EXECUTIVE SUMMARY

This study examines the legal feasibility of establishing an electricity derivatives market ("**EDM**") in the Philippines. It provides an overview of the current legal framework governing the electric power industry and the derivatives market in the country; identifies legal challenges to the establishment of an EDM; and proposes solutions to these challenges, including the passage of key legislation and regulations.

I. Overview of the Electric Power Industry

The electric power industry in the Philippines is primarily governed by the Electric Power Industry Reform Act of 2001 ("**EPIRA**"). The EPIRA *(a)* laid down the regulatory regime governing the industry, allocating functions among various regulatory agencies, *(b)* unbundled the industry into four sectors, namely, the generation, transmission, distribution, and supply sectors, *(c)* decreed the privatization of National Power Corporation's generation and transmission assets and the devolution of its generation and transmission functions to the private sector, and *(d)* liberalized the trading of electricity through, among others, the creation of the wholesale electricity spot market ("**WESM**"). It likewise recognizes four key government agencies regulating or overseeing the industry, namely, the Department of Energy ("**DOE**"), the Energy Regulatory Commission ("**ERC**"), the Joint Congressional Power Commission, and the National Electrification Administration.

As mentioned, the EPIRA mandated the creation of the WESM, a market or venue for trading electricity as a commodity. The WESM serves as a clearing house to reflect economic value of electricity for a particular period, as indicated by the "spot price" and likewise provides a central scheduling and dispatch mechanism for electricity. The DOE and ERC exercise authority over the WESM operations. The DOE, jointly with electric power industry participants, formulates the WESM Rules, which sets out the basic rules, requirements and procedures that govern the operations of the WESM. The ERC, on the other hand, enforces the WESM Rules. All generation companies, distribution utilities, suppliers, bulk consumers/end-users and other similar entities authorized by the ERC are eligible to become WESM members. These entities, upon compliance with certain requirements under the WESM Rules, can become WESM members with the ability to trade, sell, purchase, dispatch and receive electricity through the market.

It is intended that the prices in the WESM shall be the principal bases for the reference or index prices for the derivatives to be traded in the EDM.

II. Derivatives and Commodity Futures in the Philippines

The Securities and Exchange Commission ("**SEC**") is the main administrative agency regulating capital markets. It regulates the trading of securities, including derivatives and commodity futures contracts. It also requires registration of securities traded in the market and issues licenses to self-regulatory organizations

operating organized markets and clearing agencies, dealers, issuers, and brokers that trade these securities.

A. Derivatives

A derivative is defined as a "financial instrument that primarily derives its value from the performance of an underlying variable." A derivative has the following elements: *(a)* it is a financial instrument (*i.e.*, a contract), *(b)* the value of the financial instrument changes in response to or is dependent on changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variables, and *(c)* it is settled at a future date. The common types of derivatives are as follows:

(a) A forward contract is a contract between a buyer and seller whereby the buyer is obligated to take delivery and the seller is obliged to deliver a fixed amount of an underlying commodity at a pre-determined price and date. Payment is full at the time of delivery.

(b) A future contract is a contract providing for the making or taking delivery at a prescribed time in the future of a specific quantity or quality of a commodity or cash value thereof, which is customarily offset prior to the delivery date, and includes standardized contracts having the indicia of commodities futures, commodity options and commodity options and commodity leverage, or margin contracts.

(c) An option contract is a financial security that gives the buyer the right (but not the obligation) to buy or sell a specified asset at a specified price on or before a specified date.

(d) A swap is a bilateral contract that calls for the periodic exchange of cash flows on specified dates and calculated using specified rules.

(e) A contract for difference is an agreement between the buyer and seller to exchange the difference between the current value of an asset and the value of an asset when the contract was initiated.

Presently, only banks and insurance companies (through or with banks) are authorized to deal in derivatives in over-the-counter ("**OTC**") markets. The Bangko Sentral ng Pilipinas ("**BSP**") authorizes banks to trade in particular derivatives, namely interest rate and foreign exchange based derivatives. Similarly, the Insurance Commission authorizes qualified insurance companies to engage in derivative transactions, albeit only with banks. To date, only equity, interest rate and currency derivatives are known to be traded in the Philippines.

B. Commodity Futures Contracts

Commodity futures contracts are a type of derivative. Presently, there are no commodity futures (such as electricity futures) legally available in the market inasmuch as under existing regulations, "no person shall offer, sell or enter into commodity futures except in accordance with the rules, regulations and orders the [SEC] may prescribe" and there are no rules governing the trade of commodity futures currently in effect.

