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The Philippine Renewable Energy Framework

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The renewable energy sector in the Philippines is expected to benefit from the strong regulatory support it is presently enjoying. The Renewable Energy Act of 2008 (the “RE Law”) presents the general plan for the renewable energy framework of the Philippines and has set the stage for the implementation of a Feed-in Tariff system (the “FIT System”) that is intended to boost investments in the renewable energy sector. The FIT System has been established and market participants await the setting of the Feed-in Tariffs (“FIT”) for qualifying renewable energy technologies.

The promotion of renewable energy has been on the Philippine energy agenda for some time. Momentum to the renewable energy agenda came in 2008 with the passage of the RE Law, which affirmed the Philippine government’s commitment to the advancement of renewable energy resources. The RE Law portrays in broad strokes a growing emphasis on the development and use of renewable energy and seeks to promote sustainable energy strategies through a package of commercial and investment incentives for qualifying renewable energy facilities (“RE Facilities”).

The Department of Energy of the Philippines (“DOE”) has promulgated the rules and regulations implementing the RE Law (“Implementing Rules” and, together with the RE Law, the “RE Rules”). On July 12, 2010, the much anticipated Feed-in Tariff Rules (“FIT Rules”) were promulgated by the Energy Regulatory Commission (“ERC”), a regulatory body attached to the DOE.

As in other jurisdictions, regulations such as the FIT Rules encourage the development of, and investments in, renewable energy. FITs embody long-term fiscal and economic incentives that aim to bring new entrants into the renewable energy sector. FITs will allow developers of RE Facilities to determine costs and revenue (typically at a price above market) in advance and, with the relative certainty made possible by the FIT System, will enable such developers to secure financing for their investments more easily. It is reported that the DOE has approved approximately PhP 87.74 billion (at an exchange rate of PhP 43.00 to USD 1.00, approximately USD 2.04 billion) in renewable energy projects following the RE Law's passage. It is expected that project sponsors will be waiting for the FIT System to be finalized (and the corresponding FITs approved) before starting development of their renewable energy projects.

This client alert provides an overview of the rules and regulatory developments in respect of the Philippine renewable energy sector.

The RE Rules: Opening Doors to the Renewable Energy Sector

The major policy of the RE Law is the acceleration of the exploration and development of renewable energy resources such as, but not limited to, biomass, solar, wind, run-of-river hydro, geothermal and ocean energy resources ("**RE Resources**"). To this end, the RE Law prescribes the establishment of Renewable Portfolio Standards, a market-based policy that obligates electric power industry participants (i.e., generators, distribution utilities or suppliers) to source a specified portion of their electricity from eligible RE Resources. The RE Law mandates the DOE to issue rules implementing such Renewable Portfolio Standards.

The RE Rules provide for the creation of a FIT System that guarantees fixed tariffs for electricity produced by eligible renewable energy projects for a prescribed timeframe, including priorities and incentives within the FIT System framework, for developers of RE Facilities. Furthermore, the RE Rules provide a list of incentives, which include the following:

- **Income Tax Holiday:** for seven (7) years from the start of commercial operations in the case of new investments and up to twenty-one (21) years, in the case of additional investments, in the renewable energy project. For this purpose, "additional investments" include investments for improvements, modernization or rehabilitation which may or may not result in increased capacity. Existing RE Facilities will enjoy such income tax holiday counted from the start of commercial operations;
- **Reduced Corporate Tax Rate:** following the lapse of the income tax holiday, registered RE developers will enjoy a preferential corporate tax rate of 10% (compared to the regular maximum corporate tax rate of 30%) of net taxable income;
- **Duty-Free Importation of Machinery, Equipment and Materials:**

machinery and equipment directly and actually needed and used exclusively in RE Facilities will be exempt from the payment of any and all tariff duties for the first ten (10) years from the issuance of a certificate of registration by the DOE;

