM continues to work on the conditions precedent stated in the Amendment Agreements before the MB gives its final approval for the remaining batches.

PSALM continues to work on the documentation of other NPC liabilities for submission to MB for the latter's approval in principle (other commercial and restructured loans) and final approval for bonds with automatic transfer provision and JBIC loans.

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 receipt of the creditors' consent. Meantime, the asset/debt transfer had been initially implemented beginning with the Magat HEPP and were reflected in the 2007 financial statements of both PSALM and NPC.

The draft accounting treatment of the asset/debt transfer based on the present set of revised guidelines have been submitted to COA for comment/approval.

IPP Renegotiations

The NEDA-Investment Coordination Committee (ICC) has approved the remaining renegotiated IPP contracts: the Bauang General Framework Agreement (GFA) with respect to the Build Operate and Transfer Agreement (BOT) for the 200 MW Bauang Power Station and Supplemental Agreement No. 1 to the Electricity Supply Operation and Maintenance Agreement for Mindanao Power Barges 117 and 118. With the approval of these contracts, the renegotiation of IPP contracts are now completed.

IPP Administrator (IPPA)

PSALM was mandated under the EPIRA to competitively select and appoint qualified independent entities called Independent Power Producer Administrators (IPPAs) to administer and manage the contracted energy output of NPC/PSALM IPP contracts. The IPPA process laid out in the EPIRA is part of a broader plan to privatize both the generation and transmission assets of NPC and to bring competition into the supply market through an 'Open Access' mechanism.

Since the Wholesale Electricity Spot Market (WESM) commenced operation in 2006, PSALM has been effectively acting as the interim IPPA by bidding the NPC/PSALM IPPs into the WESM on a day-by-day basis. PSALM initially split the IPPs into four (4) groups, and set up four (4) trading teams to manage them; this has subsequently been reduced to three (3) teams. The total MW capacity of the portfolios of the trading teams has increased, but is still below the 30% of the Luzon Grid capacity threshold established in the EPIRA.

The World Bank, through PHRD Grant Number TF055609 provided Technical Assistance (TA) on the Appointment of IPPAs and Energy Trading for both PSALM and NPC. The objective of the TA is to advise the IPPA-Technical Working Group (IPPA-TWG) on the structure, contract terms and process for the appointment of IPPAs. The IPPA-TWG was created by the DOE with NPC and PSALM as members.

The selection of Consultants has been completed. The IPPA Advisor commenced work on 30 April 2007 and is tasked to review the three (3) options prepared, develop alternative approaches to the privatization of PSALM/NPC-IPP contracts and make final recommendations.

Support to Electricity Market Development

The PSALM Board, through Board Resolution No. 07-60 prescribed the policy measures and courses of action that will strengthen the independence of the PSALM trading teams in response to the ERC Resolution recommending that PSALM adopt measures ensuring the independence of its trading teams. It may be noted that the ERC found no prima facie evidence against PSALM on the alleged price manipulation.

Organizational Development and Efficiency

Significant corporate efficiency milestones include the approval by the PSALM Board under Board Resolution No. 07-54 of PSALM's 2007-2008 Corporate Priorities and Targets and Corporate Performance Metrics and the submission of the Media and Communications Plan and the Document Management and Control System Policy Manual. Significant accomplishments in organizational development include the hiring of additional manpower complement, the

commencement of initial job evaluation activities, refurbishment of the newly-leased 7th floor of Bankmer building to serve primarily as venue for corporate functions and the implementation of training and development programs and employee wellness programs.

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 assumed office on March 1, 2007.

22. AUTHORITY FOR ISSUANCE

These financial statements have been approved for issue by the PSALM Board of Directors on February 14, 2008.