The 2015 Implementing Rules and Regulations of the Securities Regulation Code defines a commodity futures contract as "a contract providing for the making or taking delivery at a prescribed *(sic)* in the future of a specific quantity or quality of a commodity or cash value thereof, which is customarily offset prior to the delivery date, and includes standardized contracts having the indicia of commodities futures, commodity options and commodity options and commodity leverage, or margin contracts." It also defines a forward as "a contract between a buyer and seller whereby the buyer is obligated to take delivery and the seller is obliged to deliver a fixed amount of an underlying commodity at a pre-determined price and date. Payment is full at the time of delivery."

III. <u>Electricity Derivatives Markets in Other Jurisdictions</u>

A review of the regulatory framework of EDMs in other jurisdictions -- namely, Norway, European Union, Australia, New Zealand, United States (New York) and Singapore -- revealed that: *(a)* the physical electricity markets in these jurisdictions are regulated by governmental institutions which are the functional equivalents of the DOE and the ERC (whether singly or combined in one institution); *(b)* the financial markets in these jurisdictions are regulated by the functional equivalent of the SEC*; (c)* the participants in the EDM are not only limited to energy industry players but also include banks, hedge funds, and other financial institutions; *(d)* the derivatives traded in these EDMs are usually futures and options and are always cash-settled; and *(e)* most jurisdictions have in place cooperation agreements between and among the different regulators of the financial and physical electricity markets to streamline their functions and prevent duplication of work.

IV. <u>Legal Framework for an EDM</u>

The following legal challenges were identified in establishing an EDM in the country: *(a)* Article 2018 of the Civil Code, *(b)* the case of *Onapal v. Court of Appeals*, *(c)* lack of existing commodity futures contracts rules, and *(d)* absence of a defined legal framework specific to the EDM.

Article 2018 of the Civil Code indicates that a contract is void when: *(a)* the contract purports to be for the delivery of goods, securities, or shares of stock, *(b)* the parties intended that the difference in the stipulated price and the exchange or market price of the goods, securities, or shares of stock shall be paid by the loser to the winner, and *(c)* there is pretended delivery. Under Article 2018, in case of these void contracts, the loser is allowed to recover what he or she has paid.

Whether the underlying asset would be delivered appears to be the relevant element which may have an influence on the feature of the derivatives which may be traded in an EDM in the Philippines. This is because derivatives in EDMs in other jurisdictions are usually settled through payment of the difference between the stipulated price and the market price. No actual delivery of the underlying asset is involved. If this feature is adopted in an EDM in the Philippines, a question may arise as to whether electricity derivatives, which are settled through cash payment and not actually delivered, are void under Article 2018.

There are two views in this regard. A conservative view may treat non-cash forwards and futures (*i.e.,* which are settled by cash payment and without actual delivery and contracts for difference) as falling within the prohibition under Article 2018 and may be declared void if the transaction is questioned, especially in light of the Onapal Case, as discussed below. A different interpretation, however, may arise if Article 2018 is to be read in context of its legislative context and history. It may be argued that Article 2018, when taken in context of its place in the Civil Code as well its provenance, was intended to cover purely speculative and simple gambling transactions – and not sensible economic behavior. Thus, there is basis to say that Article 2018 does not contemplate derivative transactions that serve a reasonable commercial purpose of managing price risks.

In *Onapal,* the Supreme Court applied Article 2018 in declaring a commodity future contract void and allowing the losing party to recover what she lost thereby. The Supreme Court classified commodity futures contracts (*i.e.* future contracts where the underlying asset is a commodity/good) which were settled through cash payment and without actual delivery as contracts covered under Article 2018, and declared them void.

As with Article 2018, distinctions can be made between the situation in the *Onapal* and the contemplated EDM. For example, arguments can be raised that *Onapal (a)* should not be indiscriminately applied to all commodity futures without considering the differences in the factual situations (*e.g.* level of government regulation and sophistication of the market participants), *(b)* should be reexamined considering that the legal sources used by the Court have since been modified if our own statutes are modified as well, and *(c)* should give way to the SRC as the later and more specific law, which recognizes the validity of derivatives and commodity futures (subject to the issuance of SEC rules).

The absence of commodity futures contracts rules also presents a challenge. Under the law, "no person shall offer, sell or enter into commodity futures contracts except in accordance with rules, regulations and order the [SEC] may prescribe in the public interest".