- **Special Realty Tax Rates:** developers of RE Facilities will enjoy preferential realty and other tax rates on civil works, equipment, machinery and other improvements that are actually and exclusively used for RE Facilities, such tax rate not exceeding 1.5% of the original cost (less accumulated normal depreciation) or the net book value;
- **Net Operating Loss Carry-Over (“NOLCO”):** an RE Facility’s NOLCO during its first three (3) years counted from the start of commercial operations may be carried over as a deduction from gross income for the next seven (7) consecutive taxable years immediately following the year of the loss;
- **Tax Exemption of Carbon Credits:** proceeds from the sale of carbon emission credits shall be tax-exempt;
- **Zero Percent Value-Added Tax:** the RE Rules provide for zero percent (0%) value-added tax for the sale of power from RE Resources, the purchase of local goods, properties and services needed for the development and construction of plant facilities by developers of RE Facilities and aspects of the exploration and development of RE Resources, which will include services by contractors or subcontractors; and
- **Accelerated Depreciation:** accelerated depreciation (i.e., up to twice the rate of normal depreciation as computed in accordance with Philippine tax rules) of the RE Facility’s plant, machinery and equipment reasonably needed and actually used for the exploration, development and utilization of RE Resources may be availed of in certain circumstances.

The exemptions and incentives provided under the RE Rules may be availed of by developers of hybrid and cogeneration systems which utilize both renewable and conventional energy so long as such exemptions and incentives apply only to the aspects of the business utilizing RE Resources. Preferential financial packages intended for the development, utilization and commercialization of renewable energy projects, duly recommended and endorsed by the DOE, are also available from government financial institutions.

The FIT System

The rules and incentives of the FIT System apply to on-grid generation facilities which (i) commence commercial operations after the effectivity of the FITs, and (ii) have obtained an ERC certificate of compliance recognizing them as FIT-eligible RE Facilities. In addition, the FIT Rules provide conditions whereby RE Facilities that (a) have been in commercial operation before the establishment of the FITs; and (b) have been in

commercial operation prior to the effectivity of the RE Law, may also be eligible for the incentives under the FIT System.

The following are the salient features of the FIT System:

- **Coverage:** FITs will be established for wind power, solar power, ocean power, run-of-river hydroelectric power and biomass energy resources;
- **Priority Connection, Purchase and Transmission:** eligible RE Facilities shall enjoy priority connection to the transmission or distribution system and shall be given priority in injecting power generated into the network;
- **Duration of FITs:** while the RE Law prescribes a minimum duration of twelve (12) years, the FIT Rules provide that the FITs shall be applicable to eligible RE Facilities for twenty (20) years. After the first generation of FITs, the ERC will determine the duration of succeeding FITs. There is a possibility that such succeeding FITs will enjoy only the minimum twelve (12) year duration as provided under the RE Law;
- **Approval of FIT Rates:** the ERC, based on the recommendation of the National Renewable Energy Board, a multi-sectoral board created under the RE Law (“**NREB**”), is tasked with the approval of FIT rates for qualifying renewable energy technologies. The FITs will cover the costs of the facility, including the cost of services that the facility may provide and the cost of connecting the plant to the transmission or distribution network. The FITs will use a market-based weighted average cost of capital in determining the return on invested capital;
- **FIT Adjustment:** the FITs will be adjusted by the ERC annually to allow pass-through of local inflation and foreign exchange rate variations; and
- **Degression:** to encourage early investments, the FITs shall be subject to a degression rate determined based on the NREB’s recommendation. The ERC may approve a different degression rate for different technologies.

To fund a portion of the costs of the FIT System, a uniform charge per kWh called the Feed-in Tariff Allowance (the “FIT-All”) will be levied on electricity consumers that are supplied through the distribution or transmission network. The FIT-All will be established by the ERC on an annual basis and shall take into account the following factors: (a) the forecasted annual required revenue of eligible RE Facilities; (b) the previous year’s over or under recoveries; (c) administration costs; (d) forecasted annual electricity sales; and (e) other relevant factors. Collections of the FIT-All shall comprise a FIT-All fund that will be used to ensure regular payment to RE Facilities under the FIT System. The National Grid Corporation of the Philippines shall be responsible for ensuring the sufficiency of the FIT-All fund and for the disbursement of collections to settle and pay the FITs of eligible RE Facilities.

Looking Ahead

With the FIT System in place, market participants now await the approval of the FITs by the ERC. The NREB must prepare its recommendations for the FIT levels and shall submit such recommendations to the ERC for approval. At present, the NREB has requested and has been granted various extensions for the deadline of its recommendations, the last one being a 30-day extension up to and until December 4, 2010. Once the NREB submits its recommendations to the ERC, public hearings will be held to allow interested parties to submit comments. The ERC will approve and publish the FITs after such rule-making process is concluded.

We will be providing an update to this client alert as and when developments to the establishment of the FITs become available.

For more information regarding O'Melveny & Myers LLP's Clean Energy Technology Practice please [click here](#).

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