As mentioned, Philippine law provides for a definition of commodity futures contracts. While the definition of commodity futures contracts appears broad enough to cover forwards, an argument can be made that forwards (and possibly options) should be excluded from this definition and the prohibition against the public trading of commodity futures without SEC rules. To recall, the law prohibits parties from offering, selling, or even **entering into** commodities futures contracts in the absence of SEC rules. If forwards (and options) are deemed included in the prohibition, then this would mean that nobody can enter or transact a sale of a future thing – common contracts part of everyday commerce – without these SEC rules. This would create an absurd situation and it is a basic principle in statutory construction that a law should not be interpreted in such a way that it shall yield to absurd results. Thus, it would appear that there is basis to argue that forwards (and possibly options) may be traded even without SEC commodity futures contracts rules.

The same rationale has been applied in U.S. law, upon which Philippine securities law is patterned after and which has persuasive effect in interpreting Philippine securities law. U.S. law excludes forwards from the jurisdiction of the Commodities Futures Trading Commission because it would be highly impractical to regulate forwards which are common contracts of everyday commerce. As a matter prudence, an opinion from SEC *en banc*, the regulator itself, confirming this could be obtained.

Finally, even if the challenges presented by Article 2018, *Onapal*, and the absence of rules on commodity futures could be overcome, the absence of a statute and regulations specifically defining the legal framework for an EDM also presents its own challenges. Presently, there are no specific rules on the market and regulatory structures that would govern an EDM nor rules delineating and allocating regulatory power among various government agencies that may be involved in an EDM. There are also no existing rules on what types of derivatives may be traded in the EDM or what taxes are applicable to the transactions therein.

In light of the foregoing legal challenges, it is recommended that the following actions be implemented: *(a)* repeal or amendment of Article 2018; *(b)* lifting of the suspension or issuance of new rules on commodity futures contracts; and *(c)* passage of a law providing a framework for the EDM.

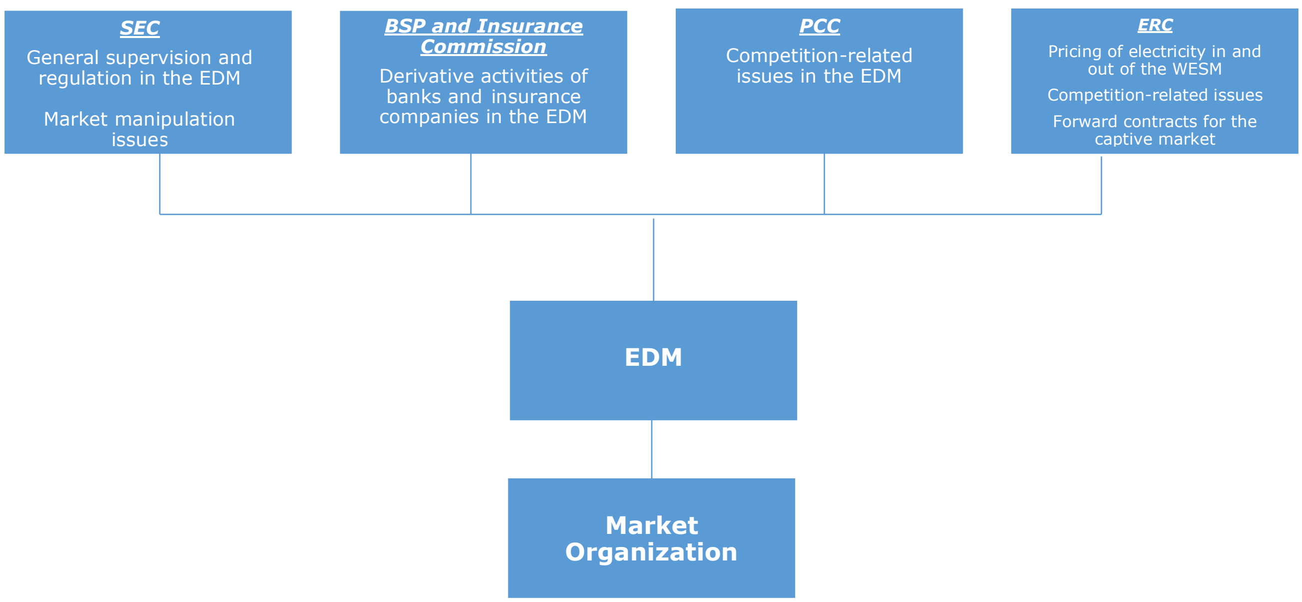
V. <u>Setting Up an EDM in the Philippines</u>

This present study provides for a proposed regulatory structure and market structure for the EDM. These structures take into consideration existing legislation, legal challenges, and the recommendations identified above.

Under the proposed regulatory structure, the EDM or its participants would be regulated by the SEC, BSP, Insurance Commission, and the Philippine Competition Commission ("**PCC**"), and the ERC. The SEC shall have primary regulatory authority and general supervision over the EDM. It shall license the operator of, the direct participants of, and the derivative products to be traded in, the EDM. The BSP and Insurance Commission shall exercise regulatory authority if banks and insurance companies are allowed to and choose to become market participants. The PCC, ERC and SEC shall have concurrent authority over competition law concerns. The ERC also has the power to approve the price determination methodology for, and impose administered prices in the WESM. The exercise of these powers may have an impact on the prices in, the EDM. The rules governing the EDM would have to take this into account to avoid disruption in the prices in the

EDM if these powers are exercised. Moreover, if forwards between a generation company/supplier and distribution utility intended to service their captive customers are traded in the EDM, it appears that the ERC would have authority to review these contracts and approve the associated generation costs passed on to captive consumers. This is of particular importance because under the EPIRA, distribution utilities have an obligation to supply elecitricity in the least cost manner to their captive customers. The ERC would clearly have an interest in protecting consumers from the indirect consequences of improper trading behavior and potentially speculative derivatives transactions of electricity industry participants in the EDM.

The regulatory structure for the EDM under existing laws and regulations is illustrated as follows:



The WESM, on the other hand, shall remain to be regulated primarily by the ERC, the DOE for policy concerns, and the ERC and PCC concurrently for competition related issues.

Considering the close correlation between the physical and financial markets, there may be jurisdictional overlaps among the government agencies which regulate the financial and physical markets. As with other countries, unless the extent of authority or jurisdiction is defined or delineated by statute, the regulators may consider entering into cooperation agreements or joint circulars streamlining their functions and supervisory authority over these closely interlinked markets.

Considering further the legal challenges in setting up an EDM, the EDM may be gradually established in steps based on the changes in legislation and regulations that need to be undertaken to have a complete and fully operational EDM. The steps are arranged in the degree of difficulty in securing the changes in legislation and regulations. The first step considers setting up an EDM without any change in current legislation, in the event that there is interest to set up the EDM immediately. The second step considers setting up an EDM after the issuance of administrative rules and regulations which are relatively more expedient to pass than statutes in Congress. The third step considers setting up an EDM after changes in statutes are passed by Congress.

These steps set out what would be legally possible – and not necessarily, what would be ideal – in light of current legal milieu and the legal challenges. As a practical note, the first step may be omitted and that the EDM be established only after certain administrative regulations are obtained, particularly the SEC commodity futures contracts rules, which would provide greater detail and clarity on the licensing, registration, and other procedures for trading of commodity futures contracts, including electricity derivatives.

	STEP 1	**STEP 2**	**STEP 3**
LEGAL REGIME	Current legislation: • Article 2018 of the Civil Code in effect • *Onapal* is good law • SEC commodity futures rules suspended • BSP regulations allow banks to trade in cash-based derivatives • IC regulations allow insurance companies to trade in certain derivatives with certain banks Subject to an SEC opinion *en banc* confirming that forwards are not covered by the proscription on trading commodities futures contracts in the absence of SEC rules on commodity futures	Changes in administrative issuances: • Lifting of suspension or passage of new SEC commodity futures rules • Passage of rules allowing banks – and consequently insurance companies – to trade in electricity derivatives	Changes in statute: • Repeal of Article 2018 of the Civil Code or amendment to create an exception for electricity derivatives • Adoption of a legal framework for the establishment of an EDM
STRUCTURE	• Exchange and/or OTC market	• Exchange and/or OTC market	• Exchange and/or OTC market
OPERATOR	• Exchange: SRO	• Exchange: SRO	• Exchange: SRO

	Step 1	**Step 2**	**Step 3**
	• OTC: registered broker, dealer or salesman of a broker or dealer in an OTC market or a group thereof which shall act as an SRO	• OTC: registered broker, dealer or salesman of a broker or dealer in an OTC market or a group thereof which shall act as an SRO	• OTC: registered broker, dealer or salesman of a broker or dealer in an OTC market or a group thereof which shall act as an SRO
Derivatives	• Forwards	• Forwards • Options	• Forwards • Options • Futures (*i.e.* with cash settlement)
Participants	• Electricity industry participants	• Electricity industry participants • All other entities that meet SEC requirements • Banks • Insurance companies	• Electricity industry participants • All other entities that meet SEC requirements • Banks • Insurance companies

There should likewise be rules that would govern entry and trading activities of participants as well as the transactions in the EDM. These trading rules should include guidelines on: *(a)* the procedure for application for membership in the EDM, *(b)* membership requirements in the EDM, *(c)* payment of fees and settlement of contracts, *(d)* the instances of non-compliance, *(e)* the liabilities and consequences of force majeure, *(f)* confidentiality and information sharing, and *(g)* the modes of resolving disputes.